Report # 04-01

OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

EVALUATION REPORT

Minnesota State Lottery

Powerball®

FEBRUARY 2004

PROGRAM EVALUATION DIVISION
Centennial Building - Suite 140
658 Cedar Street - St. Paul, MN 55155
Telephone: 651-296-4708 • Fax: 651-296-4712
E-mail: auditor@state.mn.us • Web Site: http://www.auditor.leg.state.mn.us

Program Evaluation Division

The Minnesota Office of the Legislative Auditor was established in 1973, replacing the century-old Public Examiner's Office. Its role is to audit and evaluate public programs and ensure accountability for the expenditure of public funds. In 1975, the Legislature created the Program Evaluation Division within the auditor's office. The division's mission, as set forth in law, is to determine the degree to which activities and programs entered into or funded by the state are accomplishing their goals and objectives and utilizing resources efficiently.

Topics for evaluation are approved by the Legislative Audit Commission (LAC), a 16-member joint, bipartisan commission. The division's reports, however, are solely the responsibility of the Office of the Legislative Auditor. Findings, conclusions, and recommendations do not necessarily reflect the views of the LAC or any of its members.

A list of recent evaluations is on the last page of this report. A more complete list is available at OLA's website (www.auditor.leg.state.mn.us), as are copies of evaluation reports.

The Office of the Legislative Auditor also includes a Financial Audit Division, which annually conducts a statewide audit of the 25 largest agencies, an audit of federal funds, and approximately 40 financial and compliance audits of individual state agencies. The division also investigates allegations of improper actions by state employees.

Professional Staff

James Nobles, *Legislative Auditor*

Joel Alter
Valerie Bombach
David Chein
Jody Hauer
Adrienne Howard
Daniel Jacobson
Deborah Junod
Carrie Meyerhoff
John Patterson
Judith Randall
Jan Sandberg
Jo Vos
John Yunker

Support Staff

Denice Malone
Barbara Wing

This document can be made available in alternative formats, such as large print, Braille, or audio tape, by calling 651-296-8976 Voice, or the Minnesota Relay Service at 651-297-5353 or 1-800-627-3529.

e-mail: auditor@state.mn.us

Reports of the Office of the Legislative Auditor are available at our Web Site: http://www.auditor.leg.state.mn.us

Printed on Recycled Paper.

Photo Credits:

The Powerball® photograph on the *Minnesota State Lottery* report cover and those on pages 10, 63, 72, 87, 90, 107, and 136 were furnished by the Minnesota State Lottery; the picture on page 15 was provided by the Board of Soil and Water Resources; and those on pages 17, 64, 71, 75, 103, 129, 131, 134, and 135 were taken by Legislative Audit staff.

OLA
OFFICE OF THE LEGISLATIVE AUDITOR
State of Minnesota • James Nobles, Legislative Auditor

February 19, 2004

Members
Legislative Audit Commission

In June 2003, the Legislative Audit Commission directed the Office of the Legislative Auditor to examine the finances and business practices of the Minnesota State Lottery. Because of concerns raised during the 2003 legislative session, the commission wanted an in-depth study of the Lottery's operating expenses and other costs.

We found that the Minnesota State Lottery's operating expenses are high compared with those of similar lotteries. As a result, the Lottery has a lower profit margin and provides less money for state programs. The report raises significant concerns about the Lottery's spending on promotions, rent, personnel, and many other activities. We are particularly concerned about the Lottery's support for a bass fishing tour, an environmental exhibit vehicle, and the production and distribution of a television program. We also have serious misgivings about the Lottery's business relationship with a firm that has done a considerable amount of work for the Lottery.

We recommend that the Lottery should be required to submit its operating and capital budgets to the Governor and the Legislature for review. The Legislature should establish amounts available for those budgets in law every two years. To improve the Lottery's accountability to elected officials, the Lottery director should serve at the pleasure of the Governor like other state agency heads.

This report was researched and written by John Yunker (project manager) and David Chein. Patrick Phillips, a financial auditor, provided valuable assistance.

Sincerely,

/s/ James Nobles

James Nobles
Legislative Auditor

Room 140, 658 Cedar Street, St. Paul, Minnesota 55155-1603 • Tel: 651/296-4708 • Fax: 651/296-4712
E-mail: auditor@state.mn.us • TDD Relay: 651/297-5353 • Website: www.auditor.leg.state.mn.us

Table of Contents

List of Tables and Figures

Figures Page

Summary

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

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 (pp. 26-29).
- The Minnesota Lottery has more autonomy and is less accountable to elected officials than other Minnesota state agencies and lotteries in most other states (pp. 33-34).
- 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 (pp. 49-55).
- 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 (pp. 62-72).
- The Lottery spends $1.2 million annually for the production and distribution of a television program that has questionable benefits for the Lottery (p. 55-60).
- 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 (pp. 58, 65-66, and 77-80).

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 (p. 129).
- The Legislature should allow the Governor more discretion in removing and appointing the director of the Lottery (p. 131).
- 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 (p. 132).
- 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 (pp. 55, 60, 62, 72, and 79-80).

Report Summary

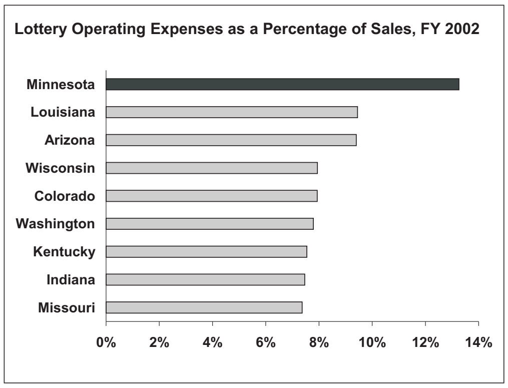
Since its inception in 1990, the Minnesota State Lottery has provided $1.1 billion for state-financed programs. During the 2003 legislative session, however, the Lottery was criticized for spending $50 million on operating expenses during fiscal year 2002. Although previous legislatures had never established 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.

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 some inappropriate procurement practices and business relationships.

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

Introduction

Since its inception in 1990, the Minnesota State Lottery has provided $1.1 billion for state-financed programs, including about $312 million for the Environment and Natural Resources Trust Fund. But, during the 2003 legislative session, an environmental group criticized the Lottery's financial record. The Minnesota Center for Environmental Advocacy (MCEA) said the Minnesota State Lottery had high administrative expenses and a low return to the state compared with other state lotteries. The Center also claimed that Minnesota's Lottery had a high number of employees and spent more than other lotteries on advertising and promotions.

Although Minnesota Lottery officials disputed the MCEA's claims, the 2003 Legislature placed a cap on the lottery's annual operating expenses for FY 2004 and subsequent years. The cap limits the Lottery's operating expenses to no more than $43.5 million, or about 5 percent less than the Lottery planned to spend in FY 2004. In addition, the Legislative Audit Commission directed the Office of the Legislative Auditor to conduct an in-depth study of the Lottery's financial practices. In this report, we address the following questions:

- **How have sales and expenses changed over the Lottery's 13-year history?**

- **How do the expenses and profits of the Minnesota State Lottery compare with those of similar state lotteries?**

- **Is the Lottery operated efficiently? Does the Lottery make prudent financial decisions?**

- **How effective are the Lottery's advertising and promotion efforts?**

- **Is there sufficient oversight of the Lottery's finances? Are the Lottery and its top officials sufficiently accountable to the people of Minnesota and their elected officials?**

To conduct the evaluation, we examined the Lottery's financial records, the Lottery's process for awarding major procurement contracts, the job descriptions of Lottery staff, and mileage logs for Lottery vehicles. We also interviewed the Lottery's managers and staff, inspected the Lottery's office and warehouse space, and visited three of the Lottery's six regional offices. In addition, we viewed the Lottery's recent television advertisements and recent airings of its Environmental Journal television program and listened to recent radio advertisements and radio broadcasts of the Environmental Journal. To provide a comparative perspective, we talked with officials from lotteries in other states and collected data from them on lottery finances in their states. We also used financial, staffing, and other data on state lotteries from national and international sources. Data on other

Minnesota state agencies were used for some staffing, salary, and rental comparisons.

Chapter 1 of this report describes the Lottery's history and finances. In addition, we discuss other forms of legal gambling in Minnesota. Chapter 2 presents information on how the Minnesota State Lottery compares with other state lotteries across the country. We provide a detailed comparison of the Minnesota Lottery's sales and expenses with eight state lotteries that are similar to ours in size and products. In Chapter 3, we examine the Minnesota State Lottery's advertising and promotional expenses in detail and highlight areas of concern. Chapter 4 discusses a wide range of Lottery expenses including prizes, tickets, personnel, rent, vehicles, and other expenses. Chapters 3 and 4 present recommendations for action by the Lottery, and Chapter 5 offers recommendations to the Legislature and Governor. An appendix provides more detailed information on the sales revenues, expenses, and operating profits of all state lotteries operating in the United States.

1 Background

SUMMARY

Since the Lottery's inception, Lottery ticket sales and proceeds to the state have declined in inflation-adjusted dollars. Lottery ticket sales increased slightly in the early 1990s but fell by 17 percent in inflation-adjusted dollars between 1997 and 2003. Lottery operating expenses kept pace with inflation during this period. As a result, Lottery proceeds transferred to the state declined 22 percent in inflation-adjusted dollars between 1997 and 2003. The percentage of sales transferred to the state fell from an average of 24 percent from 1991 through 1997 to 22 percent from 1998 through 2003.

The Lottery is not required to have its budget approved by the Governor or the Legislature. In addition, the lottery is not subject to all of the accounting and contracting requirements that apply to most state agencies, although statutes require lottery procurement contracts to be determined through an open bidding process. In response to concerns that the Lottery's administrative expenses were too high, the 2003 Legislature placed a limit on Lottery spending for the 2004-2005 biennium. This amounted to about a 7 percent reduction from 2003 spending. In response, the Lottery laid off 34 permanent employees and 10 student workers and reduced its planned spending on promotions, advertising, and other Lottery operations.

Minnesota began selling lottery tickets in 1990.

In November 1988, Minnesota voters approved a constitutional amendment to authorize a lottery.[1] The 1989 Legislature established the Minnesota State Lottery, which sold its first tickets in 1990.[2] Minnesota is currently one of 40 states that operate lotteries. Like most of those states, the Minnesota State Lottery offers a combination of "instant" or "scratch" games, where purchasers can scratch off the coating on a ticket to reveal whether or not they win a prize, and "online" games, where tickets contain several numbers and a drawing is held at a scheduled time to determine the winning numbers. In fiscal year 2003, Minnesota State Lottery sales were $352 million, including $211 million in scratch ticket sales and $141 million in online sales.[3] About 70 percent of the Lottery's online sales in 2003 came from Powerball, a multi-state game with jackpots that start at $10 million and increase until a winning ticket is sold.

1 *Minn. Const.,* art. XIII, sec. 5.

2 *Laws of Minnesota* (1989), ch. 334, art. 3.

3 Unless indicated otherwise, all years cited in this report are fiscal years ending June 30.

In this chapter, we provide a general overview of the Lottery and the legal and social context in which it operates. We address the following questions:

- **How is the Lottery organized, and what are the legal requirements governing its operation? What provisions exist in the law to oversee Lottery actions?**

- **How much money does the Lottery receive and what does it do with the money? How have revenues and expenses changed since the Lottery's inception?**

- **What other forms of legal gambling are available to Minnesotans?**

To answer these questions, we reviewed state laws relating to the Lottery and other legal forms of gambling, interviewed numerous officials from the Lottery and other state agencies, examined Minnesota State Lottery annual financial reports, and reviewed reports about other forms of legal gambling.

ORGANIZATION

Unlike other department heads appointed by the Governor, the Lottery director may only be removed for cause.

Under state law, the Minnesota State Lottery is operated by a director appointed by the Governor with the advice and consent of the Senate.[4] The Lottery director is authorized to employ personnel to operate the Lottery; adopt rules and game procedures; issue contracts to retailers to sell Lottery tickets; contract with vendors for goods and services, advertise and promote the Lottery; and take steps to ensure the integrity of, and public confidence in, the Lottery.[5] Unlike most other state agency heads appointed by the Governor, the Lottery director may only be removed for cause after a hearing and is not routinely replaced when a new Governor assumes office.[6] Minnesota's first lottery director served in that position from 1989 until his death in January 2004.[7]

As shown in Figure 1.1, the Lottery is organized into four divisions: the Executive, Administration, Operations, and Marketing divisions. The director heads the Executive Division while each of the other divisions is headed by an assistant director. A fourth assistant director serves as the Lottery's legal counsel. The Executive Division includes several small units responsible for legal issues, research and planning, public relations, security, and graphic arts. The Operations Division oversees ticket procurement and distribution and develops and maintains information systems to keep track of sales and ensure the integrity of the games. The Marketing Division is responsible for advertising, promotions, and sales, and

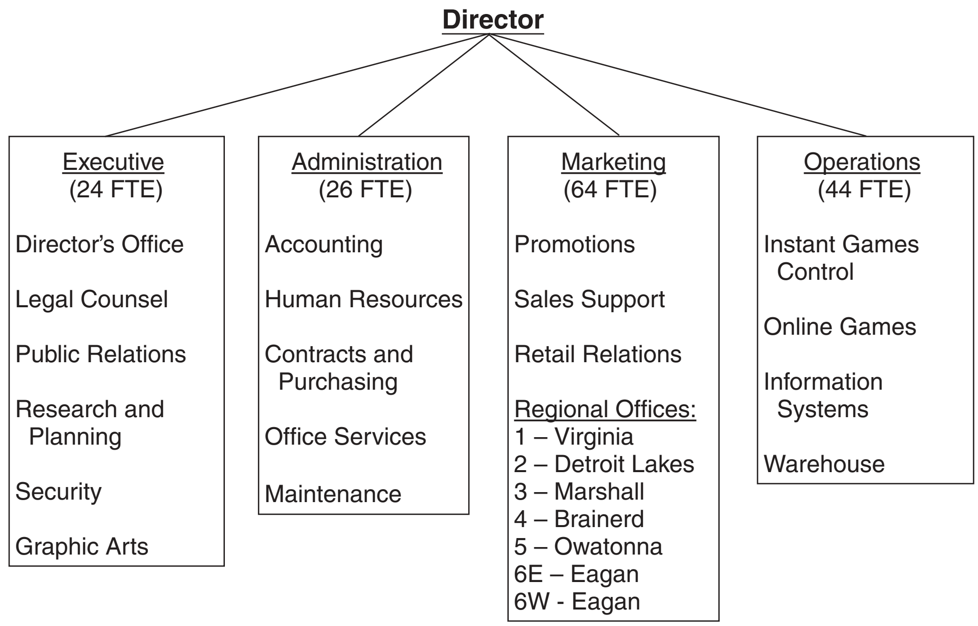
4 *Minn. Stat.* (2003), §349A.02, subd. 1.

5 *Minn. Stat.* (2003), §349A.02, subd. 3.

6 Causes for removal are: (1) conflict of interest violations; (2) malfeasance, nonfeasance, or misfeasance; and (3) failure to adequately perform the duties of director, as measured by Lottery revenues, efficiency of operations, public confidence in the integrity of the Lottery, and compliance with requirements governing Lottery advertising. *Minn. Stat.* (2003), §349A.02, subd. 2.

7 The original lottery legislation provided for a State Lottery Board consisting of the Commissioner of Gaming and six members appointed by the Governor. *Laws of Minnesota* (1989), ch. 334, art. 3, sec. 3. The board functioned in an advisory capacity and had no authority over the running of the Lottery. It was abolished in 1995. *Laws of Minnesota* (1995), ch. 254, art 1, sec. 80.

Figure 1.1: Minnesota State Lottery Organization Chart, November 2003



SOURCE: Minnesota State Lottery.

it includes 30 sales representatives who provide the primary contact with retail establishments that sell Lottery tickets. About one-third of the Lottery employees, including all of the home-based sales representatives, are assigned to regional offices located in Eagan, Owatonna, Marshall, Brainerd, Detroit Lakes, and Virginia. These offices serve as supply centers and meeting places for Lottery sales representatives and places where customers can redeem winning tickets.

At the end of fiscal year 2003, the Lottery employed 191 full-time staff, 2 part-time workers, and 11 part-time student workers. In October 2003, in response to a legislative requirement to reduce operating expenses, the Lottery laid off 33 permanent and 1 temporary full-time employees, 1 part-time worker, and 10 part-time student workers, leaving it with 157 full-time workers, 1 part-time worker, and 1 part-time student worker. Overall, the Lottery reduced the number of full-time equivalent staff by 20 percent.

Table 1.1 provides details on the staffing reductions. Two-thirds of the reductions were made in the Marketing Division. They included the entire telemarketing unit, five regular employees and two student workers in the Roseville office, nine lottery sales representatives, and five customer service representatives in the regional offices who validated winning tickets. The only reduction in the Executive Division was the elimination of one student worker position.

In response to legislative budget cuts, the Lottery reduced its staff by about 20 percent.

Table 1.1: Lottery Staff Reductions, October 2003

Division/Unit	Staff Before Reductions	Staff After Reductions	Positions Eliminated
Executive Division			
Director's Office	3	3	
Legal Counsel	1.5	1.5	
Research and Planning	3.5	3.5	
Public Relations	4	4	
Security	7	7	
Graphic Arts	5.5	5	1 part-time student worker
Subtotal	24.5	24	
Administration Division			
Division Director	1.5	1.5	
Personnel	4.5	4	1 part-time office specialist
Accounting	8.5	8.5	
Contracts and Purchasing	7	5	1 buyer and 1 management analyst
Office Services	5.5	4	3 part-time student workers
Maintenance	3	3	
Subtotal	30	26	
Operations Division			
Division Director	1.5	1.5	
Information Systems	17.5	15.5	1 information specialist and 1 EDP temp
Instant Games Control	13.5	12	3 part-time student workers
Online Games	6	6	
Warehouse	10.5	9	1 supervisor position and 1 part-time student worker
Subtotal	49	44	
Marketing Division			
Roseville Office:			
Division Director	2	2	
Retail Relations	6	5	1 key accounts representative
Promotions	7	3	1 events coordinator, 2 administrative specialists, 2 part-time student workers
Sales Support	16	5	9 telemarketing representatives, 1 telemarketing supervisor, 1 office specialist
Subtotal	31	15	
Regional offices:	63	49	9 lottery sales representatives, 5 customer service representatives
Total Marketing	94	64	
Lottery Total	197.5 [a]	158 [b]	

[a]Includes 11 part-time students and two part-time regular workers. Excludes four vacant positions.

[b]Includes one part-time student worker and one part-time regular worker.

SOURCE: Minnesota State Lottery.

FINANCES

In this section, we present an overview of Lottery revenues and expenses. We also examine the distribution of Lottery profits.

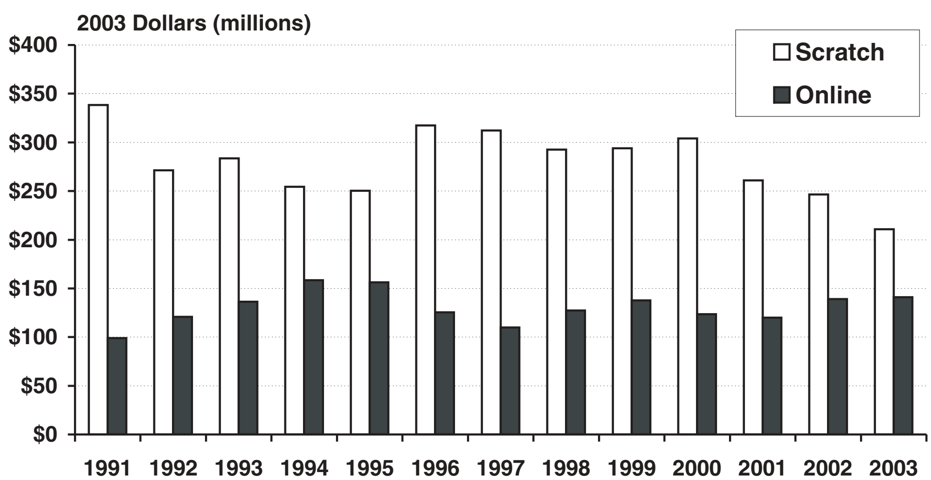
Revenues

Over 99 percent of Lottery revenue comes from ticket sales, with less than 1 percent coming from interest, retailer fees, and a variety of other sources. The Minnesota State Lottery sold its first scratch game tickets in April 1990 and its first tickets for online games in August 1990. It began participation in the multi-state Powerball game in April 1992. Between fiscal years 1991 (the Lottery's first full year of operation) and 2003, ticket sales revenue was fairly stable, increasing 9 percent from $321 million to $352 million. Figure 1.2 shows, however, that after adjusting for inflation, scratch ticket sales fell by 38 percent between 1991 and 2003.[8] Revenue from online game sales, on the other hand, increased 17 percent between fiscal year 1992, when Powerball was added to the mix of online games, and 2003. Overall:

- **Revenue from Lottery ticket sales fell 20 percent between 1991 and 2003 after adjusting for inflation.**

Scratch game sales have fallen in recent years.

Figure 1.2: Minnesota State Lottery Sales of Scratch and Online Games, FY 1991-2003



NOTE: All figures adjusted for inflation using the Bureau of Labor Statistic's Consumer Price Index for all Urban Consumers (CPI-U).

SOURCE: Office of the Legislative Auditor analysis of Minnesota State Lottery financial data.

8 We adjusted for inflation based on changes in the Bureau of Labor Statistics' *Consumer Price Index for All Urban Consumers (CPI-U)*, ftp.bls.gov/pub/special.requests/cpi/cpiai.txt; accessed August 15, 2003.

Most of the decline in ticket sales has occurred since 1997. Inflation-adjusted ticket sales fell 3 percent between 1991 and 1997, but sales declined by 17 percent from 1997 to 2003. Lottery officials attribute some of this decline to economic conditions and other factors that are outside the Lottery's control. They cite the Lottery's reliance on convenience stores that also sell gasoline. Sales at convenience stores have fallen in recent years due, in part, to the conversion to pay-at-the-pump gasoline sales.[9] Motorists who used to purchase lottery tickets and other items when they paid for their gas, can now fill their tanks and drive off without entering the store.

Figure 1.2 also shows that Minnesotans spend more on scratch games than online games, but the proportion of sales coming from online games has increased since the mid 1990s. Scratch games accounted for 74 percent of ticket revenues in 1997 but only 60 percent in 2003. Preliminary figures from the first half of fiscal year 2004 suggest that the shift towards online games is continuing. From July through December 2003, scratch tickets made up 52 percent of sales and online games accounted for 48 percent.

Lottery sales were higher during the first half of fiscal year 2004, due to changes in Powerball that have resulted in larger jackpots.

Preliminary sales figures also indicate that:

- **Lottery sales are up for the first half of fiscal year 2004, primarily due to an increase in Powerball sales.**

Lottery ticket sales totaled $199.5 million from July through December 2003, $12.3 million (6.6 percent) above July through December 2002. During this period, online game sales were 19 percent higher and scratch game sales 3 percent lower than the first half of fiscal year 2003. Lottery officials believe that the increase in online game sales is primarily due to a change in the prize structure of Powerball that has made it more difficult to win the jackpot. This has led to larger jackpots, attracting more players. Powerball sales in the first half of fiscal year 2004 increased by $11.7 million (20 percent) over the first half of fiscal year 2003. Sales of other existing online games increased 4 percent. Powerball was responsible for 78 percent of the increase in sales during the first half of fiscal year 2004. Northstar Cash, a new online game introduced in October 2003, sold $2.4 million worth of tickets and was responsible for 16 percent of the increase in online sales. It was too early to know if this increase in online sales is the beginning of an upward trend in sales.

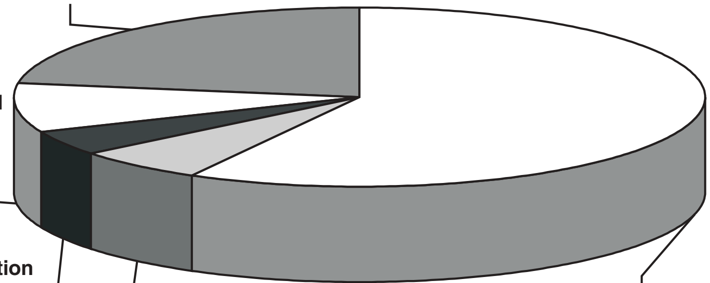
Expenses

As noted above, Lottery sales totaled $351.8 million in fiscal year 2003. Interest and other non-operational income brought total revenue to $353.3 million. As shown in Figure 1.3, the Lottery spent its revenue to 1) pay prizes to game winners; 2) pay commissions to retailers who sell Lottery tickets; and 3) operate the Lottery. The money left over after paying prizes, commissions, and operating expenses is transferred to several different funds in the State Treasury.

9 National Association of Convenience Stores, *2003 State of the Industry Highlights*, (Alexandria, VA, 2003).

Figure 1.3: Distribution of Lottery Revenues, FY 2003

Almost three-fifths of Lottery revenues in 2003 was used to pay prizes.



SOURCE: Office of the Legislative Auditor analysis of Minnesota State Lottery financial data.

Prizes

As shown in Figure 1.3, 59 percent of Lottery revenues went for prizes in 2003, by far the largest Lottery expense. State lotteries have to carefully consider the percentage of sales to return as prizes. Higher prize levels probably result in increased ticket sales, but lower profit margins. Finding the optimum prize level to provide the best possible return to the state is a challenge that all lotteries face. Minnesota law requires that scratch game prizes are at least 60 percent of gross receipts and that online games pay at least 45 percent.[10] In 2003, scratch game prizes were 69 percent of gross receipts (65 percent of scratch game sales) and online game prizes were 51 percent of gross receipts (48 percent of online sales). Prizes were 56 percent of ticket sales in 1991, the Lottery's first full year of operation. Since then, total Minnesota Lottery prizes have varied within a narrow range of 58 to 61 percent of sales.

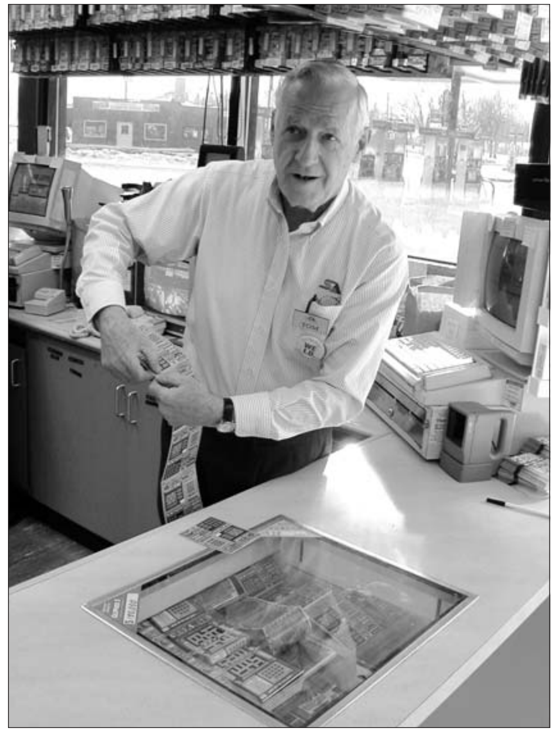
Retailer Commissions

The Lottery uses 6 percent of its revenues to pay commissions to retail establishments that sell Lottery tickets. Minnesota has about 3,200 Lottery retailers. About two-thirds of them are convenience stores, with the remaining third divided among grocery stores, liquor stores, restaurants, bars, and other retail establishments. Retailers may only accept cash for tickets, and they must sell both scratch and online tickets. Retailers receive a 5.5 percent commission on

10 *Minn. Stat*. (2003), §349A.10, subd. 2(b). "Gross receipts" in this context are all money received from the sale of Lottery tickets less an amount (6.5 percent) paid to the Department of Revenue in lieu of state sales tax. *Minn. Stat*. (2003), §349A.01, subd. 8.

About 6 percent of revenues are used to pay commissions to Lottery retailers.

each ticket they sell and 1 percent of each winning ticket under $600 that they redeem.[11] The Lottery also, on occasion, has established incentive programs, such as sales contests for retailers to promote ticket sales.[12]



Retail establishments receive a 5.5 percent commission on each lottery ticket they sell.

Between 1991 and 1998, retailer commissions adjusted for inflation ranged from $22 to $25 million per year, or between 5.2 and 5.9 percent of sales. The 1998 Legislature directed the Lottery to increase retailer commissions by 0.5 percent and to provide retailers with at least a 1 percent commission on tickets they redeem.[13] As a result, inflation-adjusted retailer commissions jumped to $30 million in 1999 and $29 million in 2000, or 6.9 and 6.8 percent of sales, respectively. Since 2001, commissions have declined but are still above the commissions of the early 1990s. Retailer commissions were $22.2 million in 2003, or 6.3 percent of Lottery sales revenue.

Retailers must be at least 18 years old, must have a good credit history and sufficient financial means; must not owe $500 or more in delinquent taxes; and must be free of any criminal convictions for a felony, gross misdemeanor, or any offense within the last five years involving gambling or fraud.[14] Contracts require retailers to pay an initial fee of $100 and a $20 annual renewal fee after that.[15] The Lottery furnishes ticket dispensers, signs, and posters. A vendor under contract with the Lottery furnishes the online terminals and pays for telecommunication charges. The Lottery's policy is to terminate the contract of a retailer that fails to sell at least $100 of tickets per week, unless it is the only Lottery retailer within 10 miles.

---

11 *Minn. Rules* (2003), ch. 7856.4030, subp. 1. Prize winners of $600 or more must complete a claim form and bring or mail the form and winning ticket to a Lottery office. Prizes over $30,000 must be claimed in person at a Lottery office. *Minn. Rules* (2003), ch. 7857.4010, subp. 2.

12 See *Minn. Rules* (2003), ch. 7856.4030, subp. 2.

13 *Laws of Minnesota* (1998), ch. 366, sec. 73; *Minn. Stat.* (2003), §349A.16.

14 Currency exchanges and family members of Lottery employees may not serve as retailers, nor may a retailer be solely in the business of selling Lottery tickets. *Minn. Stat.* (2003), §349A.06, subd. 2.

15 *Minn. Rules* (2003), ch. 7856.2010, subp. 2.

Operating Expenses

In addition to paying game prizes and retailer commissions, the Lottery incurs several operating expenses. Table 1.2 presents a breakdown of operating expenses for fiscal year 2003. The top expense category was the $12.3 million spent on employee wages and benefits, representing over one-fourth of operating expenses. Online ticket processing is primarily a contract with a vendor to provide the communications network to run the online games. Likewise, the Lottery contracts with vendors to produce scratch tickets and deliver them to retailers. Together, the costs of printing and delivering scratch tickets and processing online tickets made up about one-third of operating costs in 2003. The Lottery spent $7.5 million on advertising and another $3.6 million on promotions. Together, advertising and promotions made up nearly one-fourth of operations spending. Other costs included rental of office and warehouse space, depreciation of assets such as motor vehicles and office furniture, travel expenses including those incurred by sales representatives, communications, data processing, and supplies. We discuss operating expenses in greater detail in forthcoming chapters.

The Lottery's largest operating expenses are for ticket costs, employee compensation, and advertising and promotions.

Table 1.2: Lottery Operating Expenses, FY 2003

Type of Expense	Amount ($000)	Percentage of Operating Expenses	Percentage of Sales
Employee Wages and Benefits	$12,272	26%	3.5%
Online Ticket Processing[a]	10,211	22	2.9
Advertising	7,504	16	2.1
Instant Ticket Printing and Delivery[b]	5,343	11	1.5
Promotions	3,622	8	1.0
Depreciation	1,880	4	0.5
Office and Storage Rent	1,637	3	0.5
Professional Services	1,461	3	0.4
Communications	850	2	0.2
Change in Liability for Persons Collecting Annuity Payments[c]	565	1	0.2
Printing	346	1	0.1
Travel Expenses[d]	236	1	0.1
MUSL Payments[e]	169	0	0.0
Maintenance and Custodial	169	0	0.0
Data Processing	151	0	0.0
Supplies and Equipment	146	0	0.0
Utilities	127	0	0.0
Other[f]	280	1	0.1
Total Operating Expenses	$46,969	100%	13.4%

[a]Includes online vendor expense, OMNI link maintenance, and 40 percent of retailer supplies.

[b]Includes printing, delivery, and 60 percent of retailer supplies.

[c]Change resulting from a change in estimated payments to annuity prize winners due to changes in interest rates and life expectancy.

[d]Includes vehicle operating expenses and other agency travel.

[e]Payments to the Multi-State Lottery Association which runs Powerball.

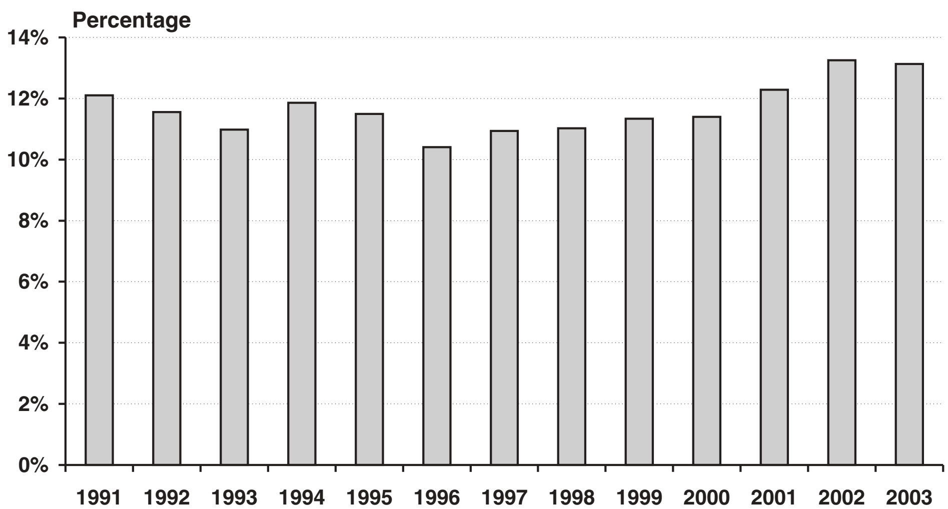
[f]Includes professional development; insurance; department head expense; employee training and education; business meeting expense; changes in the value of investments, and other expenses.

SOURCE: Office of the Legislative Auditor analysis of Minnesota State Lottery financial statements.

Operating expenses were highest in fiscal year 1991, the Lottery's first full year, when it spent $53 million in inflation-adjusted dollars, about 12 percent of Lottery ticket sales. Since then, the Lottery has spent between $45 million and $49 million in inflation-adjusted dollars in every year except 2002, when it spent $51 million. Operational expenses fell to $46 million in 2003. As shown in Figure 1.4, operational expenses fluctuated between 10 and 12 percent of Lottery sales during the 1990s. In fiscal year 2002, operational expenses rose to 13.3 percent of sales. Although the Lottery reduced operational expenses in 2003, they remained above 13 percent of sales because Lottery sales also fell.

In recent years, operating expenses have increased to more than 13 percent of sales revenues.

Figure 1.4: Lottery Operating Expenses as a Percentage of Sales, FY 1991-2003



SOURCE: Office of the Legislative Auditor analysis of Minnesota State Lottery financial data.

State law requires that the Lottery's total operating expenses not exceed 15 percent of gross revenues, and that the portion of operating expenses devoted to advertising not exceed 2.75 percent of gross revenues.[16] Gross revenues are ticket sales plus interest and other revenues less an amount transferred to the Department of Revenue in lieu of sales taxes.[17] When calculated in this manner, the Lottery's operating expenses were 14.1 percent of gross revenues in 2002 and 14.2 percent in 2003, both below the legal limit. We discuss advertising expenses in Chapter 3.

Proceeds to the State

After paying prizes and commissions and operating costs, the Lottery transfers the remaining revenues to several funds in the State Treasury. In 2003, the Lottery transferred $79.4 million, or 22 percent of its revenues, to other funds in the State

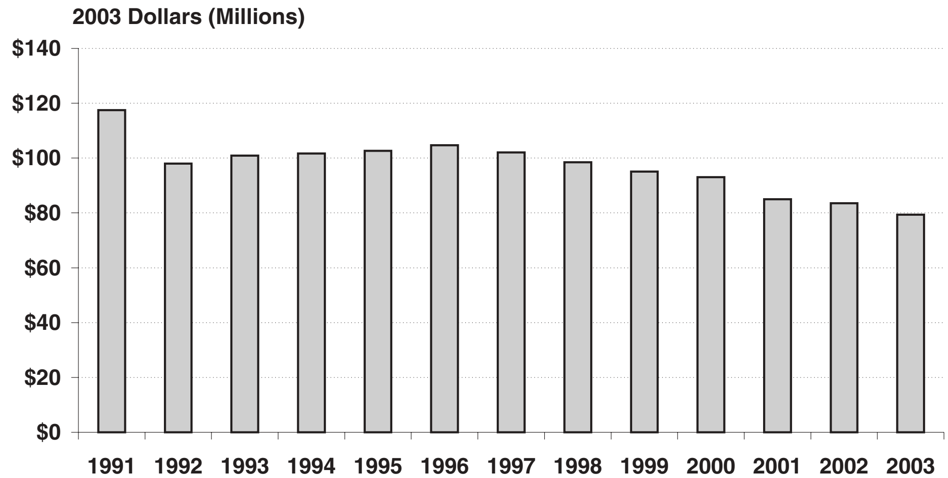
16 *Minn. Stat.* (2003), §349A.10, subd. 3 (b) and (c).

17 *Minn. Stat.* (2003), §349A.01, subd. 8.

Treasury. As shown in Figure 1.5, the Lottery has transferred less money, in inflation-adjusted dollars, in recent years than in its earlier years. For example, from 1991 through 1997, the Lottery transferred, on average, the equivalent of $104 million per year in 2003 dollars. From 1998 through 2003, however, the state received an average of only $89 million per year, a difference of $15 million per year (in 2003 dollars).

Since the mid-1990s, the amount of money generated by the Lottery for state programs has declined by more than 20 percent in inflation-adjusted dollars.

Figure 1.5: Lottery Proceeds Transferred to the State, FY 1991-2003



NOTE: All figures adjusted for inflation using the Bureau of Labor Statistic's Consumer Price Index for all Urban Consumers (CPI-U).

SOURCE: Office of the Legislative Auditor analysis of Minnesota State Lottery financial data.

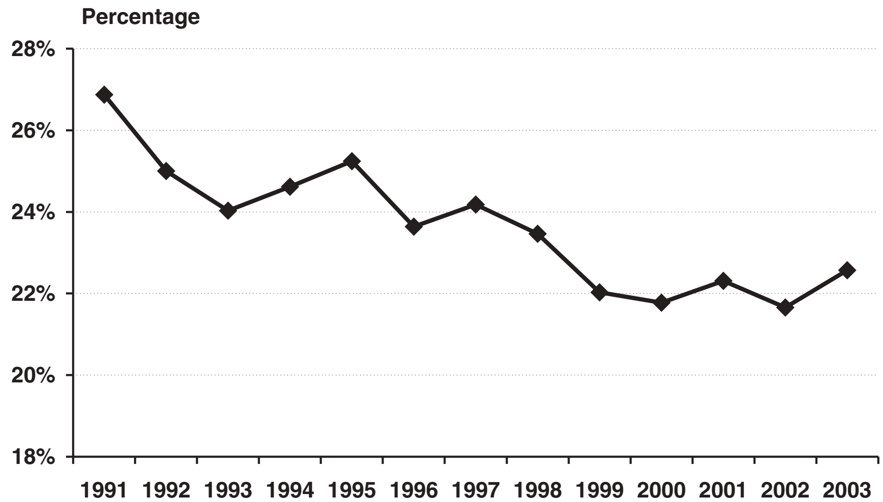
Some of the decline in Lottery proceeds to the State Treasury is the result of declining sales, as discussed above. The decline in sales, however, has not been met by a proportionate decline in expenses, particularly operating expenses. As a result, as Figure 1.6 shows, the Lottery has transferred a lower percentage of sales to the State Treasury in recent years than it did in its early years. From 1991 through 1997, for example, the Lottery transferred, on average, 24.8 percent of sales to the state, but from 1998 through 2003, transfers to the state averaged 22.3 percent of sales.

Several state laws and constitutional provisions determine how Lottery funds are distributed to other state funds. First, since ticket purchasers do not pay state sales tax, 6.5 percent of Lottery ticket sales are transferred to the Department of Revenue in lieu of sales tax.[18] In 2003, this amounted to $22.9 million. State law determines how the in lieu of sales tax proceeds are distributed. During the Lottery's history, the Legislature has changed the distribution formula several times. Beginning in fiscal year 2004, 72.43 percent of the money collected in lieu of sales tax must be distributed as follows:

18 *Minn. Stat*. (2003), §297A.65.

While the share of Lottery revenues paying for operating expenses has increased, the portion of revenues available for state programs has declined.

Figure 1.6: Percentage of Lottery Sales Transferred to the State, FY 1991-2003



SOURCE: Office of the Legislative Auditor analysis of Minnesota State Lottery financial data.

- 50 percent to the Game and Fish Fund for activities that improve, enhance, or protect fish and wildlife resources;
- 22.5 percent to the Natural Resources Fund for state parks and trails;
- 22.5 percent to the Natural Resources Fund for metropolitan park and trail grants;
- 3 percent to the Natural Resources Fund for local trail grants; and
- 2 percent to the Natural Resources Fund for the Minnesota Zoological Garden, the Como Park Zoo and Conservatory, and the Duluth Zoo.[19]

The remaining revenue collected in lieu of sales tax goes to the state's General Fund.

Each year, a small percentage of winning Lottery tickets are not redeemed ($9.5 million or 4 percent of eligible prizes in 2003). Until fiscal year 1995, the Lottery retained the unclaimed prizes and used them to enhance the prize level of subsequent games. From 1995 through June 2003, state law required the Lottery to retain 30 percent of unclaimed prizes to enhance prizes. Of the remaining 70 percent, 60 percent (or 42 percent of total unclaimed prizes) went to the General Fund and 40 percent (28 percent of the total) went to the Environment and Natural Resources Trust Fund for environmental projects. The 2003

19 *Minn. Stat*. (2003), §297A.94 (e). For 2002 and 2003, 87 percent of the funds collected in lieu of taxes were distributed in this manner.

Legislature required that 100 percent of the unclaimed prizes be deposited in the General Fund, beginning with unclaimed prizes in fiscal year 2004.[20]

The Legislature annually appropriates Lottery funds to the Department of Human Services for problem gambling programs. The Lottery transferred $1.8 million for gambling programs in 2003. The 2003 Legislature appropriated $1.9 million for each year of the 2004-2005 biennium for this purpose.[21]

Most of the profits generated by the Lottery are transferred to the State's General Fund and the Environment and Natural Resources Trust Fund.

The Minnesota Constitution requires that 40 percent of the net proceeds of the Lottery be transferred each year to the Minnesota Environment and Natural Resources Trust Fund.[22] Net proceeds are Lottery revenues less prizes, retailer commissions, operating expenses, payments in lieu of sales tax, payments to the state for unclaimed prizes, and transfers for problem gambling treatment programs. State law requires transfer of the other 60 percent of net proceeds to the General Fund.[23] In 2003, net proceeds from the Minnesota State Lottery were $48.1 million.

In fiscal year 2003, the Lottery provided nearly $22 million to the Environment and Natural Resources Trust Fund.

Overall, in 2003, the Environment and Natural Resources Trust Fund received 40 percent of the net proceeds plus 28 percent of the unclaimed prizes for a total of $21.9 million. The General Fund received a total of $37.3 million including portions of net proceeds, unclaimed prizes, problem gambling funding, and in lieu of taxes money. The Game and Fish Fund and the Natural Resources Fund each received $10 million from money collected in lieu of taxes. The Indian Gaming Revolving Account in the Special Revenue Fund received $340,000 for problem gambling programs.

---

20 *Minn. Stat.* (2003), §349A.08, subd. 5.

21 *Laws of Minnesota* (1Sp2003), ch. 14, art. 13C, sec. 2, subd. 1, and *Laws of Minnesota* (1998), ch. 407, art. 8, sec 11.

22 *Minn. Const.,* Art. XI, sec 14. Minnesota voters created this fund in November 1988 in the same election that they approved an amendment to allow creation of a lottery. The Legislature may annually appropriate up to 5.5 percent of the market value of the fund for the protection, conservation, preservation, and enhancement of the state's air, water, land, fish, wildlife, and other natural resources.

23 *Minn. Stat.* (2003), §349A.10, subd. 5.

OVERSIGHT AND ACCOUNTABILITY

Since its creation, the Minnesota State Lottery has not been subject to the same level of oversight and controls applicable to most state agencies. For example, the Lottery is not subject to all of the budgeting and contracting requirements that apply to most state agencies, although Lottery procurement contracts must be determined through an open bidding process.[24] The Lottery presents its biennial budget to the Department of Finance and the Governor. It also is required to make an annual appearance before the House and Senate committees having jurisdiction over gaming policy to explain its spending plans for the next fiscal year. But the Lottery is not required to have its budget approved either by the Department of Finance, the Governor, or the Legislature.[25]

While its budget is not approved by the Legislature, state law requires the Lottery to keep its operating expenses under 15 percent of gross revenues.

In lieu of requiring the Lottery to go through the normal appropriations process, the Legislature has placed certain limits on Lottery spending. As noted earlier, for example, advertising expenses must not exceed 2.75 percent the Lottery's gross revenue, and operating expenses must not exceed 15 percent of gross revenue in a fiscal year.[26] In addition, the Lottery must annually contract with a certified public accountant for a financial audit and is subject to periodic audits by the Office of the Legislative Auditor.[27]

In response to criticism that the Lottery was spending too much on operations, the 2003 Legislature limited the Lottery's operating budget to $43.5 million for each year of the 2004-2005 biennium and thereafter.[28] This represented a $3.1 million, or 6.7 percent, reduction from fiscal year 2003 spending. The budget reduction resulted in the staff layoffs described above as well as cuts in advertising and promotions, communications, depreciation (by not replacing vehicles and equipment as often as before), and other areas.

OTHER LEGAL GAMBLING

The Lottery competes in general for customers with other forms of entertainment, and in particular with other forms of legal gambling. The two largest types of legal gambling in Minnesota are charitable gambling and Indian casinos. In addition, Minnesota has a horse track with pari-mutuel betting and a card club.

The Indian tribes do not reveal much about casino revenues. Nationally, there were 330 tribal gaming operations with total net revenues of about $14.5 billion in fiscal year 2002.[29] Minnesota had almost 20,000 gaming positions in 17 Indian casinos in 2002, about 12 percent of all the gaming positions at Indian casinos in

24 *Minn. Stat.* (2003), §349A.07, subd. 6 and *Minn. Stat.* (2003), §349A.10, subd. 3(d).

25 *Minn. Stat.* (2003), §349A.15, subd. 6.

26 *Minn. Stat.* (2003), §349A.10, subd. 3 (b) and (c).

27 *Minn. Stat.* (2003), §349A.14.

28 *Laws of Minnesota* (1Sp2003), chap. 1, art. 1, sec. 23.

29 National Indian Gaming Commission, *Tribal Gaming Revenues*, www.nigc.gov/nigc/nigcControl?option=TRIBAL_REVENUE; accessed November 24, 2003.

the United States.[30] If Minnesota casinos received 12 percent of the national revenues from Indian gaming, Minnesotans would have spent over $1.7 billion at Indian casinos, considerably more than they spent on the Lottery. Casinos are not unique to Minnesota. Minnesota is among 23 states with Indian casinos including Arizona and Wisconsin with 22 and Washington with 18.[31] Some states have commercial casinos that pay state and local taxes. Iowa's three racetrack casinos had revenues over $300 million in 2001.[32] Riverboat casino gambling is available in Iowa, Illinois, Louisiana, and Missouri.[33]

The Lottery faces competition from other types of legal gambling in Minnesota, including the nation's largest charitable gambling industry.

Charitable gambling is another big industry in Minnesota. Organizations conducting charitable gambling in Minnesota must be licensed by the Minnesota Gambling Control Board.[34] Charitable gambling may be conducted by a fraternal, veterans, religious, or other nonprofit organization that has existed for at least three years and has at least 15 active members.[35] Permissible forms of charitable gambling include pull-tabs, bingo, paddlewheels, raffles, and tipboards.[36] Prizes are limited depending on the game. For example, individual pull-tab prizes may not exceed $599.[37] Charitable gambling is also subject to state and local taxes.[38]

Minnesota led the nation in pull-tab sales in fiscal year 2001.

30 Jason N. Ader, *Bear Stearns 2002-03 North American Gaming Almanac (2nd Edition)*, (Las Vegas, NV: Huntington Press, 2002).

31 American Gaming Association, The AGA Survey of Casino Entertainment, 2002, www.americangaming.org/survey2002/overview/over_view.html; accessed September 16, 2003 and North American Association of State and Provincial Lotteries, 2003 Lottery Resource Handbook (Willoughby Hills, OH: 2003), 207. Net revenues are revenues remaining after prizes are paid.

32 American Gaming Association, *The AGA Survey*.

33 *Ibid.*

34 *Minn. Stat.* (2003), §349.16, subd. 1. The Minnesota Gambling Control Board has seven members. The Governor appoints five members, and the Commissioner of Public Safety and the Attorney General each appoint one member. The board is responsible for regulating charitable gambling and has no authority over the Lottery.

35 *Minn. Stat.* (2003), §349.16, subd. 2.

36 For definitions of these games, see *Minn. Stat.* (2003), §349.12. For a summary of rules pertaining to these games, see Minnesota House of Representatives Research Department, *Charitable Gambling in Minnesota* (St. Paul, August 2002), 10-12.

37 *Minn. Stat.* (2003), §349.211, subd. 2a.

38 For a description of Minnesota's charitable gambling taxes, see Minnesota Gambling Control Board, *Annual Report – Fiscal Year 2003*, www.gcb.state.mn.us/PDF_Files/fy03.pdf; accessed June 5, 2003, 7.

In fiscal year 2003, over 1,400 nonprofit organizations had licenses to conduct charitable gambling in Minnesota. Gross receipts totaled $1.4 billion, slightly below 2001 and 2002 and about 5 percent less than 2000, when charitable gambling sales hit an all-time high of $1.5 billion. This was almost four times as much as the Lottery's sales in 2003. Between 1991 and 2003, charitable gambling gross receipts fell by about 18 percent after adjusting for inflation, a decline similar to the 20 percent decline in sales experienced by the Lottery over that period.

The vast majority of charitable gambling receipts (93 percent) came from pull-tab sales, 5 percent came from bingo sales, and the remaining 2 percent came from paddlewheels, raffles, and tipboards. About $1.2 billion (82 percent) was paid in prizes (considerably higher than the Lottery), leaving net receipts of $254 million. Of that, $130 million paid for operating expenses, $56 million went for gambling taxes, and $67 million (less than 5 percent of gross receipts) was contributed to charity.[39]

Minnesota's charitable gambling industry is more extensive than other states. Data from 34 states surveyed by the National Association of Fundraising Ticket Managers in 2001 found that Minnesota far eclipsed other states in the amount of gross receipts received from charitable gambling, primarily due to pull-tab sales.[40] Minnesota reported $1.3 billion in pull-tab sales and an additional $0.1 billion in other charitable gambling in 2001. Ohio had the second most pull-tab sales ($557 million) followed by Washington ($500 million) and Kentucky ($476 million). Thirteen states exceeded Minnesota's $70 million in bingo sales, topped by Indiana with $495 million. Minnesota led in total charitable gambling with $1.4 billion in sales, followed by Washington ($902 million), Ohio ($748 million), and Kentucky ($607 million). Minnesota's gross receipts from charitable gambling were almost one-sixth of the national total.

The effect of competition on Lottery sales is unclear.

It is difficult to assess the impact of Indian casinos and charitable gambling on Lottery sales in Minnesota. While they may sometimes attract similar clientele, they serve different market niches. Casino gambling, for example, requires individuals to set aside a block of time (and probably a greater outlay of cash) to get to and participate in what usually amounts to an afternoon or evening of entertainment. In contrast, people can easily purchase Lottery tickets for as little as $1 apiece on their lunch breaks or on the way to or from work. The Lottery and charitable gambling have similar products, but they have carved out different territories to sell their products. Pull-tabs tend to be sold at bars and restaurants and at social events put on by sponsoring organizations. Lottery tickets are sold in convenience stores and other retail establishments. Also, while pull-tab prizes are a higher percentage of sales revenue than Lottery prizes, pull-tab prizes are capped in Minnesota at $599. The customer looking for a chance at a larger prize would have to buy a Lottery ticket.

Greater participation by Minnesotans in charitable and casino gambling may simply signal a greater proclivity towards gambling in general than people in

39 Minnesota Gambling Control Board, *Annual Report,* 5-7.

40 National Association of Fundraising Ticket Managers, *Charity Gaming in North America: 2001 Annual Report*, (St. Paul, 2002), 9. The remaining 16 states either did not permit charitable gambling, did not regulate it, or did not respond to the survey.

other states. If this is the case, one might expect greater participation by Minnesotans in lottery games as well. Still, the extensiveness of Indian casinos and charitable gambling in Minnesota suggests that they do have the potential to draw sales away from the Lottery.

Finally, we note that a portion of the population opposes gambling in any form, even one that generates revenue for the state. Lotteries may be opposed because they proliferate and legitimize gambling, are viewed as a regressive tax, or can contribute to compulsive gambling and other social and personal problems. Lotteries exist in a world of mixed messages, where too much success may raise concerns. Thus, Minnesota and several other states impose restrictions on Lottery advertising, and most states have programs to prevent and treat compulsive gambling.

2 Comparisons

SUMMARY

Compared with similar lotteries, the Minnesota State Lottery spends substantially more on operations and provides less in state proceeds. In 2002, Minnesota's operating expenses were more than 13 percent of sales compared with an average of 8 percent for similar lotteries. Minnesota's operating profits available for environmental and other state programs were 21 percent of sales, while similar lotteries had a 27 percent return.

The Minnesota Lottery spent more than similar lotteries in most spending categories, including advertising and promotions, personnel, tickets, rent, depreciation, and miscellaneous expenses. Minnesota's higher spending could be due to the Minnesota Lottery's greater autonomy and the absence of budgetary oversight. Differences in the cost of living and the type of games played explain only about one-fourth of the overall spending differences between Minnesota's Lottery and similar state lotteries.

There are no industry standards for lottery expenses or profit margins. In evaluating the Minnesota State Lottery, therefore, we think it is reasonable to compare Minnesota's Lottery with other state lotteries that are similar in size and product mix. This chapter poses the following research questions:

- **How does the Minnesota State Lottery's spending on prizes, retailer commissions, and operations compare with the spending of similar state lotteries?**

- **How does the Minnesota State Lottery compare with other state lotteries in the percentage of proceeds from Lottery ticket sales that is available for public programs?**

- **To what extent do differences in product mix and cost of living account for differences in spending patterns between the Minnesota Lottery and other state lotteries?**

To select a group of comparable states, we relied primarily on data that state lotteries submitted to the North American Association of State and Provincial Lotteries (NASPL) for fiscal year 2002, the most recent year available. To compare Minnesota's spending with other states, we reviewed fiscal year 2002 comprehensive annual financial reports for the eight states that we selected as comparison states. We also spoke with financial officials from Minnesota and each of the eight states to clarify accounting practices and collect additional information.

SELECTION OF COMPARISON STATES

No two state lotteries are exactly alike. Lotteries may differ in their organization, their degree of autonomy, the games they offer, the prizes they award, the commissions they pay, the socioeconomic backgrounds and game preferences of players, and the competition they face from alternative forms of gambling. For example, lottery players in some states purchase more online than scratch tickets, whereas in other states, including Minnesota, players play more scratch games. Since online games tend to pay out less in prizes than scratch games, state lotteries with a higher proportion of online sales, all other things being equal, will be somewhat more profitable. Some states attract lottery players from surrounding states that do not have the same online games, especially when jackpots are high.

We compared Minnesota's Lottery with eight other state lotteries with similar sales.

In selecting comparison states, we did not attempt to match states with Minnesota on every possible factor that might affect lottery sales and expenses. Rather, we focused on states with populations and annual lottery sales similar to Minnesota. States with more people and annual sales may be able to take advantage of economies of scale to reduce costs. For example, lotteries with higher sales generally receive lower rates for ticket printing or processing services. We picked states with 2002 populations between about 4 and 6 million in fiscal year 2002 (Minnesota had 5 million people) and fiscal year 2002 lottery sales between $250 and $650 million (Minnesota's sales were $377 million). We also excluded a state if more than 10 percent of its sales came from video lottery terminals or keno, which Minnesota does not offer.[1] Nine states met the criteria. We excluded South Carolina, because it only began operating during the second half of fiscal year 2002. Over a full year, its sales would have exceeded the $650 million upper limit of the range.

Table 2.1 lists the eight state lotteries in the comparison group and compares some of their characteristics with the Minnesota State Lottery. While the states fall within the population and lottery sales ranges in our selection criteria, they are not perfect matches. On average, the states had larger populations and higher lottery sales than Minnesota in 2002. They are smaller in area than Minnesota, on average, but have about the same percentage of their population living in urban areas. All of the states derived a greater percentage of revenues from online games than Minnesota. Appendix A contains data on lottery sales, expenses, and profits for all 38 state lotteries operating in fiscal year 2002.

---

1 Video lottery terminals are the equivalent of slot machines. Keno combines elements of online and instant games. A player selects several numbers out of a larger set of numbers (for example, 1 through 80). A computer randomly draws 20 numbers. If enough of the drawn numbers match the player's choices, the player wins. Prizes are based on how many numbers the player attempts to match, how many of those are drawn, and the size of the wager. Games usually start every four or five minutes throughout the day. Both video lottery terminals and Keno allow players to play multiple games in succession as opposed to other online games that have drawings at most once per day.

Table 2.1: Features of Minnesota and Comparison State Lotteries, FY 2002

State	2002 Population[a] (Millions)	Percentage Urban[b]	Area (Square Miles)	2002 Sales (in Millions)	Percentage of Sales from Online Games
Minnesota	**5,002,128**	**71%**	**79,610**	**$377**	**36%**
Arizona	5,381,710	76	113,635	295	51
Colorado	4,468,766	85	103,718	408	37
Indiana	6,142,906	71	35,867	626	44
Kentucky	4,080,854	56	39,728	639	48
Louisiana	4,476,507	73	43,562	312	64
Missouri	5,654,944	69	68,886	585	41
Washington	6,031,193	82	66,544	439	45
Wisconsin	5,423,572	68	54,310	428	44
Average	5,207,556	72	65,781	467	47
Median	5,381,710	72	60,427	434	45

[a]Average of July 1, 2001 and July 1, 2002 estimated population.

[b]Percentage of population living in a metropolitan area or city cluster.

SOURCES: United States Census, *2002 Population Estimates* (Tables GCT-T1, GCT-PH1, and PCT2), http://factfinder.census.gov, accessed 7/23/03; and North American Association of State and Provincial Lotteries, *NASPL 2003 Lottery Resource Handbook* (Willoughby Hills, OH, 2003).

METHODS

We interviewed officials from comparison state lotteries and adjusted financial statements to make expense categories comparable.

As noted above, we relied primarily on the audited financial statements from the 2002 comprehensive annual financial reports (or equivalent documents) of the eight comparison states listed in Table 2.1. We used each state's statement of revenues, expenses, and changes in net assets for fiscal year 2002.[2]

States differed somewhat in the way they categorized and presented expenses.[3] Accordingly, we made adjustments to the financial statements so that all states' financial statements counted items the same way. We based these adjustments on the notes that accompany financial statements and telephone interviews with financial officers of the eight state lotteries. The adjustments primarily shifted items from one expense category to another. For example, some states combined several types of operating expenses into a miscellaneous expenses category. We separated some types of expenses such as office rent and travel from miscellaneous expenses into their own expense category. In no case did we change the total amount of lottery sales or expenses.

2 Fiscal years end June 30 for Minnesota and all of the comparison states.

3 All states prepared their statements in accordance with Government Accounting Standards Board (GASB) Statement Number 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that use Proprietary Fund Accounting*, and GASB Statement Number 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*. Despite complying with GASB statements, lotteries exercised considerable discretion in their treatment of specific expense items.

States accounted for supplies given to retailers such as ticket dispensers or signs in a variety of ways. We treated those items as a ticket production cost and made adjustments accordingly. Some states included the prizes associated with free promotional tickets as a prize expense, but we felt it was more accurate to treat them as a promotions expense. One state included its $10 million of online vendor expenses with other smaller items in a category called "professional services." We moved the online vendor expenses into online ticket processing to be consistent with the other states. These adjustments were necessary to present a fair and accurate comparison among the states.

States reported an assortment of non-operating revenues that made direct comparison with Minnesota difficult. For example, Washington, the only non-Powerball state in our comparison group, included $50 million of interest from a $500 million fund used to make future annuity payments to prize winners. Washington and some other states carried cash balances in their operating funds, allowing them to retain some of their earnings in some years, and to draw on their retained earnings to increase transfers to other state funds in other years. Also, some states had significant non-cash items, such as changes in the value of investments, in non-operating revenues. Rather than attempting to deal with each non-operating item separately, we excluded all non-operating income and focused on ticket sales revenues. We use the term "operating profits" to mean ticket sales less direct costs and operating expenses. We believe that this is an appropriate bottom line by which to compare a lottery's financial performance.[4]

FINDINGS

The Minnesota Lottery spends a greater share of revenues on operating expenses and provides a smaller share of revenues for public programs than similar lotteries.

Table 2.2 shows lottery expenses and operating profits as a percentage of lottery sales for Minnesota and the average for the eight comparison states. (Appendix A provides the underlying data for Minnesota and the eight comparison states, as well as the other states with lotteries.) The table is important because it reveals how much of the proceeds from lottery ticket sales go to run the lottery and how much is left over to be used for public purposes. It also shows how the Minnesota State Lottery differs from comparison state lotteries for different categories of expense. In general, Table 2.2 shows that:

- **Minnesota's Lottery spends more on operating expenses and has less money remaining to distribute to environmental and other public programs than similar state lotteries.**

Direct Costs

Lottery expenses include both direct costs and operating expenses. Direct costs consist of lottery prizes and retailer commissions. As shown in Table 2.2:

4 In all cases, operating profits differed from reported transfers to state treasuries by less than 2 percent of sales.

- **Minnesota's Lottery spends slightly more on direct costs than similar state lotteries. This is primarily because scratch tickets, which return more in prizes than online tickets, make up a higher proportion of sales in Minnesota than in the comparison group of similar state lotteries.**

Table 2.2: Lottery Expenses as a Percentage of Ticket Sales for Minnesota and Comparison States, FY 2002

	Minnesota	Comparison States Average	Difference (in percentage points)
Prizes	59.1%	58.0%	1.2%
Retailer Commissions and Incentives	6.3	6.6	-0.2
Subtotal: Direct Costs	65.5%	64.6%	0.9%
Ticket Production, Distribution, and Processing	4.7%	3.3%	1.3%
Wages and Benefits	3.1	1.7	1.3
Advertising and Promotion	3.3	1.8	1.5
Office and Warehouse Rent	0.4	0.1	0.3
Travel	0.1	0.1	0.0
Depreciation	0.4	0.2	0.2
Miscellaneous	1.4	0.9	0.5
Subtotal: Operating Expenses	13.3%	8.1%	5.1%
Total Expenses	78.7%	72.7%	6.1%
Operating Profits	21.3%	27.3%	-6.1%

NOTE: The eight comparison states are Arizona, Colorado, Indiana, Kentucky, Louisiana, Missouri, Washington, and Wisconsin. Operating profits are ticket sales less expenses. Totals do not always add up due to rounding.

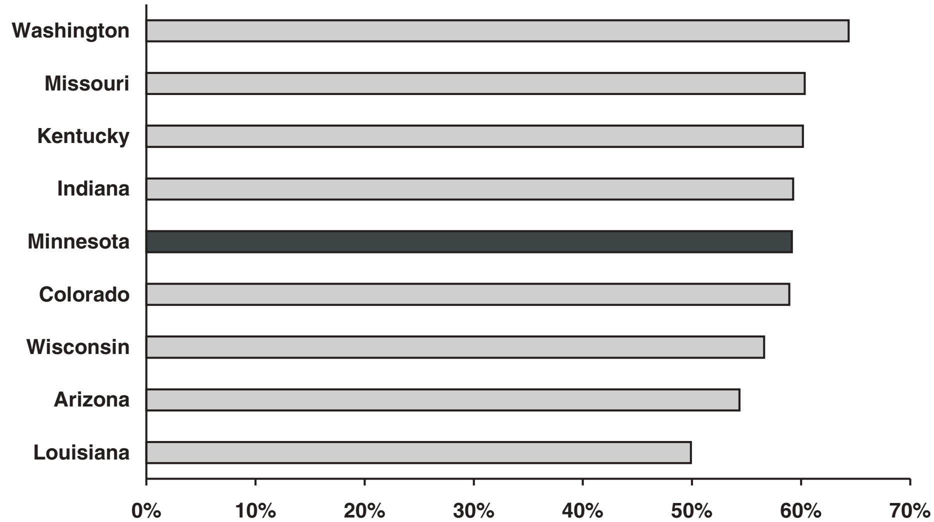
SOURCE: Office of the Legislative Auditor analysis of lottery financial statements and interviews with lottery financial officials from Minnesota and the eight comparison states.

The share of revenues that pays for prizes and retailer commissions is slightly higher in Minnesota than in other states with similar lotteries.

There is less than one percentage point difference between Minnesota and the comparison states in the percentage of lottery sales used to pay direct costs. Figure 2.1 shows that four of the comparison state lotteries paid out more for prizes than Minnesota and four paid out less. Our analysis also revealed that Minnesota's Lottery paid out more for scratch game prizes but less for online game prizes than the comparison state lotteries. In 2002, scratch game prizes were 64.5 percent of scratch game sales in Minnesota, compared to 62.8 percent for the comparison group. Online game prizes were 49.7 percent of online game sales in Minnesota compared to an average of 51.8 percent for the comparison state lotteries. Total prizes were proportionally higher in Minnesota because scratch tickets, which return more in prizes than online tickets, made up a higher proportion of sales in Minnesota (64 percent) than in the comparison group (53 percent).

Table 2.2 also shows that the Minnesota Lottery paid slightly less for retailer commissions and incentives than the average for comparison state lotteries. Among the eight state lotteries, commissions ranged from 5.5 to 7.5 percent of sales, compared with 6.3 percent in Minnesota. Four of the comparison state lotteries paid more than Minnesota for retailer commissions and four paid less.

Figure 2.1: Percentage of Lottery Sales Paid as Prizes, FY 2002



SOURCE: Office of the Legislative Auditor analysis of lottery financial statements.

Operating Expenses

As indicated earlier, operating expenses were substantially higher in Minnesota than in the comparison states during fiscal year 2002. Furthermore,

- **Minnesota's Lottery spends more than similar state lotteries on most operating expense categories, including tickets, personnel, advertising and promotions, rent, depreciation, and miscellaneous expenses.**

In 2002, Minnesota's Lottery spent close to two-thirds more of its sales revenue on operating expenses than similar lotteries.

Table 2.3 shows the percentage difference in operating expenses between Minnesota's Lottery and the average for the similar state lotteries. Minnesota spent more than the comparison states in all categories except travel. Minnesota's Lottery spent over six times as much as the other states on promotions, and 80 percent more on the combined category of advertising and promotions. Personnel spending as a percentage of sales was 77 percent higher in Minnesota than in the comparison states. Spending on office rent appears to be over three times higher in Minnesota, but this is misleading because three of the comparison states owned their headquarters building in 2002.

Total lottery operating expenses as a percentage of sales was 63 percent higher in Minnesota than the average for the comparison states. As shown in Figure 2.2, Minnesota is well above all eight of the comparison states in the percentage of lottery sales that pays for operating expenses. Nationally, only five state lotteries spent more on operating expenses as a percentage of sales than Minnesota. The median for all lotteries in the United States was 7.5 percent. In Chapters 3 and 4, we examine the Minnesota Lottery's operating expenses in greater detail.

Minnesota's Lottery spent more than other lotteries in nearly all categories of operating expenses.

Table 2.3: Percentage Difference in Operating Expenses Between Minnesota and Comparison States, FY 2002

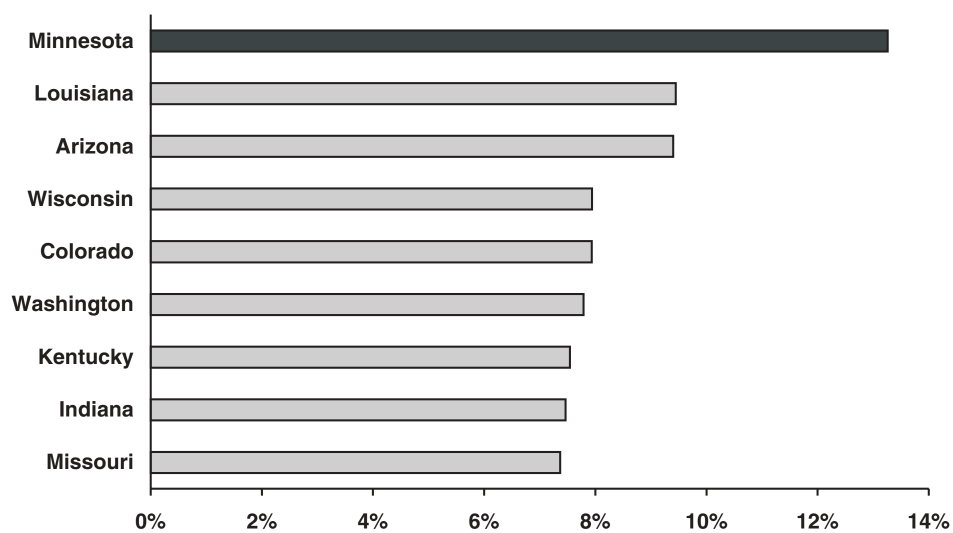
Expense Category	Percentage Difference[a]	
Scratch Tickets	39%	
Online Tickets	65	
Total Ticket Costs		40
Advertising[b]	23	
Promotions[b]	505	
Advertising and Promotion		80
Wages and Benefits		77
Office and Warehouse Rent		278
Travel		-30
Depreciation		106
Miscellaneous		63
Total Operating Expenses		63%

[a]This table measures the percentage difference between spending as a percentage of sales by the Minnesota State Lottery and the average spending as a percentage of sales by eight comparison state lotteries. The scratch ticket percentage difference is based upon scratch ticket costs as a percentage of scratch ticket sales, and the online percentage difference is based on online costs as a percentage of online sales. Percentage differences for all other expense categories are based on expenses as a percentage of total sales. A negative number means that Minnesota spent less than the comparable states.

[b]Kentucky did not provide us with a breakdown of advertising and promotions. We assumed that all of Kentucky's advertising and promotions expenses were for advertising. In addition, we did not include Kentucky when calculating a comparison state average for promotions spending.

SOURCE: Office of the Legislative Auditor analysis of lottery financial statements and interviews with lottery financial officials from Minnesota and the eight comparison states.

Figure 2.2: Lottery Operating Expenses as a Percentage of Sales, FY 2002



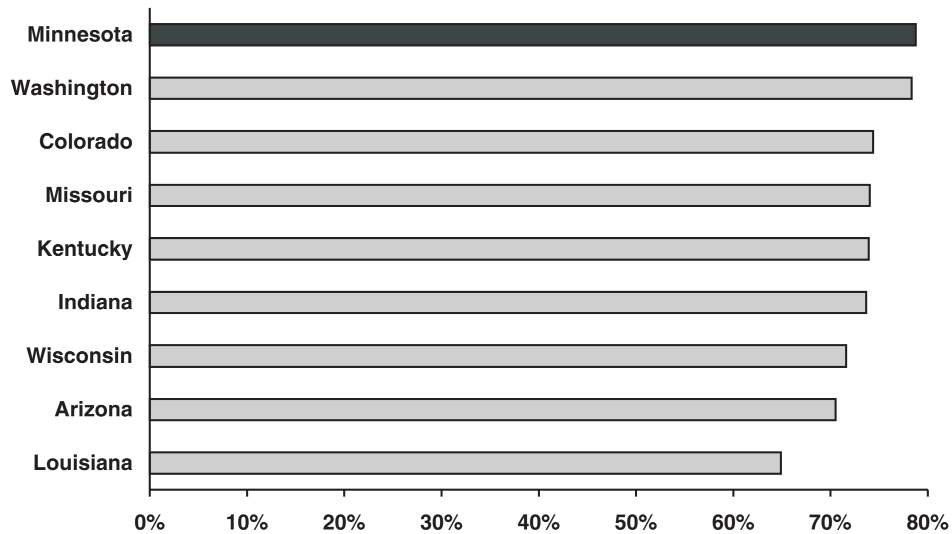
SOURCE: Office of the Legislative Auditor analysis of lottery financial statements.

Operating Profits

Figure 2.3 shows total lottery expenses – including prizes, retailer commissions, and operating expenses—as a percentage of sales for Minnesota and the eight

Total expenses were a higher share of sales revenues in Minnesota than in any of the comparison states.

Figure 2.3: Total Lottery Expenses as a Percentage of Sales, FY 2002



SOURCE: Office of the Legislative Auditor analysis of lottery financial statements.

comparison states. Similarly, Figure 2.4 shows operating profits as a percentage of sales for Minnesota and the comparison group states. These figures demonstrate that:

- **Total lottery spending as a percentage of sales is higher in Minnesota than any other state in the comparison group. As a result, operating profits are lower in Minnesota than all of the other comparison states.**

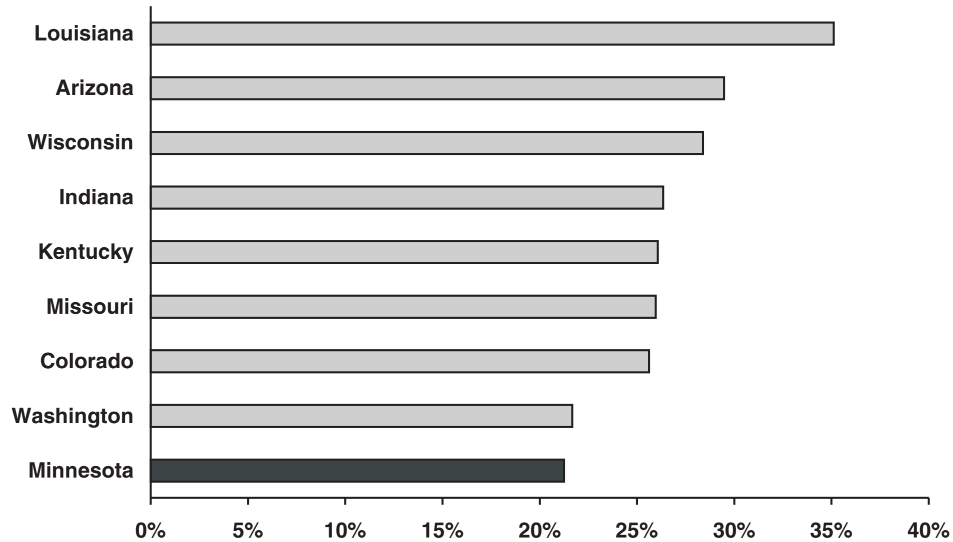
Minnesota used 78.7 percent of Lottery sales revenue to operate its Lottery in fiscal year 2002 and had operating profits equal to 21.3 percent of sales.[5] The operating profit, plus interest and other non-operating income, was distributed to environmental and other programs according to law, as discussed in Chapter 1.[6] The comparison state lotteries, on average, spent 72.7 percent of sales and had

5 Washington spent nearly as much as Minnesota, primarily because its prizes (64 percent of sales) were higher than the other comparison states (58 percent of sales). Washington's operating expenses were slightly below the eight state average.

6 In total, the lottery transferred 21.7 percent of sales ($81.7 million) in fiscal year 2002, including $24.5 million in lieu of taxes, $5.1 million in unclaimed prizes, $2.5 million for compulsive gambling programs, and net proceeds of $49.5 million.

Operating profits for the Minnesota Lottery were 21 percent of sales revenues, compared with an average of 27 percent for similar lotteries.

Figure 2.4: Operating Profit as a Percentage of Sales, FY 2002



SOURCE: Office of the Legislative Auditor analysis of lottery financial statements.

operating profits equal to 27.3 percent of sales.[7] In other words, the Minnesota Lottery's operating profit as a percentage of sales was 22 percent less than the average operating profit for the comparison state lotteries. Had Minnesota been able to hold expenses to the average level of other states while maintaining the same level of sales ($377 million in 2002), it would have generated an additional $23 million in operating profits to be used for environmental and other programs.

Per Capita Revenues and Expenses

Lotteries of different sizes can also be compared using per capita revenues and expenses. Table 2.4 presents those results for Minnesota and the eight comparison states. On a per capita basis, Minnesota's Lottery has slightly lower scratch ticket sales but much lower online sales than the comparison states. Overall, Minnesota's per capita sales in 2002 were 17 percent below the comparison state average. Because prizes and commissions are directly related to sales, Minnesota's per capita prizes and commissions are also lower than the comparison states. However, per capita operating expenses were 38 percent higher in Minnesota than in the comparison states. In sum, Minnesota spends more per capita to operate a Lottery that brings in less revenue than the average for comparison state lotteries. As a result, per capita operating profits are over one-third lower in Minnesota than the comparison states.

7 On average, the comparison states reported transferring 27.9 percent of sales to a variety of state and local funds as directed by their laws. The average return for all U.S. lotteries was 28.6 percent.

On a per capita basis, Minnesota has lower sales but significantly higher operating expenses than similar lotteries.

Table 2.4: Per Capita Lottery Operating Revenues and Expenses for Minnesota and Comparison States, FY 2002

	Minnesota	Comparison States Average	Percentage Difference From Average
Scratch Sales	$48.19	$49.05	-2%
Online Sales	27.20	42.12	-35
Total Sales	$75.39	$91.16	-17%
Prizes	$44.59	$53.35	-16%
Retailer Commissions	4.79	5.99	-20
Total Direct Costs	$49.38	$59.34	-17%
Ticket Production, Distribution, and Processing	$ 3.53	$ 2.90	22%
Wages and Benefits	2.32	1.59	46
Advertising and Promotion	2.46	1.57	56
Office and Warehouse Rent	0.32	0.09	236
Travel	0.04	0.07	-40
Depreciation	0.28	0.19	44
Miscellaneous	1.05	0.82	28
Total Operating Expenses	$10.00	$ 7.23	38%
Total Expenses	$59.37	$66.58	-11%
Operating Profits	$16.02	$24.59	-35%

NOTE: Operating profits are ticket sales less expenses.

SOURCE: Office of the Legislative Auditor analysis of lottery financial statements and interviews with lottery financial officials from Minnesota and the eight comparison states.

DISCUSSION

Minnesota Lottery officials have argued that comparisons such as the ones made above are unfair. They say that Minnesota's Lottery profits are a lower percentage of sales than other states because of Minnesota's greater reliance on scratch games, higher cost of living, and greater competition from other forms of legal gambling. In this section, we consider these factors. In addition, we examine the Minnesota State Lottery's autonomy and external budget oversight relative to the eight comparison state lotteries.

Sales Mix

As noted earlier, Minnesotans have shown a preference for playing scratch games over online games, whereas lottery players in the comparison group of states distributed their purchases more evenly between online and scratch tickets in fiscal year 2002. Since scratch tickets pay out a higher percentage of sales as prizes, Minnesota's total expenses are slightly higher as a percentage of sales. To measure the effect of Minnesota's high proportion of scratch ticket sales, we calculated a hypothetical statement of revenues and expenses for Minnesota. We assumed that Minnesota had the same total sales ($377 million) but that sales were distributed between scratch and online in the same way as the eight comparison states (53.1 percent scratch and 46.9 percent online). Table 2.5 shows the results of our analysis.

The left-hand set of columns in Table 2.5 shows actual revenues and expenses for fiscal year 2002, and the middle set of columns estimates what they would have been if sales were distributed as they were in the comparison states. Prize expenses would be lower in this hypothetical scenario because online ticket prizes are a lower percentage of sales than scratch ticket prizes. On the other hand, it costs more to pay a vendor to process online tickets than to print and distribute scratch tickets, so increasing the share of online tickets would increase total ticket costs. Finally, retailer commissions would be slightly lower with a shift to more online sales. Selling commissions would not be affected, but there would be a smaller dollar volume of winning tickets.

Minnesota's greater reliance on scratch games explains only a small part of the differences in profits between Minnesota and similar lotteries.

We found no basis to conclude that any other operating costs would be affected by a shift of sales from scratch to online games. But, even if other operating costs were 25 percent higher for scratch tickets than online tickets, the impact on Minnesota's operating expenses would be minimal. We estimated that this factor would reduce Minnesota's expenses by about $440,000, or just over 0.1 percent of total sales. Overall:

- **Minnesota's greater reliance on scratch tickets explains only one-sixth of the Lottery's lower operating profit.**

Table 2.5: Effect of Sales Mix and Cost of Living on Minnesota Lottery Expenses, FY 2002

	Actual		Estimates for Alternative Sales Mix		Estimates for Lower Cost-of-Living and Alternative Sales Mix	
Sales, Expenses, and Profits	(Millions)	Percentage of Sales	(Millions)	Percentage of Sales	(Millions)	Percentage of Sales
Scratch Ticket Sales	$241.1	63.9%	$200.4	53.1%	$200.4	53.1%
Online Ticket Sales	136.1	36.1	176.7	46.9	176.7	46.9
Total Sales	377.1	100.0	377.1	100.0	377.1	100.0
Scratch Prizes	155.4	41.2	129.3	34.3	129.3	34.3
Online Prizes	67.6	17.9	87.8	23.2	87.8	23.2
Total Prizes	223.0	59.1	217.0	57.5	217.0	57.5
Retailer Commissions and Incentives	23.9	6.3	23.8	6.3	23.8	6.3
Subtotal: Direct Costs	$247.0	65.5	$240.8	63.8	$240.8	63.8
Scratch Ticket Production and Distribution	6.3	1.7	5.3	1.4	5.3	1.4
Online Ticket Processing	11.3	3.0	14.7	3.9	14.7	3.9
Additional Operating Expenses	32.4	8.6	32.4	8.6	29.8	7.9
Subtotal: Operating Expenses	50.0	13.3	52.3	13.9	49.7	13.2
Total Expenses	$297.0	78.7%	$293.1	77.7%	$290.8	77.0%
Operating Profits	$ 80.1	21.3%	$ 84.0	22.3%	$ 86.7	23.0%

NOTE: The middle set of columns estimates what expenses would be if the $377.1 million dollars in sales were split between scratch and online tickets in the same proportions as the comparison states. The right-hand set of columns estimates what Minnesota's expenses would be if Minnesota's sales mix and cost of living were the same as the average for the comparison states. Operating profits are ticket sales less expenses.

SOURCE: Office of the Legislative Auditor analysis of lottery financial statements from Minnesota and the eight comparison states.

As Table 2.5 indicates, under this hypothetical scenario the Minnesota State Lottery would have had operating profits equal to 22.3 percent of its 2002 sales. This is more than the 21.3 percent actually achieved, but still below the average operating profit of 27.3 percent of sales for the comparison states. The net result is that the Lottery's operating profit would have been about $3.9 million more if its sales had been distributed between scratch and online games in the same proportion as the comparison states.

Cost of Living

Minnesota's higher cost of living explains only a small part of the difference in operating expenses between Minnesota and other lotteries.

It is possible that differences in the cost of living explain, in part, why the Minnesota State Lottery has higher operating costs than the comparison state lotteries. Cost-of-living differences are most relevant for personnel costs because lotteries might need to pay more to attract workers in a high cost area. On the other hand, ticket production and processing is less likely to be affected by cost-of-living differences. Scratch tickets are printed by a vendor located outside of Minnesota and online ticket processing is provided through a contract with a company based outside of Minnesota that provides similar services to many state lotteries.

We used data from the American Chamber of Commerce Research Association (ACCRA), which calculates a cost-of-living index for many large and mid-sized cities.[8] ACCRA assigns a score of 100 percent to the national average, and each city's score is its percentage above or below average. We computed a composite state cost of living score for Minnesota and the eight states in our comparison group by weighting the lottery headquarters city 50 percent and the average of the cities with regional lottery offices 50 percent.[9] Based on this analysis, we concluded that the cost of living is about 8 percent higher for Minnesota than the average for the comparison states. In the right-hand set of columns in Table 2.5, we reduced Minnesota's operating expenses other than ticket printing and processing by 8 percent to put them on a par with the comparison states. This set of columns thus represents the cumulative effect of Minnesota's greater reliance on scratch sales and its higher cost of living. With both adjustments, the Minnesota Lottery's operating profit would have been 23.0 percent of sales, still below the average operating profit of 27.3 percent for the comparison states. In other words:

- **The combined effect of Minnesota's higher cost of living and its greater reliance on scratch tickets explains about one-fourth of the Lottery's lower operating profit.**

In fiscal year 2002, Minnesota would have had to reduce expenses by an additional $16.4 million while maintaining the same level of sales to have operating profits on a par with the comparison states.

8 American Chamber of Commerce Research Association, *ACCRA Cost of Living Index* (Arlington, VA, August 2003).

9 The ACCRA reports do not list every city, so we had to make some substitutions. For example, in Minnesota, we substituted Duluth/Superior, Rochester, and St. Cloud for Virginia, Owatonna, Marshall, Brainerd, and Detroit Lakes. In Wisconsin, we substituted 2002 Milwaukee data for Madison. Although Pueblo is the official headquarters of the Colorado Lottery, most of the operations are based in the Denver office, so we treated Denver as the headquarters city and Pueblo as a regional office.

Border Sales

Lottery officials maintain that Minnesota does not benefit as much as other state lotteries from sales to residents of neighboring states. Minnesota has benefited in the past from sales to North Dakota residents, since North Dakota did not have a lottery. But Lottery officials believe that some of the comparison states have benefited more than Minnesota from sales to nonresidents. For example, Indiana and Wisconsin may experience sales increases to Illinois residents when the Powerball jackpot is high because Powerball is not available in Illinois. Kentucky is expecting fiscal year 2004 sales to decline because Tennessee is inaugurating its lottery early in calendar year 2004. Kentucky officials estimated that 12 percent of its 2003 sales came from Tennessee residents.[10]

It is difficult to obtain information on the percentage of lottery tickets sold to residents of neighboring states, Wisconsin Lottery officials, for example, were unable to tell us what percentage of their sales came from Illinois. Furthermore, Wisconsin residents may purchase tickets in Illinois when the jackpot for Mega-Millions, a multi-state game not available in Wisconsin, is high. Thus, we could not determine whether Minnesota benefits less from border sales than Wisconsin or other comparison states. Nor can we say what impact, if any, border sales have on a lottery's profitability.

Competition

Minnesota Lottery officials have suggested that Minnesota's Lottery has to spend more to generate sales than other state lotteries because of the greater amount of competition in Minnesota from other types of legalized gambling. In particular, they maintain that the Lottery needs to spend more on advertising, promotion, and other marketing efforts. As discussed in Chapter 1, it is hard to measure the impact of competition on Lottery ticket sales and expenses. But we address this question indirectly by examining the Lottery's operating expenses in greater detail. In Chapters 3 and 4, we attempt to identify expenses that may be unnecessary or ineffective in increasing sales. Such expenses cannot be justified even in the face of greater competition.

Most other state lotteries are governed by a board or commission or are part of another state agency.

Budgetary Oversight

As discussed in Chapter 1, the Minnesota State Lottery has greater spending autonomy than most state agencies. It does not have to have its budget approved by the Department of Finance, the Governor, or the Legislature. The Lottery does not have to achieve a minimum level of operating profits, although it does have to limit operating expenses to 15 percent of gross revenue. Unlike other state agency heads who serve at the pleasure of the Governor, the director of the Minnesota State Lottery may only be removed for cause. Moreover:

10 Kentucky Lottery Corporation, *Lottery News*, July 25, 2003, www.kylottery.com/show_news_story.html; accessed December 15, 2003).

- **The Minnesota State Lottery has a greater degree of autonomy than other state lotteries, including most of the lotteries in our comparison group of states.**

Most state lotteries are governed by a board or commission, or they are part of another government agency such as a revenue department. According to the North American Association of State and Provincial Lotteries, 22 state lotteries were governed in fiscal year 2002 by a commission or board with authority over lottery budgets and operations.[11] In addition, seven lotteries were part of a government agency.[12] Thus, 29 of the 38 states with lotteries in 2002 (76 percent) were subject to oversight by a commission, board, or state agency.

Most of the comparison state lotteries must have their budgets approved by their state legislature.

Among the comparison state lotteries, Colorado and Washington are governed by commissions, and Kentucky and Louisiana are governed by boards with authority over lottery budgets and operations.[13] Wisconsin's Lottery is a division of the state's revenue department. Lotteries in Arizona, Indiana, and Missouri have more autonomy, with commissions that play only an advisory role.[14] Six of the eight states have to submit their budgets to their state legislatures for approval. One of the remaining two states has its budget approved by a lottery board appointed by the Governor. The findings presented in this chapter suggest that:

- **In the absence of legislative and executive branch oversight of its budget, Minnesota's Lottery officials have not controlled spending to the same extent as other state lotteries.**

Chapters 3 and 4 provide more details on how Minnesota's Lottery spends more than comparison state lotteries. They also discuss several instances of questionable spending by Minnesota Lottery officials.

RECENT SPENDING CHANGES

Table 2.6 presents preliminary data concerning lottery expenses and profits for fiscal year 2003.[15] For some states, the information has not yet been audited, although it is unlikely that the percentages will change significantly. The table shows that:

- **Operating expenses as a percentage of sales for the Minnesota State Lottery remained higher than the average operating expenses for the comparison states in fiscal year 2003.**

---

11 Generally, governors appoint commission and board members for fixed terms.

12 *NASPL 2003 Resource Handbook,* 211.

13 Colorado's lottery is a division of the state's revenue department, and the revenue commissioner appoints the lottery director. Colorado also has a lottery commission that adopts rules, approves the budget, and has general authority over lottery operations.

14 Missouri's lottery is located in the revenue department for administrative purposes but the department has no authority over lottery operations.

15 Because 2003 data for the comparison states became available near the end of our study, we were unable to explore the data with as much depth as we did for 2002 data. For example, we did not present office rent, travel, and depreciation as separate categories in Table 2.6, but instead included those expenses with other miscellaneous expenses.

Preliminary figures for fiscal year 2003 show that Minnesota continued to use more of its sales revenues to pay operating expenses than the comparison states.

Table 2.6: Lottery Expenses as a Percentage of Ticket Sales for Minnesota and Comparison States, FY 2003

	Minnesota	Comparison States Average
Prizes	58.2%	58.2%
Retailer Commissions and Incentives	6.3	6.5
Subtotal: Direct Costs	64.5	64.7
Ticket Production, Distribution, and Processing	4.4	3.2
Wages and Benefits	3.5	1.7
Advertising and Promotion	3.2	1.9
Miscellaneous	2.3	1.2
Subtotal: Operating Expenses	13.4	7.9
Total Expenditures	77.8%	72.7%
Operating Profits	22.2%	27.3%

NOTE: Operating profits are ticket sales less expenditures. Totals do not always add up due to rounding. Some data from comparison state lotteries are preliminary and subject to audit.

SOURCE: Office of the Legislative Auditor analysis of lottery financial statements.

Minnesota reduced operating expenses by 6 percent in 2003, but because sales also declined by 7 percent, operating expenses were 13.4 percent of sales, slightly above 2002. In contrast to Minnesota, sales increased in the comparison states in 2003 by an average of 6 percent over 2002 sales. Operating expenses for the comparison states increased by an average of 2 percent, but because sales increased, operating expenses as a percentage of sales declined slightly from 8.1 percent of sales in 2002 to 7.9 percent in 2003. Prize expenses in Minnesota declined from 59.1 percent of sales in 2002 to 58.2 percent in 2003, mainly because online games, which pay out less, made up a greater proportion of sales in 2003. As a result, operating profits increased to 22.2 percent of sales in 2003, up from 21.3 percent in 2002. Average operating profits for the comparison states remained at 27.3 percent of sales.

As discussed in Chapter 1, the 2003 Legislature limited the Lottery's operating budget to $43.5 million for each year of the 2004-2005 biennium. This constitutes a $3.1 million (6.7 percent) reduction from fiscal year 2003 spending and resulted in staff layoffs and other spending cuts. Table 2.7 shows actual Minnesota State Lottery revenues and expenses for fiscal years 2002 and 2003, along with budgeted amounts for 2004. It also shows average spending for the comparison states in 2002. It is clear from Table 2.7 that:

- **Recent budget cuts have not reduced Minnesota Lottery spending sufficiently to bring its operating profits as a percentage of sales up to the average level of comparison state lotteries in fiscal year 2002.**

The Lottery is projecting $374 million in ticket sales for fiscal year 2004, a 6.3 percent increase over 2003 sales. Its budget calls for $237.1 million in direct costs, 4.5 percent above 2003, and $43.5 million in operating expenses, a 7.3 percent decrease from 2003 operating expenses. If the Lottery's sales meet projections and the Lottery keeps expenses at budgeted amounts, Lottery operating profits will increase to 25 percent of sales. That would be an

Even after recent budget cuts, the Lottery's operating expenses will probably be higher than those of similar lotteries.

Table 2.7: Lottery Revenues, Expenses, and Operating Profits as a Percentage of Sales, FY 2002, 2003, and Budgeted 2004

	Minnesota			Comparison State Average
Sales, Expenses, and Profits	FY2002	FY2003	FY2004 (Budgeted)	FY2002
Scratch Ticket Sales	63.9%	60.0%	54.8%	53.1%
Online Ticket Sales	36.1	40.0	45.2	46.9
Total Sales	100.0%	100.0%	100.0%	100.0%
Prizes	59.1%	58.2%	56.9%	58.0%
Retailer Commissions and Incentives	6.3	6.3	6.4	6.6
Subtotal: Direct Costs	65.5%	64.5%	63.4%	64.6%
Scratch Ticket Production and Distribution	1.7%	1.5%	1.3%	1.0%
Online Ticket Processing	3.0	2.9	2.8	2.4
Wages and Benefits	3.1	3.5	3.2	1.7
Advertising and Promotions	3.3	3.2	2.3	1.8
Office and Warehouse Rent	0.4	0.5	0.5	0.1
Travel	0.1	0.1	0.1	0.1
Depreciation	0.4	0.5	0.2	0.2
Miscellaneous Operating Expenses	1.4	1.2	1.2	0.9
Subtotal: Operating Expenses	13.3%	13.4%	11.6%	8.1%
Total Expenses	78.7%	77.8%	75.0%	72.7%
Operating Profits	21.3%	22.2%	25.0%	27.3%

SOURCE: Office of the Legislative Auditor analysis of lottery financial statements from Minnesota and the eight comparison states.

improvement over 2002 and 2003 profits, but it would still be below the average operating profits of 27.3 percent of sales for the comparison states in 2002 and 2003.[16] Assuming that the $374 million sales projection for 2004 is met and that comparison states achieve the same profit levels of 2002 and 2003, Minnesota would have to reduce 2004 spending by an additional $7.7 million to achieve operating profits equal to the comparison states.[17]

Because of Minnesota's higher cost of living and its greater reliance on scratch ticket sales than the comparison states, it might be unreasonable to expect the Minnesota Lottery to achieve the same level of profitability as the comparison states. In addition, it might be difficult for Minnesota to reduce spending this much without negatively affecting sales. We think, however, that some further reductions in the Lottery's operating expenses could be made without affecting sales. In Chapters 3 and 4, we discuss a number of areas in which spending could be reduced.

16 Minnesota's higher cost of living and its greater reliance on scratch sales could explain some of the difference. However, the lottery's 2004 budget projects that scratch tickets will account for 59 percent of sales, compared with 64 percent in 2002. Unless the comparison states show a similar shift from scratch to online lottery ticket sales, Minnesota's greater reliance on scratch sales will have less effect on sales than discussed earlier in this chapter.

17 The full effects of the October layoffs will not occur until fiscal year 2005. The layoffs took effect the second quarter of fiscal year 2004, and the Lottery had to make severance payments and pay unemployment benefits for laid-off workers. Lottery officials estimate that wages and benefits will be $1.5 million less in 2005 than in 2004.

3 Advertising and Promotions

SUMMARY

We have numerous concerns about the Lottery's spending for promotional activities. The Lottery has committed more than $1 million to lease and improve a tractor/trailer to serve as a traveling exhibit on the Lottery's benefits to the environment. This project was ill conceived and mismanaged, and the Environmental Experience vehicle was only used 33 days during 2003. The Lottery has eliminated most of its sponsorships in response to legislative budget cuts but continues to expend significant financial and staff resources on the Minnesota Pro/Am Bass Tour, which we think has less value for the Lottery. The Lottery spends $1.2 million to produce and distribute a television program that has questionable benefits for Lottery sales. The Lottery's expenditure of $0.4 million annually for specialized radio spots needs further review. In addition, the Lottery needs to reassess its advertising strategy. Scratch ticket sales have been declining, and the Lottery has not measured the effectiveness of its advertising campaigns since 1997.

The Lottery has a close relationship with a public relations and event management firm called Media Rare, which has done considerable work with the Lottery and is owned by the same individual who owns the Minnesota Pro/Am Bass Tour. Despite statutory requirements to receive competitive bids, the Lottery has never competitively bid any of the work done by Media Rare. In addition, we have significant concerns about the amount of money that the Lottery has paid Media Rare for some of its work.

In Chapter 2, we saw that the Minnesota State Lottery spends more than similar lotteries on most types of operating expenses. This chapter focuses on the Minnesota Lottery's advertising and promotions expenses. In particular, this chapter examines the following questions:

- **To what extent is Minnesota's higher spending on advertising explained by higher media costs?**

- **Is advertising generally effective in stimulating sales in the lottery industry? Has the Lottery attempted to measure the impact of its advertising on ticket sales?**

- **How have the Lottery's ticket sales changed in recent years? How do Minnesota's sales trends compare with those at similar lotteries?**
- **What have been the Minnesota Lottery's major promotional expenses? Does the Lottery adequately measure and compare the benefits and costs of promotional activities?**
- **What organizations and events is the Lottery continuing to sponsor? How much is the Lottery spending to sponsor the Minnesota Pro/Am Bass Tour? Why is this sponsorship being continued when others have been terminated?**
- **Should the Lottery continue to pay for the production and distribution of the Environmental Journal television program? Do the Lottery's Player Spotlight and Environmental Journal radio programs provide sufficient value to merit continuation?**
- **Has the Lottery's traveling exhibit vehicle—called the Environmental Experience—been a worthwhile investment? Were the acquisition and improvement of the vehicle handled in an appropriate manner?**
- **Does the Lottery have good information on whether retail promotions are effective?**
- **Does the Lottery use free tickets and merchandise for appropriate business purposes?**
- **Has the Lottery followed state laws governing procurement of services and products, particularly those involving promotional activities?**

ADVERTISING

Minnesota statutes place a limit on the Lottery's advertising expenses.

During fiscal year 2002, the Minnesota State Lottery spent about $7.6 million on advertising. This figure includes advertising by radio, television, newspaper, and signage, as well as advertising at retail locations where lottery tickets are purchased. Radio advertising accounted for 43 percent of all advertising, while television advertising was 31 percent of the total. Indoor or outdoor signage represented 17 percent, and newspaper or print media accounted for 6 percent of all advertising expenses. Advertising expenses include the costs of preparation, production, and placement.

The Minnesota State Lottery is required by law to limit its advertising expenses to no more than 2.75 percent of its gross revenues in any fiscal year.[1] The Lottery's gross revenues, which are its sales and other revenues less the payments in lieu of taxes paid to the Minnesota Department of Revenue, were $354.2 million in fiscal year 2002. As the Lottery defines advertising, its advertising expenses were about 2.1 percent of gross revenues in 2002. The Lottery's advertising expenses declined slightly to $7.5 million in fiscal year 2003. But, because sales dropped,

1 *Minn. Stat.* (2003), §349A.10, subd. 3(c).

advertising expenses rose to close to 2.3 percent of gross revenues. In fiscal year 2004, the Lottery plans to spend about $7.0 million on advertising, or about 2.0 percent of estimated gross revenues. However:

- **Minnesota statutes do not clearly define advertising.**

The Lottery has some flexibility in determining what constitutes "advertising."

As a result, the Lottery must decide whether certain expenses qualify as advertising. In addition to standard advertising, the Lottery includes a portion of its sponsorship expenses to the extent that sponsorships involve signage or coverage by radio, television, and print media. In fiscal year 2002, the Lottery included $0.77 million of sponsorship expenses in advertising. But, the Lottery did not include its expenses for certain advertisements that it considers promotional in nature. Promotional advertisements may encourage awareness of how lottery proceeds are used or provide other public information. Among the past exclusions were any expenses for advertisements that appeared on the Lottery's Environmental Journal television or radio programs or on its Player Spotlight radio segments. Also excluded from 2002 advertising expenses was an advertising campaign that attempted to increase public awareness of how Lottery proceeds are used. The Lottery also excluded a media campaign that encouraged the public to play Powerball in moderation when the jackpot was high. Instead, these expenses were classified as promotions expenses in 2002. Even if a reasonable share of these expenses had been included as an advertising expense, the Lottery's advertising expenses would have been below the statutory limit.[2]

State law also places some restrictions on the content of Lottery advertising and promotional materials. The Lottery may present information on the Lottery, identify state programs supported by the Lottery, and present the Lottery as a form of entertainment. But the Lottery may not present a lottery game as a means of relieving financial difficulties or achieving financial security. In addition, the Lottery may not use its advertisements to specifically target with the intent to exploit a person, a specific group or economic class of people, or a religious holiday by using a religious theme or symbol.[3] The Lottery estimates that it could raise an additional $0.6 million for the state if the restriction on holiday games were removed.[4]

---

2 For fiscal year 2004, the Lottery has changed the format of the Player Spotlight and Environmental Journal radio spots and is including them in advertising. The Lottery has also decided to include the costs of purchasing television air time for its Environmental Journal television programs in the advertising budget.

3 See *Minn. Stat.* (2003), §349A.09, subd. 2 for other restrictions on advertising and promotional materials.

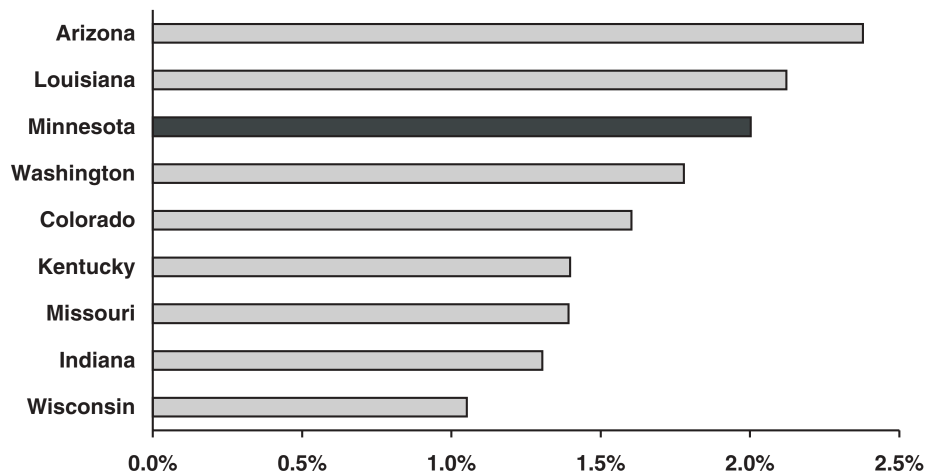
4 The Lottery has also estimated that it could return an additional $2 million for state programs if the cap on advertising were removed but the Lottery was still required to keep overall operating expenses within 15 percent of gross revenues. This estimate assumes an increase in advertising expenses of $0.8 million. It is unclear that the Lottery would need relief from the statutory cap on advertising expenses to increase spending on advertising by this amount. The Lottery's advertising expenses, as the Lottery defines them, have been sufficiently below the advertising cap to accommodate even a larger increase. But Lottery officials maintain that their advertising budget must be well below the estimated maximum, since advertising expenses are incurred before final sales are known.

Comparisons with Other States

During fiscal year 2002, the Minnesota State Lottery spent about 23 percent more on advertising as a percentage of sales than the average for comparison state lotteries.[5] The Lottery spent 2.0 percent of sales revenue on advertising, while the comparison state average was about 1.6 percent. Figure 3.1 shows that Minnesota spends more on advertising than six of the eight comparison states. Arizona and Louisiana spend a greater percentage of sales revenue on advertising than Minnesota. But:

- **Minnesota's higher spending on advertising can be explained in part by the higher costs that Minnesota faces for radio and television advertisements.**

Figure 3.1: Advertising Expenses as a Percentage of Sales, FY 2002



NOTE: Kentucky did not separate advertising and promotions expenses. We assumed all of its combined expenses were for advertising.

SOURCE: Office of the Legislative Auditor analysis of lottery financial statements.

Media costs are higher in Minnesota than the average for comparison states.

Data on rates charged by radio and television stations indicate that it may cost more to place advertisements with Minnesota media than with media in our comparison group states. Rates for Minnesota radio stations average about 13.7 percent higher than in the other states, while rates for Minnesota television stations are about 18.4 percent higher. Even if rates for other types of advertising were the same in Minnesota as the comparison state average, the higher rates for radio and television could explain up to one-half of the difference in advertising expenses. Close to two-thirds of the difference could be explained by the

5 We were unable to obtain a breakdown of Kentucky's combined advertising and promotions expenses. This calculation assumes that all of Kentucky's advertising and promotions expenses were for advertising. This appears to be a reasonable assumption, since the other comparison states spend close to 90 percent of their combined advertising and promotions expenses on advertising.

difference in media costs if the costs for other media are higher in Minnesota like radio and television costs.[6]

It is not clear what explains the rest of Minnesota's higher advertising expenses after higher media costs are considered. Except for Wisconsin, other states do not face significant statutory restrictions on advertising.[7] In most other states, however, the lottery budget is reviewed and approved by either the legislature or a lottery board or commission. Minnesota State Lottery officials believe that advertising is more essential in Minnesota than some of these other states, since the Lottery faces stiffer competition from other forms of gambling.

The reduced advertising budget for fiscal year 2004 means that advertising expenses are expected to decline to less than 1.9 percent of sales revenue. If that occurs, then advertising expenses would be about 15 percent higher than the comparison state average for 2002. In that case, differences in media costs could explain much of the difference in spending between Minnesota and the comparison group states.

Effectiveness of Advertising

Generally, advertising is thought to be an effective way to improve a product's sales and a company's profits. Many private sector firms selling products to the public use various advertising media to promote their products and improve sales. Lotteries also market products to the public and find that advertising is helpful in making customers aware of new lottery games and in improving or maintaining sales.

Advertising is generally considered an effective way of increasing sales and profits.

The Lottery provided us with information about other states and a Canadian province that had reduced advertising expenses. In addition, other state auditors or controllers have examined lottery advertising. These reports and analyses are not definitive in that they do not precisely measure the effect of advertising on sales and control for all other factors that could explain changes in sales. But:

- **The experience of other states suggests that reducing lottery advertising may lead to future reductions in sales and profits.**

The impact on sales and profits may not occur during the year in which reductions in advertising expenses are made. Instead, the effects may come in subsequent years as potential lottery customers lose interest in existing lottery games and are not informed about new lottery games.

The presumed impact of advertising on sales and profits may not be realized, however, if advertising does not capture the attention of potential lottery customers and increase their interest in purchasing lottery tickets. So, the value of

6 The comparison of radio and television rates is based on published rates. Frequently, advertisers such as the Minnesota Lottery are able to obtain discounts from those rates. We do not know whether the size of the typical discount in Minnesota varies from those in other states.

7 Wisconsin's lottery can only fund informational advertising. In addition, Arizona's lottery is required to limit advertising expenses to no more than four percent of sales.

lottery advertising depends on its effectiveness in stimulating sales. We found, however, that:

- **The Lottery has not measured the effectiveness of its advertising since 1997.**

Measuring effectiveness is not without cost or complications. It costs money to survey customers on their reaction to Lottery advertisements, and their reaction may not match their actual response in purchasing tickets. Alternatively, the effectiveness of advertising can be measured by limiting some advertising to certain markets and comparing changes in sales in those markets to changes in sales in markets with no advertising. This can be complicated because radio and television stations, particularly cable television stations, may reach viewers beyond the immediate metropolitan area in which they are broadcast.

But there are questions about the effectiveness of the Lottery's recent television advertising campaign.

Nevertheless, there are some reasons to be concerned about the effectiveness of the Lottery's recent advertising campaigns. In particular:

- **Lottery sales of scratch tickets have declined by one-fourth since 2000, and some concerns have been raised about the Lottery's television advertising campaign.**

Between 2000 and 2003, scratch ticket sales fell from $282 million to $211 million. While the recession and other factors have played a role in this decline, trends in scratch ticket sales were much worse in Minnesota than in any of our comparison states between 2000 and 2002. Scratch sales fell by 14 percent in Minnesota, while they rose in six of the comparison states and fell in two states. The average change in scratch ticket sales was a 5 percent increase for the eight comparison states.

We have also heard some concerns about the Lottery's television advertisements from Lottery staff. Most of the television advertisements, unlike radio advertisements, attempt to encourage the public to buy scratch tickets but do not identify any of the scratch games being sold. The advertisements are so generic that it is somewhat difficult for the viewer to understand what is being advertised.

As a result, we think there is reason for concern about the effectiveness of the Lottery's advertising efforts, particularly recent television advertising. While advertising typically increases sales, there is no guarantee that it will work. The Lottery needs to consider ways in which it can improve its scratch ticket sales. Changes in its advertising strategy, as well as more extensive research into customer demand, should be considered. The Lottery should also examine whether the effectiveness of advertising campaigns can be measured in a meaningful and cost-effective way.

RECOMMENDATIONS

The Minnesota State Lottery should rethink its advertising strategy, particularly for television. While humorous or entertaining ads are worth considering, the lottery should also consider increased mention of the environmental and other public benefits of lottery sales.

The Minnesota State Lottery should consider whether additional research on customer demand or advertising effectiveness would help the Lottery in improving its advertising strategy and its sales.

PROMOTIONS

Besides advertising, the Lottery also attempts to stimulate sales through a variety of promotional methods. In fiscal year 2002, the Lottery spent $4.7 million on promotions, or close to 1.3 percent of its sales revenues. Spending declined to $3.6 million in 2003 and, in response to the legislative cap on operating expenses, the Lottery significantly reduced spending on promotions. The Lottery's promotions budget for 2004 is less than $0.8 million, but this overstates the extent of the reductions since some spending previously categorized as promotion expenses has been shifted to advertising or prizes and others to a new category called brand/beneficiary awareness. Including the items shifted to other categories, promotions expenses in 2004 are estimated to be about $2.3 million.[8]

As Table 3.1 indicates, the Lottery's promotional efforts have included a variety of items. The Lottery has sponsored sports teams and events, fishing tournaments, and community events. The Lottery also pays for the production and distribution of a television show—the Environmental Journal—which, in part, promotes awareness of how Lottery proceeds are used to improve Minnesota's environment. Similarly, the Lottery has also paid for a two-minute radio program that has promoted awareness of Lottery beneficiaries. The Lottery's Player Spotlight series has been a two-minute radio segment that highlights Lottery winners from around the state. Other promotional expenses include free Lottery tickets, premium items or merchandise giveaways, and specialized consumer promotions. Promotion expenses also include the lease and other operating expenses for the Lottery's Environmental Experience vehicle. The vehicle is a traveling exhibit that is used to promote awareness of the Lottery's benefits to the environment.

The Lottery drastically cut the number of sponsorships for 2004 in response to legislative budget cuts. While Table 3.1 shows a significant decline, the decline has been even greater when sponsorship expenses included in advertising are counted. Overall, sponsorship expenses have declined from close to $2 million in both 2002 and 2003 to $0.4 million in 2004. The Lottery sponsored about 30 different organizations and events in recent years, but this number is expected to decline to about seven. The Lottery no longer sponsors the Minnesota Twins,

8 If the items shifted to the advertising budget remained in promotions, the advertising budget for 2004 would be about $6.7 million.

Due to budget cuts, the Lottery reduced its promotional expenses in half between fiscal years 2002 and 2004.

Table 3.1: Minnesota Lottery Promotions Expenses (in $1,000s) FY 2002-04

Type of Expense	FY 2002 (Actual)	Percent	FY 2003 (Actual)	Percent	FY 2004 (Budgeted)	Percent
Sponsorships[a]	$1,177	25%	$1,432	40%	$ 430	19%
Beneficiary Promotions[b]	1,189	25	87	2	50	2
Environmental Journal Television	1,011	21	1,167	32	1,194	52
Environmental Journal Radio[c]	138	3	138	4	138	6
Player Spotlight[d]	264	6	264	7	264	11
Premium Items[e]	506	11	221	6	0	0
Consumer Promotions	206	4	5	0	0	0
Promotional Tickets[e]	141	3	102	3	20	1
Airport Sales Subsidy	72	2	72	2	72	3
Environmental Experience Vehicle	9	0	98	3	80	3
Miscellaneous	34	1	36	1	54	2
Total	$4,748	100%	$3,625	100%	$2,302	100%

[a]These figures do not reflect the full cost of sponsorships. Some sponsorship expenses are included in advertising. Other expenses are included in expenses for premium items and promotional tickets.

[b]We subtracted purchases of air time for the Environmental Journal television program from this category and included them in expenses for the program. We included these expenses for each year although the Lottery's budget included them in advertising in 2004.

[c]For comparison purposes, we included these expenses in the promotions area. For FY 2004, the Lottery included some of these expenses in the advertising budget.

[d]For comparison purposes, we included these expenses in the promotions area. For FY 2004, the Lottery included all of these expenses in the advertising budget.

[e]The Lottery now includes premium items and promotional tickets in prizes. Prior to the end of fiscal year 2003, they were included in promotions expenses.

SOURCE: Office of the Legislative Auditor analysis of financial data from the Minnesota State Lottery.

the Minnesota Vikings, the Minnesota Wild, the Minnesota Timberwolves, the St. Paul Saints, University of Minnesota athletics, Minnesota State University-Mankato athletics, the Canterbury Park racetrack, the WE Fest, Como Zoo, and other organizations and events. The Lottery was planning to continue sponsorship of the Taste of Minnesota, the Minnesota Pro/Am Bass Tour, the National Sports Center, the Governor's fishing opener, and several other events. The Lottery also added a one-time event—the Mark Tipler Bass Tournament.

The Lottery is continuing its spending on the Environmental Journal television and radio programs and the Player Spotlight radio segments. Spending on these items is not expected to change significantly, although some of the spending will be in the Lottery's advertising budget in 2004. Both of the radio programs have been changed to one-minute programs that are designed to be more like advertisements. As a result, the Lottery intends to include all of the expenses of these radio spots in advertising during 2004. The expenses of the Environmental

Journal television program have also been shifted out of the promotions budget. The productions expenses will be in a new category called brand/beneficiary awareness, and the costs of air time will be included in advertising. A company named Media Rare produces these television and radio programs for the Lottery.

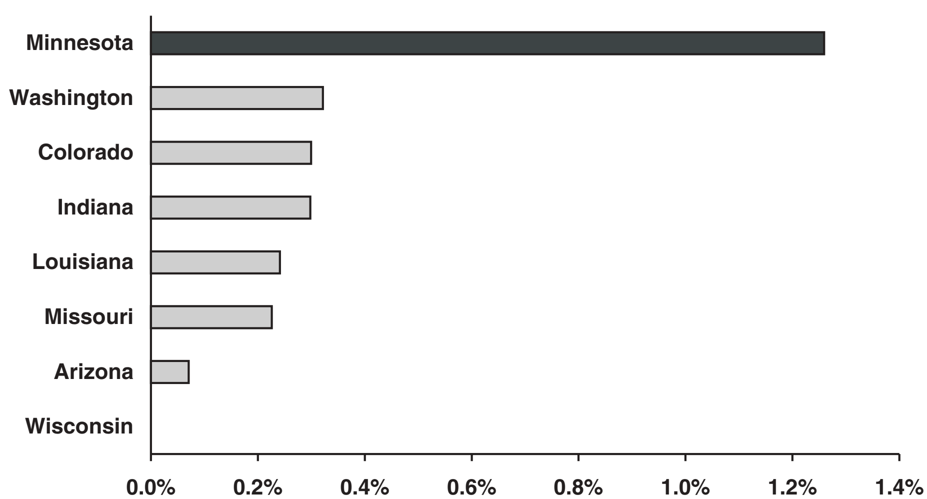
Several other areas of promotional expenses are declining between 2002 and 2004. Beneficiary promotion is declining significantly because 2002 expenses included some one-time expenses. About $0.84 million was spent on a television and newspaper campaign that promoted public awareness of how Lottery proceeds have been used. In addition, the Lottery spent $0.17 million on television commercials that cautioned the public to play Powerball in moderation since the Powerball jackpot was high at that time. This expense was classified as promotional rather than advertising. Ironically, it may have been as effective as an advertisement since it increased public awareness of the size of the Powerball jackpot. Significant declines in ticket giveaways, specialized consumer promotions, and the purchase of premium items are also occurring. The Lottery has an inventory of premium items—namely merchandise given away during promotional activities—that is expected to last through most of fiscal year 2004.

Comparisons with Other States

In fiscal year 2002, Minnesota's promotions expenses were about 1.3 percent of sales revenue, while the average for our comparison state lotteries was only about 0.2 percent. As Figure 3.2 shows, Minnesota's promotion expenses were greater than any of the comparison states as a percentage of sales. In fact:

In 2002, the Minnesota Lottery spent six times as much as similar lotteries on promotional expenses.

Figure 3.2: Promotions Expenses as a Percentage of Sales, FY 2002



NOTE: We excluded Kentucky from this comparison because it did not separate advertising and promotions expenses.

SOURCE: Office of the Legislative Auditor analysis of lottery financial statements.

- **Minnesota spent six times more than the average comparison state lottery on promotions expenses as a percentage of sales in fiscal year 2002.**

Due to its budget cuts, the Minnesota State Lottery expects to spend less than 0.6 percent of sales revenue on promotions in 2004. Even with this reduction, Minnesota's promotions expenses as a percentage of sales would still be 176 percent higher than the comparison state average was in 2002.[9]

We cannot say for certain how Minnesota compares with other states on particular types of promotion expenses. But, it is probably true that Minnesota spent more than other states for most types of promotion expenses. In addition, Minnesota's production and distribution of the Environmental Journal television show may be unique among other state lotteries.

Sponsorships

Sponsorships have been the largest type of promotional expense incurred by the Lottery. The costs of sponsorships exceed the amount of expenses identified as sponsorship fees in Table 3.1. Sponsorships often involve ticket and merchandise giveaways. In addition, staff time and other expenses may be incurred. As a result, in this section, we examine the Lottery's methods for evaluating the benefits and costs of sponsorships. In the following section, we focus particular attention on the Lottery's sponsorship of the Minnesota Pro/Am Bass Tour. The bass tour is one of the few sponsorships that the Lottery has chosen to continue in fiscal year 2004 even though the bass tour has questionable benefits for the Lottery.

Lottery Evaluations

Lottery staff prepare estimates of the benefits and costs of sponsorships.

Prior to approving a sponsorship, Lottery management requires promotions staff to prepare a proposal for management review. Staff assess a sponsorship's potential for improving Lottery sales by making favorable impressions on potential customers. They then submit a proposal for management review. The proposal includes estimates of the potential benefits and costs of the sponsorship. Lottery management uses the proposal to help decide whether to fund the sponsorship.

For each sponsorship that is funded, promotions staff annually evaluate the benefits and costs of the sponsorship. On the cost side, they include the following expenses: 1) sponsorship fees, 2) expenses for premium items (or merchandise), 3) ticket expenses, 4) staff overtime expenses, and 5) miscellaneous expenses. In estimating benefits, they include estimates of the following benefits: 1) sponsorship value to the Lottery, and 2) ticket sales at sponsored events. Estimates of sponsorship value include the value of signage at sponsored events or other locations, media attention or advertising that promotes the Lottery and is provided by the sponsored organization, and other contributions by the sponsored organization such as free event tickets or meals. Estimates of value attempt to indirectly get at the potential impact of the sponsorship on subsequent lottery

9 In making this comparison, we are including all those types of expenses that were included in Minnesota's promotions expenses in fiscal year 2002.

sales. By including lottery ticket sales at sponsored events, promotions staff attempt to measure the immediate impact of sponsored events on ticket sales.

For fiscal year 2002, promotions staff estimated an overall value to cost ratio of 2.47 for its sponsorships and other promotions run by the promotions unit. In other words, for each dollar spent on sponsorships, the Lottery received a benefit of about $2.47. Eight of the 42 sponsorships or promotions had estimated values below expenses. Four of the sponsorships with poor returns were continued in fiscal year 2003, and two—the Minnesota Pro/Am Bass Tour and the Governor's fishing opener—are among the few sponsorships that the Lottery continued to fund in fiscal year 2004. Table 3.2 provides a list of selected sponsorships and their estimated benefits and costs according to Lottery promotions staff.

For fiscal year 2003 sponsorships and promotions, Lottery promotions staff estimated an overall value of $2.82 for each $1.00 in cost. Seven of the 35 sponsorships or promotions had benefits less than their costs. The sponsorships with unsatisfactory returns included the four sponsorships that also had

Most Lottery sponsorships have higher estimated benefits than costs.

Table 3.2: Minnesota State Lottery Sponsorships, 2003

Organization or Event	Lottery Estimate of Expenses (in $1,000s)	Lottery Estimate of Benefits (in $1,000s)	Benefit/ Cost Ratio	Continuing Sponsorship in 2004
Monster Jam Events	$ 60	$1,300	21.75	No
WE Fest	102	1,143	11.23	No
WE Fest/K102	18	148	8.09	No
St. Louis County Fair	7	41	5.81	No
Bayfront Blues Festival	23	121	5.34	No
WE Fest/Sawyer Brown Bus Tour	31	127	4.12	No
Canterbury Park Racetrack	45	177	3.92	No
KFAN Outdoors and Motorsports	48	179	3.73	No
Star Tribune/State Fair	127	369	2.91	No
Fan Jam/K102	43	122	2.87	No
St. Paul Saints	53	145	2.73	No
Minnesota Wild	76	191	2.50	No
Mankato-MSU Athletics	15	29	1.90	No
Taste of Minnesota	202	377	1.86	Yes
WCHA Men's Final Five Hockey Tournament	10	15	1.43	No
National Sports Center	30	42	1.40	Yes
Minnesota Vikings	226	311	1.38	No
Women's Expo/Cub Foods	14	20	1.36	Yes
University of Minnesota Athletics	208	282	1.35	No
Minnesota Twins	273	341	1.25	No
Super Ice Rink	30	36	1.20	No
Minnesota Timberwolves	392	415	1.06	No
Minnesota Pro/Am Bass Tour	113	85	0.74	Yes
Governor's Fishing Opener	12	6	0.50	Yes
Como Zoo	16	6	0.39	No
Northland 300/Special Olympics	1	0	0.34	No
Minnesota Thunder/USA vs. Norway Soccer	10	3	0.33	No
National Wheelchair Shooting Federation Tourney	4	1	0.14	No
National Pheasant Fest and Convention	2	0	0.08	No

SOURCE: Promotions Unit of the Minnesota State Lottery.

unsatisfactory returns in 2002, as well as three new sponsorships. As a result, we conclude that:

- **The Lottery has continued a few sponsorships—including the Minnesota Pro/Am Bass Tour—despite Lottery staff estimates of unsatisfactory benefit-cost ratios.**

Concerns about Lottery Methods

We have a number of concerns, however, about the methods that Lottery staff have used to estimate benefits and costs of sponsorships. In particular, we think that:

- **Lottery staff understate sponsorship costs.**

But the Lottery overstates the benefits and understates the costs of some sponsorships.

Lottery staff generally use accurate figures for sponsorship fees, but their figures for other expenses understate the Lottery's costs. For example, estimates of staffing costs only include overtime costs and not the value of other staff time spent planning, implementing, evaluating, and working at sponsored events. The value of that time can be considerable and should not be ignored even though it is a fixed cost in the short term. Travel expenses include lodging costs but not vehicle expenses. The costs of ticket giveaways are not based on the face value of tickets but instead on the estimated costs of prizes. Costs should be adjusted upward slightly to include the estimated costs of printing or producing tickets. Merchandise costs should include all merchandise provided to sponsored organizations even if that merchandise is not part of the original proposal. We also noticed that staff estimates of various expenses often fail to consistently include all expenses that staff are supposed to include. For example, staff have not always included the overtime spent on certain promotions. Considerable overtime, as well as regular staff time, and lodging and meal expenses have been incurred at Minnesota Pro/Am Bass Tour events, but Lottery estimates of costs do not include any of these expenses.

In estimating benefits:

- **Lottery staff significantly overstate the value of lottery sales at sponsored events and do not seem to have a documented methodology for estimating the value of signage and media.**

Lottery staff include all sales revenue from tickets sold at sponsored events. This greatly overstates the value of the sales since prize expenses and ticket production costs accounted for about 55 percent of online sales and about 68 percent of scratch sales in fiscal year 2003.[10] It is also unclear that the sales at sponsored events should be considered a net addition to overall lottery sales. Some purchases at sponsored events may substitute for purchases at a retail location. Lottery staff have also included some sponsor provided items in benefits, even though they provide no potential benefits for lottery sales. For example, staff have included the value of a tent or booth provided to the Lottery at a sponsored event as a benefit. In our view, a tent provides no benefits for future lottery sales

10 In some instances, the Lottery may also have used a retailer to sell tickets and paid a commission to the retailer.

unless there is signage affixed to the tent; and Lottery staff already include the value of signage in benefits. In addition, we found it difficult to check how the Lottery establishes the value of signage and media provided as a result of sponsorship activities. Clearly, signage and media are of value, but the calculation of their value needs better documentation.[11]

Overall, the Lottery's methods for estimating the benefits and costs of sponsorship activities need to be revised. We think that several additional sponsorships that were funded in 2003 would have had unsatisfactory returns if benefits and costs were properly estimated. One of those sponsorships was funded in 2004. In addition, better information would be useful to the Lottery in the future if funding is available to reinstate some sponsorships.

RECOMMENDATIONS

The Minnesota State Lottery, with assistance from its research director and its chief accounting officer, should develop a more accurate method of estimating the value and measuring the costs of lottery sponsorships.

The Minnesota State Lottery should have detailed documentation on how it estimates the value of sponsorship benefits such as signage, dasher boards, and media mentions.

Minnesota Pro/Am Bass Tour

The Lottery has a long history of sponsoring bass tournaments.

In this section, we examine the Lottery's sponsorship of the Minnesota Pro/Am Bass Tour (MNPABT). As mentioned above, the Lottery is continuing its sponsorship of the bass tour even though it is eliminating most sponsorships due to agency budget cuts.

History

The Lottery has a long history of sponsoring bass tournaments. Prior to the summer of 2000, the Lottery sponsored the Silverado Bass Tour. Following the end of the 1999 season, the Lottery and other sponsors wanted to improve the tour.[12] They arranged for Media Rare, a public relations and events management firm that already performed extensive services for the Lottery, to take over ownership of and marketing for the tour. In return, they offered the owners and operators of the Silverado Bass Tour a contract to run the fishing portion of the new tour called the Minnesota Pro/Am Bass Tour. Those individuals agreed to the arrangement since they were being offered more money to operate the new tour than they made from the Silverado Bass Tour.

After the end of the 2000 fishing season and before paying the remaining portion of the contract for 2000, Media Rare terminated the contract of the tournament

---

11 Lottery officials say they use standard industry methods for estimating the value of signage and media. But, evaluations of sponsorships do not include sufficient information to determine how Lottery staff arrive at their estimates.

12 The fishing season generally involves five to six tournaments between May and September of each year.

directors (and owners of the Silverado Bass Tour). The tournament directors sued Media Rare and the Lottery, but the Lottery was released from the lawsuit since it was not the owner of the tour. Ultimately, Media Rare settled the lawsuit by paying the tournament directors their remaining payment. The Lottery paid the Attorney General for legal services but was not responsible for paying the settlement.

The Lottery began to sponsor the Minnesota Pro/Am Bass Tour in 2000.

During the 2000 fishing season and subsequent seasons, the Lottery has sponsored the MNPABT. The Lottery has provided significant financial and operational assistance to Media Rare, which owns the tour. In addition, several Lottery employees have fished in events run by the tour, including the former Lottery director, the promotions manager, and an information systems specialist.[13] These three staff, plus up to five additional Lottery employees, have traveled to bass tour events at Lottery expense to assist Media Rare in running the events. Since 2002, the Lottery has also brought its Environmental Experience vehicle to all tour events except one. The Lottery pays a driver to take the vehicle to and from tour events.

Rationale

MNBAPT events are not heavily attended like Twins or Vikings games that the Lottery has sponsored in the past. Estimates of the attendance at bass tour events vary. It appears that about 200 to 600 people may attend an event. Most of these people are either tour contestants or friends or family of the contestants.

Lottery officials feel that the primary value of the MNPABT to the Lottery comes through the media attention the Lottery receives through its sponsorship. Previous evaluations of the MNPABT sponsorship did not indicate that the media or other benefits exceeded the costs of the sponsorship. But, in December 2003, the director of the Lottery told us that the Lottery was continuing to sponsor the Minnesota Pro/Am Bass Tour because he felt the tour provides a 4:1 return to the Lottery on its investment. The former director said that the benefits of the MNPABT exceeded $400,000 while the costs were about $100,000. He provided us with a handwritten sheet of paper that listed the benefits of the tour along with a rough estimate of their value to the Lottery. He also provided us with independent research that suggests that people who fish are somewhat more likely to buy lottery tickets than the general public. The former director said that this relationship is one of the reasons that the Lottery has been involved with the bass tour. He felt that the bass tour was a way of targeting promotional efforts to those more likely to purchase lottery tickets.

As with other sponsorships, there is no way of knowing for certain whether the Lottery's sponsorship of the MNPABT is stimulating lottery ticket sales. As a result, we examined the former director's estimates of the benefits of the sponsorship. In addition, we scrutinized the Lottery's expenses and estimated the costs of the Lottery's sponsorship of the bass tour. Finally, we examined several additional issues including the Lottery's relationship with the owner of the

---

13 In recent years, only the former director and the information systems specialist have fished in tour events. According to Media Rare and the former director, Lottery employees personally paid their entry fees for Minnesota Pro/Am Bass Tour events.

MNPABT, the Lottery's involvement in running the tour, and potential conflicts of interest for Lottery officials.

Benefits

Lottery officials have overstated the benefits of sponsoring the Minnesota Pro/Am Bass Tour.

In his handwritten estimate, the former director of the Lottery cited four main benefits for the Lottery and a number of other benefits of small or undeterminable value. According to the director, the Lottery receives about $195,000 in advertising discounts from the Star Tribune because both the Lottery and the Star Tribune are sponsors of the MNPABT. In addition, the former director estimated that an insert on the MNPABT that included a Lottery advertisement appeared in six newspapers and Outdoor Weekly and was worth $30,000 in publicity for the Lottery. The former director also estimated that the Lottery received about $120,000 worth of publicity in newsprint coverage of the tour and $60,000 worth of publicity from other media such as KFAN radio.

But the former director did not provide us with any documentation of how he estimated the value of these various items. In addition, we do not believe that advertising discounts provided by the Star Tribune can be solely attributed to the Lottery's involvement with the bass tour. These discounts could simply be negotiated discounts from published rates that are normally received by customers that do a certain volume of business with the newspaper. The discount might also be attainable through other sponsorships that provide the Lottery with a better return. The Lottery receives some media attention on KFAN and elsewhere across the state due to the free tickets it gives to radio stations and other media outlets. But, the Lottery could do this in connection with other sponsorships or on its own without a sponsorship being involved. In our view:

- **The Lottery's sponsorship of the Minnesota Pro/Am Bass Tour has questionable value for lottery sales.**

The continuation of the MNPABT sponsorship and elimination of many other sponsorships does not make sense to us. Other sporting activities are capable of reaching more potential lottery customers than the bass tour. Furthermore, among those who fish, the Minnesota Pro/Am Bass Tour is a fairly low profile event. National bass or walleye tours are of much greater interest, and there are many rivals for the MNPABT among fishing tournaments in Minnesota.

Costs

The former director's estimate of a 4:1 return to the Lottery from the MNPABT sponsorship is based on an estimated cost of about $100,000. This figure is close to the $113,000 cost estimated by the Lottery's promotions staff for the 2003 season. But:

- **Lottery officials have greatly understated the costs of their involvement with the Minnesota Pro/Am Bass Tour. We estimate the costs for the recent 2003 season to be at least $400,000, not including the considerable staff resources involved in planning, participating in, and helping to operate the tour.**

The annual costs of sponsoring the bass tour were about $400,000 plus significant amounts of staff time.

The Lottery's sponsorship expenses for the 2003 season were $102,300. In addition, the Lottery pays for the production and distribution of the Environmental Journal television program and devotes five to six programs per year to the MNPABT. We estimate that the Lottery's costs for the television shows devoted to the bass tour were about $190,000 in fiscal year 2003. In addition, at least one-fourth of the Lottery's use of the Environmental Experience vehicle during 2002 and 2003 was for the bass tour. We estimate that the cost of the vehicle's use for the tour is about $75,000 per year, based on the costs of leasing and operating the vehicle and a pro-rated share of the depreciation expenses for the vehicle.

The Lottery also gave away $7,300 worth of tickets in fiscal year 2003; about $20,000 worth of free tickets were given away in 2002. Most of these tickets appear to have gone for media promotions, but the Lottery's accounting for the tickets is incomplete. It appears some of the tickets went to fishing contestants.[14] The Lottery also paid $13,200 in fiscal year 2002 and $28,000 in 2003 for lodging, meals, and other travel expenses for Lottery employees who went to the tour events. We found that the Lottery paid $187 per night per employee for accommodations at one event.

Finally, we found that, during the 2002 season, the Lottery provided tour participants and others with merchandise that cost $7,500 but was valued at more than $21,000. In 2003, the Lottery provided merchandise costing $3,500 and valued at about $6,300. In addition, the Lottery provided 25 NASCAR jackets that it had received free from Ford as a result of the Lottery's contract for a Ford truck scratch ticket. The 2003 merchandise also included 36 Kevin Garnett bobble head figures remaining from a previous promotion with the Minnesota Timberwolves. In 1999, the Lottery gave away two Caribbean cruises to bass tour anglers. These trips, which cost the Lottery more than $6,500 were purchased as prizes for a scratch ticket game. The Lottery gave away a handful of these cruises at sponsored events such as the bass tour. Most were awarded to scratch ticket prize winners, retailers via a sales contest, and members of the public through radio promotions.

Our estimates do not include the staff time spent on the MNPABT or the expenses for Lottery vehicles—other than the Environmental Experience vehicle—that are taken to tour events. The Lottery expends considerable staff resources in planning, traveling to and from events, setting up before and tearing down after the tour events, assisting with tournament day activities, providing computer support, and working with existing sponsors and meeting with potential new sponsors. The Lottery's timekeeping system does not allow us to estimate the personnel expenses involved with the tour sponsorship. The system does not require Lottery employees to provide any details on the projects on which they are working.

The Lottery has sent up to eight staff and a driver to bass tour events.

We know that most of the eight employees who attend the events are being paid by the Lottery on the days they are at tour events and some are paid to travel to the events. In addition, there is considerable time involved planning for and getting ready for tour events and some time spent between bass tour seasons in

14 The face value of the free tickets was about $31,000 in 2002 and $11,200 in 2003.

meeting with potential and existing sponsors. But it is difficult to accurately estimate the staff costs for the MNPABT sponsorship. We think, however, these costs could be conservatively estimated at $50,000. We know that the overtime costs alone in fiscal year 2003 were $10,400, and these costs only include overtime pay on the days of the events for those employees eligible to receive overtime pay. The amount of overtime pay may be greater since it was calculated only for the days that employees were at tour events. The amount of work claimed by some employees during tour events is significant, and we found an instance where one employee claimed 19 hours of work in one day.

In our view:

- **The costs of sponsoring the Minnesota Pro/Am Bass Tour appear to be considerably larger than the benefits to the Lottery.**

Additional Issues

We think that there are several other significant issues that can be raised about the Lottery's involvement with the Minnesota Pro/Am Bass Tour. First, the Lottery's considerable use of staff resources for the bass tour is highly unusual. The Lottery does not commit this amount of staff resources for any other sponsorship. In addition, it is unusual that Lottery employees would participate—as the former director and another employee did—in sponsored events. We think that:

The owner of the bass tour also receives significant payments for other promotional work done for the Lottery by his firm (Media Rare).

- **The Lottery's commitment of significant financial and staff resources raises the question of whether the Lottery's sponsorship of the bass tour is based on sound business practice.**

Second:

- **The Lottery's extensive payments to the owner of the Minnesota Pro/Am Bass Tour for other work raise questions about the Lottery's relationship with that firm.**

The Lottery has spent considerable financial and staff resources on the Minnesota Pro/Am Bass Tour, which is owned by Media Rare. At the same time, the Lottery has paid significant additional money to Media Rare for its work on the Environmental Journal television program, the Environmental Journal radio program, and the Player Spotlight. In addition, Media Rare leases the Environmental Experience trailer to the Lottery and was paid to make considerable improvements to the vehicle. Later in this chapter, we will discuss each of these expenses. In each case, we found that the Lottery has never taken competitive bids on any of the work done by Media Rare for the Lottery. There are also significant issues about whether the Lottery obtains sufficient value from these expenses. We think that the Lottery's involvement with Media Rare on these projects and the MNPABT also raises significant questions.

Third, we think that:

- **The Lottery's involvement with potential and existing sponsors of the Minnesota Pro/Am Bass Tour raises questions about whether the Lottery is negotiating the best deals for the state.**

The Lottery has solicited contributions for the bass tour from companies with which it was negotiating scratch ticket contracts.

The Lottery helps to recruit new sponsors for the MNPABT and works with existing sponsors. Some networking activity can be beneficial for the Lottery and the state. But, the Lottery has also worked with these companies on lottery business as well. For example, the Lottery met with representatives of the Ford Motor Company and Ford dealers to negotiate terms of the Lottery's purchase of Ford trucks and the marketing of its "Trucks 'N' Bucks" scratch game. At the same meeting, the Lottery discussed possible sponsorship by Ford of the MNPABT. In addition, Lottery officials solicited a contribution from Hormel for the bass tour at the same time the Lottery was negotiating a promotional agreement with Hormel. The agreement was associated with the introduction of a scratch game named after one of Hormel's best-known products. The bass tour received $50,000 from Hormel. These practices may constitute a conflict of interest and raise questions about whether the Lottery is negotiating in the state's best interest or in the interest of the MNPABT.

In addition, we have some questions about the Lottery's negotiations with television stations. The Lottery pays commercial television stations to air the Environmental Journal, including five to six shows per year that focus exclusively on the bass tour. But, Media Rare is able to get Fox Sports Network, Channel 45, and Channel 5 to air reedited versions of the bass tour shows for no charge. Media Rare claims that the free television air time is given to the bass tour shows because they require no expense by the television stations and because Fox Sports Network is a sponsor of the bass tour. However, the Environmental Journal television program is also available to stations without any station expense required. The free air time for the bass tour shows could be the result of the stations' willingness to air the shows given the Lottery's payments for advertisements or the Environmental Journal's air time.

Finally, we have questions about the Lottery's sponsorship of certain supplemental aspects of the bass tour. In each of the last two years (2002 and 2003), the Lottery provided $27,500 to the MNPABT for its fishing seminars, bump tank system, and live release pontoon. These payments were in addition to the Lottery's basic sponsorship agreement with the bass tour. According to this supplemental agreement, the Lottery was supposed to receive certain promotional benefits. We found, however, that:

- **The Lottery did not receive a number of the promotional benefits it was supposed to receive from sponsoring the Minnesota Pro/Am Bass Tour's fishing seminars, bump tank system, and live release pontoon.**

In particular, during the 2002 season, the Lottery did not receive a one-quarter page advertisement, full-wrap signage, and a billboard during commercial airings of the bass tour show. During the 2003 season, the Lottery did not receive full-wrap signage during one of the tour events.

RECOMMENDATIONS

The Minnesota State Lottery should discontinue its sponsorship of the Minnesota Pro/Am Bass Tour.

If the Minnesota State Lottery continues its sponsorship of the Minnesota Pro/Am Bass Tour, it should discontinue providing operational support for the tour using lottery resources and staff time. The lottery should substantially reduce the number of employees it sends to tour events and discontinue paying for the salary, travel, lodging, and meal expenses of any employee fishing in tour events.

The Lottery should also discontinue the practice of providing free lottery tickets to bass tour participants and substantially reduce the amount of merchandise provided to tour participants.

The Lottery should also insist that it receive all of the sponsorship benefits that are detailed in its contract with the bass tour.

The Minnesota State Lottery should cease negotiating with any parties on behalf of the Minnesota Pro/Am Bass Tour.

Environmental Journal Television Program

The Minnesota State Lottery pays for the production and distribution of a weekly 30-minute television show called the Environmental Journal. The show began in 1995 and was initially distributed to local access cable television channels. Currently, the show is aired on weekend mornings on four commercial channels including KSTC (Channel 45) in the Twin Cities area, KTTC (NBC affiliated Channel 10) in Rochester, WDIO (ABC affiliated Channel 10) in Duluth, and Fox Sports Network, a cable television channel.[15] In addition, the show is distributed to about 70 local access cable television channels throughout the state. The frequency of airings on these channels varies significantly.

Costs

The Lottery pays Media Rare about $1.2 million per year to produce and air a weekly television program.

The Lottery indirectly pays Media Rare for the production of 52 shows per year. The Lottery requires its advertising agency—currently the Foley Group—to subcontract with Media Rare for the production of the shows. Foley Group bills the Lottery at an agreed rate, plus certain additional costs, and passes the Lottery's payment to Media Rare. The Foley Group does not receive a commission on the payments to Media Rare. In fiscal year 2003, the Lottery paid about $941,000 for the production of the 52 shows. Media Rare also received about $42,000 in additional payments for closed captioning and travel expenses. The Lottery spends an additional $190,000 per year to purchase air time for the program on the four commercial stations. Overall:

15 Currently, the Environmental Journal is aired at 11:00 am on Saturday mornings on KSTC, at 6:30 am on Saturday mornings on KTTC, at 9:00 am Sunday mornings on WDIO, and at 8:00 am Sunday mornings on Fox Sports Network.

- **The Lottery spent about $1.2 million in fiscal year 2003 to produce and distribute the weekly Environmental Journal television programs.**

Table 3.3 provides a detailed breakdown of the Lottery's expenses for the television program over the last three years. Expenses for the program were a little lower in 2002 partly because the Lottery did not begin airing the program on commercial television until several months after the beginning of fiscal year 2002.

Table 3.3: Minnesota Lottery Expenses for the Environmental Journal Television Program (in $1,000s), FY 2002-04

Type of Expense	FY 2002 (Actual)	FY 2003 (Actual)	FY 2004 (Budgeted)[c]
Regular Monthly Payments	$ 795	$ 878	$ 901
Additional Summer Payments	21	63	42
Upgrading to Commercial Standards[a]	45	0	0
Closed Captioning	26	33	17
Travel Expenses	8	9	2
Increase Contingent on Director's Approval	0	0	40
Subtotal: Payments to Media Rare	$ 895	$ 983	$1,002
Purchases of Television Air Time[b]	$ 116	$ 183	$ 192
Total	$1,011	$1,167	$1,194

[a]This was a one-time payment for the purpose of upgrading the production of the show for commercial television.

[b]The show began to be aired on commercial television after the beginning of fiscal year 2002. Payments for 2002 reflect less than a full year of purchases. Beginning in 2004, payments for television time are in the Lottery's advertising budget rather than the promotions budget.

[c]The Lottery's budget for 2004 includes only $870,000 for payments to Media Rare. Our estimate is based on current written agreements.

SOURCE: Office of the Legislative Auditor analysis of financial data from the Minnesota State Lottery.

Content

The purpose of the television program is to improve sales by promoting awareness of how Lottery proceeds benefit the environment.

The Lottery's main purpose in funding the program is to improve public awareness of how Lottery proceeds benefit the state's environment. The Lottery hopes that, through increased awareness and a more favorable view of the Lottery, the public will purchase more lottery tickets. The shows, however, do not focus exclusively on how Lottery proceeds are used. The Lottery-related content of each 30-minute show is generally limited to between one and a half to five minutes. In addition, there is a brief mention at the beginning and end of the show that the show is sponsored by the Lottery. The Lottery-related content includes about one and a half to two minutes of Lottery commercials. Typically, one of these commercials—which is generally 30 seconds in length—promotes the Lottery's image as a benefactor of the environment. On commercial stations, the remaining commercials are typical of the Lottery's standard commercials. These advertisements have in the last year attempted to sell the public on the ideas that "just one scratch game could make your day" and "what you do with it is up to you." On public access channels, the remaining commercials are promotional and mention how Lottery proceeds are used to benefit the environment. In addition, a show may include a three-minute story about an environmental project that Lottery proceeds have funded.

Besides the Lottery-related content, the majority of each show consists of three to five features on a variety of subjects. The topics may be environment-related, such as prairie restoration, inventories of birds in state parks, and recycling. But, more often, the features include other subjects such as harvest-time activities at a commercial apple orchard, a man who makes music using ordinary household objects, and a new treasure-hunting pastime called geo-caching.

Five or six shows per year—depending on the number of annual events—are exclusively about the Minnesota Pro/Am Bass Tour, which is owned by Media Rare and sponsored by the Lottery. These shows have virtually little or no Lottery-related content. For example, the October 4-5, 2003 commercial airings of the Environmental Journal focused entirely on the Bass Tour's Tournament of Champions. The show briefly mentioned that the Bass Tour is sponsored by the Lottery but also mentioned many other sponsors as well. No lottery commercials were included in the program.

Lack of Competitive Bids

The Lottery spends nearly $1 million on the production of the Environmental Journal television program. But, we found that:

- **The Lottery has never sought competitive proposals on the production of the Environmental Journal television program and has not followed state laws in procuring services for the production of the shows.**

The Lottery has not solicited competitive bids for the production of the television program.

The Lottery began a relationship with Media Rare when the firm began producing the Environmental Journal radio programs for the Lottery in the early 1990s. But the Lottery never sought competitive proposals for the production of either the radio or television shows, even though sound business practice, as well as state laws and rules, would suggest that competitive proposals on price and quality of services should have been solicited.

Instead of a contract between the Lottery and Media Rare, the Lottery has required its advertising agency to write letters of agreement between the agency and Media Rare. These letters of agreement are short and do not provide much detail regarding the work product or provide the necessary protections for the state provided by standard state contracts. Prior to December 1, 2001, the letter of agreement did not even mention the number or length of shows to be produced. The Lottery has occasionally solicited competitive proposals from prospective advertising agencies on advertising work but has required all prospective advertising firms to subcontract with Media Rare. The Lottery has not solicited proposals from prospective firms on the work done by Media Rare.

Later in this chapter, we discuss the Lottery's procurement practices. We also discuss why the lack of an open and competitive bidding process violates state laws.

The Lottery has paid about $76,000 in unauthorized compensation for the production of the television program.

We also found that:

- **Media Rare received $76,000 in unauthorized compensation from the Lottery for the production of the Environmental Journal television program during fiscal years 2002 through 2004.**

Lottery officials told us that this was an inadvertent error. Prior to fiscal year 2002, the letter of agreement between the Lottery's advertising agency and Media Rare allowed payments for closed captioning expenses. These payments were in addition to the standard monthly payments made by the Lottery for the production of the program. But Lottery officials say that the language authorizing the payment of these additional closed captioning expenses was inadvertently left out of the letter of agreement that covered payments beginning in fiscal year 2002.

Nevertheless, these overpayments should be recovered by the Lottery from Media Rare since they were not part of the letter of agreement. Furthermore, we think that the overpayments reflect the inherent problems with the Lottery's procurement practices for Media Rare services. The Lottery does not have an adequate contract directly with Media Rare and permits its advertising firm and Media Rare to write letters of agreements. These letters of agreements are the only legal documents covering important issues such as how much the Lottery's payments to Media Rare and the scope of the required work.

Cost Issues

In addition, we found that:

The costs of producing the television program increased by two-thirds in recent years.

- **The amount of money paid to Media Rare for the production of the Environmental Journal television show increased 68 percent between fiscal years 2000 and 2003.**

In fiscal year 2000, payments for the production of the Environmental Journal television program were about $560,000 not including miscellaneous expenses.[16] These payments increased to $660,000 in 2001, $861,000 in 2002, and $941,000 in 2003. Based on the current letter of agreement, we estimate the expenses to be 943,000 in 2004.[17]

Lottery officials say these cost increases are justified mainly due to improvements in the show's quality and content that were needed when it began airing on commercial television stations. The Lottery provided some information to us about the increased costs that Media Rare incurred as a result of that decision. Our concern is that the Lottery has never solicited open and competitive bids on the production work and yet has significantly increased the payments. In our view, the Lottery should have sought competitive bids prior to airing the show on commercial television stations. Then, it would have been clear how much the Lottery should be paying for production of the show.

16 In examining the increase in production expenses, we did not include payments for various expenses such as closed captioning, travel, and talent fees.

17 The estimate for 2004 does not include a $40,000 increase that the letter of agreement permits the director of the Lottery to approve, since the director has not yet approved that increase. Beginning in December 2003, Media Rare was no longer permitted to bill for travel and closed captioning expenses.

Six of the 52 weekly shows are devoted to the bass tour.

A second issue involves the use of the show for the Bass Tour. The Lottery never accounts for the costs of the television show when it estimates the costs of its sponsorship of the Bass Tour. In 2003, we estimate that the production and distribution expenses were about $21,750 per show, or about $130,500 for the six Bass Tour shows. We suspect that a significant portion of the payments for travel expenses may also be related to the Bass Tour. In addition, part of the $941,000 that Media Rare received from the Lottery through the Foley Group appears to be related to the Bass Tour. That amount included a $63,000 expense, which was for the production of on-site shows during the period between May and September of each year. This coincides with the airing of Bass Tour events and should probably be considered a tour-related expense. Since a portion of the $63,000 is already included in the estimate of $130,500, it cannot be directly added to that amount. Overall, we estimate that:

- **About $190,000 of the money spent by the Lottery in 2003 to produce and distribute the Environmental Journal television program was for the airings of the Minnesota Pro/Am Bass Tour.**

A final concern centers on the travel and miscellaneous expense reimbursements that the Lottery has paid Media Rare up until December 2003. While these expenses are small compared with the overall cost of the program, we think that reimbursement has not been a good practice. Reimbursement does not encourage Media Rare to economize on its lodging or meal expenses. Instead, the Lottery needs a better contract with the producer of the show that excludes reimbursement but spells out the Lottery's expectations for the program including the amount of production work outside the Twin Cities. As mentioned above, the latest letter of agreement does not include travel reimbursement but also provides hardly any details on the Lottery's expectations for the product.

Value for Lottery Sales

The production and distribution of a television program is a unique and significant promotional expense for a state lottery. The Lottery believes the program has significant benefits, but we found that:

- **The Lottery has not evaluated the Environmental Journal television program or attempted to compare its benefits with the costs.**

The only information the Lottery was able to provide was a one-page sheet from Media Rare that estimated the benefits and costs of the television program, as well as the benefits and costs of the Environmental Journal radio program. We found, however, that Media Rare failed to include all of the Lottery's costs and provided benefit estimates that were excessive and outdated. Media Rare did not include the Lottery's expenses for purchased air time in its estimate of costs. On the benefit side, Media Rare estimated $190,000 in benefits from the commercial airings based on the cost of purchased air time and $1,352,000 in benefits from airings on local access cable television stations. It estimated that these stations air each weekly show about four times during a week and estimated each airing by a station to be worth $100 of value to the Lottery.

Media Rare was unable to provide any evidence to support its estimate of $100 in value for each showing. In addition, Media Rare had not updated the list of stations to include only those currently airing the show. Media Rare did not have any documentation for its assumption that local access channels air the show about four times per week on average and lacked current information on how frequently channels now air the show. As a result of our inquiries, Media Rare is now compiling information on the frequency of airings from stations currently receiving the program. In our view:

- **Media Rare's estimate of the benefits of the Environmental Journal television program is questionable and needs further scrutiny.**

The value of the television program for Lottery sales needs to be examined.

The estimate of $100 in value for airings on local access stations seems high. It is also questionable whether each airing is worth the same value. Some of the multiple airings occur at odd hours including late night and very early in the morning. It is doubtful that these airings have many viewers. The benefit estimates for commercial television airings also need revision. Media Rare includes the full cost of 30 minutes of purchased air time. But the Lottery is only mentioned during a fraction of those minutes. Including all 30 minutes of air time in benefits is questionable.

RECOMMENDATIONS

The Minnesota State Lottery should consider whether the benefits of the Environmental Journal television program are sufficient to justify its continuation.

If the Lottery decides to continue the program, it should provide the Legislature with detailed estimates of the value of the Environmental Journal television program. The Lottery should provide accurate information on the stations airing these items and the annual number of program airings, as well as a detailed methodology of how the value of each airing was estimated. Particular attention should be paid to estimating the value of airings of the Environmental Journal on public access channels on cable television.

The Minnesota State Lottery should recover the $76,000 in past unauthorized charges for closed captioning on the Environmental Journal television program from Media Rare.

Radio Programs

As mentioned previously, the Lottery also has two radio programs that are produced by Media Rare—the Environmental Journal radio program and the Player Spotlight. In the past, both of these programs have been two-minute radio segments. Beginning in fiscal year 2004, the Lottery has shortened them to one-minute segments in response to feedback from radio stations and is changing their content to include more commercial advertisements about particular lottery games.

Prior to this change, the Environmental Journal radio programs included a one and a half minute story. The messages before and after the story mentioned the Lottery and its contributions to the environment. A few of the stories were about environmental projects funded by the Lottery, while some of the other stories were about other environmental projects or issues. The remaining stories were on topics of general interest such as a reindeer farm, winter camping, a Nordic ski center in Duluth, the ski patrol, cross country skiing, and a motorcycle accident victim who now skis. The new program has a shorter story and the closing message is a commercial for Lottery scratch games. The structure of the Player Spotlight segments was similar except the stories were about lottery players who either have won particular prizes or otherwise enjoy purchasing lottery tickets.

We have similar concerns with Lottery radio programs produced by Media Rare.

Lack of Competitive Bids

Some of our concerns about the radio programs parallel those about the Lottery's television program. In particular:

- **The Lottery has never solicited competitive bids for the production of its Player Spotlight and Environmental Journal radio programs.**

Again, the lack of competitive bidding involves the Lottery's payments for services provided by Media Rare. As with the television program, the Lottery does not contract directly with Media Rare for its services. Instead, the Lottery pays its advertising firm and that firm passes along the Lottery's payments to Media Rare. The Lottery requires the advertising firm to subcontract with Media Rare for these radio programs; and the arrangement is governed by letters of agreement between the advertising firm and Media Rare. The letters of agreement, however, provide few details on what products Media Rare is expected to deliver.

Cost Issues

The Lottery's expenses for the Player Spotlight segments have also increased significantly in the past. The expenses grew 73 percent from about $152,500 in fiscal year 1998 to $264,100 in fiscal year 2001 but have remained at $264,100 since then. The expenses for the Environmental Journal radio program have been stable for years at $138,500 per year since at least 1999. But:

- **Despite the reduction in the length of the Player Spotlight and Environmental Journal radio programs, the Lottery did not reduce Media Rare's compensation when it recently extended these arrangements.**

Value for Lottery Sales

As with the Lottery's television program:

- **The Lottery has not assessed the benefits of the Player Spotlight and Environmental Journal radio programs and compared them with the Lottery's costs.**

The only information the Lottery was able to provide us was from Media Rare on the Environmental Journal radio program. According to Media Rare, the benefits of the program were about $972,000 compared with costs of $138,000. But, Media Rare was unable to show us exactly how the estimate of benefits was calculated. In addition, Media Rare agreed its estimate of the value of two minutes of air time was too high and subsequently reduced its overall estimate of benefits. Media Rare had originally valued two minutes of air time at an average of $115. The estimate was also based on a list of stations airing the program that was outdated. Some popular stations in the Twin Cities and elsewhere no longer air the program. In addition, it appeared that Media Rare was basing its estimate on a rough average of Twin Cities area stations and outstate stations, even though the program is primarily aired on outstate stations. In addition, Media Rare appeared to basing its estimate on published rates that do not reflect customary discounts available to advertisers. Given the recent changes in the length of the program and the stations airing the program, there is a need for the Lottery to estimate the value of the program.

The value of the Player Spotlight and Environmental Journal radio programs also needs to be reexamined.

We think that the value of the Player Spotlight segments also needs to be reviewed. Neither the Lottery nor Media Rare made estimates of the value of the previous version of the program. The Lottery's advertising firm, however, estimated the value of the Player Spotlight programs, and the estimated value was less than the program's cost. The program has since decreased in length and now airs on some different radio stations. The Lottery needs to examine the program's benefits and compare them with its costs.

RECOMMENDATION

The Minnesota State Lottery should consider whether the benefits of the Environmental Journal radio program and the Player Spotlight series are sufficient to justify their continuation.

If the Lottery decides to continue the programs, it should provide the Legislature with estimates of the value of the Environmental Journal radio program and the Player Spotlight series. The lottery should provide accurate information on the stations airing these items and the annual number of program airings, as well as a detailed methodology of how the value of each airing was estimated.

Environmental Experience Vehicle

Another promotional activity of the Lottery is its use of a traveling exhibit vehicle called the Environmental Experience. The vehicle, through videos and interactive kiosks, provides information to the public on the Lottery's contributions to environmental projects in Minnesota. According to Lottery officials, research suggests that increased public awareness of the Lottery's contributions to environmental improvements will lead to increased lottery sales and thus increased returns to the state.

Most of the expenses for the vehicle are not included in the Lottery's promotional budget. Only the vehicle's lease and other operating expenses are promotional

The purpose of the Environmental Experience vehicle is to promote awareness of the Lottery's contributions for environmental improvements.

The Lottery has committed about $1 million to lease and improve a vehicle that serves as a traveling exhibit.

expenses. The costs of improving the tractor/trailer that is leased by the Lottery are considered capital costs and will be included in the Lottery's depreciation expenses over a five-year period. We discuss depreciation expenses in greater detail in Chapter 4. But we have included a discussion of the Environmental Experience vehicle in this chapter, since the vehicle's purpose is to promote public awareness of the benefits of the Lottery and stimulate sales.

Background

On January 31, 2002, the Lottery entered into an agreement with Media Rare to lease a tractor/trailer for five years for $4,000 per month, or a total of $240,000. In that lease agreement, the Lottery agreed to pay an additional $200,000 to cover Media Rare's costs to make necessary improvements to the tractor/trailer. On February 8, 2002, the Lottery signed a February 1, 2002 letter of agreement between Media Rare and the Foley Group, which is under contract to provide the Lottery with advertising services. The letter of agreement called for an additional $200,000 for development of the interior and exterior of the vehicle and the purchase and installation of media and computer software and hardware. Between February and mid-November 2002, the Lottery signed six amendments to the initial letter of agreement, adding a total of $481,000 more to the costs to the project. Most of this additional money was used to prepare the vehicle to be a traveling exhibit for the Lottery, although $65,000 was used to construct six portable kiosks that the Lottery could use without the vehicle. The Lottery also spent close to $85,000 for electronic equipment purchased directly from vendors.

Media Rare owns the vehicle and was responsible for arranging for the improvements to the vehicle.

Overall, the Lottery spent $769,000 for the trailer improvements and portable kiosks. This figure includes about $32,000 for an artist's painting, which was then used as the model for the wildlife mural on the sides of the trailer.[18] The Lottery also committed to making lease payments of $240,000 over the five-year lease period, which began on June 1, 2002 and ends on May 30, 2007. These figures do not include other expenses paid by the Lottery, which is responsible for the vehicle's operating, storage, repair, and insurance expenses. The Lottery also compensates the driver for his time and travel expenses.

The Environmental Experience vehicle features a log cabin like interior with a large video screen and interactive touch-screen video exhibits. The front portion

18 The image of the painting has also been used for Lottery posters and T-shirts.

of the trailer includes an area where visitors can sit and watch a 10-minute presentation on a plasma screen about the Lottery's impact on the environment. Special acoustic equipment was used so that the visitors can hear the audio portion of the presentation. Another plasma screen can be used on the exterior of the vehicle. Four kiosks are arranged in the back portion of the vehicle so that visitors can view information about environmental projects supported by the Lottery on touch screens. Visitors can also learn facts about Minnesota's natural resources.

We think that the Environmental Experience Vehicle was an ill conceived and poorly managed project. The Lottery could have owned the vehicle for the amount it has paid to lease and improve it. In addition, the usage of the vehicle does not seem to be adequate to justify its costs. At least one-fourth of its use has been for the Minnesota Pro/Am Bass Tour, which Media Rare owns and the Lottery sponsors and assists Media Rare in operating. Our concerns about the Environmental Experience vehicle are discussed below.

At the front of the trailer, visitors can watch a 10-minute video about the Lottery's impact on the environment.

Project Management

The Environmental Experience project was poorly planned.

This project was poorly managed from a number of perspectives. First:

- **The Lottery did not have a clear idea of the scope and costs of the project at the outset.**

Over its history, the Lottery has had discussions with its advertising firm and Media Rare about possible methods of increasing public awareness of the benefits of the Lottery. Discussions about using a trailer as a traveling exhibit, however, did not begin until sometime in 2001. Media Rare purchased the tractor/trailer now leased by the Lottery in May 2001 and used it for Minnesota Pro/Am Bass Tour events during the summer of 2001. In mid-December of 2001, Media Rare made a presentation to the Lottery recommending that the Lottery lease and improve the vehicle so that it could be used as a traveling exhibit by June 1, 2002.

It appears that costs were estimated to be about $400,000, since the lease agreement signed on January 31, 2002 and the letter of agreement signed by the Lottery on February 8, 2002 each allocate $200,000 for vehicle improvements.

We asked the Lottery and Media Rare for the cost estimates that were used as a basis for these initial agreements. Media Rare provided us with an undated document listing costs that totaled between $383,000 and $426,000. According to Lottery officials: "Detailed 'final' specifications were necessarily unknown as the elements such as power, usage, electronic/computer equipment, final presentation output, inherent vehicle limitations and the like were both inter-related and necessarily fluid."[19]

The project had inadequate cost controls.

Ultimately, the Lottery spent about $769,000 on the improvements, or 92 percent more than initially budgeted. In part, the Lottery did not have a clear initial idea of costs because it had not determined the specifications of the project. But also:

- **The Lottery did not seek competitive bids or proposals for the Environmental Experience project.**

Instead, the Lottery simply chose to lease a vehicle from Media Rare and to establish the cost of improvements through the lease agreement and a series of letters of agreement. The Lottery did not know what the project would ultimately cost but instead relied on Media Rare to manage the project and paid Media Rare based on the costs Media Rare said it would incur.

Media Rare told us it solicited proposals for some of the improvement work from several firms and selected the firms that could best accomplish the work within the timeframe for a reasonable price. The Lottery, however, did not formally require Media Rare to seek competitive bids or proposals. We also found that at least one quote that was not obtained until nearly a month after the date of the applicable amendment to the initial letter of agreement. The quote was for $30,000 more than called for in the letter of agreement. Furthermore, an individual who has fished in Media Rare's bass tour events is employed by the firm that did the most work on the project. The firm, which is owned by his father, received $343,000 in payments for work on the Environmental Experience vehicle.

In addition to not seeking competitive bids, the Lottery lacked adequate cost controls. We found numerous problems including the following:

- **The lease agreement committed the Lottery to spend $200,000 to cover Media Rare's costs of making improvements but did not specify what improvements were expected for that amount of money. The amendments to the letter of agreement did not provide a detailed list of the work expected to be done.**

- **The Lottery paid Media Rare $5,000 more to manage the work than was outlined in the agreements and amendments. Media Rare received a $5,000 management fee for the portable kiosks even though the amendment for the kiosks does not mention a management fee.**

- **The Lottery paid $2,567 more for the project than was agreed to in the lease agreement and the letter of agreement and amendments.**

19 Correspondence from George R. Andersen and Dale L. McDonnell, Minnesota State Lottery, to John Yunker, Office of the Legislative Auditor, November 5, 2003.

- **While the Lottery purchased some electronic items using state contracts, the Lottery paid $3,140 extra for other electronic items that could also have been purchased from state contracts.**

- **The Lottery failed to hold Media Rare to the costs outlined in the lease agreement and the letter of agreement and amendments. Media Rare was permitted to have cost overruns on some agreements or amendments and use underruns on others to fund the cost overruns.**

- **The Lottery paid $14,400 for a three-year extended warranty on certain electronic equipment that cost about $57,000 even though much of the equipment already came with a one-year factory warranty. The three-year warranty provides some additional service, but its value is limited when the trailer travels more than 60 miles from Minneapolis.**

- **Some work was done prior to the effective dates of the amendments to the letter of agreement.**

The Lottery's financial staff did catch some problems with excessive charges during a year-end review. The staff disallowed payments that had been made for warehouse space rented prior to the effective date of the lease agreement ($1,300) and for costs related to the Minnesota Pro/Am Bass Tour ($2,600). But, the Lottery's contract management and financial staff did not accurately track the bills received by the Lottery and assign them to the proper agreements. This would have been a complicated task given the number of agreements and amendments, their lack of specifics about the nature of the work to be done and by whom, the layout of the billings, and the fact that more than one amendment was effective on a particular date. The Lottery should have written better agreements and insisted on clearer billings.

RECOMMENDATIONS

The Minnesota State Lottery should seek recapture of the $5,000 in unauthorized management fees that were paid to Media Rare for the portable kiosks.

The Minnesota State Lottery should also recapture $24,518 in additional overpayments to Media Rare. These overpayments occurred because the Lottery permitted Media Rare to exceed the payment limits set in certain amendments to the letter of agreement.

The Lottery overpaid Media Rare for improvements to the Environmental Experience vehicle.

We also found several instances in which the Lottery incurred additional costs. For example:

- **The Lottery paid an additional $8,000 to redesign and reinstall the four kiosks in the trailer at an angle rather than flush with the sides of the trailer.**

These costs were incurred because the Lottery did not adequately review the initial proposal. After the kiosks were installed, the Lottery director wanted them redesigned to increase the amount of space down the center of the trailer.

In addition:

- **The Lottery paid $40,000 to repair the roof of the trailer. The roof leaked within three weeks from the beginning of the Lottery's lease period.**

Lottery officials justified the payment by saying that the roof was damaged when Lottery employees walked on the roof while installing pennants during a Minnesota Pro/Am Bass Tour event. They also said the roof may not have been made to withstand a human walking on it. The president of Media Rare admitted to us, however, that the roof may have been damaged prior to the lease period while improvements were being made. In any event, we think that Media Rare should have borne some responsibility for repairing the leaks. While the lease agreement called for the Lottery to be responsible for the repairs during the lease period, the Lottery should have written a lease agreement that required the vehicle to meet certain requirements at least through the first several months.

The terms of the Lottery's lease agreement for the Environmental Experience vehicle were very unfavorable to the Lottery.

Lack of Ownership Rights

In addition to poor planning and project management, the Lottery negotiated an extremely poor deal with Media Rare. We found that:

- **The Lottery is making lease payments that are roughly equivalent to the cost of the Environmental Experience vehicle and yet, according to the January 2002 lease agreement, the Lottery would not have any ownership rights to the vehicle.**

Media Rare purchased the vehicle for $210,000 on May 15, 2001 and used the trailer for its bass tour events and other purposes during the remainder of 2001. No improvements were made to the vehicle other than those paid for by the Lottery. The Lottery agreed to make lease payments totaling $240,000 over five years. Those payments are the same as what it would have cost to purchase the vehicle in June 2002 and finance a 60-month loan at an interest rate of 7.53 percent.[20] The Lottery would not have needed to borrow money. It could have simply purchased the vehicle and depreciated it over a period of years.

The lease agreement of January 2002 did not provide the Lottery with any ownership rights to the vehicle despite the size of the Lottery's lease payments. The lease merely states the Lottery has the right to purchase the vehicle if Media Rare ceases to operate. The purchase price would need to be negotiated with Media Rare.

20 In making this calculation, we assumed that the vehicle depreciated five percent during the year between the time Media Rare purchased the vehicle and the start of the Lottery's lease period. If the vehicle had depreciated ten percent, the Lottery would have paid less to purchase the vehicle and finance it at any interest rate below 9.83 percent than the Lottery is paying to lease the vehicle. Media Rare financed the vehicle at a 9.0 percent interest rate.

Furthermore, we found that:

- **The Lottery made significant permanent improvements to the Environmental Experience vehicle but the 2002 lease agreement does not provide the Lottery with any rights to those improvements.**

The Lottery paid about $0.7 million for improvements to the tractor/trailer.[21] Some of these improvements are permanent in that they are part of the vehicle's mechanical, electrical, structural, or ventilation systems. Others—such as the kiosks, video screen, acoustic devices, and interior log cabin siding—may also be considered permanent, since they are fixed in place. Some items like video recordings and computer equipment and software might be considered movable and not permanent. The lease agreement, however, made no mention of whether the Lottery had rights to any of the improvements or equipment. As a result, the Lottery would only have ownership rights to movable property under contract law. In effect, the Lottery agreed to a contract that required them to make lease payments roughly equivalent to the cost of the vehicle but left the Lottery without any ownership rights to either the vehicle or the permanent improvements paid for by the Lottery.

Recently, the former director renegotiated the terms of the lease agreement, but the revised lease is still unsatisfactory.

In early December 2003, we told the director of the Lottery of our concerns about the Lottery's lack of ownership rights to the Environmental Experience vehicle. We had also discussed the issue with officials from Media Rare. Within two weeks, the Lottery and Media Rare executed an amendment to the lease agreement that spells out the Lottery's rights to certain property and provides the Lottery with an option to purchase the vehicle at the end of the lease period. The amendment states that the Lottery is entitled to all property added or attached to the vehicle that can be removed with little or no damage to the vehicle. This property includes but is not limited to kiosks, computers, sound domes, screens, amps, switches, splitters, and racks. The amendment allows the Lottery to purchase the vehicle at the end of the lease period for the amount of debt Media Rare still owes on the vehicle or one dollar, whichever is greater.

This amendment raises two concerns. First, the amount of debt that Media Rare will owe on the vehicle at the end of the lease period is unknown and can be controlled by Media Rare. As a result:

- **Even under the December 2003 lease amendment, Media Rare could control the purchase price of the vehicle.**

As of late December 2003, Media Rare's existing loan for the vehicle required a balloon payment of about $135,000 in early 2004. Media Rare intends to pay off the balloon payment by taking out a new loan, but the terms of the new loan were unknown at the time the Lottery agreed to the lease amendment. A new loan could have a term extending beyond the end of the lease period or could have a balloon payment due shortly after that time. A new loan could potentially also be for the full value of the vehicle and not just a refinancing of the balloon payment on the existing loan.

21 This figure does not include the $65,000 for portable kiosks.

Second, it does not seem reasonable that the Lottery should owe Media Rare anything for the vehicle. The Lottery's lease payments are roughly equivalent to the vehicle's cost, and the Lottery paid for all improvements to the vehicle including a management fee to Media Rare. In our view, this amendment is an improvement but still does not correct what was a very poor business deal.

RECOMMENDATION

If the Lottery decides to continue leasing the Environmental Experience vehicle, the Lottery should renegotiate the lease agreement with Media Rare so that tractor—as well as the trailer—can be purchased by the lottery for $1 at the end of the lease period. Given that the lottery is making lease payments that are equivalent to the cost of both the tractor and the trailer, the lottery should be entitled to the vehicle for a nominal amount of compensation at the end of the lease agreement.

Vehicle Usage

The Environmental Experience vehicle has not been used enough to justify the vehicle's cost.

Lottery officials believe the Environmental Experience vehicle has served a useful purpose in promoting public awareness of how Lottery proceeds benefit the state's environment. They have not, however, generally kept track of the number of people who have been through the vehicle or how many people actually use the kiosks or listen to the video. In addition, the Lottery has not attempted to evaluate the impact the vehicle has had on the public's perception of the Lottery or on Lottery sales.

We believe the impact of the vehicle has been minimal due to its limited usage. In fact:

- **The Environmental Experience vehicle was used only about 44 days in calendar year 2002 and 33 days in 2003. About one-fourth of that use was for Minnesota Pro/Am Bass Tour events.**

As Table 3.4 shows, the vehicle was used about 44 days in 2002, including a total of 12 days at the six Minnesota Pro/Am Bass Tour events. The vehicle was also used at the Minnesota State Fair for 12 days. Lottery staff estimate that 40,000 people went through the vehicle during the State Fair. It is not known how many people used the kiosks or watched the video. Some people went to the Lottery's vehicle simply to receive one of the four puzzle pieces that would entitle them to a small prize. The vehicle was also used at the Taste of Minnesota, the Blaine Sports Center, three county fairs, a pet fair, and a boat sale.

During 2003, the vehicle was on display to the public for only 33 days. The Lottery did not go back to the State Fair, since the Fair's rates were increasing and sales of lottery tickets are not permitted on the fairgrounds. Besides eight days at bass tour events, the vehicle returned to the Taste of Minnesota, visited two county fairs, and was at the Governor's fishing opener and a walleye tournament. The vehicle was also used for nine events at Lottery retailers. These events typically lasted about three or four hours each and involved various retail and Lottery promotions similar to those the Lottery frequently runs with retailers.

Table 3.4: Use of the Environmental Experience Vehicle, CY 2002-03

Events	Number of Days 2002	Number of Days 2003
Minnesota Pro/Am Bass Tour Events (6 events in 2002 and 4 in 2003)	13	8
Other Events		
State Fair	12	0
Taste of Minnesota	5	5
Pet Fair	3	0
Blaine Sports Center (USA Cup)	5	0
Chisago County Fair	1	0
Waseca County Fair	1	2
St. Louis County Fair	1	0
Department of Natural Resources employee tours	1	0
Crystal Pierz Boat Sale	2	0
Governor's Fishing Opener	0	1
Evinrude Walley Classic	0	1
Minnesota Zoo	0	2
East Ottertail County Fair	0	2
St. Paul Saints game	0	1
Retailer promotions	0	9
Radio station promotions	0	1
Buffalo Fire Department	0	1
Subtotal	31	25
Total	44	33

SOURCE: Minnesota State Lottery.

Lottery officials said that the vehicle might have been used more during the summer and fall of 2003 absent budget reductions.

Overall, we think that:

- **The use of the Environmental Experience vehicle has been quite limited and does not seem sufficient to justify its cost.**

The Lottery has six portable kiosks that have also been used infrequently.

In addition, we found that:

- **The Lottery's use of the six portable kiosks has been extremely limited. The Lottery has had portable kiosks at only six events or locations other than Lottery headquarters.**

The Lottery used all six of its portable kiosks, in addition to the Environmental Experience vehicle, at the Minnesota State Fair in 2002. Five of the kiosks were not used for the remainder of 2002. One kiosk was stationed in the lobby of the Lottery's Roseville headquarters in September 2002 after the State Fair and has remained there since. In 2003, as Table 3.5 indicates, the Lottery used one kiosk each at four shows or conventions during the winter months. On these occasions, the kiosk was used for between three and six days. In addition, the Lottery had a kiosk at the Minnesota Zoo from April 18 through September 1 of 2003. Other than those occasions, the kiosks have remained in storage in the Lottery's Eagan warehouse.

Table 3.5: Use of Portable Kiosks, CY 2002-03

	Number of Kiosks 2002	2003
Pheasants Forever Convention (3 days)	0	1
Cenaiko Sports Show (5 days)	0	1
Cenaiko Home Show (4 days)	0	1
Minneapolis Outdoor Show (6 days)	0	1
State Fair (12 days)	6	0
Minnesota Zoo (4-1/2 months)	0	1
Minnesota Lottery headquarters (continuous since September 2002)	1	1
Total number of events/locations	2	6

SOURCE: Minnesota State Lottery.

Increased awareness of the Lottery's environmental contributions may improve sales, but the Environmental Experience vehicle may not have been a cost-effective way to do so.

We would agree with Lottery officials that promoting awareness of the Lottery's benefits for the environment has some potential value in increasing sales. But, the evidence supporting the Lottery's view is not definitive. Lottery players are more likely than others to be aware that the Lottery's profits are used for environmental projects and agree that the Lottery's profits are used for worthwhile purposes. But the Lottery has no evidence that indicates that educating non-players about the use of the Lottery's profits will result in additional sales. Purchasers of lottery tickets may rationalize their purchase by saying the money went for a good cause. Certainly, providing some public information about the Lottery's beneficiaries is helpful, but the question here is whether the Lottery needed to spend $1 million to get out its message. The issue is also whether there was a more cost-effective way of getting out the message. We think the Lottery should have explored less costly ways of educating the public. The Lottery has more portable kiosks than it can use and has used its Environmental Experience vehicle for less than 10 percent of the days during calendar year 2003.

The portable kiosks are similar to the kiosks located in the Environmental Experience vehicle.

RECOMMENDATIONS

The Minnesota State Lottery should consider whether the promotional benefits of the Environmental Experience vehicle are sufficient to justify the continued lease of the vehicle.

If the Lottery continues to lease the Environmental Experience vehicle, it needs to develop additional opportunities to use the vehicle to promote the Lottery's image. The Lottery also needs to look for additional uses for the portable kiosks. The additional costs of using the vehicle and kiosks should, however, be considered in assessing the benefits and costs of promotional opportunities.

Retail Promotions

The Lottery operates many retail promotions that involve a single retailer or a group of stores under common ownership. Sales representatives are responsible for arranging and operating these promotions, although some larger promotions are set up through staff at the Lottery's Roseville headquarters. These promotions typically involve some sort of ticket or merchandise giveaway by the Lottery. Lottery players may receive a free ticket or a T-shirt for purchasing a certain number of tickets. Alternatively, players may win a chance at a bigger prize by purchasing tickets. Often, these promotions are part of a larger storewide promotion that is operated by the retailer and could be part of an annual promotional event.

Retail promotions generally increase sales during the promotional period.

The Lottery uses retail promotions to boost player and retailer interest in lottery games.

These retail promotions are relatively inexpensive in terms of ticket and merchandise expenses, although the staff resources spent on promotions is more significant. Yet, Lottery officials believe that they are effective, for the most part, in improving lottery sales and improving retailer interest in selling lottery tickets. Typically, retail promotions boost lottery sales during promotional events—which usually last one to three days—but little is known about whether promotions increase sales over the long run. Furthermore, it is not clear whether customers increase purchases of lottery tickets during a promotion and then buy fewer tickets than they would have bought in the absence of a promotion during the weeks or months following the promotion.

Lottery sales managers attempted to measure the effect of promotions held during the spring and summer of 2001. They had three sales representatives from three different regional offices focus on running frequent and consistent promotions and compared the sales results for each representative's participating retailers with those for the representative's non-participating retailers. Lottery sales managers also compared the sales results for these sales representatives with those for other sales representatives in the same three regions.

Lottery sales managers told us that the results showed that promotions are generally effective. But, we found that Lottery managers misinterpreted the results. Sales increased during promotional events but did not necessarily increase over a longer period of time. As Table 3.6 indicates, there was no real difference in sales growth over a six-month period between the sales representative's participating retailers and non-participating retailers in the Owatonna region. In addition, other sales representatives in the Owatonna region experienced nearly similar sales growth. In the Brainerd region, the sales representative's participating retailers had higher sales growth than non-participating retailers, but other sales representatives in the region had even higher sales growth. Only in the Metro East region was the sales growth for the sales representative's participating retailers greater than the growth for other groups. In our view:

It is unclear whether retail promotions increase sales over the long run.

Table 3.6: Growth in Sales for Sales Representatives Who Emphasized Retail Promotions, 2001

Sales Group	Region 4 Brainerd	Region 5 Owatonna	Region 6E Metro East
Sales Representatives Emphasizing Promotions			
Participating Retailers	12.3%	7.2%	11.9%
Non-Participating Retailers	10.7	7.8	5.5
All Sales Representatives in the Region	14.4	7.0	6.2

SOURCE: Office of the Legislative Auditor analysis of data from the Minnesota State Lottery.

- **The long-term effectiveness of retail promotions is unclear and should be examined more carefully by Lottery staff.**

RECOMMENDATION

The Minnesota State Lottery, with assistance from its research director, should attempt to measure the effectiveness of retail promotions. The Lottery should attempt not only to measure the overall effectiveness but also to identify the types of retail promotions that have greater potential to increase sales.

Premium Items

The Lottery purchases premium items to give away as part of its promotional activities. This merchandise includes a variety of items such as T-shirts, sweatshirts, mugs, mini-binoculars, playing cards, large prints of wildlife or landscape scenes, and bobblehead dolls of players for the Minnesota Timberwolves. The market value of individual items varies significantly from less than a dollar per item to $400.[22] During fiscal year 2002, the Lottery purchased $0.5 million in merchandise, but the Lottery's purchases decreased to $0.2 million in 2003. The Lottery currently does not have any funds budgeted for premium items in 2004, although it may purchase some items later in 2004 if money is available. The current inventory of items may be sufficient to last until the early summer of 2004.

The Lottery appears to review its use of premium items when evaluating the benefits and costs of sponsorships and retail promotions. As noted previously, however, there are some problems with the Lottery's evaluations of sponsorships and promotions.

The Lottery appears to have adequate controls on the withdrawal of items from its warehouses. The Lottery requires individuals withdrawing merchandise from the warehouses to fill out a form that provides information on the purpose of the withdrawal and the destination of the merchandise. Most withdrawals are done using numbers that are assigned to specific promotions that have been approved by Lottery management. For other withdrawals, Lottery employees are supposed to list the purpose and destination of the items. But, we found problems with some of these withdrawals. In particular:

- **The Lottery has allowed certain top managers and staff to withdraw merchandise from the warehouse without detailing the purpose and destination of the items.**

The Lottery lacks adequate controls over the use of merchandise.

We checked with some Lottery employees who failed to provide such information. One of them said he kept records on the purpose and destination of items and provided us with specific information. Others did not keep records, and some of them were not entirely sure of the purpose and destination of the items they had requested.

We think that there are two problems with this practice. First, permitting certain employees to withdraw merchandise without specifying the purchase and destination of the items increased the chance that items could be used for questionable purposes or even given to friends or family or kept for personal use. We did not attempt to verify how the merchandise was used. But, based on what Lottery employees told us, we think that:

- **Some of the items were used for purposes that had questionable value for future lottery sales.**

22 Generally, the Lottery is able to purchase items for a significant discount from their market value.

It appeared that some of the items went as gifts to individuals with whom the Lottery works. These individuals included employees of organizations sponsored by the Lottery and employees of companies that do work for the Lottery such as Media Rare. For example, the Lottery's promotions manager gave Christmas gifts to people at certain organizations sponsored by the Lottery. We also found that some items were provided to individuals or organizations for use as door prizes or for fundraising. For example, an expensive print was provided to a Lottery employee for use in raising funds for the health care costs of a close relative of the employee. A similar print was provided to a state employee union for use as a door prize at an upcoming meeting.

The cost of Lottery merchandise ranges from six cents for a plastic gift bag to $101 for this framed print, which has a retail value of $400.

Second, this practice may prevent the Lottery from considering all the costs of a sponsorship or promotional activity when assessing the benefits and costs of the activity. When merchandise goes to a sponsored organization, the costs of that merchandise should be included in sponsorship costs. It appears that some of these costs are not being included.

RECOMMENDATIONS

The Minnesota State Lottery should not permit anyone to take or requisition merchandise from its warehouse without an assigned promotion number.

The lottery should reduce its use of merchandise for questionable and low-priority purposes.

If the lottery insists on continuing the current practice, the lottery should at least require those requisitioning merchandise to state the destination of the item and the purpose of the request. To the extent possible, the lottery should require that the cost of items being used in connection with a sponsorship or promotion to be included in their costs when their benefits and costs are being evaluated.

Free Tickets

The Lottery provides free tickets during certain promotional activities. The most common activities involving free tickets are retail, event, and media promotions. As mentioned earlier, the Lottery may give lottery players a free ticket if they buy so many tickets during a retail promotion or a sponsored event. Alternatively, ticket purchasers could be eligible for a drawing with free tickets as a prize. In some cases, the Lottery has provided free tickets to retailers or retail clerks as incentives during a sales contest. The Lottery may also provide free tickets to media outlets such as radio stations or newspapers. The radio stations may give tickets away to callers that answer a trivia question or may have a contest that awards free tickets to winners. In return, the Lottery expects the stations to provide free and favorable publicity about the Lottery over a specified period of time.

During fiscal year 2002, the Lottery spent $141,000 for free tickets. The expenses for promotional tickets declined to $102,000 in 2003, and the Lottery's budget for 2004 currently includes $20,000 for free tickets. In addition to these amounts, the Lottery has provided $72,000 of free tickets during each of these years to the foundation that runs ticket sales at the Minneapolis-St. Paul International Airport. The foundation sells these tickets but keeps the proceeds to help finance its lottery ticket operations. The Lottery believes that the foundation needs such a subsidy since the foundation, unlike other lottery retailers, does not sell other retail products and must rely exclusively on sales of lottery tickets and pull-tabs to pay for the operation of their airport store.

The Lottery's expenses for promotional tickets, including those used at the airport, do not include the full face value of the tickets. The Lottery only includes its estimated expenses for prizes in calculating its expenses for free tickets. It includes about 65 percent of the face value of scratch tickets and about 50 percent of the face value of online tickets.

Although most free tickets are for retail or media promotions, we found that:

The Lottery has given free tickets to police officers attending gambling enforcement training sessions.

- **The Lottery occasionally provides free tickets for some purposes that have limited value for Lottery sales.**

For example, the Lottery provides about $10 worth of free tickets to each individual who attends speeches given by Lottery officials to community groups. Sometimes, Lottery officials give away free tickets to the same group a second time, although officials say that they will not do so more frequently than once every two years. The Lottery believes this practice helps to promote the Lottery and improve sales, although we think retail or media ticket giveaways can be more effective. We also found that the Lottery has given free tickets to members of committees or subcommittees of the North American Association of State and Provincial Lotteries when these groups meet in Minnesota. Lottery officials say this is a common practice for lotteries. Finally, we found that the Lottery has given free tickets, on at least two occasions, to police officers attending training sessions on gambling enforcement at the Lottery's headquarters. The enforcement training sessions covered the lottery as well as other forms of gambling and were run by the Minnesota Department of Public Safety.

We think that these practices should be reexamined. The use of free tickets during retail promotions or media giveaways has greater potential to impact sales of lottery tickets.

RECOMMENDATION

The Minnesota State Lottery should reexamine its practice of providing free tickets to various groups. Promotional tickets should be reserved for lottery customer promotions and for media giveaways.

Procurement Practices

Earlier in this chapter, we discussed the lack of competitive proposals and bidding on work done by Media Rare for the Lottery. We found this problem with the Environmental Journal television and radio programs, the Player Spotlight, and the improvements to the tractor/trailer that now serves as the Environmental Experience vehicle. We also found that the Lottery overpaid Media Rare for some of its work and paid Media Rare too much for the lease of the tractor/trailer. Finally, we found the Lottery has invested significant financial and staff resources in Media Rare's bass tour. The Lottery's commitment of considerable staff resources to the Minnesota Pro/Am Bass Tour is very different from its more limited involvement with other sponsored organizations and events.

The lack of competitive bidding is also unique to Media Rare's work, as shown in Table 3.7. On other major contracts, the Lottery appears to use an open and competitive process to solicit and award contracts. These other contracts include online ticket services, scratch ticket printing, and advertising. Clearly, the Lottery treats Media Rare differently than other companies with which the Lottery has a business relationship.

The Lottery's failure to seek competitive proposals on Media Rare's work appears to violate state law.

The Lottery is required to follow the laws and rules applicable to all state agencies for its purchases of goods and services except for lottery procurement contracts. The Lottery considers most of its purchases—including those involving Media Rare—to be lottery procurement contracts and exempt from laws and rules governing state agency purchases. The Lottery only complies with requirements for state agencies on the procurement of supplies like furniture, computers, and vehicles that are common to other state agencies

We think the Lottery's interpretation of the statute governing lottery procurement contracts is incorrect, although the statute is admittedly silent about certain types of contracts such as those involving advertising and promotional activities. The statutes define a lottery procurement contract as "a contract to provide lottery products, computer hardware and software used to monitor sales of lottery tickets,

The Lottery has generally sought competitive proposals on most major contracts except those involving Media Rare.

Table 3.7: Information on Selected Lottery Vendors

Vendor	Services Provided	Year of Most Recent Competitive Bids	Term of Contract
GTECH	Online ticket production and computer support for scratch tickets	2001-02	Five years ending in February 2008 with possible extensions through February 2013
Oberthur Gaming Technologies Corporation[a]	Scratch ticket production and marketing assistance	1999	Two years ending in January 2002 plus extensions totaling three years; contract now ends in January 2005
Speedee Delivery	Scratch ticket delivery	1999	Three years ending in August 2002 plus extensions totaling two years; contract now ends in August 2004
Foley Group	Advertising	1998	Three years and one month ending in September 2001 plus extensions totaling three years; contract now ends in September 2004
Media Rare	Production and distribution of the Environmental Journal television show	None	No contract. Current letter of agreement between Foley and Media Rare provides for a three-year term ending in November 2006.
Media Rare	Production and distribution of the Environmental Journal radio spots	None	No contract. Current letter of agreement between Foley and Media Rare provides for a three-year term ending in November 2006.
Media Rare	Production and distribution of the Player Spotlight radio segments	None	No contract. Current letter of agreement between Foley and Media Rare provides for a three-year term ending in November 2006.
Media Rare	Environmental Experience vehicle lease, improvements, project management, and maintenance	None	Five-year lease expires in May 2007. Improvements are complete, but maintenance is ongoing.

[a]Oberthur is the main supplier of scratch tickets to the Minnesota State Lottery. The Lottery also has contracts with Scientific Games, Inc. and Pollard Banknote Limited for scratch ticket production.

SOURCE: Minnesota State Lottery.

and lottery tickets." The statutes also say that lottery procurement contracts do not include "a contract to provide an annuity or prize payment agreement or materials, supplies, equipment, or services common to the ordinary operation of a state agency."[23] Lottery officials say that the statute provides the Lottery with an exemption from state agency requirements for all contracts except those common to other state agencies. We disagree since the list of lottery procurement contracts does not include advertising and promotional activities.

Regardless of one's interpretation of the statutory definition of lottery procurement contracts, we think that:

- **In its business arrangements with Media Rare, the Lottery violated, or at least circumvented the intent of, *Minn. Stat.* (2003), §349A.07, subd. 6, which requires the Lottery director to use an open and competitive bid process for lottery procurement contracts.**

In addition, the director is required to follow statutes governing state agency contracts "as nearly as practicable." Statutes also require that the director use an open bid process for contracts involving equipment, supplies, or services.[24] Lottery officials claim that the Lottery has used an open and competitive process in soliciting bids for advertising services and that Media Rare's work is a part of those services. However, the Lottery has never solicited bids on Media Rare's services, and there is no good reason for Media Rare to be a subcontractor to the advertising agency.

In the future, all major Lottery contracts—including all of the work that Media Rare does for the Lottery—should be openly and competitively bid, as required by Minnesota law.

RECOMMENDATION

The Lottery should conduct an open and competitive bid process on the work currently done by Media Rare.

The Lottery should either terminate its relationship with Media Rare or seek competitive proposals on the services now performed by the firm.

During September 2003, the Lottery's advertising firm and Media Rare signed new letters of agreement covering Media Rare's work on the Environmental Journal television and radio shows and the Player Spotlight. These new agreements covered a period of three years ending on November 30, 2006. Despite these extensions, we think that the agreements with Media Rare could be terminated much earlier. The Lottery's contract with the advertising firm expires on September 3, 2004. Since Media Rare is a subcontractor to the advertising firm, the Lottery does not need to honor lengthier agreements between Media Rare and the advertising firm.

23 *Minn. Stat.* (2003), §349A.01, subd. 10.

24 *Minn. Stat.* (2003), §349A.07, subd. 1.

RECOMMENDATION

During its upcoming solicitation of proposals for advertising services, the Lottery should sever the work done by Media Rare from the request for proposals for advertising services and separately conduct an open and competitive procurement process for the services now provided by Media Rare.

The Lottery should give the Legislature and the Governor sufficient opportunity to review the expenses and value of the Environmental Journal television and radio shows and the Player Spotlight before soliciting competitive proposals for these services.

There is less that can be done regarding the Environmental Experience vehicle. The costs of improving the vehicle have already been spent, and they will continue to affect the Lottery's operating expenses through depreciation for a number of additional years. We have some concerns, however, about future payments to Media Rare if the Lottery decides to continue leasing the vehicle. The Lottery has paid Media Rare to arrange for vehicle maintenance, and we think the Lottery could either arrange for services or hire someone else at a lower rate. In addition, there is a possibility that the vehicle could require major repair work in the future.

RECOMMENDATIONS

If any substantial repair work needs to be done on the Environmental Experience vehicle, the Minnesota State Lottery should solicit competitive bids.

The Lottery should consider less costly alternatives to paying Media Rare to arrange for maintenance work on the Environmental Experience vehicle.

4

Other Expenses

SUMMARY

We have numerous concerns about the Lottery's spending practices. The Lottery uses considerably more office and warehouse space than other states when relative sales are considered. Even after its October 2003 layoffs, the Lottery has more staff than comparable state lotteries had in fiscal year 2002. Ticket expenses are higher in Minnesota than at other lotteries, and the Minnesota Lottery places insufficient emphasis on ticket costs when selecting vendors. The Lottery has a pool of unclaimed prize money that it uses to supplement prize levels of selected games. But, the games with higher prize levels have significantly lower profits than other games.

Recently, the Lottery ended some practices we think were inappropriate. For example, the Lottery permitted excessive use of its vehicles for employee commuting, purchased coffee for its employees, and rented plants for its offices. But the Lottery continues to inappropriately use a department head expense account and incurs business meeting expenses despite its lack of authority to do so.

The Lottery also needs to review cell phone expenses and employee travel expenses more carefully. We identified a number of concerns about travel expense reimbursements and advances, particularly for the former Lottery director. The former director also expended Lottery resources in order to participate in a fishing tournament for free. Both the use of state resources and the receipt of a gift may be violations of state law.

In Chapter 2, we saw that the Minnesota State Lottery spent significantly more than similar lotteries on personnel, ticket costs, rent, depreciation, and miscellaneous expenses in fiscal year 2002. This chapter examines the Minnesota Lottery's expenses in each of these areas in greater detail. It is not always possible to pinpoint exactly why the Minnesota Lottery's expenses are higher than similar lotteries. But, we attempt to explain, where possible, what accounts for Minnesota's higher expenses. In addition, we highlight expenditures that we think have not been prudent or expenditures that merit greater oversight and review by elected officials.

We also examine the Lottery's prize expenses, which are a direct cost and not an operating expense. The Minnesota Lottery only spent slightly more on prizes than similar lotteries. But we examine prize expenses because they accounted for about three-fourths of the Lottery's total expenses in 2002. We do not examine retailer commissions in this chapter, since the Lottery's expenses are about comparable to those in similar states. This chapter examines the following issues:

- **Could overall prize levels be adjusted to increase the state's return from lottery sales? Does the use of unclaimed prize money to increase prize levels of selected games stimulate sales and increase the state's return?**

- **Why are the Minnesota Lottery's ticket production and distribution costs higher than those in other states? Has the Lottery made prudent decisions in awarding contracts for ticket production?**

- **Why are the Minnesota State Lottery's personnel expenses higher than those of similar lotteries? Have the Lottery's recent layoffs reduced its staff to a size comparable with other lotteries? How does staff compensation at the Minnesota State Lottery compare with compensation of employees at similar lotteries?**

- **How does the amount of office and warehouse space leased by the Lottery compare with the amount occupied by other lotteries? How do the Lottery's amount of office space and rental rates compare with those of other state agencies in Minnesota?**

- **Does the Lottery need as many motor vehicles as it has in its fleet? Has the Lottery used its vehicles for legitimate state purposes?**

- **Has the Lottery been prudent in making capital expenditures?**

- **Has the Lottery kept other spending to a minimum?**

- **Could the Lottery increase sales and the return to the state through the development of new games? To what extent do statutes restrict the Lottery's ability to increase sales?**

PRIZES

Prize expenses are the largest type of expense incurred by the Lottery. In fiscal year 2002, the Lottery spent about $223 million on prizes, or about 59 percent of its total sales revenue. In this section, we compare the Lottery's prize levels with comparable states and consider whether adjustments in overall prize levels or the structure of prizes within games would improve the Lottery's profits. We also examine how the Lottery has used unclaimed prize money to supplement the prize levels of subsequent games.

Comparisons with Other States

In discussions with the 2003 Legislature, Lottery officials maintained that comparisons of the Minnesota State Lottery's operating returns with those of other lotteries were inappropriate. They said that comparisons were difficult in part because scratch games were a higher portion of the Minnesota Lottery's sales and scratch prize levels are higher than those for online games. Data from comparable state lotteries contradicts the Lottery's contention. In fact:

- **Prize levels at the Minnesota State Lottery are very close to those at comparable state lotteries.**

In fiscal year 2002, the Minnesota State Lottery spent about $155 million for scratch game prizes, or about 64.5 percent of its revenues from scratch game sales. As Table 4.1 shows, Minnesota's scratch prize levels are lower than five of the eight comparison group states. Minnesota's scratch prize percentage was a little higher than the average for other states but lower than the median for the comparison group. For online games, the Minnesota Lottery's prize percentage was a little lower than the average for the comparison group but almost identical to the group's median. Minnesota's prize percentage for online games was higher than four of the states but lower than the other four. Overall, Minnesota's prize percentage was identical to the median for the eight comparison group states and a little higher than the group's average.

Prize levels in Minnesota are similar to those at comparable lotteries.

Table 4.1: Prizes as a Percentage of Sales, FY 2002

	Scratch Games	Online Games	Overall
Minnesota State Lottery	64.5%	49.7%	59.1%
Comparison State Average	62.8	51.8	58.0
Comparison State Median	65.1	49.8	59.1
Minnesota's Rank	6th highest of 9	5th highest of 9	5th highest of 9

SOURCE: Office of the Legislative Auditor analysis of lottery financial statements.

Minnesota and most of the comparison states had very similar prize percentages overall and for both types of games. Louisiana and Washington were the exceptions. Louisiana had a significantly lower prize percentage for scratch games (51 percent). As a result, Louisiana's profits as a percentage of sales were higher than those in the other comparison group states. Washington, which unlike the other states is not a Powerball state, paid a much higher percentage of prizes for online games than other states in our comparison group (63 percent). As a result, Washington had a profit rate much lower than the other comparison group states and closer to Minnesota's rate of return. Although Minnesota's rate of return was low relative to the other states, we demonstrated in Chapter 2 that this was due to Minnesota's higher operating expenses and not due to differences in prize expenses.

Overall Prize Levels

Because prize expenses are the largest expense of any lottery, some states have attempted to increase lottery profits by reducing the percentage of sales that are spent on prizes. In fact, the discussion above suggests that, among the comparison group states, the state with the lowest prize percentage had the highest rate of return. But, a reduction in prize levels can be risky because it can also negatively impact sales, which can lower profits. While a lottery's profit margin might be higher with a lower prize percentage, its total profits could be lower if sales decline enough.

Lowering prize levels could negatively impact sales.

While there is no definitive study that examines the effect of prize levels on lottery profits, we think that:

- **There is enough evidence from other states to suggest that lowering prize levels could reduce lottery profits.**

For example, in 1997, the Texas Legislature reduced prize payouts on scratch tickets from more than 60 percent to 53 percent. The Texas Lottery's profit margin increased, but its sales dropped by about 18 percent and its total profits dropped by close to 9 percent. Negative publicity about reduced prizes can cause lottery customers to reduce their purchases.

Prize Structures

Minnesota's recent experience with prize structures of scratch games also suggests that changing prize structures, like changing prize levels, can have negative consequences. During fiscal year 2003, the Lottery attempted to stimulate scratch ticket sales by increasing the number of large prizes and reducing the number of small prizes. The Lottery did not change overall prize levels but instead changed the share of prize money going for low, middle, and high tier prizes. Lottery officials told us that they were influenced by the experience of other states, which suggested that sales would go up if a scratch game offered more large prizes.

Instead, changes in the prize structure tended to reduce sales. Lottery customers were used to winning some prizes even if they were small. When they found that they were less likely to win even small prizes, they reduced their purchases of scratch tickets. This experience suggests that changes in prize structures are also risky.

Unclaimed Prizes

In Minnesota, purchasers of winning lottery tickets have one year to redeem their winning tickets. After one year, they no longer are entitled to the winnings, and the unclaimed prizes are placed in an account at the Minnesota State Lottery. Prior to June 1, 1995, the Lottery retained all unclaimed prize money and used it to supplement the prize levels of subsequent games. Since then and until recently, the Lottery returned 70 percent of the prizes that became unclaimed to the state and kept 30 percent. The money returned to the state was split between the General Fund (60 percent) and the Environment and Natural Resources Trust Fund. The 2003 Legislature, however, required that the Lottery return all unclaimed prize money to the state beginning with prizes that became unclaimed after June 30, 2003. In addition, the Legislature directed that all unclaimed prize money be deposited in the General Fund. But, the 2003 Legislature permitted the

Lottery to keep previously unclaimed prize money that was not committed to a lottery game. As a result:

- **On June 30, 2003, the Lottery had close to $2.5 million in previously unclaimed prize money that it could use to supplement prize levels during fiscal year 2004 and subsequent years.**

The Lottery is still using unclaimed prize money to supplement the prize levels of selected games.

In recent years, the Lottery has primarily used unclaimed prize money to supplement prize levels of selected scratch games. The Lottery does not publicize that certain games have enhanced prize levels, although an alert customer might observe that the odds of winning are higher for these games. Providing greater publicity might be detrimental if customers reduced their purchases of other games in order to buy tickets for the game with an enhanced prize level.

Lottery officials have argued that unclaimed prize money should stay with the Lottery, although they are now resigned to the fact that the Legislature is unlikely to allow the Lottery to retain unclaimed prizes in the future. Lottery officials have cited two reasons for permitting the Lottery to retain some or all of the unclaimed prizes. First, they have said that unclaimed prizes help stimulate lottery sales by increasing prize levels. Second, they have stated that unclaimed prize money belongs to the players and should be returned to the players.

We think the important issue is whether the Lottery's use of unclaimed prizes is productive in stimulating sales and increasing the returns to the state. State law terminates a player's right to a prize one year after the purchase of a winning ticket. After that time, the prize no longer belongs to the purchaser of the ticket or any other lottery customer. Minnesota even provides more time than some other states before a prize is considered unclaimed. For example, Wisconsin only provides six months.

We reviewed all scratch games that ended between May 1, 2001 and May 1, 2003. We compared the sales, profits, and rate of return for scratch games that had prize levels supplemented by unclaimed prize money with those for all other scratch games. Our review of those games demonstrates that:

- **The Lottery's use of unclaimed prize money to supplement prize levels of selected scratch games has not been a productive way to increase state returns.**

In fact, we found that scratch games with prize levels enhanced by unclaimed prize money had lower profits and lower rates of return than other scratch games with the same ticket price. As Table 4.2 shows, one game even incurred a loss. Sales tended to be higher for games that used unclaimed prize money than for other games, although sales were lower for some games that used unclaimed prize money to supplement prize levels. Expenses, however, tended to be even higher for the games with enhanced prize levels. On average, profits were between 30 and 53 percent lower for games with higher prize levels. In fact, one scratch game

The use of unclaimed prize money to supplement prize levels has resulted in lower profits in recent years.

Table 4.2: Profits of Scratch Games with Prize Levels Supplemented by Unclaimed Prize Money, 2001-03

Type of Game[a]	Average Sales	Average Expenses[b]	Average Profits	Average Profit Margin[c]
$1 Games				
Games with Higher Prize Levels	$6,035,447	$5,236,485	$ 798,962	13%
All Other Games	4,445,289	3,299,560	1,145,728	26
Percentage Difference from All Other Games	36%	59%	-30%	
$2 Games				
Games with Higher Prize Levels	$6,095,140	$5,309,711	$785,429	13%
All Other Games	4,924,881	3,773,935	1,150,946	23
Percentage Difference from All Other Games	24%	41%	-32%	
$3 Games				
Games with Higher Prize Levels	$6,946,398	$6,346,632	$599,766	9%
All Other Games	6,003,956	4,716,746	1,287,210	21
Percentage Difference from All Other Games	16%	35%	-53%	

[a]Scratch games that ended between May 1, 2001 and May 1, 2003 are included in this analysis. No $5 or $10 games received unclaimed prize money to supplement their prize levels. One $7 game received unclaimed prize money, but there were no other $7 games.

[b]The following expenses are included: prizes, retailer commissions, advertising, royalty fees, and ticket production, delivery, and destruction expenses.

[c]The profit margin is profits as a percentage of sales.

SOURCE: Office of the Legislative Auditor analysis of data from the Minnesota State Lottery.

that used unclaimed prize money—the Instant Powerball TV Game—lost about $54,000.[1]

Games using unclaimed prize money would need to have significantly higher sales in order to have higher profits than other games. A simple example shows why this is true. A typical game that uses unclaimed prize money might pay about 75 percent of its sales revenue for prizes and have other costs that total to about 10 percent of revenues. As a result, the game using unclaimed prize money has costs totaling 85 percent of revenues and a profit margin of 15 percent of sales. A game without unclaimed prize money would have costs equaling 75 percent of revenues, including prizes of 65 percent of revenues and other expenses of 10 percent of revenues. This game would have a profit margin of 25 percent of revenues. As a result, the game using unclaimed prize money would need to have sales that are about 67 percent higher than the other game to get profits equal to the game without unclaimed prize money.

1 In calculating a game's profits, we subtracted certain expenses from sales revenues. Those expenses included prize expenses, retailer commissions, advertising expenses, and ticket printing, delivery, and destruction expenses. We did not subtract any overhead expenses. We also did not include the expenses incurred by the Lottery for the production of the Powerball game shows, which averaged $340,000 for the four game show scratch tickets that received unclaimed prize money and were included in our analysis. We also did not consider the promotional value of the game shows. Regardless of the net value of the game shows, the use of unclaimed prize money does not appear to stimulate scratch ticket sales. In any event, prizes for the Powerball game show scratch tickets could be supplemented without using unclaimed prize money.

The Lottery lost $54,000 on one scratch game that received unclaimed prize money.

If both types of games had non-prize expenses equaling 15 percent of revenues, the games would have profit margins of 10 and 20 percent. The game that used unclaimed prize money would need to have sales that are double those for the other game in order to have profits that are equal to the game without the additional prize money.

Using unclaimed prize money for selected games is unlikely to stimulate sales to that degree. In fact, sales are not much higher for games with unclaimed prize money than they are for other games. The failure to stimulate sales results because the higher prize levels are not widely publicized by the Lottery. Only very informed players are likely to know that prize levels are enhanced for certain games. Publicizing the enhanced prize levels is not the answer either since customers might reduce purchases of other games in order to buy games with enhanced prize levels. A more productive way to stimulate sales might be to raise the prize levels of all scratch games. But that would be a very risky strategy and could reduce profits if higher overall prize levels do not sufficiently increase sales.

The remaining unclaimed prize money should be transferred to the State Treasury.

As noted above, the Lottery had $2.5 million in previously unclaimed prize money that it could still use to enhance prize levels of future games. As of mid-December 2003, the lottery had committed only a portion of that money. The Lottery was using the unclaimed prize money for the scratch games that provide customers a chance to appear on the Powerball Instant Millionaire television program. At the rate the money was being used, the pool of $2.5 million would last several years. Given the evidence cited above, we think it would be best if the remainder of the unclaimed prize money were returned to the state. In Chapter 5, we recommend that the Legislature amend state law so the remaining unclaimed prize money is transferred to a state fund.

RECOMMENDATION

In the spirit of cooperation, after receiving the draft of this report, the Minnesota State Lottery should not commit additional monies from the pool of accumulated unclaimed prize money to any other lottery games until the 2004 Legislature has adjourned.

TICKET COSTS

The costs of printing and distributing lottery tickets are a significant portion of the operating expenses of most lotteries. In Minnesota, ticket costs account for about one-third of the Lottery's operating expenses. In fiscal year 2002, the Minnesota

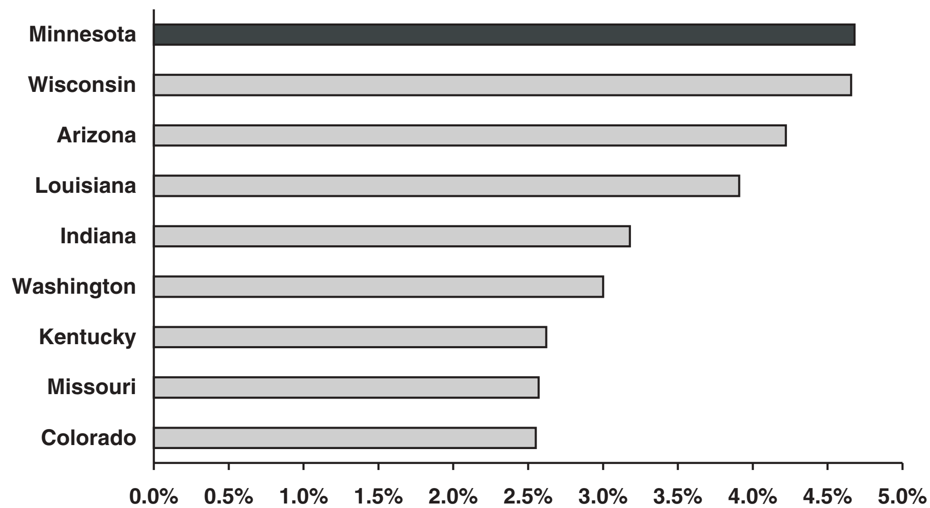
State Lottery spent about $17.6 million on ticket costs, or about 4.7 percent of its revenues from lottery ticket sales. We found that:

- **The Minnesota State Lottery spent a significantly greater percentage of its sales revenues on ticket costs than other lotteries in our comparison group during fiscal year 2002.**

On average, other lotteries in our comparison group spent 3.3 percent of sales revenues on tickets. In comparison, Minnesota spent about 40 percent more than the average comparison group state. Figure 4.1 shows that Minnesota's ticket expenses as a percentage of sales were higher than any of the comparison states in 2002.

Minnesota spends more than similar lotteries for ticket production and distribution.

Figure 4.1: Ticket Expenses as a Percentage of Sales, FY 2002



SOURCE: Office of the Legislative Auditor analysis of lottery financial statements.

Minnesota's ticket expenses decreased in 2003 and are expected to decline more in 2004. The decrease was primarily the result of a new contract for online ticket services. At the expiration of the previous contract, the Lottery solicited bids from vendors and awarded a contract to a new vendor at a lower rate than charged by the previous vendor. The new online vendor started processing tickets for the Lottery in February 2003. The Lottery also negotiated a modest reduction in the rates charged by the Lottery's primary scratch ticket supplier in June 2003. As a result, the Lottery's ticket costs are expected to decline to about 4.1 percent of sales revenues during fiscal year 2004. Even with the decline, the Lottery's ticket costs as a percentage of sales would be higher than those in seven of the eight comparison group states.

In the remainder of this section, we compare the Lottery's ticket costs for scratch and online tickets with costs in other states. We also examine the most recent contract awards for both scratch tickets and online services and assess the Lottery's process for soliciting bids and awarding contracts.

Scratch Tickets

The main costs of scratch tickets are printing and distribution. The Minnesota State Lottery has one primary vendor that supplies it with scratch tickets. The Lottery has contracts with two other vendors that supply scratch tickets several times each year. The Lottery also contracts with a company that delivers the scratch tickets to retailers across the state.

Comparisons with Other States

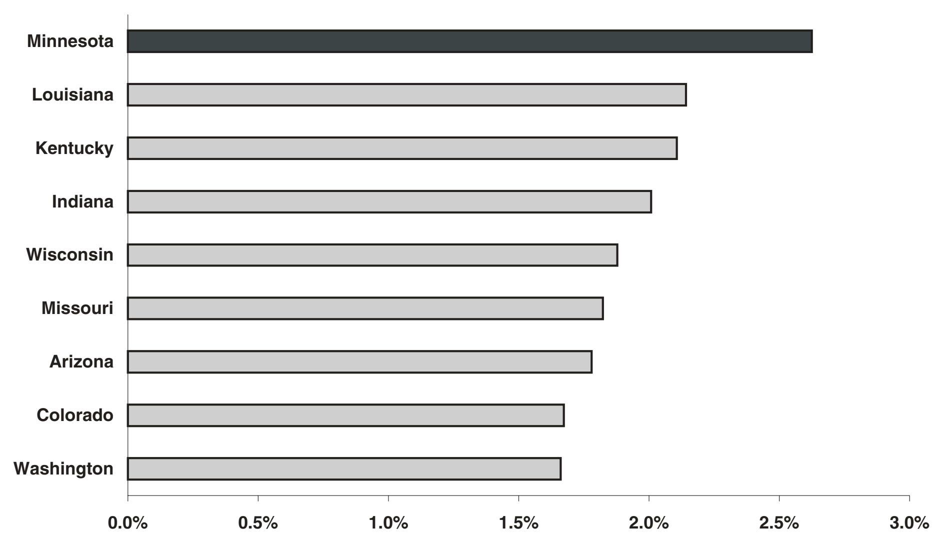
During fiscal year 2002, the Lottery spent about $6.3 million on scratch ticket production and distribution and related retailer supplies. The Lottery's scratch ticket expenses were a little more than 2.6 percent of scratch ticket sales, compared with 1.9 percent on average for our group of comparison state lotteries. Overall:

- **In fiscal year 2002, the Minnesota State Lottery spent about 39 percent more on scratch ticket production and delivery as a percentage of sales than comparable lotteries.**

As Figure 4.2 shows, the Lottery's scratch ticket expenses as a percentage of scratch ticket sales were higher than all of the eight states in our comparison group of lotteries.

In 2002, scratch ticket expenses were higher in Minnesota than in any of the eight comparison state lotteries.

Figure 4.2: Scratch Ticket Expenses as a Percentage of Scratch Game Sales, FY 2002



SOURCE: Office of the Legislative Auditor analysis of lottery financial statements.

The Lottery's scratch ticket expenses declined during fiscal year 2003 and are expected to decline further in 2004. Some of the decline is due to declining scratch ticket sales. But, during 2004, some of the decline is due to lower rates negotiated with the Lottery's main vendor.[2] The expected decline is, however, modest. The Lottery's scratch ticket expenses as a percentage of sales are expected to decline about 8 percent, going from 2.6 percent in 2002 to 2.4 percent of scratch ticket sales in 2004. Even with this reduction, the Lottery's scratch ticket expenses as a percentage of sales would be higher than the expenses of all of the eight comparison group states in fiscal year 2002.

It is not entirely clear why Minnesota's scratch ticket expenses are higher than those in other states. Sales volume differences do not account for the difference in costs since Minnesota's scratch ticket sales were about equal to the average for the group of comparison states.[3] We also doubt that differences in delivery costs account for much of the cost difference since delivery costs were less than 13 percent of the total scratch ticket costs in Minnesota.[4] Four of the comparison states sell pull-tabs, which are grouped with scratch tickets because they produce instant results. Pull-tabs are cheaper to produce than scratch tickets, but none of the states in our comparison group derived more than 10 percent of scratch ticket sales from pull-tabs.[5]

- **One possible explanation for Minnesota's higher scratch ticket costs is the extra features the Lottery adds to its scratch tickets.**

The Lottery has used more expensive paper and other features on some scratch games.

On five games we examined, the extra features accounted for between 4 and 79 percent of the total printing costs. In one of the games we examined, the lottery spent $225,000 to print the ticket on holographic paper for a total cost of $300,000. The printing costs were 6.6 percent of the sales revenues for that game, compared with 1.7 percent for other $1 scratch games. Despite the additional printing expense and a higher prize level than other scratch tickets, this game had lower sales and a significantly lower profit margin than other $1 scratch games.

The Snow Bank scratch game had lower than average profits despite higher prize levels and the use of holographic paper.

We do not know, however, the extent to which states in the comparison group pay these additional printing costs. So, we cannot say whether these extra costs are a major factor in the Lottery's higher than average scratch ticket expenses. Nevertheless, this is an area that

2 In return for the reduction in rates, the Lottery extended the vendor's contract for two years—the maximum permitted under the vendor's existing contract.

3 In fiscal year 2002, Minnesota had $241.1 million in scratch ticket sales compared to an average of $252.4 million for the comparison states.

4 Minnesota is about 21 percent larger than the average state in our comparison group. Minnesota may have higher delivery expenses due to its larger area. In addition, one of the comparison group states has its sales representatives deliver the tickets. As a result, its delivery costs are included in personnel and travel expenses rather than ticket expenses.

5 Kentucky derived 9.7 percent, Missouri 8.0 percent, Wisconsin 1.9 percent, and Indiana 0.2 percent of 2002 scratch ticket sales from pull-tabs.

the Lottery needs to study more carefully. Officials from the Minnesota State Lottery told us that features such as high gloss coatings attract players to games and increase sales and that some other states have had success with features such as holographic paper. While this seems possible, we are unaware of any research demonstrating that the additional sales resulting from a high gloss finish or other feature offsets the extra costs.

- **Another possible explanation is that the Minnesota State Lottery has placed a relatively low weight on cost when awarding the primary contract for scratch ticket production.**

The Lottery also selected a higher cost vendor as its primary supplier due to other considerations.

In 1999, when the Lottery last put the scratch ticket printing contracts out for bids, it gave cost considerations only 30 percent of the weight in its decision to award the main contract for scratch tickets. If the lottery had placed 50 percent or more of its weight on costs, it would have awarded the main contract to another company. That company offered prices that were about 20 to 25 percent lower than the company that was awarded the main contract. It is possible that other states place a greater weight on cost than the Minnesota State Lottery, but detailed information on contract awards in other states is not readily available.

Officials at the Lottery believe their decision to place only a 30 percent weight on cost is appropriate. They say that factors other than cost are very important. New scratch games come out every three weeks. According to Lottery officials, a scratch ticket vendor must be able to propose ideas for tickets that will sell. Assessing the marketing abilities of potential vendors is important, since profits probably depend more on sales volume than printing costs. Lottery officials also say that the 30 percent weight on cost is roughly the average weight assigned by other state lotteries.

Bidding Process

The Lottery used a competitive process to solicit bids and award contracts for both scratch ticket printing and delivery. As indicated above, proposals for scratch ticket printing were last solicited in 1999. Current contracts will expire in January 2005. Proposals for delivery services were last solicited in 1999. Only one vendor responded to the request for proposals for delivery services. That vendor's contract expires in August 2004.

Although the Lottery has used competitive processes, we found an irregularity in the process used by the Lottery in selecting the primary vendor for scratch ticket printing. In particular:

- **The Lottery's request for proposals for scratch ticket printing indicated that cost would receive greater weight than any other factor, but the Lottery ultimately gave cost the same weight as marketing capability.**

Specifically, the Lottery's request for proposals listed five criteria: 1) compliance with the request for proposals (Required); 2) experience, expertise, reputation and financial condition (Important); 3) technical capabilities (Very Important); 4) marketing capabilities (Very Important); and 5) price/cost (Extremely

Important). The Request for Proposals also said, " 'Extremely Important', 'Very Important', and 'Important' are in descending order of significance."[6] Thus, the request for proposals indicated that cost was more important than any of the other criteria in awarding the main contract.

Instead, the former director assigned the same weight of 30 percent to both marketing capability and cost. As noted above, a different main vendor might have been selected if cost received greater weight. Lottery officials maintain the winning bidder, who became the primary vendor, produced a superior and more marketable product. But, the Lottery has also used the low-cost bidder to produce at least two scratch games per year.

RECOMMENDATION

In 2004, when the Minnesota State Lottery solicits new bids for the production of scratch tickets, the Lottery should give more weight to price than it has in the past.

We understand that price should not be the only criterion used in evaluating competing proposals from vendors. But the Minnesota State Lottery has spent more to print scratch tickets than other states, and its sales have dropped in recent years while sales in similar states have increased. The Lottery needs to reassess whether the marketing advice provided by the primary scratch vendor has been worth the additional costs.

Online Tickets

Like other lotteries, the Minnesota State Lottery contracts with a private vendor to provide tickets for its online games. The vendor's online gaming system also provides online support to scratch ticket games. In fiscal year 2002, the Lottery spent about \$11.3 million for online services, maintenance of online equipment, and miscellaneous retailer supplies. These online expenses accounted for nearly 23 percent of the Lottery's operating expenses in 2002. In addition, the Lottery had \$0.8 million in depreciation expenses for online equipment that it had purchased.

Comparisons with Other States

In 2002, the Minnesota Lottery spent more than any other comparison group lottery for online tickets.

The Lottery's expenses for online services were 8.3 percent of its online ticket sales in fiscal year 2002. In contrast, the average online expense for comparison group states was 5.0 percent. Overall:

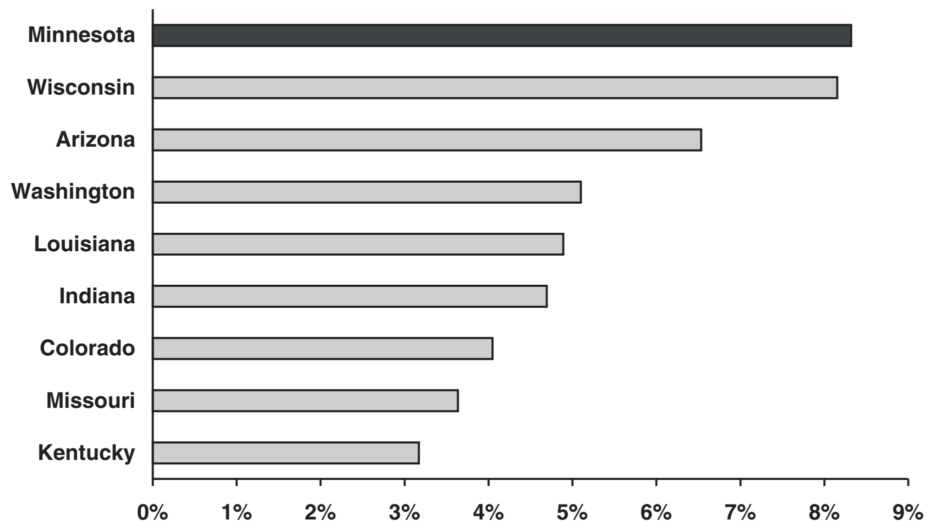
- **The Minnesota State Lottery paid 65 percent more than the average comparison state for online expenses as a percentage of online sales in fiscal year 2002.**

---

6 Minnesota State Lottery, *Request for Proposals for Scratch Game Tickets and Related Services*, (Roseville, October 19, 1999), 19-20.

As Figure 4.3 shows, Minnesota's online expenses as a percentage of online sales were higher than each of the comparison group states.[7] It is not entirely clear why Minnesota's costs were higher. Sales volume explains some of the difference, since Minnesota's online sales were about one-third lower than the average comparison group state. Generally, states with lower sales volume pay a higher percentage of sales to their online vendors. Differences in services and features of the online gaming system could also explain differences in cost. But we do not know whether Minnesota required more services and features of its online vendor

Figure 4.3: Online Ticket Expenses as a Percentage of Online Game Sales, FY 2002



SOURCE: Office of the Legislative Auditor analysis of lottery financial statements.

The Lottery's online ticket expenses are decreasing due to a new contract that began in February 2003.

than other states. Minnesota's online contract may also have been structured differently than contracts in other states. Minnesota did not receive a discounted rate for higher sales. Instead, the contract called for the vendor to be paid significantly higher percentages of sales for any sales in excess of $100 million. Up to $100 million in sales, the Lottery paid the vendor 6.862 percent of sales, but the rate increased to 11 percent for sales between $100 million and $125 million and to 12 percent for any sales in excess of $125 million. The Lottery's online sales were $136 million in fiscal year 2002.

Minnesota's online expenses declined to 7.2 percent of online sales in fiscal year 2003 and are expected to decline further to 6.2 percent in 2004.[8] This decrease was largely due to the Lottery's selection of a new online vendor, which started

7 This comparison does not include any depreciation expenses incurred by lotteries for online equipment. The Minnesota State Lottery incurred $0.8 million in depreciation expenses for online equipment in fiscal year 2002.

8 The percentage for fiscal year 2003 does not include $1.3 million in depreciation expenses for online equipment. The Lottery depreciated the book value remaining for online equipment used with the previous online vendor's system. This equipment became obsolete when the Lottery switched to a different online vendor in February 2003.

operating in Minnesota in February 2003. Even with the lower rates charged by the new vendor, the Lottery's online expenses as a percentage of online sales would exceed the 2002 average for comparison states by 23 percent. In addition, it would exceed the percentage spent by six of the eight comparison states in 2002.

Bidding Process

With the online services contract set to expire in mid-August 2002, the Lottery issued a request for proposals in November 2001 and awarded a new contract in June 2002. Because the new vendor was implementing a completely new system, the Lottery extended the previous vendor's contract until February 2003. The Lottery used an open competitive process to solicit proposals. Three vendors responded to the request for proposals. After reviewing the proposals and interviewing the responding vendors, a committee of Lottery employees recommended that GTECH Corporation replace Automated Wagering International, Inc. as the Lottery's online vendor.

The director of the Lottery awarded the contract for online services to GTECH, which was clearly the lowest bidder on cost. The Lottery gave cost a weight of 36 percent in its scoring of proposals and gave various technical criteria a combined weight of 64 percent. Since the committee gave very similar overall technical scores to each of the three interested vendors, cost was the deciding factor. GTECH had offered its services at 4.0 percent of sales while the other vendors bid 8.5 percent and 10.53 percent. However:

- **The Lottery requested additional services that increased the cost of online vendor expenses by more than 50 percent.**

The Lottery negotiated addtional features and services that were not part of the winning bidder's base price.

While GTECH offered its services at 4.0 percent of sales, the Lottery added additional features and services that increased the negotiated rate to 6.142 percent. One of the additional costs involved the lottery terminals. The Lottery chose to have all lottery terminals be identical and able to issue coupons and support other marketing efforts. The option of having uniform terminals—rather than some with a lower capacity and fewer options—cost the Lottery 0.412 percent of all online sales and increased the overall contract rate to 4.412 percent. This option was bid as part of the contract. The winning vendor's bid also included an option for the Lottery to purchase Aladdin terminal equipment for a cost of $1,513 per terminal. This option allows a terminal to read, write, and erase a magnetic card and could be used to support the use of a players club card, a gift certificate, or possibly support non-Lottery applications such as Department of Natural Resources (DNR) licenses. Under the bid, it would have cost the Lottery about $5 million to equip 3300 terminals with this option. The Lottery instead negotiated to purchase this option for 1.0 percent of future online sales. The Lottery will probably pay more for this option as a result of the negotiated deal. The Aladdin option increased the overall contract rate to 5.412 percent of online sales.

The Lottery also added a number of other features for a combined cost of 0.73 percent of online sales, bringing the total cost to 6.142 percent. First, the Lottery selected an Altura branding option that prevents attempts to cash a ticket a second time and prints the amount of a winning ticket on the bottom of the ticket to help ensure correct payouts. The winning bid offered this option for $153 per terminal, or about $500,000. Instead, the Lottery negotiated to include this option as part of the various options added for 0.73 percent of sales. Second, the Lottery wanted terminals to be able to issue coupons and gift certificates, which were used with the Lottery's existing online system. Lottery officials claim that this option was not bid since some vendors—including the winning vendor—did not have this capability, and the Lottery did not want to exclude any vendors from bidding. Yet, the winning vendor developed the capability for the Minnesota Lottery in order to get the contract. Third, the Lottery wanted terminals with larger customer displays. The winning bidder had offered 24-inch terminals at $603 per terminal in its bid. The Lottery negotiated to have these larger terminals as part of the final 0.73 percent cost.

Finally, the Lottery chose to use internet protocol technology that used satellite transmission instead of transmission via ground telephone wires. This option permits the Lottery to install retail terminals much quicker than when they relied on telephone lines. In addition, Lottery officials say that internet protocol enables the Lottery to broadcast Amber Alert pictures and full motion video to retailers. Retailers are also able to utilize a PC-based cash register to run the lottery terminal. Lottery officials claim that the technology can also run other gambling options such as bingo and keno if these are authorized by the Legislature. It might enable lottery terminals to issue DNR or state licenses or serve other functions such as voter registration, organ donation, issuance of storm warnings, or the sale of bus passes or movie tickets.

The Minnesota Lottery was the first state lottery to use internet protocol technology with satellite transmission.

Even though the Minnesota Lottery was the first in the nation to have internet protocol with satellite transmission, officials maintain that this technology has been selected by each of the states that have subsequently solicited bids for online services.[9] In addition, according to Lottery officials, the consultant who analyzed the online bids for the Minnesota Lottery says that Minnesota's online costs are reasonable in comparison with those of other state lotteries.

We think the Lottery's choice to add these options and increase the costs of the new system by more than 50 percent warranted review by the Legislature and the Department of Finance. We think that some of the Lottery's choices were merited but others deserved greater discussion and review.

The Lottery's current contract with the online vendor does not expire until February 2008, so there is little that could be done to change the contract at this point. The contract, however, can be extended for up to five more years. In addition, the Lottery could potentially modify the existing contract prior to 2008 to procure additional services and incur additional costs. As a result, we think there should be oversight of the Lottery's online ticket contract if the need arises.

9 The states that have also selected internet protocol technology over satellite include California, Georgia, Florida, and Tennessee.

RECOMMENDATIONS

The Minnesota State Lottery should consult with appropriate legislative committees and the Department of Finance if it decides to extend the contract for online services beyond 2008.

If the Minnesota State Lottery wishes to add more services or costs to the current contract for online services, the lottery should consult in advance with appropriate legislative committees and the Department of Finance.

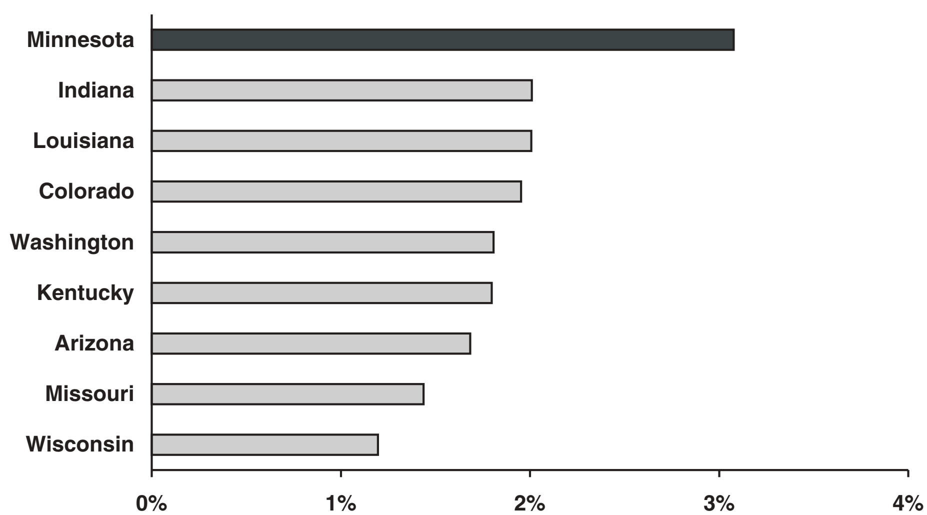
PERSONNEL EXPENSES

Personnel expenses are an important component of lottery operating expenses in Minnesota and other states. In Minnesota, about one-fourth of the Lottery's operating expenses are for employee salaries and benefits. As Figure 4.4 demonstrates, however, the Minnesota State Lottery spends considerably more on personnel than other lotteries in our comparison group. In fiscal year 2002, Minnesota spent 3.1 percent of its sales revenue to pay for employee salaries and benefits. No other state in the comparison group of lotteries spent more than 2.0 percent of sales on wages and salaries. The average among comparison states was only 1.7 percent of sales. Overall, we found that:

- **The Minnesota State Lottery's personnel expenses as a percentage of sales were 77 percent higher than the average for comparison state lotteries during fiscal year 2002.**

The Minnesota Lottery spends more on personnel than similar lotteries.

Figure 4.4: Employee Salaries and Benefits as a Percentage of Sales, FY 2002



SOURCE: Office of the Legislative Auditor analysis of lottery financial statements.

Two factors explain Minnesota's higher personnel expenses: staffing levels and compensation. The Minnesota Lottery had both higher staffing levels and higher compensation than the average state lottery in our comparison group. As we will demonstrate below, the Minnesota State Lottery's staffing level was about 50 percent higher than the average for the comparison group in fiscal year 2002. The average salaries and fringe benefits per employee was about 18 percent higher in Minnesota than in the comparison states. As a result, we conclude that:

- **Close to three-fourths of the difference in personnel expenses between Minnesota and the comparison state lotteries was due to Minnesota's higher staffing levels, while about one-fourth was due to Minnesota's higher salaries and fringe benefits.**

Staffing Levels

In fiscal year 2002, the Minnesota State Lottery had 192 full-time staff and sales of $377 million. As shown in Table 4.3, the eight comparison states had, on average, $467 million in sales and employed 156 full-time staff. Minnesota had 0.51 staff per $1 million of sales, compared with an average of 0.34 staff per $1 million of sales for the comparison states.[10] In other words:

- **In fiscal year 2002, the Minnesota State Lottery had about 50 percent more staff per $1 million in sales than the average for our comparison group of state lotteries.**

Minnesota had more staff per $1 million in lottery sales than each of the eight states in our comparison group. Minnesota's staffing-to-sales ratio was 10 percent

In 2002, the Minnesota Lottery had higher personnel costs than comparable lotteries due mostly to Minnesota's higher staffing levels.

Table 4.3: FTE Staff at Minnesota and Comparison State Lotteries, FY 2002

State	(in Millions of $)	FTE Staff	Staff Per $1 Million in Sales
Minnesota	**$377**	**192**	**0.51**
Arizona	295	123	0.42
Colorado	408	125	0.31
Indiana	626	213	0.34
Kentucky	639	205	0.32
Louisiana	312	145	0.46
Missouri	585	179	0.31
Washington	439	149	0.34
Wisconsin	428	105	0.25
Average	467	156	0.34
Median	434	147	0.33
Minnesota (Projected for FY 2004)	374	158	0.42

SOURCES: Office of the Legislative Auditor analysis of data from the Minnesota State Lottery and the North American Association of State and Provincial Lotteries, *NASPL 2003 Lottery Resource Handbook*, (Willoughby Hills, OH, 2003).

10 Minnesota's staffing level was nearly double the average level for all other states with lotteries in 2002. The average number of staff per $1 million in sales was 0.26 for these 37 states. Only Montana and Iowa had higher staff-to-sales ratios than Minnesota.

higher than the ratio in Louisiana and 108 percent higher than in Wisconsin. In addition, Minnesota's sales representatives covered about 22 percent less territory—as measured by square miles per sales representative—than the average for the comparison group of states.

Effect of October 2003 Layoffs

In October 2003, the Minnesota State Lottery reduced its workforce from 191 to 157 full-time staff. The Lottery also laid off one of its two part-time employees and 10 of 11 student workers. These reductions were among the budget cuts that the lottery director implemented in order to reduce the Lottery's fiscal year 2004 operating expenses below the cap set by the 2003 Legislature.

Even after recent layoffs, the Minnesota Lottery has more staff than most of the comparison group lotteries.

As part of the staff reduction, the director of the Lottery eliminated the entire telemarketing office (10 staff). The Lottery also laid off 9 of the 39 sales representatives and 5 of the 17 office and warehouse personnel at the Lottery's regional offices. Other reductions included two staff in the Administration Division, two staff in the Operations Division, and five additional staff in the Marketing Division. The Executive Division retained all 24 of its full-time employees and lost only one student worker in the Graphics Office. In our view:

- **Most of the recent staff reductions made by the Minnesota State Lottery in response to expense caps imposed by the Legislature were reasonable. But, even after the October 2003 layoffs, the Minnesota State Lottery had about one-fourth more staff per $1 million in sales than the comparison group average for fiscal year 2002.**

The telemarketers provided a communications link between the Lottery and its retailers. They answered questions from retailers, informed retailers when the retailers' ticket supplies were low, provided information on new games and promotions, and informed sales representatives if retailers were having equipment problems. The telemarketers provided a useful role but were not essential to the Lottery's operation. Sales representatives, who regularly visit retailers, and staff from the Lottery's Operations Division, who control ticket distribution, can handle most of the functions of the telemarketers. The telemarketers may have been more proactive in anticipating the ticket needs of retailers than the Lottery's computerized system of ticket distribution, but we do not think that the elimination of the telemarketing office should affect sales.

Similarly, we think that the other staff reductions are not likely to significantly affect lottery sales. The most significant area of concern would be regarding the reduction in the number of sales representatives. Sales representatives work with retailers and attempt to improve lottery sales through favorable signage and promotions targeted at lottery customers. As a result of the staff reductions, sales representatives will be able to visit each retailer less frequently since each representative will be responsible for about 100 retailers instead of 80. But, the representatives should be able to handle the increase in workload by setting priorities for retailer visits. With the reduction in the number of sales representatives, Minnesota sales representatives will be covering about the same number of square miles per representative as in the average comparison group state in fiscal year 2002.

After the layoffs, the Minnesota State Lottery had 158 full-time equipvalent employees, or about 0.42 staff per $1 million of estimated sales for fiscal year 2004. Seven of the eight comparison lotteries had lower staff-to-sales ratios in fiscal year 2002. Minnesota would have to reduce its workforce to about 128 full-time employees to match the comparison state average of 0.34 staff per $1 million of sales.

Managerial and Supervisory Staff

We think that the size of the Lottery's staff merits additional review by legislative budget committees. In addition, we have concerns about the composition of the Lottery's staff. In particular, we are concerned that:

- **The Minnesota State Lottery has a higher percentage of managers and supervisors than most state agencies. In addition, the Lottery has four assistant directors each earning $98,100 annually.**

As of July 1, 2003, 18 percent of the lottery's employees—including part-time staff and student workers—were managers or supervisors. After the layoffs, the percentage of managers and supervisors grew to 21 percent. By comparison, the average for state agencies in Minnesota with 25 or more employees was 15 percent on July 1, 2003. The average was only slightly higher (16 percent) for state agencies that, like the Lottery, had between 100 to 300 employees.[11]

The Lottery has a higher percentage of assistant agency heads and managers than most other Minnesota state agencies.

The Minnesota State Lottery also has four assistant directors and two assistants to the director, as well as a research director and small research staff. Before the layoffs, the Lottery had one assistant director for every 48 employees, excluding student workers and part-time employees. After the layoffs, this ratio dropped to 40 employees per assistant director. One of the Lottery's assistant directors is its legal counsel. This individual does not manage a division and has no supervisory responsibilities. Another assistant director heads the Administration Division—which employs 26 staff in human resources, accounting, purchasing, office services, and maintenance—but has no involvement with operations or sales. We question whether these two positions need to be filled by employees with the rank and salary of assistant director, each earning $98,100 per year.

In contrast to the Lottery, the 23 Minnesota state agencies with 50 or more employees averaged 2.7 deputy or assistant commissioners per agency, and had a median 201 staff per deputy or assistant commissioner. Only three of these agencies before the Lottery's layoffs—and one after the layoffs—had fewer employees per deputy and assistant agency head than the Lottery.[12]

Comparative data on other lotteries is not readily available. Some lotteries have more assistant directors (or their equivalents) than the Minnesota State Lottery, while others have fewer. Some only have one deputy director. We do not have information on the overall percentage of managers and supervisors at other

11 Information provided by the Workforce Analysis Unit, Minnesota Department of Employee Relations, September 2003.

12 Information provided by the Workforce Analysis Unit, Minnesota Department of Employee Relations, October 2003.

lotteries, but we know that comparable lotteries have fewer supervisors overseeing their sales representatives. The Minnesota State Lottery had seven regional managers supervising its 39 sales representatives prior to the October 2003 layoffs, or 5.6 sales representatives per supervisor. As a result of the layoffs, this figure has fallen to 4.3 sales representatives per supervisor, or more than 40 percent lower than the average of 7.3 for the comparison state lotteries.

Employee Compensation

We estimated average compensation—including salaries and fringe benefits—for lottery employees in Minnesota and the eight comparison states by dividing the salaries and benefits reported in their financial statements by the number of full-time staff they reported to the North American Association of State and Provincial Lotteries. As shown in Table 4.4:

- **In fiscal year 2002, compensation per employee at the Minnesota State Lottery was about 18 percent higher than the average for our eight-state comparison group.**

Salaries at the Minnesota Lottery are generally higher than those at comparable lotteries.

Table 4.4: Employee Compensation at Minnesota and Comparison State Lotteries, FY 2002

State	Salaries and Benefits Expenses (in Millions of $)	FTE Staff	Average Compensation Per Employee
Minnesota	**$11.6**	**192**	**$60,434**
Arizona	5.0	123	40,379
Colorado	8.0	125	63,738
Indiana	12.6	213	59,084
Kentucky	11.5	205	56,000
Louisiana	6.3	145	43,121
Missouri	8.4	179	46,976
Washington	7.9	149	53,200
Wisconsin	5.1	105	48,679
Average	8.1	156	51,397
Median	7.9	147	50,939

SOURCES: Office of the Legislative Auditor analysis of data from lottery financial statements and the North American Association of State and Provincial Lotteries, *NASPL 2003 Lottery Resource Handbook*, (Willoughby Hills, OH, 2003).

Minnesota State Lottery employees received, on average, $60,434 in salaries and benefits compared with $51,397 for the comparison states. Among the eight comparison lotteries, only Colorado employees had higher compensation than Minnesota. It is not entirely clear why compensation was higher in Minnesota. As discussed in Chapter 2, the cost of living in Minnesota is about 8 percent higher than in the comparison group states, so that could explain some of the difference. In addition, it appears that State of Minnesota employees, in general, are paid more than state employees in comparison states. An Office of the Legislative Auditor analysis of a salary survey conducted in 1998 found that state employee salaries in Minnesota ranked in the upper third of the 24 states participating in the survey for 87 of 107 comparable positions.[13] Most of the positions compared were not job titles held by Lottery employees. We looked at average salaries for nine job titles currently held by at least one Lottery employee. Average salaries for Minnesota workers in those positions exceeded the average salaries for those positions in the 24 states participating in the survey by 11 percent.

But, the Lottery's higher salaries are generally consistent with the higher salaries in Minnesota state government when compared with other states.

More recently, the American Federation of Teachers surveyed state governments to determine average salaries of state workers for a selection of jobs.[14] We reviewed the results for 15 job titles where average salary data existed for Minnesota and the eight comparison states. None of these specific job titles are currently held by Minnesota Lottery employees. They include a range of positions such as corrections officer, nurse, accountant, chemist, environmental engineer, tax auditor, and librarian. Depending on the position, Minnesota state employee salaries exceeded the average salaries in the comparison states by 7 to 37 percent, with the average difference being 19 percent. For most job titles, salaries of Minnesota workers were higher than all of the comparison states except Colorado.

Compensation for most of the Lottery's non-management employees is set through the collective bargaining process. Many of the positions, such as "management analyst" or "information technology specialist" exist statewide with an established salary range. Some positions, such as "lottery sales representative," are unique to the lottery. These positions, when created, were rated by the Department of Employee Relations and assigned a salary grade and pay range. Sales representatives currently earn between $35,245 and $51,469, depending on their years with the state. While this seems reasonable, we do not know how salary ranges for specific non-managerial jobs in Minnesota compare with salaries for comparable jobs in other states.

There are some comparative data about managerial positions. The North American Association of State and Provincial Lotteries (NASPL) surveyed lotteries about the salaries of top management positions.[15] Lotteries from 27 states responded, including 6 of the 8 states in our comparison group.[16] Results from the NASPL survey suggest that the top management salaries at the Minnesota State Lottery are higher than typical salaries at other state lotteries. The director of the Minnesota Lottery earns $114,300 annually compared with a median of $105,300 for all of the lotteries responding to the survey and $109,526 for the eight comparison states. Minnesota has four assistant directors (for operations, marketing, administration, and legal counsel) who each earn $98,100 annually. The median salary for deputy directors at other states was $87,900, while the medians for general counsels, marketing directors, and operations directors, were $84,253, $78,000, and $73,425 respectively. Minnesota salaries for top management also appear to be generally higher than salaries for those

13 Office of the Legislative Auditor, *State Employee Compensation*, (St. Paul, 2000), 21.

14 American Federation of Teachers, *AFT Public Employees Compensation Survey, 2003*, (Washington, DC, 2003).

15 North American Association of State and Provincial Lotteries, *NASPL Salary Survey* (Willoughby Hills, OH, January 2003).

16 Colorado and Missouri did not respond to the survey, although we ascertained the lottery director's salary from them. Of the states that did respond, not all of them responded to every item.

positions in comparison group states, although only about half of the comparison group states reported salaries for some of these positions.[17]

RECOMMENDATIONS

The Minnesota State Lottery should compare its staff size and composition with similar lotteries and consider further reductions in staff as appropriate.

The Minnesota State Lottery should consider reducing the number of assistant directors and assistants to the director, as well as the number of managers and supervisors.

OFFICE AND WAREHOUSE RENT

The Minnesota State Lottery leases about 46,000 square feet of office space for its headquarters in Roseville and nearly 20,000 square feet at its six regional offices around the state. It also leases close to 57,000 square feet of warehouse space in Roseville, Eagan, and the other regional offices. We found that:

- **Minnesota spent more on office and warehouse rent in fiscal year 2002 than comparable state lotteries.**

As we saw in Chapter 2, Minnesota's spending as a percentage of sales on office and warehouse rent in fiscal year 2002 appeared to be almost four times what lotteries in our comparison group spent on rent. This comparison is misleading, however, because three of the state lotteries in the comparison group (Arizona, Kentucky, and Missouri) owned their headquarters building and did not pay rent for it.[18] Nevertheless, Minnesota spent 168 percent more on rent as a percentage of sales than the average amount spent by the five lotteries from our comparison group that leased their headquarters.

The Minnesota State Lottery uses more space than comparable lotteries.

Office and Warehouse Space

One reason for Minnesota's higher than average expenditures on rent is clear. Namely:

- **The Minnesota State Lottery uses significantly more office and warehouse space than lotteries in our comparison group.**

As shown in Table 4.5, the Minnesota State Lottery has larger facilities than most states in the comparison group when measured per employee or per million dollars of sales. In 2002, Minnesota's Lottery had 150 square feet of office space

---

17 The median salary for general counsel for the five comparison state lotteries that responded was $82,469; the median salary for marketing director (5 respondents) was $78,000; and the median salary for operations director (4 respondents) was $62,332.

18 Although Louisiana rented its headquarters building in fiscal year 2002, it has recently completed construction of a new headquarters building. All four states used lottery proceeds to pay for their facilities.

Table 4.5: Office and Warehouse Space Used by Minnesota and Comparison State Lotteries, FY 2002

State	Lottery Sales (in Millions of Dollars)	FTE Employee	Office Space (Square Feet)	Office Space Per $1 Million in Sales (Square Feet)	Office Space Per FTE Employee (Square Feet)	Warehouse Space (Square Feet)	Warehouse Space Per $1 Million in Sales (Square Feet)
Minnesota	**$377**	**192**	**56,582[a]**	**150**	**295**	**56,917**	**151**
Arizona	295	123	28,080	95	228	12,000	41
Colorado	408	125	32,335	79	259	30,145	74
Indiana	626	213	58,800	94	276	29,000	46
Kentucky	639	205	56,900	89	278	68,200	107
Louisiana	312	145	44,574	143	307	15,000	48
Missouri	585	179	67,000	115	374	35,080	60
Washington	439	149	37,273	85	250	22,279	51
Wisconsin	428	105	19,106	45	182	8,000	19
Average	467	156	43,009	93	269	27,463	56
Median	434	147	40,924	91	267	25,640	49

[a]Includes total office space of 65,718 square feet less 9,136 square feet sublet to online games vendor.

SOURCES: Office of the Legislative Auditor analysis of data from lottery financial statements, the Real Estate Management Division of the Minnesota Department of Administration, and the North American Association of State and Provincial Lotteries, *NASPL 2003 Lottery Resource Handbook*, (Willoughby Hills, OH, 2003).

per million dollars of sales. This was more than any of the comparison states and 61 percent above the comparison group average.

Some of this difference is due to the fact that the Minnesota State Lottery has more employees per million dollars of sales than comparable lotteries. But, the Minnesota Lottery also has more office space per employee. In 2002, Minnesota's Lottery had 295 square feet of office space per employee, 9 percent more than the average of 269 square feet per employee for the comparison group of lotteries. Since 2002, office space per employee at the Minnesota State Lottery increased 41 percent to 416 square feet per FTE employee due to the end of the sublease of space to the Lottery's online vendor in February 2003 and the reduction in staff that occurred in October 2003. This increase would put the Lottery's office space per employee about 54 percent higher than the average for comparable lotteries was in 2002. In addition, the Lottery's office space per million dollars of sales would now be about 87 percent higher than the 2002 average for comparable lotteries.

The Lottery has even more office space per employee since it reduced its staff size in October 2003.

Lottery headquarters building in Roseville.

The Lottery's warehouse space of 151 square feet per $1 million of sales was more than two and a half times the comparison group average of 56 square feet per million dollars of sales. Since warehouse space is used far more for scratch tickets than for online sales, we also calculated warehouse space per dollar of scratch ticket sales. Minnesota has 121 percent more warehouse space per million dollars of scratch ticket sales than the average for our comparison states.[19]

We also compared the Lottery's amount of office space and its rental rates for office and warehouse space with those of other Minnesota state agencies. We found that:

- **The Minnesota State Lottery also has more office space per employee than most state agencies of comparable size.**

Most state agencies in Minnesota have less office space per employee than the Lottery.

As shown in Table 4.6, even prior to its October 2003 layoffs, the Lottery ranked third highest in office space per employee among the 16 state agencies with between 50 and 1,000 employees. During fiscal year 2003, the Lottery had about one-third more office space per employee than the average for this group of agencies. This difference may have increased significantly after the Lottery's October 2003 layoffs since the Lottery's office space per employee increased by

Table 4.6: Office Space Used by Minnesota Agencies With 50 to 1,000 Employees, FY 2003

Agency	Employees	Square Feet of Office Space	Square Feet Per Staff
Education	424	159,218	376
Attorney General	390	139,542	358
Lottery	**202**	**65,718**	**325**
Commerce	323	98,441	305
Higher Education Services	88	24,818	282
Labor & Industry	355	96,898	273
Employee Relations	162	42,896	265
Pollution Control	776	204,271	263
Housing Finance	190	48,097	253
Secretary of State	86	21,715	253
Finance	161	38,655	240
Administration	869	200,676	231
Board of Water and Soil Resources	70	15,227	218
State Auditor	124	20,046	162
Agriculture	517	67,672	131
Military Affairs	267	23,237	87
Average	320	80,094	246
Median	267	48,097	253

NOTE: Employees include part-time and student employees. Office space includes offices leased from private firms and offices in state owned buildings leased through the Department of Administration. The averages and medians exclude the lottery.

SOURCES: Office of the Legislative Auditor analysis of data provided by the Workforce Analysis Unit, Minnesota Department of Employee Relations and the Real Estate Management Division, Minnesota Department of Administration.

19 While warehouse space is best measured by volume, available information only includes square footage. It is possible that some warehouses in comparison states are taller than in Minnesota. If that were generally true, then Minnesota's warehouse volume would be closer to the comparison group average than is indicated in this report.

more than 25 percent after the layoffs. Changes in the number of employees and the amount of office space may also have occurred, however, at state agencies in our comparison group.

Lease Rates

Data on the lease rates paid by other state lotteries are not generally available. So, we could not directly compare Minnesota's lease rates to those paid by other lotteries. Instead, we compared the Lottery's lease rates with the rates paid by other Minnesota state agencies leasing buildings in the same or nearby communities. These comparisons did not take into account the characteristics of the buildings such as their age and condition, the convenience and desirability of their locations, or any tenant obligations to pay for maintenance and utilities. The rate comparison indicated that:

The Lottery's lease rates for its outstate offices are higher than those paid by other state agencies.

- **The Lottery's lease rates for its offices and warehouses in the Twin Cities area are about average for state agencies, but its lease rates for outstate space are generally higher than those paid by other state agencies.**

The Lottery's rate per square foot for office space at its headquarters in Roseville is equal to the average rate paid by state agencies in the northern suburbs of St. Paul, while its rate for office space in Eagan is about 8 percent lower than the average rate paid by state agencies in nearby suburbs. Lease rates for warehouse space in Roseville and Eagan are within one percent of the average paid by state agencies in Ramsey County.

In contrast, the Lottery pays rates for office space in outstate Minnesota cities that range from 13 to 68 percent higher than the rates paid by other state agencies in the same or nearby cities. Lease rates for three of the regional offices—Detroit Lakes, Owatonna, and Marshall—were higher than rates for any other state offices in those cities.[20] The rates paid by the Lottery for outstate warehouse space are two to three times the rates paid by other state agencies.

Options

Lottery officials are currently weighing options on what to do with the space leased to its former online games vendor. The Lottery is consulting with the Department of Administration to determine whether it can consolidate some offices and relocate its headquarters to the state building occupied by the Minnesota Department of Revenue. Space is available in that building, but the Department of Administration is examining the suitability of the space for the Lottery.

One issue that must be overcome is that most of the existing leases for the Lottery's buildings do not expire until 2010 or later, so the Lottery would either have to find a legal basis for breaking the lease or find another party to occupy the

20 The regional offices in Marshall and Owatonna and their attached warehouses were constructed specifically for the Lottery after Lottery officials decided that the facilities they were leasing were not adequately meeting the Lottery's needs.

The Lottery could terminate existing leases if offices are moved to state-owned space.

facility. Statutes allow the state to cancel a lease upon 30 days notice for any reason other than to lease other non-state-owned property for the same use.[21] Lottery office leases all contain similar language. In addition, Lottery office leases allow the Lottery to cancel the lease upon 30 days notice if the Legislature does not appropriate sufficient funds to continue the lease agreement. Lottery officials interpret the law and their lease agreements to prohibit them from closing a regional office and relocating the staff to another Lottery office because the existing offices are all privately owned. We question their interpretation. In our opinion, if the Lottery closes an office and does not replace it with a new office, it would not be violating the terms of the lease. Furthermore, the cap placed on Lottery operating expenses by the Legislature, while technically not an appropriation cut, has the same effect and might be sufficient grounds for the Lottery to cancel a lease.

RECOMMENDATION

Following assessment of the Lottery's space needs and options, the Department of Administration and the Minnesota State Lottery should report back to the Legislature on options for reducing the amount of leased space. The lottery should examine the potential for consolidating the Roseville headquarters and the Eagan regional office and eliminating one of the regional offices outside the Twin Cities area.

TRAVEL EXPENSES

It is difficult to compare travel costs for the Minnesota State Lottery with those for other comparable lotteries. In fiscal year 2002, Minnesota had lower operating expenses for travel, including travel within Minnesota and to other states. But the Minnesota Lottery had higher depreciation expenses than other states, and some of that depreciation was for vehicles. As a result, we cannot draw any conclusions about how Minnesota's travel expenses compare with those of other state lotteries. We did, however, review Minnesota's travel expenses.

In fiscal year 2002, the Minnesota State Lottery spent about $218,000 in operating expenses on travel and had depreciation expenses of $175,000 on vehicles owned by the Lottery. The travel expenses included $109,000 for operations and repair of Lottery vehicles, $18,000 in reimbursements for employee use of personal vehicles, $44,000 for airplane travel, and $46,000 for lodging and meals. In this section, we focus mainly on the expenses related to the purchase and operation of the Lottery's vehicles. We also performed a limited review of the Lottery's out-of-state travel expenses and its in-state lodging and meal expenses. Out-of-state trips by Lottery employees were limited to several trips to national conventions and numerous trips by the Lottery's security director to inspect scratch tickets prior to their printing by an out-of-state vendor. We comment elsewhere in this report about lodging and meal expenses incurred by the Lottery at Minnesota Pro/Am Bass Tour events.

21 Minn. Stat. (2003), §16B.24, subd. 6.

Vehicle Fleet

In fiscal year 2003, the Minnesota State Lottery owned 59 vehicles, including 45 minivans, 12 cars, a van, and a truck. Most of the vehicles were assigned to Lottery employees in the regional offices. Each of the 40 sales representatives had a minivan, each of the seven regional managers had a car, and a promotions coordinator from the Virginia office had a minivan. Cars were also assigned to four individuals working at the Roseville headquarters, including the former director, the state sales manager, and two investigators from the Security Office. In addition, the Roseville headquarters had three minivans and one car for general use by Lottery employees, as well as a minivan for courier use and a van and truck assigned to the warehouse.

Sales representatives need vehicles to conduct Lottery business.

Lottery officials had previously expressed concern that some of their vehicles have considerable mileage on them and may not be worth keeping much longer. For example, thirteen vehicles had been driven more than 100,000 miles. The Lottery's fleet included vehicles purchased between fiscal years 1997 and 2001.

Each of the Lottery's sales representatives has a minivan, while certain other employees had sedans.

In our view, the Lottery has purchased vehicles that seem appropriate for use by state employees. They include Dodge Caravan and Plymouth Voyager minivans; Dodge Stratus, Chevrolet Lumina, and Dodge Intrepid sedans; and a Chevrolet cargo van. The purchase price of the vehicles has ranged from $13,700 to $20,500, not including sales tax. The Lottery purchased the used truck for about $50,000. But, we think that:

- **The Lottery has incurred unnecessary vehicle expenses and could reduce the number of vehicles in its fleet.**

Vehicles Used for Commuting

One of our concerns about the Lottery's fleet focuses on the vehicles that were assigned to the former director, the state sales manager, the security investigators, and the seven regional managers.

- **The Lottery has allowed eleven employees to use Lottery vehicles to commute to and from work.**

Some of the individuals have fairly lengthy commutes. Three of the regional managers have daily round-trip commutes of 92, 116, and 128 miles, while one of the security investigators has a daily commute of 60 miles. The others have commutes ranging from 20 to 40 miles per day. These three regional managers may be putting as many as 20,000 to 28,000 miles per year of commuting mileage on Lottery vehicles.[22] The Lottery also assigns a vehicle to each sales representative, and these sales representatives use their Lottery vehicles to travel between their home and various business locations. But, under collective bargaining agreements, a sales representative's home is considered the employee's primary place of work in most cases. As a result, such travel is not considered commuting for sales representatives.

In our view:

- **None of the Lottery employees with assigned vehicles except sales representatives should use them for commuting purposes.**

The Lottery allowed too many employees to commute to and from work with Lottery vehicles.

In the worst cases, we believe that 75 percent or more or the total mileage on Lottery vehicles has been due to commuting. In some other cases, the commuting mileage may only be 33 to 50 percent of the miles driven on the Lottery vehicles. But, even in those cases, the amount of business miles does not justify permanently assigning a vehicle to an employee.

We noted that one of the regional managers does not use the Lottery-assigned vehicle for commuting on most days. She leaves the vehicle at home unless she is traveling to a location other than the regional office that day. While we might still consider some of her mileage as commuting mileage on those days depending on her trips, her practice has limited the amount of total mileage on the vehicle. In fiscal year 2003, she put a total of 7,900 miles on the Lottery vehicle, while other outstate regional managers drove between 19,400 and 28,600 miles. One of the regional managers in the metropolitan area drove about 12,400 miles in 2003, while the other—who commutes from Owatonna—drove 27,800 miles.

The Lottery does not receive any reimbursement from its employees for commuter use of Lottery vehicles. State policy does not permit such reimbursement.[23] Instead:

- **State law prohibits use of state vehicles for commuting except under very limited circumstances.**

---

22 Their commuting mileage is difficult to estimate without a complete examination of vehicle logs. Regional managers sometimes travel from their homes to retailers before going to the regional office, or travel from the office to retailers before going home in the evening. The Lottery excludes any such trips when estimating commuter mileage. But we think that some of that mileage is also commuting mileage. For example, if a regional manager leaves the office and goes to a retailer 2 miles away and then travels 56 additional miles to reach home, we would consider 4 miles to be business-related and the other 54 miles to be commuter miles. State employees using their personal vehicles for business would be reimbursed for only 4 miles, including 2 miles to the retailer and the lesser of the mileage back to the office (2 miles) or the mileage from the retailer to the manager's home (56 miles).

23 For tax purposes, $1.50 is added to an employee's gross pay for each direct one-way trip between home and the permanently assigned workstation. Nothing is added to the employee's gross pay if that trip is interrupted by a stop at another business-related site. However, other than the taxes on this addition to gross pay, the state does not receive any reimbursement for the employee's use of a state vehicle for commuting purposes.

In our view, state law prohibits any of the Lottery employees that had permanently assigned vehicles—except sales representatives—from using them for commuting except on those days and occasions when the employees had business away from their permanent work stations and the number of miles traveled or time needed to conduct business would be minimized.[24]

In late October 2003, following our review of Lottery vehicle usage and as part of its budget cuts, the Lottery ended its practice of permitting these employees to use Lottery vehicles for commuting purposes. The vehicles previously assigned to Roseville employees are now available for use by all employees. The regional managers still have assigned vehicles but are supposed to use them only on days that they are traveling to sites other than the regional offices.

Fleet Size

The Lottery has excess vehicles that should be sold.

This change addresses some of our concerns about vehicle expenses and usage. But we think that the Lottery does not need to retain all of the vehicles that were permanently assigned to individuals, particularly the ones at their Roseville headquarters. The Lottery already had four vehicles available for general use in Roseville. In addition, the Roseville headquarters has a cargo van that was driven only 2,500 miles in fiscal 2002 and 2,900 miles in 2003 and had been driven a total of only 19,800 miles as of the end of fiscal year 2003. While the Lottery finds the size of this vehicle desirable for some uses:

- **The cargo van does not appear to receive enough use to justify continued ownership.**

The truck or one of the Lottery's pool minivans may be adequate to meet the Lottery's needs. On those limited occasions where neither is adequate or available, the Lottery might find it more efficient to rent a cargo van. In deciding whether to sell the cargo van, the Lottery needs to consider the van's market value, along with its operating costs, and the Lottery's ability to use other Lottery vehicles or a rental vehicle.

RECOMMENDATION

The Minnesota State Lottery should assess how many vehicles it needs for efficient operations. The lottery should sell any excess vehicles through the state's surplus property program.

Other Travel Issues

We also reviewed reimbursements that Lottery employees have received for travel expenses. This section presents our concerns about Lottery practices.

24 *Minn. Stat.* (2003), §16B.55.

Vehicle Mileage Reimbursements

We also found some problems with employee reimbursements for the use of personal vehicles while we were reviewing the Lottery's expenses for the Minnesota Pro/Am Bass Tour. As previously mentioned, the Lottery has been sending as many as eight employees to Bass Tour events. While we find this practice inappropriate, we also think that, if employees are required to attend these events, they should be reimbursed for travel and meal expenses in accordance with state policy. Instead, we found that:

- **Some employees traveling to Minnesota Pro/Am Bass Tour events were reimbursed for the use of their personal vehicles at a higher rate than allowed by state policy.**

Under the state's policy for travel expenses, reimbursement for use of a personal vehicle is seven cents per mile lower if a state vehicle is available for use. In four instances, we found that Lottery employees used their own vehicles and were reimbursed at the higher rate even though several Lottery vehicles were available. The amount of excess reimbursement was $110. These particular instances may not be isolated examples. We found that:

- **The Lottery does not review mileage reimbursement claims to see if a Lottery vehicle could have been used instead of an employee's personal vehicle and employees should receive the lower of the two reimbursement rates.**

RECOMMENDATION

The Minnesota State Lottery should periodically review employee requests for vehicle mileage reimbursement to see if a Lottery vehicle could have been used instead of the employee's vehicle. Employees should be reimbursed at the lower of the two rates if it would have been more efficient to use a Lottery vehicle instead. The Minnesota State Lottery should clearly communicate this policy regarding vehicle mileage reimbursements to its employees.

Lodging in the Twin Cities Area

The former director received lodging and meal reimbursements for a fishing tournament held in the Twin Cities area.

In reviewing fishing-related travel expenses, we also found that:

- **The former Lottery director received reimbursement of about $211 for lodging and $55 for meals while he fished at a Twin Cities bass fishing tournament sponsored by the radio station KFAN.**

In our view, reimbursement for these expenses was inappropriate for several reasons. First, the tournament was in the Twin Cities metropolitan area, and the lodging was only 19 miles from the Lottery's Roseville headquarters. So, the former director could have returned home in the evening and avoided the lodging expense. Second, the connection between the tournament and Lottery business is weak. The former director could have attended the tournament and made business contacts without staying overnight and incurring meal expenses. Finally, the former director received a personal benefit from fishing in the tournament and should not have received state reimbursement of his lodging and meal expenses to support his interest in fishing.

It should be noted that this fishing tournament was not a Minnesota Pro/Am Bass Tour event. The Lottery does business with KFAN and has an interest in maintaining its relationship with the radio station. But, we think that the former director could have done that without billing the state for lodging and certain meals.

Travel Advances

We reviewed the Lottery's practice of providing travel advances to employees. The Lottery has paid travel advances to some employees—including the former director and at least two other employees—through a Lottery checking account rather than through the state's payroll system as is required for state employees. By not using the state's payroll system, the Lottery has violated several Department of Finance policies. These violations would have been prevented if the Lottery had instead used the payroll system. We observed the following problems:

The former director received inappropriate travel advances and failed to settle advances in a timely manner.

- **The former Lottery director had an outstanding travel advance from September 2002 that was not settled until after we raised the issue in late August 2003.**

- **The former Lottery director received additional travel advances on at least three occasions before settling a previous advance.**

- **The former Lottery director received a travel advance for two separate travel dates.**

Each of these practices violates Department of Finance policies. The non-settlement of a travel advance may result in excessive compensation if the amount of the advance exceeds reimbursable expenses. The extended period of time before settlement may amount to an interest-free loan. The state's payroll system should be used for travel advances since it will automatically deduct the amount of the advance if travel claims are not filed in a timely manner. Use of the payroll system for travel advances will also prevent additional travel advances from being issued before a previous advance has been settled.

There is another important reason to comply with Department of Finance policies on travel advances. The Internal Revenue Service requires employers to have an "accountable plan" in order for travel and business expense reimbursements to be exempt from income, social security, and Medicare taxes. If employees do not account for their expenses within 60 days after expenses were paid or incurred, an employer is considered to have a "nonaccountable" plan. An employer also has a nonaccountable plan if employees do not return any excess advances within 120 days after the expenses were paid or incurred. All travel and business expense reimbursements for employees working under a nonaccountable plan are taxable. As a result, it is important that the Lottery comply with Department of Finance policy on travel advances.

RECOMMENDATION

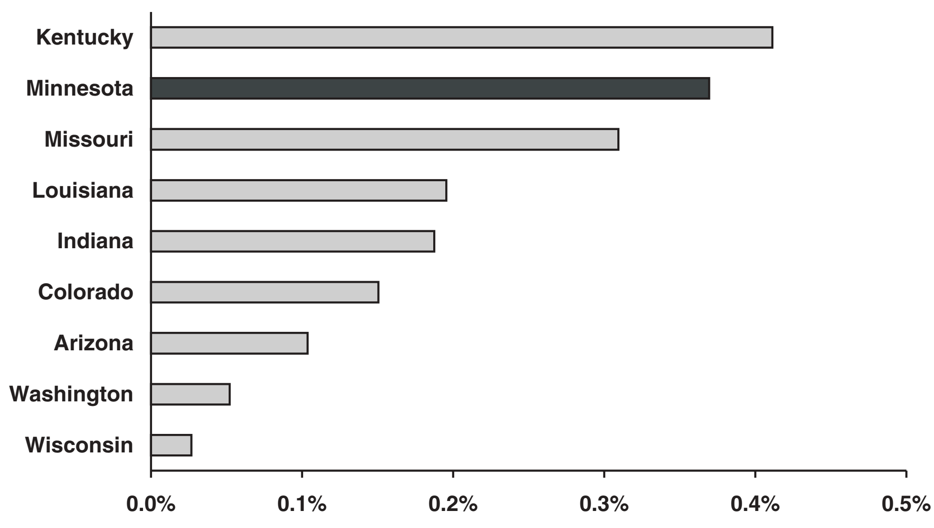
In issuing travel advances, the Minnesota State Lottery should use the state's payroll system. A lottery checking account should not be used for this purpose.

DEPRECIATION EXPENSES

As we indicated in Chapter 2, the Minnesota State Lottery incurred depreciation expenses that, as a percentage of sales, were more than double the average for comparable lotteries in fiscal year 2002. Figure 4.5 shows that Minnesota's depreciation expenses as a percentage of sales were higher than those in seven of the eight comparison states in fiscal year 2002. It is difficult, however, to make a more detailed comparison, since we do not have detailed information on the depreciation expenses of other lotteries. In addition, depreciation expenses vary considerably from year to year, so a comparison based on only one year may not be representative of long-range trends.

In 2003, Minnesota's depreciation expenses were higher than those for seven of the eight comparison state lotteries.

Figure 4.5: Depreciation Expense as a Percentage of Sales, FY 2002



SOURCE: Office of the Legislative Auditor analysis of lottery financial statements.

Recent Trends

In fact, the Lottery's depreciation expenses increased significantly in fiscal year 2003 from about $1.4 million to almost $1.9 million. But they are expected to decline to below $0.6 million in fiscal year 2004. The main reason for these fluctuations is that, during fiscal year 2003, the Lottery depreciated the remaining book value of equipment for its online gaming system. This equipment became obsolete when the Lottery switched to a new online vendor in February 2003. Depreciation expenses for online equipment increased from $0.8 million in fiscal year 2002 to $1.3 million in 2003 but will not be incurred during 2004. Depreciation for vehicles has also fallen from about $175,000 in 2002 to $100,000 in 2003 and an estimated $94,000 in 2004. This decrease is occurring because some of the Lottery's vehicles have become fully depreciated, and the Lottery is not currently planning to purchase new vehicles.

The Lottery's depreciation expenses will be significantly lower in 2004 than in 2002.

Some of the Lottery's depreciation expenses increased during fiscal year 2003. Depreciation expenses for leasehold improvements increased from about $54,000 in fiscal year 2002 to $172,000 in 2003 and are expected to be $173,000 in 2004. These expenses are largely due to the Lottery's capital expenditures for improvements to the tractor/trailer it is leasing from Media Rare. The Lottery is using this vehicle, called the "Environmental Experience," to educate the public about how lottery proceeds are used to benefit Minnesota's environment.

Review of Capital Expenditures

We reviewed the Lottery's capital expenditures and selected two types of expenditures for more detailed examination. First, we examined the leasehold improvements made to the Environmental Experience vehicle and, in Chapter 3, we reported significant concerns about that project. Second, we reviewed the Lottery's vehicle fleet and determined that the Lottery had an excessive number of vehicles. If the Lottery had not permitted employees to use vehicles for commuting, the Lottery could have reduced both its depreciation and operating expenses. While these capital expenditures are not necessarily representative of all capital expenditures by the Lottery, we think that our findings demonstrate that:

- **Outside oversight is needed of the Lottery's capital expenditures, as well as its operating expenses.**

Oversight of capital expenditures is necessary because they later impact the Lottery's operating expenses and profits through depreciation expenses. Control over depreciation expenses occurs only by reviewing capital projects and expenditures before the Lottery spends, or commits to expend, funds.

MISCELLANEOUS EXPENSES

In Chapter 2, we observed that the Minnesota State Lottery spent more as a percentage of sales on "miscellaneous" expenses than the average comparison state in fiscal year 2002. Minnesota's miscellaneous expenses totaled about $5.3 million, or 1.4 percent of sales revenue. The average for the comparison group of lotteries was 0.9 percent of sales. Overall:

- **Minnesota spent about 63 percent more on "miscellaneous" expenses than the average for the other states and spent more than all of the eight comparison states in fiscal year 2002.**

In 2003, the Minnesota Lottery also spent significantly more than other lotteries on miscellaneous expenses.

Miscellaneous expenses include a variety of expenses that do not fit in the other categories listed in Chapter 2. Some of the larger items in other expenses for Minnesota in fiscal year 2002 included professional services ($1,688,000), communications ($964,000), office supplies and printing ($579,000), and fees ($329,000) paid to the Multi-State Lottery Association (MUSL). Another large item in this category—increases in liability for annuity prizes ($768,000)—was not an actual expenditure but reflects the Lottery's increased prize liability due to a decline in interest rates and an increase in the life expectancy of annuity prize winners. Additional items in this category include repair and maintenance, information management, utilities, professional development, and non-capital equipment.

More detailed comparisons of Minnesota to other states are not possible given the information available from other states. As a result, we could not determine how Minnesota compared with other states on particular items within this category of expenses. Part of the difference between Minnesota and other states might be explained by Minnesota's treatment of increased prize liabilities. It is possible that some of the comparison group states do not account for these increased liabilities like Minnesota and might otherwise have higher costs in this category. But we do not know how many of the states treated increased liabilities differently than Minnesota. Even if all of the states treated these liabilities differently, it would have accounted for less than half of the difference in miscellaneous spending.

Spending Trends

Legislative budget cuts have, however, had an impact on the Lottery's spending in this area.

- **Spending on "miscellaneous expenses" is expected to decline during fiscal year 2004.**

As Table 4.7 shows, excluding changes in liability and a reserve set aside for new initiatives or unexpected expenses, miscellaneous expenses are expected to decline from $4.3 million in fiscal year 2002 to a budgeted figure of $3.0 million in 2004. This reduction in spending means that expenses would decline from 1.1 percent of sales in 2002 to 0.8 percent in 2004. We cannot estimate how the expenses for changes in liability will change, since this amount is not known until the close of the fiscal year. At that time, accounting staff determine the amount of expense based on changes in interest rates and life expectancy. The amount can be negative, and thus subtracted from other expenses, if interest rates rise during the fiscal year or life expectancies decline.

A number of the items in the miscellaneous expense category are expected to decline in fiscal year 2004. The largest reduction is expected for professional services used to produce the Lottery's drawing shows. The Lottery has eliminated its live television broadcasts of the drawings for its online games such as Daily 3

But the Lottery's miscellaneous expenses declined in 2003 and are expected to decline further in 2004.

Table 4.7: Miscellaneous Lottery Expenses in $1,000s, FY 2002-04

	FY 2002 (Actual)	FY 2003 (Actual)	FY 2004 (Budgeted)
Professional Services	$1,688	$1,461	$ 847
Communications	964	850	628
Office Supplies and Printing[a]	579	436	465
MUSL Fees	329	169	203
Repair and Maintenance	212	169	190
Information Management	198	151	177
Utilities	120	127	111
Non-Capital Equipment/Equipment Rental	80	56	92
Professional Development and Training	72	56	66
Insurance	30	36	41
Unspecified	53	6	179
Subtotal	$4,323	$3,518	$2,997
Change in Liability for Annuity Prizes	$ 768	$ 565	Unknown
Change in Value of Investments	179	182	Unknown
Reserve[b]	0	0	$1,945
Total	$5,270	$4,265	Unknown
Subtotal as a Percentage of Sales	1.1%	1.0%	0.8%

[a]This category excludes retailer supplies, which we have elsewhere included in ticket expenses.

[b]This reserve will likely be used for game development, new initiatives, or ticket expenses. It is included in other expenses since we cannot allocate it to another category at this time.

SOURCE: Office of the Legislative Auditor analysis of Minnesota State Lottery financial statements and budget.

and Gopher 5. The drawings are now conducted using a computer that generates random numbers. The drawings are still broadcast but are animated. The cost of professional services for the drawing shows is expected to drop from $949,000 in fiscal year 2002 to $248,000 in fiscal year 2004. Another significant reduction is occurring in the cost of toll-free telephone services. The Lottery eliminated the toll-free number that the public could call to get the numbers drawn in lottery games. Expenses for toll-free services are expected to decline from $286,000 in 2002 to $50,000 in 2004. In both these areas, some reduction already occurred in 2003.

We did not examine the category of miscellaneous expenses in detail, since it only accounts for a small part of the Lottery's total operating expenses. We did, however, examine certain items in this category, including some items that had been brought to the Lottery's attention in May 2002 at the conclusion of our office's most recent financial audit of the Lottery.

Cell Phones and Pagers

We performed a limited review of telephone usage and policies at the Minnesota State Lottery. We examined cell phone statements for 24 employees at the Roseville headquarters and 15 employees from regional offices. Overall, the Lottery has 80 cell phones. In addition, we reviewed long distance telephone bills for six employees. In each of these cases, we initially examined the last two months of invoices for fiscal year 2003. We examined additional billings if we identified any areas of concern.

We did not find widespread problems with cell phone and long-distance usage. Lottery staff routinely check cell phone use by field staff. But, they do not check the use by all staff. In particular, we found that:

- **The Lottery does not consistently follow state policy that requires an annual review of cell phone bills to determine whether employees still need a cell phone or could use a different calling plan.**

The Lottery needs to more tightly control employee cell phone usage and costs.

We found that two employees have calling plans that provide far more calling time than they typically use. Over an eight-month period, these two employees combined to use only 74 minutes of calling time for a cost of $294, or $3.97 per minute. The cost of their cell phone plans could be reduced by decreasing the number of monthly minutes included in their call plans. Alternatively, the Lottery could terminate their cell phone contracts.

The former Lottery director had a cell phone plan that provides 600 minutes of domestic calling time per month for $79.99 and calls to Canada for $19.99. The basic monthly cost of the plan was $99.98, not including roaming charges, additional calling time, or applicable taxes. During one month, the former director's bill was $172. We noted the former director used his cell phone for personal calls more than any other Lottery employee whose phone usage was reviewed. In one month, 35 percent of the calls he made were to his personal residence, while the percentage varied between 7 and 18 percent during other months. We do not know how much additional personal business was conducted on the former director's cell phone since the telephone number on incoming calls is not identified on cell phone invoices. In addition, we did not attempt to identify the nature of other calls made by the former director. We did note that the former director called a particular official of the Pennsylvania Lottery frequently. Even if these calls were business-related, state policy encourages employees to use regular long distance service to make calls rather than cell phones since long distance rates are cheaper.

We think that the director's phone use and calling plan need to be reviewed. Personal calls should be minimized, and long distance service should be used for calls during business hours. In addition, we question whether there is a need for cell phone service to Canada. We observed only two instances in which the former director used his cell phone to call Canada and, on these occasions, the former director called a resort area in Ontario.

We also found that one employee—the assistant director for administration—is reimbursed by the Lottery for business use on her personal cell phone. While reimbursement may be appropriate, state policy requires that it be done through the state's payroll system and not with a check from the Lottery.

The Lottery also has 61 pagers in use and 10 spares. This is another area that merits review of usage.

RECOMMENDATIONS

The lottery should review its use of cell phones. The lottery may be able to eliminate some cell phones—particularly for staff at the Roseville headquarters office—or reduce the number of minutes in their plans.

Similarly, the lottery should review whether employees with a pager need one. If a pager is rarely used, it could be eliminated. There are probably other ways to reach employees in the event of an emergency.

Department Head Expenses

Over the last six fiscal years, the Lottery spent close to $1,000 per year on department head expenses. The former director used this money primarily to send flowers to hospitalized business contacts and to funerals for current or past business acquaintances. We think that:

- **The former director of the Lottery used a department head expense account for inappropriate purposes.**

Department of Finance policies suggest a number of appropriate uses for department head expense accounts. These purposes generally involve the purchase of food and related expenses for meetings with other government officials, citizens, boards, commissions, or task forces. Department head expenses are also permitted for coffee and cake at receptions for retiring employees or similar events that affect employee morale. While Department of Finance policies do not precisely define those purposes for which department head expenses can be used, they say that expenditures must have a public purpose and must stand the test of public scrutiny.

The Lottery lacks clear authority to incur department head expenses and incurred expenses for inappropriate purposes.

We think that many of the ways in which the Lottery used department head expenses do not have a public purpose. Most of the expenses in recent years were for flowers sent to funerals for current or past business acquaintances of the former director. For example, the Lottery sent a donation of $70 to a non-profit organization called the Wild Cat Society upon the death of the father of an employee of a firm that provides consulting services to lottery vendors and lotteries. The Lottery also sent flowers to the funeral of several individuals—including the former director of the Pennsylvania Lottery ($118), the husband of a former employee of the Minnesota State Lottery ($78), and a former member of the Lottery's advisory board ($116). The latter expense occurred more than six years after the board was abolished by the Minnesota Legislature. In addition, the Lottery sent flowers ($40) to a Media Rare official and his wife upon the birth of their child.

It is unclear whether the Lottery even has authority to incur department head expenses. The Lottery has not had explicit statutory authority to incur such expenses since 1993. Prior to 1993, the director's salary was set through the statute used to set other agency head salaries. That statute is also used to establish which agencies have authority to spend money on department head expenses.

But, in 1993, the Legislature moved the language setting the director's salary to the chapter dealing with the Lottery. As a result, the Lottery lost explicit statutory authority for department head expenses.

It can be argued that some agencies have authority to incur department head expenses even though they do not have explicit statutory authority. For example, they may receive this authority by virtue of having their budgets reviewed and approved on a biennial basis by the Legislature. The Lottery, however, does not have its budget reviewed and approved like other state agencies. As a result, it would appear that the Lottery does not have authority to incur such expenses, although this issue is not dealt with in a definitive way in Minnesota statutes.

In May 2002, at the conclusion of the most recent financial audit, staff from the Office of the Legislative Auditor informed the Lottery director and the chief financial officer that the Lottery may lack authority to incur department head expenses. Despite the warning, the Lottery has continued to incur these expenses.

RECOMMENDATIONS

The Minnesota State Lottery should stop using department head expenses for items that lack a clear public purpose.

If the Lottery wishes to continue incurring department head expenses, the Lottery should seek clarification of its authority to incur such expenses from the Legislature.

The Lottery has incurred "special," or business meeting, expenses without the required authorization.

Special Expenses

Over the last six years, the Lottery also spent about $4,400 annually on business meeting expenses. These expenses included meals at Minnesota Pro/Am Bass Tour events and lunches that the former director had with vendors, individuals from Lottery-sponsored organizations, and others. Other examples include meetings in which the former director regularly participated, monthly marketing staff meetings, meetings of staff committees reviewing requests for proposals, and monthly meetings of the human resource directors of all state agencies. Over the last two years, the former director was reimbursed for $1,135 for meals related to the Bass Tour. The total cost of two of these meals was in excess of $300 and included tips of up to $60. We found that:

- **The Lottery has been incurring special, or business meeting, expenses without required authorization from the Department of Employee Relations.**

Any expenditures of this type require a plan approved by the Department of Employee Relations (DOER). In addition, such expenses cannot include routine staff meetings. Meetings should be scheduled to minimize the inclusion of meals and should be held no more frequently than once per quarter. The lottery does not have an approved plan. It submitted a special expense plan to DOER in 1993 and was denied approval.

As was the case with department head expenses, this finding was verbally communicated to Lottery officials at the conclusion of the last financial audit. But the Lottery has continued to incur such expenses.

RECOMMENDATION

The Minnesota State Lottery should stop incurring special (or business meeting) expenses, since it does not have the authority to incur such expenses.

Until last year, the Lottery rented plants for its offices and supplied coffee for its employees.

Coffee for Employees and Guests

Shortly after we began our study, we found that:

- **The Lottery spent close to $33,000 over the last six years to provide free coffee to its employees and guests.**

The coffee was delivered by a private vendor. In May 2003, after a legislative committee raised concerns about the Lottery's spending, the Lottery discontinued the practice. Now, employees are responsible for paying for their own coffee.

Plant Rental

We also found that:

- **The Lottery paid $49,000 over the last six years to have a company provide, maintain, and water potted plants in its Roseville, Eagan, and Detroit Lakes offices.**

In March 2003, the lottery discontinued the service in Roseville and Eagan and purchased the plants for $5,027—the amount the service would have cost had the lottery paid the remainder of the period covered by the purchase order. The lottery could have ended the service immediately, however, without additional cost and should have considered whether $5,027 was a fair market price for the plants.

Home Computers and Internet Service

We reviewed the Lottery's expenses for computers and internet service and found that:

- **The Lottery has provided internet connections in the homes of up to eight Lottery employees at a cost of about $2,700 annually. The Lottery provided the former director with high-speed broadband connection to the internet at a cost of about $600 per year.**

Two other employees had high-speed internet service at home provided by the Lottery. Five others had dial-up service, and one employee had access only to e-mail service. In addition, the Lottery provided the former director with a desktop computer and color printer for both his Roseville office and his home. The former director also had a laptop computer assigned to him. Several other employees have Lottery computers at home including two who, along with the former director, are very involved with the Minnesota Pro/Am Bass Tour. The Lottery also provides these two employees with dial-up internet service at home. While there may be legitimate business reasons for the Lottery to provide home computers and internet service, we have concerns that these expenses may be unnecessary and may facilitate the involvement of Lottery employees in operating the bass tour.

RECOMMENDATION

The Minnesota State Lottery should reassess the need for some of its employees to have home internet service and for its director to have three computers. Lottery policy should clearly state that home internet service is not for personal use and should not be for the purpose of operating, or assisting in the operation or organization of the Minnesota Pro/Am Bass Tour.

Artwork

Since its inception, the Lottery has spent about $43,000 for artwork and other furnishings in its offices, including paintings, prints, vases, baskets, antiques, and some lamps.[25] While some amount of spending on artwork in common areas is reasonable, we think that the Lottery could have shown more fiscal restraint.

OTHER ISSUES

While our study focused primarily on the Lottery's expenses, we encountered a number of other issues during the study. This section examines those issues.

Gifts

Minnesota law prohibits state employees from accepting certain gifts. We found that:

- **Lottery officials sometimes receive gifts that may violate state law. For example, the former director participated for free in a bass tournament.**

In August 2002, the Lottery director fished in the 10,000 Rinks Foundation Bass Tournament at Cragun's Resort. The 10,000 Rinks Foundation is a charitable arm of the Minnesota Wild hockey team and raises funds for youth hockey in

---

25 This figure does not include the $32,000 spent on the painting used as a model for the exterior of the Environmental Experience vehicle. That painting is currently hung in one of the Lottery's conference rooms.

Minnesota. The suggested donation for those fishing in this charity event was $1,000, but the former director paid nothing and a second lottery employee fished for free for part of one day. In return, lottery employees helped set up tournament equipment and the layout of the site and assisted the tournament director. The Lottery also paid for the lodging of the former director and three other lottery employees for two nights each for a total of about $1,500. The Lottery spent at least $2,660 in staff time to provide assistance for this tournament. This figure only includes time spent at the tournament.

The former director fished for free in a tournament, and his participation may have violated state laws.

This tournament was not part of the lottery's sponsorship agreement with the Minnesota Wild. But, Lottery officials told us that the Lottery received additional value from the Minnesota Wild as a result of the Lottery's help during the tournament. The Lottery's promotions director told us that the Lottery received a dasherboard during the Wild's playoff run in the spring of 2003. The dasherboard was part of the Lottery's sponsorship agreement with the Wild for the regular hockey season but not the playoffs. Minnesota Wild officials, however, told us that this was not the case. They said every sponsor, including the Lottery, received these benefits during the playoffs as they had during the regular season. The Wild provided the benefits as a bonus to all its sponsors. Wild officials said the Lottery's work at the tournament was not at all a factor in this decision. It appears to us that the reason the Lottery provided assistance was that the tournament operator was Media Rare. As with the Minnesota Pro/Am Bass Tour, the Lottery—and not Media Rare—had more expertise in the operation of a fishing tournament at that time.

The former director later told us that his fishing served a business purpose. He said he was able to discuss potential business with Minnesota Wild officials as a result of the Lottery's participation in the event. It would be difficult to determine whether the event served a valid business purpose. But, even if it did, Lottery officials could have discussed business with Minnesota Wild officials without participation in the tournament. The Lottery was already sponsoring the Minnesota Wild hockey team.

The former director's acceptance of a gift—namely, free participation in the fishing tournament—appears to violate state law.[26] It may also represents a conflict of interest, which would have made the former director subject to disciplinary action.[27] The former director's use of Lottery resources to obtain a benefit for himself may also be a violation of state law.[28]

In addition, other Lottery employees may occasionally receive benefits or gifts that are not allowed under state law. For example, they participate in golf tournaments and banquets operated by organizations sponsored by the Lottery. Lottery employees receive free tickets for food and beverages when they work at the Taste of Minnesota. Lottery employees may also receive free gifts from organizations sponsored by the Lottery or other business partners. In return, the Lottery may also provide gifts of merchandise to these organizations. Minnesota

26 *Minn. Stat.* (2003), §43A.38, subd. 2.

27 *Minn. Stat.* (2003), §43A.38, subd. 5(a).

28 *Minn. Stat.* (2003), §43A.38, subd. 4(a).

statutes do not permit state employees to receive gifts or benefits that are unavailable to the general public.[29]

Statutes also prohibit Lottery employees and their immediate families from receiving gifts from any Lottery retailer or vendor in excess of $100 in any calendar year.[30] It is unclear whether this statute allows gifts that are not allowed under other statutes. In addition, it is unclear whether Lottery-sponsored organizations are considered to be Lottery vendors under state law.[31] Finally, the statute that prohibits gifts in excess of $100 appears to allow gifts of food and beverages of any amount.

RECOMMENDATION

The Legislature should examine whether the statutes governing gifts to Lottery employees and their families should be revised.

We think that the Legislature should examine whether there is reason to allow Lottery officials or their families to accept any gifts—including food and beverages—from Lottery retailers or vendors. In addition, the Legislature may wish to clarify the definition of a Lottery vendor for the purpose of the gift restrictions.

Accounting Changes

The Lottery should revert back to the previous practice of accounting for merchandise and free tickets as operating expenses.

The Lottery's accounting for operating expenses can be complicated, but it has not changed significantly over the Lottery's history until recently. Specifically:

- **After the end of fiscal year 2003, the former director of the Lottery changed the Lottery's accounting for premium items and promotional tickets so that future expenses of these types would not be subject to the legislative cap on operating expenses.**

Beginning with the Lottery's audited financial statement for 2003 and its budget for 2004, the former director decided to report expenses for premium items and promotional tickets under prizes. This change moved future expenses for merchandise or free tickets out of operating expenses and into direct costs, where they will not be subject to the legislative cap on operating expenses. While the Lottery's budget for these items in 2004 is greatly reduced from prior years, the former director indicated to us that he might increase the budget for merchandise later in 2004 if funds were available.

Lottery officials told us that there were two reasons for making the change. First, they said that merchandise and free tickets are prizes and belong in prize expenses. Second, they said that other states put these types of expenses in prize expenses, although they were unable to identify any of these states.

---

29 *Minn. Stat.* (2003), §43A.38, subd. 2.

30 *Minn. Stat.* (2003), §349A.11, subd. 1.

31 *Minn. Stat.* (2003), §349A.01, subd. 13.

We disagree with the Lottery's decision to move these expenses to prizes and potentially avoid the impact of legislatively imposed caps on operating expenses. Expenses for merchandise and free tickets are sometimes unrelated to any purchase of lottery tickets and, therefore, do not belong in the prize category. We are particularly concerned about the change for premium items since these are often used for sponsorships and given to business associates and do not always go to lottery players as part of retail promotions. As a result, it is difficult to view these items as prizes. Promotional tickets are somewhat more likely to be given away to players as part of a retail promotion, but some are given away through media promotions and some are given away at speeches by lottery officials.

RECOMMENDATION

The Minnesota State Lottery should report expenses for premium items and promotional tickets under promotions as it did prior to FY 2003. The lottery should only report these expenses under prizes to the extent that the lottery can demonstrate that these items are given away in connection with sales of lottery tickets.

Liabilities and Assets for Annuity Prizes

In the past, the Lottery operated games that offered winners fixed annual payments for life. These "Cash For Life" and "Win For Life" games require the Lottery to make payments to each winner until the winner dies. Following the end of these games, the Lottery purchased bonds to cover the estimated liabilities for the prize annuities. In fiscal year 2002, the lottery changed the life expectancy tables it used for the purpose of estimating the future liabilities. We found that:

The Lottery has not reserved sufficient assets to cover future liabilities for prize annuities.

- **The change in life expectancy tables increased the Lottery's estimated liabilities for annuity prizes, but the lottery has not purchased additional bonds or reserved cash to meet those increased liabilities.**

Apparently, the Lottery is not required to reserve such assets, but we feel an obligation to report the potential shortfall of reserved assets of $250,000 to $300,000. Currently, the lottery has sufficient assets to pay those liabilities, but this shortfall could begin to require some unreserved assets to be expended as early as 2008 depending on the number of years that winners actually live.

Lottery officials believe that it is not a good time to purchase bonds due to low interest rates. But, they also have not reserved any of their cash reserves for the future payment of these liabilities.

RECOMMENDATION

The Minnesota State Lottery should purchase bonds, or reserve funds, sufficient to cover the liabilities created by the decision to switch life expectancy tables.

Fixed Asset Inventory

The Lottery maintains a database on physical assets that it currently owns. This database includes a variety of items such as furniture, computers, and other equipment. The Lottery's accountants primarily use this database for the purpose of calculating and documenting the Lottery's depreciation expenses. But, this database cannot identify where the items are currently located. Maintaining information on asset location is an essential function and helps provide adequate accounting controls on physical assets. Without location information and periodic inventories of physical assets, it is difficult to know if assets are still in the Lottery's possession.

The Lottery separately maintains an inventory by location for certain sensitive items like computers, cell phones, pagers, and other electronic equipment. But:

- **The Lottery has not maintained an adequate inventory of the location of its furniture or periodically inventoried these assets.**

The Lottery needs to improve its inventory procedures for fixed assets.

The problem started early in the Lottery's history. Lottery staff did attempt to inventory furniture once in the late 1990s but have not periodically inventoried its furniture including many items in excess of $1,000. In the future, we think that the Lottery should attempt to keep track of all significant new purchases. In addition, the Lottery should attempt to keep track of existing furniture better than they have in the past.

We also noticed that the Lottery has, in the past, depreciated many items of furniture or equipment that were of relatively low value, including some below $100 in cost. The Lottery depreciated them because they were part of a larger purchase order totaling more than $1,000. We do not think those items should have been depreciated. Instead, they should have been part of current operating expenses. Lottery accountants indicated to us that they no longer depreciate individual items under $1,000 in cost.

RECOMMENDATION

The Minnesota State Lottery should ensure that any newly acquired fixed asset receives an identification number. The lottery should identify the location of that asset and periodically update the location of fixed assets.

Development of New Games

Initially, we intended to spend more time examining the potential for additional revenue through the development of new games. The number of expense-related issues caused us to reduce the time devoted to this topic. We did, however, acquire an understanding of lottery games and their potential for sales. In addition, we became familiar the Lottery's estimates for revenues from the development of new games, although we did not attempt to review those estimates. Table 4.8 lists the estimates that Lottery officials have made for the

Table 4.8: Lottery Estimates of Additional State Revenue from New Games or Initiatives

New Game or Initiative	Additional Annual State Revenue[a] (in Millions of Dollars)
International Game	$13.8
Scratch Ticket Vending Machines	10.0
E-Commerce Play (with PIN Number)	9.4
New Lotto Game	5.2
Promotion Coupon Program	3.0
Player-Activated Terminals	2.1
Elimination of Advertising Limits	2.0
Holiday Games	0.6

[a]This is the additional revenue that the Lottery estimates would be available to the state after expenses.

SOURCE: Minnesota State Lottery.

amount of additional money that the state could expect to earn from certain Lottery games or initiatives.

The opportunities for increasing revenues with new lottery games are limited unless the Legislature wishes to authorize keno games or casino-type slot machines.

In general, we think that the opportunities for additional revenues are somewhat limited unless the Legislature is interested in permitting the Lottery to operate casino-type slot machines or keno games. Slot machines are called video lottery terminals (or VLTs) in the lottery industry. Five state lotteries including South Dakota have the authority to operate VLTs and realize significant revenues for their states. Table A.2 in the appendix to this report provides information on the VLT sales revenues in these five states. Another option would be to allow the Lottery to operate keno games in bars. The Lottery has not been given the authority to operate VLTs or keno games in the past due to significant public and legislative opposition to increased gambling. In addition, the operators of Indian casinos and charitable gambling have opposed the Lottery's expansion into their business or territory.

The Lottery estimates that authorizing the purchase of games that could be played on a computer could raise another $9 million annually for the state. Under this option, a PIN number to be used to access the games on a computer would still have to be purchased from a retailer. Players would not be able to purchase games online. This option might also face significant opposition.

Another of the possibilities listed in the table is the installation of instant ticket vending machines. This would raise another $10 million in state revenues according to Lottery estimates. Lottery officials are concerned that many of the retailers that sell lottery tickets have fewer walk-in customers since they can pay for their gas at the pump. Vending machines could be used to enable customers to purchase lottery games at the gas pump. The Lottery already uses vending machines at the Minneapolis-St. Paul International Airport.

We think the opportunities for raising additional revenue are somewhat limited unless the Legislature is willing to permit the Lottery to expand into types of gambling that the Lottery is not currently permitted to operate. The Lottery is constantly introducing new scratch games and has, from time to time, tried new online games. In late 2003, the Lottery began a new online game called Northstar Cash. We think the potential for new scratch or online games is somewhat limited. Even if Northstar Cash is somewhat successful, it remains to be seen if its introduction will increase the Lottery's sales of all online games excluding Powerball. A new game like Northstar Cash could just take sales away from other online games or even scratch games.

5 Legislative Recommendations

SUMMARY

Given the significant problems we found, officials of the Minnesota State Lottery need to be more accountable for their financial decisions to elected officials. The Legislature should review and approve the Minnesota State Lottery's budgets for operating and capital expenditures, as is the case for other state agencies. Furthermore, the Legislature should allow the Governor discretion in removing and appointing a lottery director. The Legislature should consider whether the Lottery should continue as a separate agency or become part of an existing state agency. The Legislature should also review whether the Lottery needs and merits continued exemption from state contracting requirements.

The Legislature and the Governor should scrutinize the Minnesota State Lottery's spending in detail. In our view, the Lottery's financial support of and extensive involvement with the Minnesota Pro/AM Bass Tour is unwarranted. The Lottery's spending on the Environmental Experience vehicle, the Environmental Journal television program, and the Player Spotlight and Environmental Journal radio spots also merit close scrutiny. In addition, legislative oversight could help ensure that the Lottery reduces its rental of office and warehouse space, decreases its cell phone expenses, sells excess vehicles, and reduces other expenses. The Legislature should also review the Lottery's relationship with Media Rare.

Finally, the Legislature should prohibit the Lottery from spending unclaimed prize money on any additional lottery games. The Lottery's use of unclaimed prize money has not been productive in increasing lottery profits.

In the previous chapters, we found that the Minnesota State Lottery spends more money on administrative expenses than similar state lotteries and has incurred some questionable expenses. In addition, we raised significant concerns about some of the lottery's business decisions and serious questions about the Lottery's failure to follow competitive bid requirements for certain contracts. This chapter presents recommendations to address these problems. In particular, this chapter addresses the following questions:

- **What should the Legislature and Governor do to improve the accountability of Lottery officials for their spending and business decisions?**

- **How should oversight of the Lottery's finances and operations be improved?**

- **What additional controls should be placed on the Lottery's financial and procurement practices?**

- **Should the Legislature take the remaining pool of accumulated unclaimed prize money away from the Lottery and deposit the money in a state fund?**

BACKGROUND

The Minnesota State Lottery spends a significantly higher percentage of its sales revenue on operating expenses than comparable lotteries. In 2002, Minnesota's spending was about 63 percent higher than the average for our comparison group. As a result, the Minnesota State Lottery returns less than other lotteries for environmental and other public programs.

Some of the additional expenditures might be the result of Minnesota's higher cost of living and its greater reliance on scratch tickets. In addition, it could be argued that the Minnesota lottery needs to spend more to compete with other forms of legalized gambling, which are probably more extensive here than in our comparison group states. But, cost of living and product mix differences explain only about one fourth of the difference between Minnesota's spending and the average for comparison group states. And, from what we reported in Chapters 3 and 4, it is doubtful that much of the remaining difference can be explained by competitive factors.

Strong legislative action is needed to improve the Lottery's efficiency and performance.

In our view, the Minnesota State Lottery's spending habits will only change if strong legislative action is taken. Legislative changes should include steps to make lottery officials more accountable to the Governor and Legislature for their spending decisions and business plans. In addition, the lottery and its budget should be subject to greater legislative and executive branch oversight. The Legislature should consider additional controls on lottery procurement practices and accounting methods.

ACCOUNTABILITY

Although the Lottery has submitted its budget to the Department of Finance every two years, it has generally not been subject to extensive review by either the department or the Legislature. Action on the Lottery's budget is not necessary, since the Lottery does not receive state appropriations. In addition, state law sets a limit on the percentage of gross revenues that the Lottery could use for operating expenses.

However, as a result of the Minnesota Center for Environmental Advocacy study, the 2003 Legislature placed a cap on the lottery's budget for fiscal years 2004 and 2005. In addition, the Governor asked the Department of Finance to provide more executive branch oversight of the lottery's budget. These measures were helpful, but a long-range solution is needed.

RECOMMENDATIONS

The Legislature should require the Minnesota State Lottery to submit its budget for operating expenses to the Department of Finance and the Governor. The Governor should make recommendations on the Lottery's budget to the Legislature.

Every two years, the Legislature should review the Governor's proposed budget for the Minnesota State Lottery's operating expenses and establish an amount available for these items in law.

The Governor and the Legislature should review and act on the Lottery's operating budget every two years.

The Lottery may need some flexibility for certain expenses. As lottery sales increase, so do expenses for prizes, retailer commissions, online vendor services, and scratch ticket production and distribution. With a cap on operating expenses, the Lottery might have to suspend sales if sales grow beyond expectations and operating expenses begin to exceed appropriated limits. Online expenses are a particular concern. Sales of Powerball could increase significantly if high jackpots are achieved. Payments to the Lottery's online vendor are about 6.1 percent of the online sales, and the payments would increase as sales grew.

Unlike other state agencies, the Lottery's budget is not approved by the Governor and Legislature.

Growth in prizes and retailer commissions would not be a problem under our recommendations, since these items are direct costs and are not included in operating expenses. We are concerned, however, that the Lottery recently began to place promotional ticket and merchandise expenses under the prize category. These expenses should be under prizes only if tickets or merchandise is awarded to a lottery customer as part of an actual sale. To the extent that tickets or merchandise are awarded or given away outside of a sales transaction, the expenses should be included in operating expenses under the promotions category as they have been in the past.

RECOMMENDATIONS

The Legislature should consider providing the Lottery some spending flexibility for ticket expenses since a strict cap on all operating expenses could limit the Lottery's ability to sell tickets in some circumstances.

The Legislature should require the Minnesota State Lottery to exclude from prize expenses any free tickets or merchandise that are given away and are not part of a sale of lottery tickets. These expenses should be included in the promotions category of operating expenses and be subject to review by the Governor and the Legislature as part of the biennial budget process.

As we noted in Chapter 3, the Lottery finances the purchase of motor vehicles, furniture, equipment, and other fixed assets out of its cash flow. The Lottery similarly finances leasehold improvements out of cash flow. In the past, leasehold improvements have included improvements to leased equipment such as the Environmental Experience vehicle and permanent changes to leased office space such as built-in cabinets and a floor-to-ceiling credenza in the director's office. These purchases are not directly a part of the Lottery's operating expenses or direct costs. Instead, they show up as depreciation on the Lottery's annual statement of operating revenues and expenses after they have been purchased. We believe that these expenditures deserve as much scrutiny as the budget for operating expenses. In some years, capital purchases and leasehold improvements may not be very significant. But, as was demonstrated in Chapters 3 and 4, these expenditures can be excessive and controversial at times. In order to control increases in operating expenses, the Legislature also needs to control the lottery's expenditures on fixed assets and leasehold improvements. Otherwise, these expenditures will be included in the depreciation category of operating expenses over a number of years, and the opportunity to question these expenditures will have been missed.

The Governor and the Legislature should also review and act on the Lottery's capital budget every two years.

RECOMMENDATION

The Legislature should require the Minnesota State Lottery to submit its proposed capital budget for leasehold improvements and the purchase of fixed assets to the Department of Finance and the Governor. The Governor should make recommendations on the Lottery's budget to the Legislature, and the Legislature should establish an amount available for these items in law every two years. The Lottery may need some flexibility to purchase equipment necessary to operate the Lottery if existing equipment fails.

Finally, we strongly believe that the Lottery director needs to be more accountable to elected officials for the budgetary and business decisions made by the director. Statutes require the Lottery director to be appointed by the Governor with the advice and consent of the Minnesota Senate. But, unlike heads of other state agencies, the Lottery director can only be removed for cause and after a hearing, if requested. The statutes provide the specific reasons for which the Governor may remove a director.

While this provision creates stability in the leadership at the lottery, it fails to ensure that the Lottery director is adequately accountable to elected officials for lottery spending and business decisions. Combined with the lack of oversight, this lack of accountability has meant that one individual can make decisions about the Lottery without significant input from elected officials and without much detailed knowledge by elected officials of what the Lottery is doing.

Statutory changes are needed to make the Lottery director more accountable to the Governor.

Current law limits the Governor's ability to improve the Lottery's efficiency and performance.

Current statutes also require that the director must be qualified by experience and training in the operation of a lottery. While this provision was important at the inception of the Lottery, the Lottery now has many employees with significant lottery experience. At this point, a new director would benefit from their expertise and thus need not be experienced directly in the operation of a lottery. Current statutory language unnecessarily narrows the field of potential candidates for the director's position. Individuals with a strong background in retail marketing and sales—but in an industry other than the lottery industry—could be strong candidates for the position but are currently excluded from consideration in the event that the position is vacant.

RECOMMENDATIONS

The Legislature should repeal Minn. Stat. (2003), §349A.02, subd. 2 and instead require that the Lottery director serve at the pleasure of the Governor like other state agency heads.

The Legislature should amend Minn. Stat. (2003), §349A.02, subd. 1 and allow the Governor broader discretion in appointing a Lottery director.

It should be noted that, after the voters approved the creation of a state lottery in November 1988, Governor Perpich appointed a commission to report to him and the Legislature on the structure and operations of a state lottery. That commission recommended that the director serve at the pleasure of the Governor.[1] The 1989 Legislature instead gave the director substantial job security on the theory that the lottery needed to be insulated from political influence. While the 1989 Legislature's rationale had merit, the findings of this report suggest that there is a need for more direct accountability of the Lottery director to elected officials such as the Governor.

1 Governor's Commission on the Lottery, *Report of the Governor's Commission on the Lottery* (St. Paul, February 2, 1989), 2.

OVERSIGHT

This report raises numerous questions about spending and other decisions of the current Lottery management. We think there is a strong case for immediate budgetary oversight during the 2004 legislative session even though biennial operating budgets are usually discussed during the odd-numbered years. Among the issues that legislative committees could review is the issue of the size and composition of the Lottery staff. Even with the staff reductions made in October 2003, the size of the Minnesota State Lottery's staff exceeds the average for our comparison group of state lotteries. Furthermore, there are questions about the number of lottery managers and supervisors and the need for four assistant directors and two assistants to the director. Other important budgetary issues include—but are not limited to—the value of sponsorships, particularly the level of support the lottery provides to the Minnesota Pro/Am Bass Tour; the cost and value of the Environmental Journal television and radio programs and the Player Spotlight radio spots; the cost, use, and value of the Environmental Experience vehicle; the potential for reducing the Lottery's office and warehouse rental costs by consolidating offices or renting smaller space; and recapturing the pool of accumulated unclaimed prize money.

Other issues merit review as well. The Lottery needs to be able to answer the question of the effectiveness of its advertising campaigns, not just provide information on the general effectiveness of advertising. The Legislature should also review the Lottery's spending on scratch ticket production and may wish to hold informational hearings about the Lottery's plans to extend existing major contracts—such as those for advertising, scratch ticket production, online services, Environmental Journal and Player Spotlight programs, and the Environmental Experience vehicle—or solicit new proposals.

Several areas of Lottery spending identified in this report should be closely examined by the Legislature.

In the long run, elected officials should be careful not to micromanage the Lottery's budget and operations. But, in the short run, the Lottery's budget needs a thorough review by elected officials.

RECOMMENDATIONS

The 2004 Legislature should review the Minnesota State Lottery's budget and consider whether additional reductions should be made in its budget for FY 2005.

Legislative committees may also wish to hold oversight hearings during the interim between the 2004 and 2005 sessions to examine budgetary and other issues concerning the Minnesota State Lottery.

In addition, it is important that the Legislature provide ongoing oversight of the Lottery. Prior to the MCEA report issued in April 2003, Lottery officials testified at legislative hearings mostly about proposals for new forms of gambling such as racinos or casinos. Officials may also have provided legislative committees with projections of state revenues from the Lottery. The issues raised in this report indicate that there is a need for more intense and ongoing scrutiny of the Lottery.

Experience suggests that Lottery officials have not been responsive to the need to be efficient except when the Lottery is under intense scrutiny—as it was during this evaluation—or is forced to be more efficient as it was following the legislative imposition of a cap on operating expenses. We think that ongoing and persistent oversight of the Lottery will be needed to make the lottery responsive to the needs of the taxpayer and to maximize the state's return from the Lottery.

The involvement of the Department of Finance—as the Governor's representative—is also important in providing ongoing oversight of the Lottery. According to department officials, the Governor indicated his desire for the department to provide more oversight of the Minnesota State Lottery following the 2003 legislative session. The department delayed some of its efforts because our office was conducting an evaluation of the Lottery. But, the department is interested in providing more ongoing oversight following the completion of our study.

The Legislature may also wish to consider the establishment of a lottery board or commission to assist in oversight of the Lottery's budget and operations. Until 1995, a lottery board provided some oversight, but the board was advisory only and did not have the power to approve or reject the Lottery's budget or business plans. The 1989 Governor's Commission on the Lottery had recommended that a lottery board be established with the power to approve the Lottery's budget, annual business plan, financial reports, and rules. The 1989 Legislature established a lottery board but gave it advisory status only. The 1995 Legislature eliminated the board along with a number of other state advisory boards and commissions.

The Legislature should consider establishing a lottery board or making the Lottery part of the Department of Revenue.

We think that establishing a board with more substantial powers might help provide ongoing oversight of the Lottery. There would be some relatively small expenses for a board, but the board could reduce the time the Legislature would need to oversee the Lottery's budget and operations. We believe that establishing an advisory board without real powers will not provide meaningful change. But, a board with greater powers might be worth trying. To help prevent Lottery officials from unduly influencing the lottery board, board members should be prohibited from soliciting or receiving anything of value—such as lottery tickets, merchandise, or sports tickets—from the Lottery, or companies doing business with the Lottery, for themselves or others.

RECOMMENDATIONS

The Legislature and the Department of Finance need to provide ongoing oversight of the Minnesota State Lottery's budget and business practices.

The Legislature should consider establishing a lottery board with the power to review and approve the lottery's budget, annual business plans, financial reports, and contract solicitation procedures and awards.

There are some potential drawbacks to using a lottery board to oversee the Lottery's finances and operations. Part-time board members may find it difficult to challenge a staff that has considerable resources. In addition, even a board with significant authority may fail to exercise significant control over the Lottery's operations.

An alternative would be to restructure the Lottery. In a number of states, the lottery is part of the state department of revenue. This option could potentially give the Governor and the Legislature a greater ability to oversee Lottery finances and make Lottery officials accountable for their decisions. Possible drawbacks to this approach are that the Lottery could become politicized or less entrepreneurial in its approach. In addition, in some states where the lottery is part of the revenue department, the lottery essentially operates independently of department management. But, because the lottery is part of a state agency, its budget is subject to gubernatorial and legislative review and approval.

In a number of other states, the lottery is part of another state agency like the state department of revenue.

RECOMMENDATION

The Legislature should consider making the Minnesota State Lottery part of the Minnesota Department of Revenue.

CONTROLS

Statutory changes may be needed to ensure competitive bidding on all major Lottery contracts.

In several areas, we think that the Legislature should consider establishing controls that would enhance oversight and encourage the Lottery to be efficient in the use of resources.

Procurement Practices

As we observed in Chapter 3, Lottery officials have violated the intent of the statutes by not soliciting bids on any of the work that Media Rare does for the Lottery. In fact, for most of this work, the Lottery does not contract directly with Media Rare and funnels the payments for Media Rare through the Foley Group, the lottery's advertising agency. This makes it very difficult for anyone—including the Lottery's own accounting staff—to track the payments to Media Rare.

It is unclear whether the Lottery has simply violated state law or has used its exemption from state procurement procedures. State law is not entirely clear what "lottery procurement contracts" are exempt from standard procedures required of state agencies. Nevertheless, the statutes require the Lottery to utilize an open and competitive bidding process and, as much as is practicable, follow state statutory requirements placed on other state agencies.

RECOMMENDATIONS

The Legislature should review the Minnesota State Lottery's contracting practices and consider revoking the Lottery's exemption from procurement procedures required of other state agencies on "lottery procurement contracts."

The Legislature should consider defining the term "lottery procurement contracts" so that it is clear that the term only applies to certain services such as scratch ticket production and online ticket services.

Separate Accounting System

The Department of Finance needs better information on Lottery spending.

One factor that inhibits the ability of the Department of Finance to provide good oversight of the Lottery is the Lottery's accounting system. While the Lottery's payroll is paid using the state's payroll system, the Lottery does not use the state's accounting system for accounting purposes. The Lottery has its own system that is better suited for an entity that runs a business, has significant revenues, and depreciates fixed assets. The Lottery's accounting system, however, has some deficiencies and may be in need of updating at some point.

The Lottery uses the state's payroll system, but not the state's accounting system.

Our initial discussions with Department of Finance and Lottery staff suggest that the Lottery could not rely entirely on the state's existing accounting system to meet its needs. But, the state's accounting system could be modified to accommodate the Lottery's needs. Alternatively, the Lottery could periodically provide expense information to the Department of Finance in a format acceptable for use in the statewide accounting system. This would require the department to establish additional object codes for certain types of expenses unique to the Lottery. In either case, some additional costs may need to be incurred to accommodate these changes.

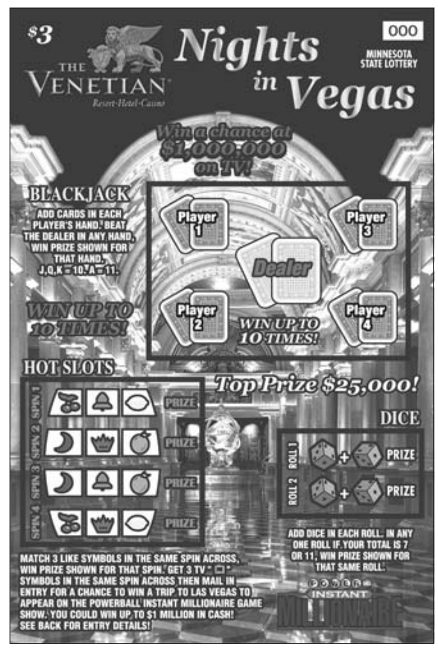
Alternatively, for little expense, the Lottery could provide detailed financial data to the department like it did for us on this study. The Lottery's accounting system would continue to be used as is currently the case. Department staff would have to learn the Lottery's accounting system and determine exactly what data they need to provide adequate oversight.

Lottery staff have security concerns about some of the information in their accounting system such as the status of winning numbers and the recipients of prizes. We think that these concerns can be resolved by the Lottery and the Department of Finance.

RECOMMENDATION

The Department of Finance and the Minnesota State Lottery should jointly study the ways in which the Lottery's accounting data—particularly expense information—can best be shared with the department. The agencies should report back to the Legislature and the Governor on advantages and disadvantages of alternative approaches.

UNCLAIMED PRIZES



Recently, the Lottery has used unclaimed prize money to pay travel expenses for winners appearing on the Powerball Instant Millionaire show.

The 2003 Legislature decided that none of the unclaimed prizes on lottery sales from July 1, 2003 on would be retained by the Lottery for use in supplementing prize levels for subsequent games. Until June 2, 1995, the Lottery was able to keep all of the unclaimed prizes and has kept 30 percent of the unclaimed prizes since that date. The 1995 Legislature also took the pool of accumulated unclaimed prize money not already committed to the prize structure of a lottery game and transferred the funds to the state's General Fund and the Environment and Natural Resources Trust Fund.

The Legislature should transfer the unclaimed prize money that remains under the Lottery's control.

Unlike the 1995 Legislature, the 2003 Legislature permitted the Lottery to retain the accumulated pool of unclaimed prize money. As of June 30, 2003, the pool was about $2,466,000. As of mid-December 2003, the Lottery has committed only a portion of that money. The money was being used on the scratch games that provide customers a chance to appear on the Powerball Instant Millionaire television program. According to Lottery officials, the pool would probably last several years at the rate it was being used.

As Chapter 4 pointed out, the use of unclaimed prize money to supplement prize levels of games has not been productive. Games utilizing unclaimed prize money have earned smaller profits and had a lower profit margin than other games.

RECOMMENDATION

The 2004 Legislature should immediately transfer the pool of accumulated unclaimed prize money not committed to the prize structure of a lottery game to a state fund such as the General Fund or the Environment and Natural Resources Trust Fund.

Revenues, Expenses, and Operating Profits of U. S. Lotteries, FY 2002

APPENDIX A

Table A.1: Lottery Sales Excluding Sales From Video Lottery Terminals, FY 2002

State	Population (Millions)	Ticket Sales (Millions)	Sales Per Capita	Percentage of Sales From Scratch Games	Percentage of Sales From Online Games	Percentage of Scratch Sales From Pull-Tabs	Percentage of Online Sales From Keno
Arizona	5.4	$ 295	$ 55	48.6%	51.3%	0.0%	0.0%
California	34.9	2,896	83	41.3	58.7	0.0	10.8
Colorado	4.5	408	91	63.0	36.9	0.0	0.0
Connecticut	3.4	908	263	59.8	40.2	0.0	0.0
Delaware[a]	0.8	117	146	18.0	82.0	0.0	0.0
District of Columbia	0.6	211	369	15.6	84.5	0.0	0.0
Florida	16.5	2,330	141	28.4	71.6	0.0	0.0
Georgia	8.5	2,322	274	50.1	50.0	0.0	3.6
Idaho	1.3	93	70	61.6	38.0	1.9	0.0
Illinois	12.6	1,567	125	40.5	59.5	0.0	0.0
Indiana	6.1	626	102	55.7	44.3	0.2	0.0
Iowa	2.9	181	62	59.0	41.0	25.6	0.0
Kansas	2.7	190	70	39.3	60.7	5.8	34.6
Kentucky	4.1	639	157	51.6	48.3	9.7	0.0
Louisiana	4.5	312	70	35.7	64.2	0.0	0.0
Maine	1.3	158	122	74.2	25.8	0.0	0.0
Maryland	5.4	1,307	241	22.9	77.1	0.0	35.3
Massachusetts	6.4	4,194	654	69.7	30.1	0.2	50.5
Michigan	10.0	1,688	168	38.8	61.2	0.0	0.0
Minnesota	**5.0**	**377**	**75**	**63.9**	**36.1**	**0.0**	**0.0**
Missouri	5.7	585	103	58.8	41.3	8.0	1.3
Montana	0.9	34	37	29.1	70.9	0.0	0.0
Nebraska	1.7	74	43	49.7	50.2	0.0	0.0
New Hampshire	1.3	213	168	65.9	34.0	0.0	0.0
New Jersey	8.6	2,069	242	37.4	62.6	0.0	0.0
New Mexico	1.8	134	73	60.6	39.4	0.0	0.0
New York	19.1	4,754	249	41.4	58.6	0.0	17.5
Ohio	11.4	1,983	174	50.3	49.7	0.0	0.0
Oregon[a]	3.5	337	96	39.9	60.1	2.8	52.7
Pennsylvania	12.3	1,934	157	37.3	62.7	0.0	0.0
Rhode Island[a]	1.1	236	221	33.2	66.8	0.3	50.0
South Carolina	4.1	335	82	90.8	9.2	0.0	0.0
South Dakota[a]	0.8	26	35	47.0	53.0	0.0	0.0
Texas	21.6	2,966	137	65.1	34.9	0.0	0.0
Vermont	0.6	82	133	83.7	16.3	0.0	0.0
Virginia	7.2	1,108	153	44.4	55.6	0.0	0.0
Washington	6.0	439	73	55.2	44.7	0.0	0.0
West Virginia[a]	1.8	207	115	45.6	54.4	0.0	12.2
Wisconsin	5.4	428	79	55.7	44.2	1.9	0.0
Average	6.5	$ 994	$ 146	49.5%	50.5%	1.4%	6.9%
Median	4.5	408	122	49.7	50.2	0.0	0.0

NOTE: Fiscal year 2002 ended June 30 in all jurisdictions except New York (March 31), Texas (August 31), and the District of Columbia (September 30). South Carolina began selling lottery tickets in January 2002.

[a]Total sales and the percentage of sales that are scratch and online exclude video lottery terminals in Delaware, Oregon, Rhode Island, South Dakota, and West Virginia. Table A.2 shows revenues from video lottery terminals for those five states.

SOURCES: North American Association of State and Provincial Lotteries, *NASPL 2003 Lottery Resource Handbook*, (Willoughby Hills, OH, 2003) and *LaFleur's 2003 World Lottery Almanac* as referenced by Colorado Office of the State Auditor, *Performance Audit: Colorado Lottery* (Denver, CO, November 2003), B-1.

Table A.2: Sales from Video Lottery Terminals (VLTs), FY 2002

State	Net VLT Sales (Millions)	Net VLT Sales Per Capita	Percentage of Net Lottery Sales From VLTs
Delaware	$557	$694	83%
Oregon	480	137	59
Rhode Island	281	264	74
South Dakota	208	273	94
West Virginia	642	356	76

NOTE: Net sales are sales less prizes.

SOURCES: North American Association of State and Provincial Lotteries, *NASPL 2003 Lottery Resource Handbook* (Willoughby Hills, OH, 2003); South Dakota Lottery, "Lottery produces record sales, revenue for the state," press release issued August 13, 2003; and Rhode Island Lottery, *Comprehensive Annual Financial Report for the Year Ended June 30, 2002* (Cranston, RI, September 2002), 39.

Table A.3: Lottery Expenses and Operating Profits, FY 2002

State	Ticket Sales	Prizes		Commissions		Operating Expenses		Total Expenses		Operating Profit[b]		Total Return to Government[c]	
	Millions	Millions	%	Millions	%	Millions	%	Millions	%	Millions	%	Millions	%
Arizona	$ 295	$ 162	55.0%	$ 20	6.8%	$ 28	9.4%	$ 210	71.2%	$ 85	28.8%	$ 86	29.1%
California	2,896	1,503	51.9	198	6.8	185	6.4	1,886	65.1	1,011	34.9	1,080	37.3
Colorado	408	240	58.9	31	7.5	32	7.9	303	74.4	105	25.6	111	27.2
Connecticut	908	546	60.1	52	5.7	39	4.3	637	70.1	271	29.9	272	30.0
Delaware[a]	117	59	50.5	7	6.3	15	13.1	82	69.9	35	30.1	35	30.1
District of Columbia	211	111	52.4	13	6.1	25	11.9	149	70.4	62	29.6	63	29.9
Florida	2,330	1,166	50.0	132	5.7	122	5.2	1,420	60.9	910	39.1	972	41.7
Georgia	2,322	1,308	56.3	164	7.0	132	5.7	1,604	69.1	718	30.9	731	31.5
Idaho	93	53	57.3	5	5.8	13	14.5	72	77.5	21	22.5	24	25.8
Illinois	1,567	867	55.3	79	5.1	87	5.6	1,033	66.0	533	34.0	566	36.1
Indiana	626	371	59.3	43	6.9	47	7.5	461	73.7	165	26.3	169	27.0
Iowa	181	100	55.2	12	6.4	26	14.4	138	76.0	43	24.0	48	26.7
Kansas	190	99	52.1	11	5.8	22	11.8	132	69.6	58	30.4	59	30.9
Kentucky	639	384	60.2	40	6.2	48	7.5	472	73.9	166	26.1	175	27.4
Louisiana	312	156	49.9	16	5.1	31	9.9	202	64.9	109	35.1	112	36.0
Maine	158	91	57.7	11	7.0	17	10.9	119	75.6	38	24.4	40	25.6
Maryland	1,307	733	56.1	85	6.5	49	3.8	868	66.4	439	33.6	440	33.6
Massachusetts	4,194	3,001	71.6	239	5.7	74	1.8	3,314	79.0	880	21.0	899	21.4
Michigan	1,688	895	53.0	121	7.2	126	7.5	1,142	67.6	546	32.4	646	38.3
Minnesota	377	223	59.1	24	6.3	50	13.3	297	78.7	80	21.3	82	21.7
Missouri	585	353	60.3	31	5.3	43	7.4	427	73.0	158	27.0	166	28.4
Montana	34	17	50.8	2	5.9	7	21.9	26	78.6	7	21.4	7	21.5
Nebraska	74	39	53.3	4	5.8	12	16.8	56	75.9	18	24.1	18	25.0
New Hampshire	213	123	57.9	11	5.4	15	7.1	150	70.4	63	29.6	66	31.1
New Jersey	2,069	1,145	55.3	113	5.5	68	3.3	1,326	64.1	743	35.9	776	37.5
New Mexico	134	73	54.4	9	6.9	18	13.2	100	74.6	34	25.4	30	22.1
New York	4,754	2,664	56.0	284	6.0	226	4.8	3,174	66.8	1,579	33.2	1,581	33.3
Ohio	1,983	1,148	57.9	127	6.4	103	5.2	1,378	69.5	605	30.5	640	32.3
Oregon[a]	337	224	66.3	30	8.8	28	8.3	281	83.4	56	16.6	57	16.8
Pennsylvania	1,934	1,002	51.8	100	5.2	95	4.9	1,198	61.9	736	38.1	749	38.7
Rhode Island[a]	236	139	59.2	26	10.9	7	3.1	173	73.2	63	26.8	65	27.6
South Carolina	335	200	59.7	23	7.0	25	7.6	249	74.3	86	25.7	88	26.1
South Dakota[a]	26	14	53.8	1	5.5	5	18.2	20	77.5	6	22.5	6	23.8
Texas	2,966	1,715	57.8	148	5.0	167	5.6	2,030	68.5	936	31.5	937	31.6
Vermont	82	52	63.8	5	5.8	9	10.5	66	80.1	16	19.9	17	20.3
Virginia	1,108	614	55.4	62	5.6	75	6.7	751	67.7	357	32.3	368	33.2
Washington	439	282	64.4	27	6.2	34	7.8	344	78.3	95	21.7	114	26.1
West Virginia[a]	207	120	58.1	13	6.3	24	11.4	157	75.7	50	24.3	67	32.4
Wisconsin	428	242	56.6	30	7.0	34	7.9	306	71.5	122	28.5	126	29.6
Average	$ 994	$570	55.4%	$ 60	6.1%	$ 56	8.6%	$ 686	70.1%	$ 308	27.3%	$ 320	28.6%
Median	$ 408	$240	56.3%	$ 30	6.1%	$ 34	7.5%	$ 303	71.5%	$ 105	27.0%	$ 112	29.6%

NOTE: Fiscal year 2002 ended June 30 in all jurisdictions except New York (March 31), Texas (August 31), and the District of Columbia (September 30). South Carolina began selling lottery tickets in January 2002.

[a]Ticket sales exclude video lottery terminals in Delaware, Oregon, Rhode Island, South Dakota, and West Virginia. Some of these states may have attributed all operating expenses to trational lottery games and none to video lottery terminals, thereby overstating operating expenses and understating operating profits attributable to traditional lottery games.

[b]Operating profits are ticket sales less total expenses.

[c]Total return to government includes nonoperating revenue such as interest, and may include transfers from prior years' operating profits.

SOURCES: North American Association of State and Provincial Lotteries, *NASPL 2003 Lottery Resource Handbook* (Willoughby Hills, OH, 2003) and *LaFleur's 2003 World Lottery Almanac* as referenced by Colorado Office of the State Auditor, *Performance Audit: Colorado Lottery* (Denver, CO, November 203), B-1.

Proceeds Benefit Our Natural and Economic Environments.

February 19, 2004

Mr. James Nobles
Office of the Legislative Auditor
658 Cedar Street
Centennial Building, Room 140
St. Paul, Minnesota 55155

Dear Mr. Nobles:

Thank you for the opportunity to respond to your evaluation report: "The Minnesota State Lottery." We appreciate the hard work and analysis that went into this report. The report provides an insightful and fundamentally fair representation of the Lottery.

The review recognizes the complexity of its subject, the challenges faced in marketing the Lottery's products, the need to maintain security and integrity, and the difficulties inherent in operating a business enterprise within the confines of state government. In particular, the report finds very little to criticize in the day-to-day operations of the Lottery or any evidence of systematic problems with lottery contracting, accounting and management. Most importantly, there are no findings regarding the security and integrity of lottery games. While the report makes a number of useful comparisons with other states, it notes that for a variety of factors "it might be unreasonable to expect the Minnesota Lottery to achieve the same level of profitability as the comparison states."

The Lottery is a marketing driven and market-driving organization. It exists in a competitive and rapidly changing marketplace—no customer must buy a lottery ticket, nor must any retailer sell them. While the forms and procedures common to state government are often applicable, the Lottery's mission is in many ways unique. As such, the Lottery must operate not only efficiently but also effectively. In order to maximize profits and achieve its mission the Lottery must take risks and make calculated business decisions.

The report contains 49 recommendations directed to the Lottery. With minor exceptions, we accept the report's recommendations. Eleven of the recommendations have already been implemented. We expect to complete action on the remaining recommendations within one to four months.

The report provides a road map to the Lottery's future. As we move forward, it is important to recognize actions that have already been taken. We began serious cost-cutting measures during FY03 that are now showing results. For the first six months of FY04 sales are up by 7 percent, but payments to the state are up by 26 percent. We 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.

Again, thank you for your efforts and the opportunity to comment on the report.

Sincerely,

/s/ Michael M. Vekich

Michael M. Vekich
Acting Director

Recent Program Evaluations

Funding for Probation Services, January 1996	96-01
Department of Human Rights, January 1996	96-02
Trends in State and Local Government Spending, February 1996	96-03
State Grant and Loan Programs for Businesses February 1996	96-04
Post-Secondary Enrollment Options Program, March 1996	96-05
Tax Increment Financing, March 1996	96-06
Property Assessments: Structure and Appeals, A Best Practices Review, May 1996	96-07
Recidivism of Adult Felons, January 1997	97-01
Nursing Home Rates in the Upper Midwest, January 1997	97-02
Special Education, January 1997	97-03
Ethanol Programs, February 1997	97-04
Statewide Systems Project, February 1997	97-05
Highway Spending, March 1997	97-06
Non-Felony Prosecution, A Best Practices Review, April 1997	97-07
Social Service Mandates Reform, July 1997	97-08
Child Protective Services, January 1998	98-01
Remedial Education, January 1998	98-02
Transit Services, February 1998	98-03
State Building Maintenance, February 1998	98-04
School Trust Land, March 1998	98-05
9-1-1 Dispatching: A Best Practices Review, March 1998	98-06
Minnesota State High School League, June 1998	98-07
State Building Code, January 1999	99-01
Juvenile Out-of-Home Placement, January 1999	99-02
Metropolitan Mosquito Control District, January 1999	99-03
Animal Feedlot Regulation, January 1999	99-04
Occupational Regulation, February 1999	99-05
Directory of Regulated Occupations in Minnesota, February 1999	99-05b
Counties' Use of Administrative Penalties for Violations of Solid and Hazardous Waste Ordinances, February 1999	99-06
Fire Services: A Best Practices Review, April 1999	99-07
State Mandates on Local Governments, January 2000	00-01
State Park Management, January 2000	00-02
Welfare Reform, January 2000	00-03
School District Finances, February 2000	00-04
State Employee Compensation, February 2000	00-05
Preventive Maintenance for Local Government Buildings: A Best Practices Review, April 2000	00-06
The MnSCU Merger, August 2000	00-07
Early Childhood Education Programs, January 2001	01-01
District Courts, January 2001	01-02
Affordable Housing, January 2001	01-03
Insurance for Behavioral Health Care, February 2001	01-04
Chronic Offenders, February 2001	01-05
State Archaeologist, April 2001	01-06
Recycling and Waste Reduction, January 2002	02-01
Minnesota Pollution Control Agency Funding, January 2002	02-02
Water Quality: Permitting and Compliance Monitoring, January 2002	02-03
Financing Unemployment Insurance, January 2002	02-04
Economic Status of Welfare Recipients, January 2002	02-05
State Employee Health Insurance, February 2002	02-06
Teacher Recruitment and Retention: Summary of Major Studies, March 2002	02-07
Local E-Government: A Best Practices Review, April 2002	02-08
Managing Local Government Computer Systems: A Best Practices Review, April 2002	02-09
State-Funded Trails for Motorized Recreation, January 2003	03-01
Professional/Technical Contracting, January 2003	03-02
MinnesotaCare, January 2003	03-03
Metropolitan Airports Commission, January 2003	03-04
Preserving Housing: A Best Practices Review, April 2003	03-05
Charter School Financial Accountability, June 2003	03-06
Controlling Improper Payments in the Medical Assistance Program, August 2003	03-07
Higher Education Tuition Reciprocity, September 2003	03-08
Minnesota State Lottery, February 2004	04-01
Compensation at the University of Minnesota, February 2004	04-02
Medicaid Home and Community-Based Waiver Services for Persons With Mental Retardation or Related Conditions, February 2004	04-03
No Child Left Behind, March 2004	04-04
CriMNet, March 2004	04-05

Evaluation reports can be obtained free of charge from the Legislative Auditor's Office, Program Evaluation Division, Room 140, 658 Cedar Street, Saint Paul, Minnesota 55155, 651/296-4708. Full text versions of recent reports are also available at the OLA web site: http://www.auditor.leg.state.mn.us