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Initial Examination on Reforming the California Lottery

Summary

The purpose of this examination of the California Lottery is to determine which means of improving lottery performance and revenue generation are available to the California state government and what actions must be taken in order to make these solutions possible. To this end, this report provides a general overview of the lottery's cost structure and performance over the last several years. The report also directly compares California's performance against those states which lead the nation in per capita lottery sales and net revenues.

Currently, the California Lottery is restricted by mandates that although they secure the percentage of funding for education each year at 34 percent of net revenues, also serve to severely restrict any investments in games or equipment that would boost the actual growth of lottery sales. The lottery is also restricted in terms of the kind of games that can be offered, as well in being able to utilized up-to-date technology. These restrictions prevent the California Lottery from effectively emulating either enacted or proposed changes in other states and countries.

Several other states have enacted or are considering changes to their lotteries that should be considered in California as means for improving lottery performance. The most notable examples of these include the establishment of an autonomous quasi-public lottery corporation in Connecticut, increasing lottery sales by raising the percentage of sales money returned to ticket buyers as in Massachusetts and Texas, and the leasing of lottery operations to a private company or consortium as has been done in the United Kingdom and is on the verge of happening in Illinois.

Several potential options for reforming the operations of the lottery and boosting lottery performance are reviewed, with benefits and drawbacks being discussed for each. These include:

- Maintain the Current Lottery System with Minor Legislative Changes
- Establishing a Quasi-Public Corporation to Operate the Lottery
- Establishing a 5 to 10 Year Lottery Concession
- Establishing a 30 Year or Longer Lottery Concession
- Outright Sale to a Private Entity
- Establishing a Public Corporation and Holding an Initial Public Offering

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Overview

The California Lottery was created to supplement education funding in 1984 through passage of Proposition 37 and enactment of the California State Lottery Act. The act authorizes the state to operate a cash prize lottery and establishes provisions for the disbursement of revenues. It empowers the governor to appoint commissioners who oversee lottery operations, and the legislature to amend the act to further "the purposes of the act."

The Lottery Act outlines a specific division of funds: At least 34 percent of total revenues go to public education. At least 50 percent of total revenues must be returned to lottery participants as winnings. No more than 16 percent of the total revenue is to be set aside for lottery operational costs, including staff, printing, marketing and distribution costs. The act stipulates that any funding that is not spent during the course of the year on prize payouts or administrative costs is automatically allocated to the state education fund at the end of the fiscal year. This prevents the Lottery from building up reserves of capital which can be used to fund more extensive marketing campaigns and instant win games with higher prize payouts.

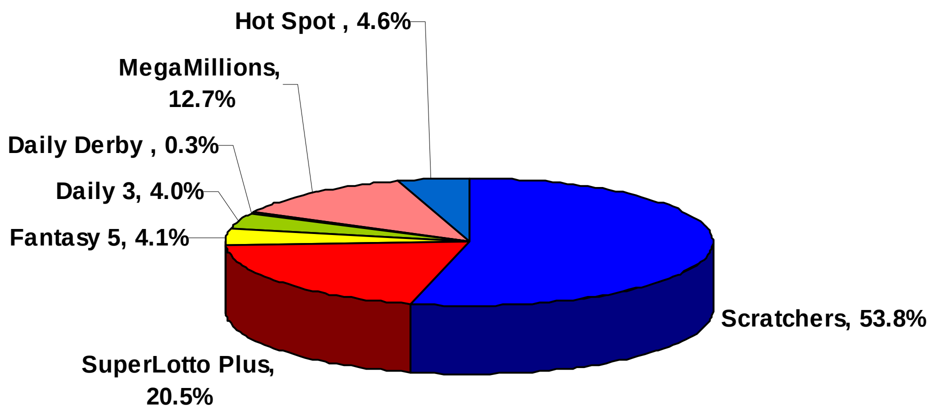
These divisions provided important guarantees that helped ensure passage of Proposition 37, but they have placed restrictions on the lottery's overall operations.

Since 1984, the California lottery has operated numerous games, including Scratchers, Super Lotto (now SuperLotto Plus), Fantasy 5, Daily 3, Hot Spot, and the Daily Derby. In 2004 the state considered participation in such popular multi-state lottery games as Powerball and Mega Millions, and in 2005, the Lottery Commission approved the state's entry into a Mega Millions partnership.[1]

The following figure shows the percentage of state sales by game type in 2006.[2]

[1] Lottery News. "Mega Millions Is Coming to California." http://www.calottery.com/NR/rdonlyres/39B29651-8042-4D7A-BC65-4A8D3184D33E/0/PressKitforMSLGameRecommendation.pdf.
[2] California Lottery, "Reports to the Public," (2006).

California Lottery By Game Type
By Percent of Sales, 2006



Source: La Fleur's World Lottery Almanac, 2007

In 2006, Scratchers contributed the highest percentage of sales (53.8 percent), followed by Super LottoPlus (20.5 percent) and Mega Millions (12.7 percent). Since 1999, in fact, Scratchers has driven total sales in the state lottery. The game has also shown the largest overall growth in sales. SuperLotto tickets enjoyed early popularity but suffered declining sales in 2002–2003 despite the introduction of the SuperLotto Plus variant with its bonus number feature in 2003, and have maintained a constant sales level since then.

The following table illustrates state lottery sales by game for the period 2001–2006. Sales from Mega Millions are aggregated for 2005 and 2006 because California started offering the multi-state Mega Millions jackpot in addition to the SuperLotto Plus jackpot in 2005. Although sales did spike initially, the profiles of the people playing the two games is similar enough that the aggregate sales of the two games is only marginally higher than for the SuperLotto Plus game on its own in 2004.

Lottery Sales in California
By Type of Game, US$ Millions

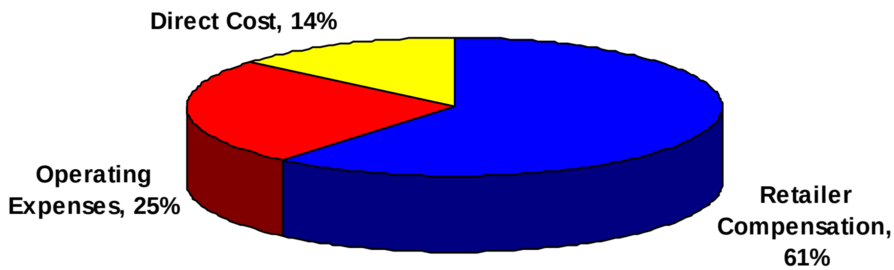
Game	2001	2002	2003*	2004*	2005**	2006**
Scratchers	1188.93	1184.12	1211.72	1338.98	1736.79	1929.63
SuperLotto	1272.36	1275.71	1110.68	1166.95	1109.93	1187.7
Fantasy 5	154.18	148.05	153.94	166.50	160.76	148.35
Daily 3	85.09	93.87	112.84	124.92	136.16	143.99
Hot Spot	184.90	184.43	180.16	167.99	174.30	163.53
Daily Derby	9.38	10.19	12.23	8.64	15.68	11.77
Total	2894.84	2896.37	2781.57	2973.98	3333.62	3585.00

* changed to SuperLotto Plus
** includes MegaMillions

Source: California Lottery

The pie chart below depicts 2006 administrative expenses. Retailer compensation, defined as "a minimum of 5% of the retail price of tickets or shares" plus incentive bonuses, has seen a rising trend in past few years. However, if administrative expenses are viewed as a total percentage of lottery sales, they amount to about 11 percent, of which retailer compensation comprises 7 percent.

Administrative Expenses of the California Lottery
By Percent, 2006



Source: La Fleur's World Lottery Almanac, 2007

Sales Comparison with Other States

In order to examine the reasons why the California Lottery has historically underperformed relative to the national average, it is important to examine the states that have historically had the best performance as well as those states that have implemented or are considering potential privatization options. States that have high levels of per capita sales include Massachusetts, New York and Georgia. Connecticut is profiled because of its establishing a quasi-public autonomous corporation to run the lottery. South Dakota, West Virginia, Delaware and Rhode Island have each significantly expanded their lottery operations through the use of the controversial video lottery terminals, which are often compared to electronic centrally controlled slot machines.

Differences in sales per capita among states depend on the games offered, as well as regulations, marketing and advertisement strategies, administrative costs, external competition, demographics, and regional attributes.

California ranks low among the selected states that operate lotteries, as shown in the two tables below. We divide the states into two groupings: sales that include revenues from video lottery terminals (VLTs) and those that do not. VLTs are game terminals, similar to slot machines, but with winning numbers generated by a central computer linking the systems. Although winning wagers are random, programmers determine the quantity and size of payouts within the system of connected terminals. Massachusetts ranks No. 1 in sales per capita, if we consider sales without VLTs.

Rank of Selected States
By Per Capita Sales 2006, US$

Without VLT			With VLT		
States	**Rank**	**Per Capita Sales**	**States**	**Rank**	**Per Capita Sales**
Massachusetts	1	707	Delaware	1	903
Georgia	2	342	South Dakota	2	890
New York	3	342	West Virginia	3	865
Connecticut	4	274	Massachusetts	4	707
Maryland	5	274	Rhode Island	5	621
New Jersey	6	267	New York	6	364
Rhode Island	9	241	Georgia	7	342
Delaware	22	145	Connecticut	9	274
West Virginia	24	118	Maryland	10	274
South Dakota	39	52	New Jersey	11	267
Colorado	27	96	Colorado	27	96
Arizona	36	75	Arizona	36	75
California	28	94	California	28	94

Source:La Fleur's World Lottery Almanac, 2007

VLTs, which were first legalized by South Dakota in 1989, are now operational in Delaware, Rhode Island, Oregon, Louisiana, New York, West Virginia, and Louisiana. In all states but Louisana—where the state Gaming Control Board regulates and administers the machines—the VLT machines are privately owned, but the states own and monitor the computer networks.

VLTs cause a considerable boost in per capita ticket sales, as shown in the preceding tables, but they are controversial. A number of studies allege that the games contribute to significant rates of gambling addiction.[3] Because VLTs are considered very similar to slot machines in terms of operation, most states that have allowed them have placed restrictions on their hours of use or locations.

The California Constitution does not permit the use of slot machines, although the governor is authorized to negotiate with Indian tribes, which can operate casino-style venues (and slot machines) in exchange for remitting a portion of the profits to the state. In 2004, according to news reports,[4] some tribes made the move to install VLTs rather than slot machines, arguing that because VLTs were not slot machines, revenues from them were not subject to taxation because they did not fall under the terms of agreement with the state. The tribes also argued that VLTs were similar to California lottery games and therefore legal. However, they have not yet been authorized by the state.

Sales of the popular game Scratchers could be enhanced with more aggressive marketing. California could also increase the prize payouts, though this may necessitate legislative action to change the rules of the game. In 1997, the Texas legislature reduced the prize payout for Scratchers; sales fell so sharply that the legistlature raised the payout within two years. At present, Texas has a prize payout of over 61 percent of lottery sales.

The most successful non-VLT lottery in the country is in Massachusetts. It is not coincidental that Massachusetts also leads the nation in returning over 70 percent of lottery sales revenues back to the public in prize money. Although Massachusetts offers the highest payout rate in the nation by a decent margin, all of the other leading states in lottery performance also offer a payout rate that significantly exceeds that in California. The following table ranks prize payouts among the selected states.

[3] "Indian Gaming in California," http://www.igs.berkeley.edu/library/htIndianGaming.htm. (accessed July 11, 2007)

[4] http://sfgate.com/cgi-bin/article.cgi?f=/c/a/2004/10/03/BAG8N933A01.DTL Indian tribes have VLTs

Percentage of Prize Payout
Selected States, 2006

State	Prize Payout (%)	PC Sales ($)
Massachusetts	71.9	707
Georgia	61.4	342
Texas	61.2	159
Florida	59.6	230
New York	59.4	342
Ohio	59.0	198
Illinois	59.0	153
Pennsylvania	58.8	247
New Jersey	57.4	267
Michigan	57.3	219
California	53.9	94
Colorado	60.1	96
Arizona	55.3	75

* No sales from VLT are included

Source:La Fleur's World Lottery Almanac, 2007

The California Lottery works through 19,000 retailers, with average sales per retailer being $188, 684. This sales figure is significantly lower than that in other states, such as New York ($405,472). California retailers receive a 6 percent sales commission, which is comparable to other states. As shown in the following table, in terms of advertisement dollars per capita, California lags far behind all other benchmarked states.

Retailer and Advertising Allocation for Lottery Sales
Selected States, 2006

State	Retailer			Advertising		
	Number	Residents per Retailer	Sales per Retailer ($)	Budget ($ Millions)	Per Capita ($)	Percentage of Sales (%)
California	19,000	1,919	188,684	36.29	1.00	1.01
Florida	12,399	1,459	316,883	24.66	1.36	0.63
Georgia	7,742	1,209	381,733	19.39	2.07	0.66
Illinois	7,884	1,628	249,146	-	-	-
Michigan	10,854	930	203,830	18.62	1.84	0.84
New Jersey	6,100	1,430	394,316	16.06	1.84	0.67
New York	15,999	1,207	405,472	81.47	4.22	1.26
Ohio	8,543	1,344	259,970	20.29	1.77	0.91
Pennsylvania	8,413	1,479	364,943	30.00	2.41	0.98
Texas	16,279	1,444	231,875	32.00	1.36	0.85

Source:La Fleur's World Lottery Alm

Administrative Restrictions on Spending and Prizes:

The 1984 California State Lottery Act set severe restrictions on prize levels and marketing. As previously noted, at least 50 percent of revenues must be returned as winnings; 34 percent is guaranteed to education; and the remainder is reserved for retailer commissions and payouts, ticket printing, and administrative costs, such as marketing.

The payout level on the prizes is unusually low, with leading states offering between 57 percent and 71 percent to winners. A clear linkage exists between prize payout rates (including odds of winning) and public perception of lotteries, and the lower payout rate present in California can be seen as a significant impediment to sales. When the state's 6-49 Lotto was changed in the early 1990s to a 6-53 version, for example, public backlash to the reduced odds of winning resulted in a drop in sales that was only reversed when a 6-51 version was hastily introduced.

The California Lottery has successfully managed to boost sales in recent years by reducing overall administrative costs—from 16 percent to around 12 percent—and using this money to boost the prize payout rate in Scratcher games.

The lottery is also restricted because fixed payouts are not permitted in any instant games. According to the 1996 Western Telcon case, the California Supreme Court ruled that the state may not offer draw lottery games that establish fixed prizes rather than prizes dependent on sales and winning tickets. To do so would necessarily create an incentive for the state to see players lose . In other words, if prize amounts were fixed, the state would know its payout, it would have reasons to ensure that players of these games did consistently lose. (An exception is made for the Hot Spot game due to the low prize levels.) Until this portion of the penal code is revised by the state legislature, California will remain the only state that does not offer fixed prizes for runners-up in the SuperLotto Plus or Mega Millions games, or fixed prizes for the winners of daily games. By not being able to inform the public of these prize levels, it necessarily restricts word-of-mouth marketing and overall sales.

Due to the constraints of the lottery act and subsequent legislation, the California Lottery offers a limited range of games and payouts, and is unable to introduce significant new technologies. In 1993, section 8880.286 of the Lottery Act was added, which limited the lottery to technology available at its inception in 1985. This precludes the introduction of video lottery terminals, as well as new electronic games, online lottery subscriptions, and other potential innovations. The restrictions also limit the ability of the lottery to cut costs, even when utilizing a third-party contractor.

One of the most important distinctions to keep in mind in measuring lottery performance is the distinction between per capita sales and per capita net revenues. Although a highly efficient lottery model with lowered costs is important, being unwilling to reinvest those savings in improvements to the lottery infrastructure and new games to promote growth will limit any long term increases in sales. In the table below, note that Delaware, West Virginia and New York do not have gross VLT sales figures available. In the case of

Delaware and West Virginia, this would significantly increase their per capital sales figures and would give them a ratio of per capita sales to per capita net revenues much closer to those of Rhode Island and South Dakota.

Lottery Revenues of Selected States
By Per Capita Sales and By Per Capita Net Revenues 2006, US$

States	Rank	Per Capita Sales	States	Rank	Per Capita Net Revenues
Rhode Island**	1	1621.82	West Virginia*	1	335.45
South Dakota**	2	877.53	Rhode Island**	2	303.39
Delaware*	3	852.97	Delaware*	3	291.51
West Virginia*	4	836.97	South Dakota**	4	152.18
Massachusetts	5	704.36	Massachusetts	5	147.77
New York*	7	352.37	New York*	8	114.11
Georgia	8	339.34	New Jersey	9	97.34
Maryland	10	277.95	Maryland	10	89.21
Connecticut	11	276.86	Georgia	11	87.83
New Jersey	12	275.84	Connecticut	12	81.28
Colorado	29	98.62	California	28	34.03
California	30	98.33	Colorado	33	26.42
Arizona	38	76.01	Arizona	36	22.89

* Includes Net VLT sales
** Includes Gross VLT sales

Source: North American Association of State and Provincial Lotteries

Gaming Competition

California's gaming industry is mainly composed of the state lottery, Indian casinos, card clubs, and racetracks. A number of cruises operating from Los Angeles and San Diego offer casinos in international waters.[5] The extensive presence of legalized gambling in Nevada provides a major competition. The activity in Las Vegas dwarfs that of East Coast venues, such as Atlantic City or the immense tribal casino Foxwoods in Connecticut.

The 1984 Gaming Registration Act was enacted to regulate gambling in California. A combination of lobbying and consumer demand led voters in California to pass Proposition 1A in March, 2000, amending the state Constitution to permit Class III (casino-style) gaming on Native American land. It also mentioned that such activities conform with a gaming compact between the tribe and the state. California currently does not permit non-tribal commercial casinos in which customers are pitted against the house.

The state has signed and ratified tribal–state gaming compacts with sixty-six tribes, of which fifty-seven currently operate fifty-eight casinos. This includes a seasonal small casino, the La Jolla Slot Arcade, that has been closed since August 2004. The next table

[5] Charlene Wear Simmons, "Gambling in the Golden State: 1998 Forward," ed. California Research Bureau (Californina State Library, 2006).

depicts tribal revenues divided into the administrative regions of the National Indian Gaming Commission. As shown, in the table below, the California-Northern Nevada region has the highest overall revenues for Native American gaming of any part of the country.

Tribal Gaming Revenues by Region
Fiscal Year 2005

States	Number of Operations	Revenues (US$ Million)
Alaska, Idaho, Oregon and Washington	47	1,829.20
California and Northern Nevada	57	7,042.69
Arizona, Colorado, New Mexico and Southern Nevada	48	2,529.13
Iowa, Michigan, Minnesota, Montana, North Dakota, Nebaska South Dakota, Wisconsin and Wyoming	118	3,984.45
Kansas, Oklahoma and Texas	93	1,729.98
Alabama, Connecticut, Florida, Louisiana, Mississippi North Carolina and New York	28	5,514.14
Total	391	22,629.59
Source: National Indian Gaming Commission		

Revenue from Commercial (non-Indian) Casinos
Selected States, 2004

State	Number of Casinos	Gross Revenue US$ Million
Colorado	46	726
Illinois	9	1,718
Indiana	10	2,369
Mississippi	29	2,781
Nevada*	258	10, 652
New Jersey	12	4,807
Sources: California State Library, American Gaming Association		

California's horse racing industry generates over $4 billion annually for the state's agribusiness, tourism, and entertainment economies and license nearly 14,000 individuals who work in the industry.[6]

Since the growth of card rooms, Native American casinos, the gaming industry in Nevada and other sources of competition, the horseracing industry in California has suffered, with overall handle (racetrack total betting) at racetracks declining to $4.1 billion in 2004–2005, a drop of $138 million from 2002–2003. In California, Hollywood Park operates

[6] California Horse Racing Board 2005 Statistical Report- http://www.chrb.ca.gov/statistical_reports_of_operation/2005_statistical_report.pdf, Accessed 6/23/07

the state's third-largest card club. However, an initiative to allow casino-style gambling operations at racetracks was rejected by California voters in 2004.

Horse Racing in California
By Type of Meetings, US$ Million 2005

	Attendance*	Handle **	Retained	Returned
Thoroughbread Race Meetings	5.99	3,075.05	604.23	2,470.82
Harness Horse Meetings	0.75	140.70	31.99	108.71
Quarter Horse Meetings	0.91	216.00	44.40	171.60
Fair Race Meetings	0.80	247.87	50.99	196.88
Total	8.45	3,679.62	731.61	2,948.01

*The Attendance column represents total patrons in attendance at on and off-track sites located in California. Attendance at sites located in other states is not reported.
** Includes all commingled wagering accepted by California Racing Associations on live and imported races. It does not include any Advance Deposit Wagering handle.
Source: California Horse Racing Board

Before the introduction of the lottery and legalization of Native American casinos, card clubs (also called cardrooms) were the major form of gambling in the state. California issues state licenses to card clubs that allow them to hold legal card games, such as poker, in which players are pitted against each other. The card room receives a share of the pot rather than from the players. Although the total revenues of card clubs are significantly lower than revenues from other forms of gambling, they do present a clear competition to the lottery's overall growth. Card rooms have continued to thrive, particularly in Southern California, despite the lottery and growth in casinos. In 2004 gross revenues at cardrooms totaled $656 million, an increase from $600 million in 2003.[7]

Number of Licensed Cardrooms
Top Ten Counties, 2006

County	Number of Cardrooms
Los Angeles	88
Orange	34
San Bernardino	25
Riverside	24
San Mateo	20
Contra Costa	19
San Diego	18
Fresno	15
Santa Clara	15
Alameda	14

Source: California Gambling Control Commission

[7] California Department of Justice, "Attorney General Lockyer Announces Release of Report Providing Detailed of California Gambling's Scope and Impact," (Office of the Attorney General, 2006).

Privatization Efforts

With a view to increasing sales, a number of states have considered privatizing their lotteries. Some of these efforts are reviewed in this section. In addition, we look at some privately run lotteries in foreign countries.

An important consideration when attempting to increase lottery sales per capita is the "substitution effect." An increase in ticket sales can lower sales of other commodities, such as clothing and electronics, and lead to lowered state and county sales tax revenue. This effect should be noted in an analysis of privatization.

Political resistance—in the form of claims that the middle class and poor buy a disproportionate share of lottery tickets or that the lottery is a form of regressive taxation—is another potential obstacle to privatization.

Connecticut

In 1996 Connecticut created the quasi-public Connecticut Lottery Corporation. Like the U.S. Post Office, the CLC is still controlled by the government (the state in this case) but run as a corporation, with its own employees. The CLC has been able to take advantage of this flexibility in bidding for services, responding to market demand, and reacting to increased competition from tribal casinos, such as Foxwoods. The corporation has announced intentions to operate as a nonprofit in order to avoid corporate taxes and enjoy more flexibility on splitting moneys between payouts, administration, and returns to the state. Despite increasing levels of revenue generated by the local casinos, sales increased by nearly 18 percent from 1996 to 2000. Connecticut was also able to cut telecommunications costs by $750,000 and instant-ticket printing costs by $500,000 almost immediately by being able to negotiate with subcontractors as an independent corporation rather than being subject to the standard regulatory restrictions of state agencies. [8]

The autonomous structure of Connecticut's lottery corporation has allowed it much greater flexibility in adjusting to changing market conditions within the state. Although Connecticut has a lower ratio of advertising to sales than found in California, increased flexibility in its budget has allowed it to more effectively target its marketing efforts. Connecticut pays a higher fee to ad agencies than California- $350,000 to $290,000, for fiscal 2006 despite a dramatically smaller market and budget. Connecticut has also been able to offer $10 instant games (scratchers) since 1997, $20 instant games since 1999, and $30 instant games since 2002 to help keep revenues rising even as California is

[8] Eugene Martin Christiansen and Sebastian Sinclair, "Global Lottery Privatization: The Equity Potential of Government Lotteries," in *CCA Research Report* (Christiansen Capital Advisors LLC, 2001).

unable to effectively offer instant games above $5 due to the restrictions placed on its winnings ratios by the 1994 Lottery Act.[9]

Wisconsin

The state's governor vetoed initial efforts in 1995–1996 to introduce partial privatization. Renewed efforts in 2003 also stalled. In 2005 the state decided to streamline operations by shifting significant operations—including retailing, information technology, ticket delivery, ticket printing, and advertising—to private vendors. [10] This was done on a more thorough scale than has occurred in California. Wisconsin's goals have been to cut operational costs and reduce the number of state employees rather than develop new revenue streams.

Michigan

The Michigan legislature has resisted efforts to privatize the lottery, including a proposal to sell the lottery outright, a transaction that could net up to $2 billion for the state.[11] Concerns have also been raised about any potential buyer being restricted by a 2004 referendum that requires the passage of a public initiative to expand the games.

Indiana

In February 2007, the state senate authorized the governor's proposal to privatize the state lottery. According to the terms of the legislation, the state may contract with a private operator for thirty years in exchange for a minimum of $1 billion in upfront payments and a minimum of $200 million a year in annual revenue to cover existing obligations to pensions and cuts in excise taxes.[12] In April, however, the governor decided to hold off on the process for a year in order to study further the potential costs and benefits of lottery privatization.[13]

Illinois

[9] La Fleur, Theresa E. and Bruce A. Lafleur, eds. "La Fleur's 2007 World Lottery Almanac." TLF Publications Incorporated, Boyds, Maryland, 2007. p48

[10] Wisconsin Joint Committee on Finance, "Privatization of Lottery Operations(Dor - Lottery Administration)," (Legislative Fiscal Bureau, Wisconsin 2003).

[11] Michael D. LaFaive, "Place a Bet on Lottery Privatization," (2003), http://mackinac.org/article.aspx?ID=5021.

[12] Lottery Post, "Indiana Senate Approves Lottery Sell-Off," (2007), http://www.lotterypost.com/news/151913.htm

[13] ———, "Indiana Lottery Privatization Takes Big Step Forward," (2007), http://www.lotterypost.com/news/151473.htm.

Illinois is may be the next state to partially privatize its lottery. Like California's, the Illinois lottery has long been considered to be an underperformer, with per capita sales trailing those of Ohio, Michigan, and successful East Coast states.

Illinois has established a plan to place its lottery operations up for bid, to be operated under a long-term lease similar to that being considered in a number of states, including California. The state legislature has already passed legislation authorizing the state to place the lottery concession up for competitive bidding, for lease terms of up to 75 years, and with a minimum level of compensation to the state of $10 billion. Illinois' lottery is considerably smaller in scale than California's so their expected level of funding is also much lower. A decision has been made in the process to emphasize immediate payments even at the risk of guaranteeing long-term educational funding, although the state will certainly remain involved in profit participation throughout the length of the contract.[14]

The purpose of the Illinois legislation has been to open up the lottery concession for competitive bidding. The state is not obligated to actually reach an agreement with any of the bidders at this time, but is authorized to pursue a bid if the right terms are offered. Illinois has set a number of supervisory controls over the lottery to secure state oversight, including the establishment of an oversight board with salaried members.

Texas

Although Texas has not actually privatized its lottery system, it has successfully outsourced a number of operations, and has successfully partnered with private firms to offer technologies and game varieties that are unavailable in California. In a nine year partnership with GTECH Corporation in 2001, Texas implemented faster ticket machines and a new reduced administrative cost per-ticket issued by utilizing the latest in lottery technology. In 2002, more than 16,500 lottery retailers changed over to a new terminal with programmable LED (light emitting diode) displays to better advertise new games and a customer display screen that provides players verification of winning tickets at lottery retail outlets.[15] Such technology is currently prohibited from being utilized in California by provisions of the Lottery Act.

Texas has also demonstrated clear examples of the importance of prize payout rates in the success of different lottery games. In 1997, the payout rate for Scratcher games was significantly reduced which resulted in a dramatic fall in sales. In 1999, Texas responded to the dropoff by boosting its prize-payout level to over 61%, resulting in Scratcher sales rising to a new high. In the past year, however, Texas was confronted by a significant market failure in their "Texas Two Step" game, which involves the customer picking two numbers and being assigned a random third. Because of the lack of control over the third number as well as a perception that the odds of winning were far too low,

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[14] Illinois General Assembly. "Full text of HB 1352" http://www.ilga.gov/legislation/fulltext.asp?DocName=&SessionId=51&GA=95&DocTypeId=HB&DocNum=1352&GAID=9&LegID=30122&SpecSess=&Session=

[15] Brad Watson, "Lottery Game Flop Stirs School Fund Concerns," KVUE.com.)

the public has reacted negatively, and the game is actually costing the state more money than it is generating,

Overseas Lotteries

United Kingdom National Lottery

The British National Lottery is the clearest example of a successfully privatized lottery that can be found worldwide that is at or above the size of the one in California. Because the National Lottery was privatized for the purpose of improving performance and cost efficiencies only, rather than emphasizing large upfront payments, it contains a number of provisions that differ from lottery privatization plans such as those in Illinois and Indiana. The National Lottery is currently operated under a shorter-term concession agreement that emphasizes short-to-medium term operational performance rather than establishing a fixed minimum level of returns to the government. Under the terms of the lottery concession, the National Lottery commission licenses the specific games, monitors operator performance and enforces the license. For the two concession periods under which the Lottery has been operating, the contract has been with the British-based gaming company Camelot.[16] Camelot is actually comprised of a mixture of British and foreign companies including Cadbury-Schweppes, Fujitsu, and Thales Electronics. Because the National Lottery has a different operating purpose, it divides up its funds in the following manner:

- 50 percent is paid to winners in prizes;
- 28 percent is given to the Good Causes as set out by Parliament;
- 12 percent is passed on to Government in lottery duty;
- 5 percent is paid to National Lottery retailers on all National Lottery tickets sold;
- 4.5 percent covers Camelot's operating costs, which comprise of running the lottery network and computer system, marketing expenses, player and retailer support services and administration costs;
- 0.5 percent is Camelot's profit in the second license, down from just under 1 percent in the first license period.

The National Lottery funds are utilized primarily for "Good Causes", which can include charitable and arts funding. National Lottery monies have been used to help support and expand the production of independent films in Britain, as well as support other significant art endeavors. The Lottery has raised over £17 billion ($34 billion) since privatization for that purpose.

Because the National Lottery has been able to operate with only limited restrictions on innovation, it has introduced a number of lottery models that could be tried in California. Lottery sales are now allowed by recurring weekly subscription, and these can be

[16] Rob van der Gaast, "The Bidding on Uk's National Lottery " *Gambling Privatization* (2006), http://gambling-privatisation.com/index.php?cat=ong_pri&sayfa=bidding

authorized both by mail and on the Lottery's secure online site. Sales are also allowed through a satellite television interactive service and by mobile phone.

The next lottery license concession is being offered for a ten year period, rather than a seven year one has been done previously. The purpose of the longer concession time is to not only encourage more competitive bidding, but also to allow time for the lottery operator to make greater investments in lottery operations and infrastructure. While only two bidders were interested in the concession in 2000 (Camelot and Virgin Group), numerous bidders have expressed interest in the contract being awarded in August, 2007. These include Camelot (the current operator), Virgin Group- which intends to donate operating profits to charity in addition to the current "Good Causes" fund, a consortium led by Lehman Brothers, Hilton/Intralot, William Hill- a betting firm, Sportstech PLC, and Tattersal's- which operates the Victoria State Lottery in Australia. It is conceivable that any of these firms would be interested in a California lottery concession as well, either on their own or with additional American partners.

Tattersals and the Victoria and Tasmania Lotteries[17]

Tattersals is an Australian gaming concern that has been in existence since 1881 and is based in Melbourne, Australia. Tattersals is unique among lottery operators in that it has been the sole operator of the Tasmania State Lottery since its inception in 1897, giving it the experience of starting and operating a state-sanctioned lottery without any privatization process. In 1954, Tattersals took over operating the Victoria State Lottery, and has since added the lotteries of the Northern Territory and Australian Capital Territory. It operates each lottery independently and under the respective governing bodies of each state and territory. As noted in the British example, Tattersals has put forth a bid on the British National Lottery. It also has expressed interest in running overseas lotteries elsewhere and has even had discussions with the Turkish government about running the Turkish national lottery.

Greece[18]

The Greek National Lottery is the one example of a government run gaming concern that has offered a stake to the general public. As a means of raising funds, the Greek Government offered a 10 percent stake in OPAP S.A. (Greek Soccer Pools and Lotteries) in a stock offering on the Athens Stock Exchange.

[17] Christiansen and Sinclair, "Global Lottery Privatization: The Equity Potential of Government Lotteries."
[18] Eugene Martin Christiansen and Sebastian Sinclair, "Case Study in Privatization: The Greek National Lottery - Opap Sa," ed. CCA Research Report (Christiansen Capital Advisors LLC 2005).

Potential Scenarios for Changing the Lottery:

Scenario 1: Maintain the Current Lottery System with Minor Legislative Changes

Due to the constraints of the lottery act and subsequent legislation, the California Lottery is essentially trapped into only offering a limited range of games and payouts, and is unable to enact any significantly new technologies. Since the state legislature has amended the Lottery Act on multiple occasions since its initial passage by referendum, a precedent exists for making changes as long as they are consistent with the original intended purpose of the Lottery Act. Making changes to the Lottery Act would allow for the potential growth of the Lottery, but would lack the revenue guarantees and upfront payments that can be found in any of the privatization models.

Potential reforms could include the introductions of new administrative and gaming technologies which would serve to reduce costs and increase potential sales. New ticket vending machines could be allowed as well as new Scratchers which could be advertised with interactive displays on the machines themselves. The Legislature could also establish a provision that instead of being diverted to the education fund, all leftover lottery revenues at the end of the year could be put towards capital improvements, new games and new marketing.

The main problems with this approach are that there is a limit to how much more growth can be achieved without significantly altering the guaranteed 34 percent of revenues due each year to education to a guaranteed fixed minimum dollar amount. Even if the courts allow such a move without a referendum, political pressure to put such an issue to a vote seems likely. Also, the Lottery will remain restricted on administrative and hiring practices as long as it remains a State agency and remains bound by Article 7 of the California State Constitution.

Scenario 2: Establishing a Quasi-Public Corporation to Operate the Lottery

In almost any potential scenario for cost savings and increased efficiencies within the State Lottery, the limitations of the California Constitution and penal code, as well as those of the Lottery Act, provide strong barriers to overall improved performance within the Lottery. By following the model utilized in Connecticut, the California Lottery can remain in state control, particularly in terms of revenues and oversight, while gaining flexibility in spending practices, hiring and subcontracting.

Functioning as a publicly-owned corporation, the California Lottery would be no longer be considered part of the state employment pool, and would be freed to delegate services such as information technology and distribution to key subcontractors on a larger scale than is currently possible. The Lottery could also offer more competitive salaries in order to attract key administrators, and could potentially move portions of operations to other locations within the state such as Silicon Valley where larger potential pools of employees could be accessed. With a more flexible cost and revenue structure, the Lottery could also potentially develop models for more wide-scale changes in games such as Scratchers, as well as develop more effective and longer-term marketing campaigns.

The key concerns with establishing a quasi-public corporation are that it would be difficult to guarantee growth in education funding in the new corporation, even if it would be likely. A quasi-public corporation would also still face some bureaucratic and recruiting issues similar to those faced by other such companies both in the US and internationally, as there would be a limit to any salary or incentive structure. There would also be no ability to raise immediate capital as with a long-term lottery concession or public stock offering. In addition, any such changes to the Lottery would require either significant legislative action or a new state initiative to be considered legal, and quite possibly both.

<u>Scenario 3: Establishing a 5 to 10 Year Lottery Concession</u>

This scenario would allow for the California Lottery to be leased out as a concession for moderate length of time at the end of which the contract could be reviewed by both parties and then renewed if everyone is satisfied. This model is the one currently being followed in the UK, which has issued two 7 year leases and is planning to shift to a 10 year lease term for 2008. In this model the focus is on year-to-year performance with specific minimums established for contributions to the state education fund of at least $1.3 billion and to be adjusted for inflation each year. As the performance of the State Lottery improves, a significant percentage of the additional revenues would then be guaranteed for the state education fund.

The key advantages of this approach is that it would be one of the strongest models for ensuring a growth in overall lottery sales and performance, as well as contributions to the state education fund. The state would also retain a level of oversight over the lottery through a public lottery commission while the private operator would be free to allocate additional funds to marketing and new games as long as the minimum education contributions are met. Because of the relatively short term of the lease, the state would then have the ability to offer the concession to a new bidder if performance has been sub-par, or to negotiate for improved revenue-sharing terms if performance is excellent, as has been the case in Britain. The 650 or so public employees who currently work for the lottery could be given a choice of private employment with the new company or a guarantee of an equivalently-salaried job in another state department.

The main problems with the shorter lease term are that any potential upfront payment would be significantly reduced, and the overall shorter term of the lottery would limit any incentive for the operator to make large investments in new technologies and lottery infrastructure. In Britain's case, the term of the lease has been expanded to 10 years because operators found 7 year terms to be too short for guaranteeing returns from any new changes they were considering. As with any of the other scenarios, significant changes to the state penal code and the Lottery Act would be required in order to allow for private operation, and would have to be implemented in advance of soliciting any bids for the concession.

Scenario 4: Establishing a 30 Year or Longer Lottery Concession

A longer-term lottery concession provides most of the administrative benefits of a shorter-term concession, while also allowing the state to secure a significant upfront payment as part of the lease terms. Unlike with a shorter lease, any potential concession operator is able to secure an upfront payment to the state with the guarantees of long term revenues over the course of the lease. This would allow the state to set terms that guarantee a significant upfront payment. Lehman Brothers has publicly stated a valuation of a long term lease at around $37 billion in today's dollars in the Sacramento Bee, and a significant percentage of that valuation could be required as part of any successful bid for the lottery concession.

As noted with the shorter lottery concession, a longer-term lease provides an increased incentive for any lottery operator to reinvest more lottery revenues into developing new games, improving technologies and expanding lottery retail operations. Because the concession operator is more concerned with continuing to grow the lottery over the long term rather than facing a shorter-term review of its operations, it can overcome many of the constraints facing the California Lottery under its current restrictions. The concession operator will also be able to hire employees more easily since they will not have to be concerned with job security each time the lottery lease comes up for review every few years.

The primary concern with any long term lease is how to address the situation if the lottery operator either fails to meet its performance requirements or in other ways proves to be unable of running the lottery in a satisfactory manner. Because the lottery is not up for review every five to ten years, the committee that oversees the lottery's operations must be able to sanction the lottery operator effectively without having so many powers that it scares off any potential bidders before the lottery concession is even awarded.

Scenario 5: Outright Sale to a Private Entity

This action has the potential to raise the largest amount of money over the short term. However, because the Lottery would necessarily retain a statewide monopoly in order to ensure the highest possible asking price, the potential for a public backlash against its sale would be high. Resistance from education advocates who would see the guarantee of funding for schools disappear would be strong. Concerns from Native American casinos and private card room operators would also be significant, as they would be facing competition from a privately held, state sanctioned monopoly. Perhaps the most important issue is that once the Lottery is sold, reversing the process if the new owner has problems will prove exceedingly difficult. Any efforts to enforce strict compliance by the state to counteract such concerns will only result in a reduced sale price that may actually be below the initial payment from a long-term lease concession.

Another possibility is to consider retaining a stake and investing significant proceeds in an annuity as well as pay off bonds. If sale is possible at $35 billion while retaining a stake, the money could be divided into an annuity to keep funding education as well as using a portion to retire bond obligations. A $20 billion annuity could net the state $1.3 billion per year at 6 ½ percent interest which would provide ongoing funding for the state's education fund. However, unless a portion of this interest was added to the capital in the fund, the overall rate of funding would stay constant even despite inflation. The result is that the fund would actually see a decline in received contributions in real terms.

Scenario 6: Establishing a Public Corporation and Holding an Initial Public Offering

This scenario combines the terms of establishing a quasi-public company with the additional step of selling a portion of the new corporation's shares to the public through a stock market public offering. This would allow the state government to retain a controlling ownership stake in the publicly traded corporation, while also gaining the benefits of raising a significant amount of capital through the public sale of stock.

This approach has significant numbers of positives and negatives. The largest positive is that it allows the California government to raise funds in the short term through the stock offering while still earning significant ongoing dividends through its ownership stake in the Lottery. Because the Lottery will operate as largely independent of the state bureaucracy, it will be able to recruit and pay employees outside of the state hiring system. In addition, since the state retains ownership of the lottery, it can enact reforms and administrative changes if needed without being in danger of abrogating a lease contract.

The chief drawback to an initial public offering comes from its chief advantage. By selling stock to the public, flexibility in revenue utilization is reduced as the lottery corporation will have to provide a share of revenues to stockholders in addition to that going back to the state. If the lottery corporation fails to provide these dividends, the overall valuation of the stake will be reduced. There is also no guarantee that the state can raise more money through a stock sale than can be raised through a competitive bid for a long-term lease. Another potential concern is conflict of interest through stock purchases by institutional investors. Since such investors are often involved in pushing for good corporate governance, outside pressures can be placed on the running of the lottery corporation. Potential conflicts of interest can also occur if various state and local pension plans become involved in purchasing lottery corporation stock.

Conclusion:

In determining which path to take in improving the performance of the California Lottery, there are three significant factors which need to be considered. These factors are the (1) regulatory framework of the lottery itself, (2) the potential financial impact of any significant changes such as privatization, and, (3) the length of time available to actually execute any significant changes to the lottery before additional hurdles are created.

If the state government agrees to proceed with significant regulatory changes to the lottery, including partial privatization, the issue of placing a proposition on the state ballot becomes significant. Although it may be possible to amend the 1984 Lottery Act through the legislature as has been done in the past, political resistance and potential court challenges are likely to be considered more daunting than placing the issue before the public. As has been noted previously, the current restrictions of the Lottery Act on spending and technology, and the Penal Code on gaming parameters serve to severely curtail any potential growth of the lottery, regardless of who actually runs it.

In order to maximize the potential return on any changes to the lottery, it is essential to focus on the financial aims of the state government in both the short and long term. With the interest payments of the Economic Recovery Bonds combined with those of the recent Infrastructure Bonds, there is strong incentive towards considering a privatization option which secures a significant upfront payment. For political considerations, it is also essential that education funding be preserved at least at the current range of $1.2 to $1.3 billion. Projected net sales assumptions should be realistic. It would be imprudent and potentially fiscally irresponsible to assume that net sales could triple or even double within five to seven years under any operating scenario even under the best of circumstances. Unfortunately, it is not possible to provide specific projections and recommendations on the ideal combination of debt relief and increased lottery income without a more thorough regression analysis of the underlying figures for each option. However, certain key items are evident.

In terms of an upfront payment, the best single option is the outright sale of the majority of the lottery, which is most likely to secure the largest amount in the short term. However, as noted previously, this also severely limits growth in long-term income. Even if a large portion of the payment is placed into an annuity, the amount of income generated is unlikely to exceed the current net revenues the lottery produces currently, and will also not grow to keep pace with inflation. The next strongest option for an upfront payment would be a long term lease concession. In the short term, annual funding could be maximized by placing the majority of the upfront payment in an annuity and using that funding to bolster a guaranteed level of net revenue from the concession that would be required to match current funding levels. This could secure annual funding that is closer to the $2 billion range, but due to an incentive structure for any private operator, growth for this number would be limited in the short term. Maintaining majority ownership, while establishing a public-private corporation that operates autonomously, offers the potential for the highest annual payments if the lottery grows rapidly. However, if the rapid growth does not occur, payments are likely to be below those from the other options.

Timing is a significant factor because California is faced with a limited window of opportunity for pursuing a stock offering or auction of a lottery concession if it hopes to get the largest valuation from any potential bidder. The market's appetite for privatization could be satisfied by enough other states going through privatization. The issue of supply and demand could come into play. Also, a number of potential suitors could wind up committed to other lotteries, reducing the pool of bidders. Because any lottery reform will require either significant legislation or a ballot initiative, and possibly both, the state government will have to act in a timely manner to place the issue on the ballot by November of 2008 or resolve the issue in the legislature or see the potential gains from privatization be significantly reduced

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