



# Georgia Department of Audits and Accounts Performance Audit Division

Greg S. Griffin, State Auditor  
Leslie McGuire, Director

## Why we did this review

This follow-up review was conducted to determine the extent to which the Georgia Lottery Corporation (GLC) has addressed the recommendations presented in our December 2016 special examination (Report #16-18).

The 2016 special examination was conducted at the request of the Senate Appropriations Committee. The Committee requested that we:

- Review the effectiveness of GLC's efforts to increase sales from existing games and provide recommendations on increasing revenues and transfers;
- Provide recommendations on operational improvements in working with retailers and advertisers;
- Evaluate the return on investment from awarding tickets as prizes as a Lottery practice and review the significance of tickets as prizes as revenue; and
- Conduct a comparison with other states.

## About the Georgia Lottery Corporation (GLC)

In 1992, Georgia voters approved a constitutional amendment authorizing the state to operate and regulate a lottery. In 1993, the Georgia Lottery for Education Act was approved, and GLC was created as a public corporation to oversee operations. As a public corporation, GLC is an instrumentality of the state, not a state agency.

GLC is charged with providing entertainment to the public, maximizing revenues, and ensuring that the lottery is operated with integrity and without political influence.

## Follow-Up Review Georgia Lottery Corporation

### Action has been taken to address most of the recommendations

#### What we found

Since our 2016 special examination, GLC has taken steps to address most of the report recommendations, including reconstructing and validating the optimal prize payout study used to set lottery payout rates in Georgia.

Our 2016 review focused on the effectiveness of GLC's efforts to increase sales from existing games, its interaction with retailers and advertisers, the return on investment from awarding tickets as prizes, and how GLC compared to other state-operated lotteries. We noted that Georgia ranked highly compared to other state-operated lotteries but also identified several areas for improvement. We recommended GLC ensure the study it relies on to establish lottery payout rates be properly vetted and that it study the effectiveness and optimal payout rate for free tickets as prizes. We also recommended operational improvements. Changes made in each of the three areas we reviewed are discussed below.

#### Sales, Revenues, and Transfers

GLC has, or plans to, address most of the recommendations related to sales, revenues, and transfers. GLC reconstructed the optimal prize payout rate study in 2016 to address concerns regarding the methodology and included variables recommended in the 2016 review. GLC also commissioned an independent reviewer to validate the study. The reviewer deemed the reconstructed study to be a valid tool for identifying the optimal prize payout rate. However, the revision to the study was conducted by the original firm which has a long-standing relationship with one of GLC's vendors, Scientific Games, leaving our recommendation that it should be conducted by an independent entity unaddressed.

GLC also developed a player information handbook to guide employees' interactions with players. It updated its website with more detailed game rules, regulations, and information, increasing transparency to its players. Additionally, GLC implemented a player information tracking system in 2017 that logs and categorizes call data. According to staff, player issues are forwarded to appropriate departments for resolution, and GLC reports using this data to make improvements to marketing efforts. Finally, GLC staff reported that it is redeveloping protocols (e.g., rules, regulations, policies, and procedures) in response to the 2016 review. GLC developed a major procurement policy in April 2019 that recognizes the "preeminence of competitive bidding" but allows GLC to renegotiate existing contracts if it can demonstrate to the Board that renegotiation is more beneficial to the state than public bidding. However, the policy does not include language regarding contract bid/renegotiation frequency.

### Retailers and Advertising

GLC has addressed, or started to address, most of the recommendations related to retailers and advertising. Staff updated the retailer termination "Reason Codes" which allow it to better identify retailers that no longer sell lottery tickets and allow it to identify those retailers that voluntarily terminate sales.

During the 2016 review, GLC was in the process of amending and extending a contract with gaming machine vendor IGT to replace, repair, and maintain lottery ticket machines. GLC indicated that executing this contract resulted in the replacement of 60% of lottery ticket machines and 25% of the lottery communication network. The contract establishes that IGT will repair machines at retailers as needed.

Regarding advertising expenditures, GLC indicated that it has not conducted a study on the optimal level of advertising expenditures but will assess the benefit of including advertising expenditures in the prize payout study to identify the optimal level as recommended. Additionally, GLC indicated that if it decides to reconsider offering additional retailer compensation, it will evaluate the impact of any change on sales and returns to the state prior to implementation. There have been no changes to retailer compensation since 2011, and GLC indicated that changes are not currently being considered.

### Free Tickets as Prizes

Since the 2016 review, GLC has not conducted research to determine whether using free tickets as prizes results in a positive return on investment. However, staff noted that it does plan to study this question in the future. Regarding the optimal rate of free tickets as prizes, GLC indicated that it lowered free ticket payout rates for \$1 and \$2 instant ticket games (the most profitable instant ticket games). Free ticket payout rates fluctuated across different \$1 and \$2 instant ticket games but have been uniformly reduced to a 10% payout rate to maintain a consistent profit margin and to align with the higher value instant ticket games. GLC indicated profits have increased as a result. While GLC did not research what an optimal rate would be when it set the 10% payout rate, staff indicated results will be analyzed as part of future optimization studies.

*GLC's Response: In its response to the follow-up, GLC provided information on actions taken, which is included in the following table. Overall, GLC agreed with the current status as presented.*

The following table summarizes the findings and recommendations in our 2016 report and actions taken to address them. A copy of the 2016 special examination report 16-18 may be accessed at <http://www.audits.ga.gov/rsaAudits>.

<b>Requested Information on the Georgia Lottery Corporation Follow-Up Review, June 2019</b>	
<b>Original Findings/Recommendations</b>	<b>Current Status</b>
<b><i>Sales, Revenues, and Transfers</i></b>	
<p><b>GLC has elected to extend contracts with gaming vendors instead of rebidding them.</b></p> <p>GLC has two primary gaming vendors, Scientific Games and IGT, currently under contract. Both contracts were awarded following a request for proposal process in 2002, with an initial contract period from 2003 to 2010. Since then, neither contract has been rebid; rather, both have been extended three times. Both contracts are set to end in September 2025. Our 2016 review identified that over time, contract amendments have expanded the scope of both contracts and provided for additional compensation without undergoing a formal bid process for additional services. Additionally, we found that GLC did not have written policies or procedures adopted by the Board that address major procurements. Draft policies were identified but were not approved and did not address contract rebid frequency.</p> <p>We recommended that GLC establish a policy regarding major procurements, including bid frequency. Additionally, we recommended that GLC competitively bid the contracts for its gaming system and instant tickets services to ensure it is receiving the most competitive pricing and most advantageous services for the state.</p>	<p><b>Partially Addressed</b> – GLC agreed that competitive bidding should always be considered but stated that contract extensions have provided the best benefit to the state in recent years. According to GLC, major procurement contracts awarded via competitive bidding in the last three years resulted in costs greater than or equal to the existing contracts.</p> <p>GLC reports that it “established a major procurement policy at the April 25, 2019 Board meeting.” The policy recognizes the preeminence of competitive bidding but also allows GLC to conduct nonpublic contract negotiations if it can demonstrate to its Board that these negotiations are more effective in securing the maximum benefit to the state. The policy does not address bid frequency.</p>
<p><b>GLC did not properly vet the study it commissioned on the prize payout rate.</b></p> <p>GLC commissioned a study in 2013 to identify the optimal payout rate that would maximize lottery ticket sales. During the review, we determined 10 of the 12 key variables used in the model were not statistically significant. As a result, the changes in sales that were reported by the study could not reliably be attributed to changes in the payout rate. We also determined that the 2013 study omitted several key factors that could impact the results. The odds of various games included in the 2013 study were not factored into the model and the 2013 study did not remove the free ticket amounts from the total sales amount, potentially affecting the profit maximization point estimate.</p> <p>We recommended GLC ensure the reliability of the study and that it analyze the study model to validate the results. We also recommended GLC ensure all factors</p>	<p><b>Partially Addressed</b> – GLC indicated that “at the recommendation of the Department of Audits and Accounts (DOAA) in 2016, the study has been both reconstructed and validated by a third party.” The reconstruction addressed concerns regarding statistical significance and methodology, and GLC indicated that additional variables recommended by the 2016 review were included in the study. GLC provided a validity study, conducted by a professor of economics with a specialization in the economics of gambling, that indicated the reconstructed study is an “appropriate and sophisticated statistical analysis.”</p> <p>Per our recommendation, GLC indicated that odds, updated sales data, and statistically significant variables were all included in the 2016 reconstructed study.</p> <p>GLC indicated it will continue to ensure future studies are independent; however, the 2016 optimal prize</p>

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<p>potentially impacting sales be accounted for in the study.</p> <p>Finally, GLC contracted for the 2013 optimal prize payout rate study through its instant ticket vendor, which selected a contractor with whom it has a long-term business relationship. For vendors, prize payout rates above the profit maximization point are advantageous, as vendors are compensated based on total sales. For the state, prize payout rates above the profit maximization point result in higher expenses that exceed additional sales, reducing returns to the state.</p> <p>Therefore, we recommended GLC ensure the optimal prize payout rate study is conducted by an independent entity to ensure incentives are properly aligned.</p>	<p>payout rate study was commissioned through the same contractor that conducted the 2013 study.</p>
<p><b>Additional areas were noted where GLC could take action to improve operations.</b></p> <p><b>Retailer and Player Hotlines</b> Our 2016 review determined that player hotline agents did not have a central source of information for agents to use to address player issues. Additionally, GLC tracked only those calls to the player hotline that required additional follow up.</p> <p>We recommended that GLC develop and implement guidelines for player hotline agents.</p> <p>Additionally, we recommended GLC monitor and track information on the calls received on the player hotline and use this information to inform decision making.</p> <p><b>Rules, Regulations, Policies (p. 29)</b> At the time of our 2016 review, GLC had multiple rules, regulations, and policies (herein referred to as protocols) that had not been updated in 10 or more years. GLC had created dozens of new and updated draft protocols that had not been approved. Additionally, GLC did not have a schedule in place to regularly review and update its protocols.</p> <p>While players, retailers, and vendors are subject to GLC protocols discussed above, our 2016 review found they were not posted on GLC's website. We recommended that, with consideration for game security, they be posted to increase transparency to stakeholders. We also recommended GLC develop a standard procedure for reviewing its regulations and policies to ensure that they are up to date and fully address the relevant issues.</p>	<p><b>Fully Addressed –</b> In response to our original recommendations, GLC created a player information handbook that provides employees with historical and financial information, answers to frequently asked questions, rules and drawings information for all lottery games, and instruction on managing calls from players appropriately. GLC also completed a player information tracking system in 2017 that logs and categorizes call data. Active or potential issues are forwarded to the appropriate department(s). GLC indicated that this player information tracking system has informed decision-making and provided an example of marketing changes that were implemented based on information from the new system.</p> <p>GLC has also begun a comprehensive effort to review protocols. It reported that, "the current state of [protocols] has evolved at times without coordination over the last 2 decades, [and] there is a Rules &amp; Regulations Manual and a Policies &amp; Procedures Manual with overlapping and at times inconsistent provisions on the same subject matter. Given the overlapping documents, it is better to start from scratch rather than try to clean up within the existing framework of the 2 manuals." GLC indicated that, as of October 2018, the Board is charged with issuing high-level policies and game rules; staff manages and develops protocols for day-to-day operations. Staff reported high-level policies and game rules would be prepared for the Board by April 2019; it did not have a time frame for revising daily operations protocols. GLC did not indicate whether it has established procedures for keeping the protocols updated.</p> <p>Finally, GLC updated its website, increasing the information available to stakeholders. It now contains expanded information regarding game rules and regulations and playing lottery games responsibly.</p>

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<b>While GLC's nominal sales are growing, sales growth is slowing when adjusted for inflation and population growth.</b>	No Action Required.
<b>GLC is taking action designed to increase sales.</b>	No Action Required.
<b>Operating expenses are primarily driven by prizes.</b>	No Action Required.
<b>Bonuses have been adjusted to reflect new statutory requirements.</b>	No Action Required.
<b>Retailers and Advertising</b>	
<b>While recent statutory changes reduced retailer compensation, it is in line with compensation practices in other states.</b>  We recommended that if GLC decides to reconsider offering additional compensation, it should first evaluate the impact of any change on sales and returns to the state.	<b>Partially Addressed</b> – GLC indicated that no changes have been made to retail compensation since 2011. However, it indicated that it will evaluate any potential impact on sales and returns before any decision is made regarding retailer compensation.
<b>Retailer density is better than the average compared to other states with a lottery.</b>  As of July 2016, there were 8,625 active lottery retailers in Georgia. Of these, 2,025 (23.5%) were corporate accounts such as Quik Trip or Kroger, while 6,589 (76.4%) were individually owned stores. Additionally, GLC operated 11 locations (0.1%), including kiosks at the Atlanta airport, GLC corporate headquarters, and GLC district offices. This number of lottery retailers equates to 1 retailer for every 1,182 residents, 10 <sup>th</sup> best out of the 44 state lotteries in 2016. Our 2016 review identified that improvements regarding retailer density could be made with efforts to improve analysis of retailer termination.  We recommended that GLC continue with efforts to improve analysis of retailer termination and follow-up with retailers who voluntarily leave to identify any actions staff could take to keep retailers engaged.	<b>Fully Addressed</b> – As a result of our original recommendation, GLC updated Reason Codes in its retailer information tracking system in 2016. During the update, three critical codes regarding retailer termination were added or clarified. According to GLC, these codes have allowed them to better identify which retailers no longer participate in the Georgia Lottery, and identify if additional effort or action should be taken to recruit them.
<b>Overall, retailers reported satisfaction with their interactions with GLC.</b>  As part of our 2016 review, we surveyed 38 members of the Lottery Retailer Advisory Board (LRAB) and representatives from retailer industry organizations. Of those responding, 71% reported experiencing problems with gaming terminals freezing up or shutting down, rendering players unable to purchase tickets.  We recommended GLC continue with reported plans to address terminal issues.	<b>Fully Addressed</b> – At the time of our initial review, GLC was aware of the reported terminal problems and had recently extended a contract with a vendor that included provisions to replace and upgrade terminals by the end of 2017. According to GLC, the contract resulted in the replacement of 60% of terminals and 25% of the communications network. GLC indicated that the contract also contains provisions regarding terminal repair services.



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<p><b>Georgia's advertising expenses are higher than most other states.</b></p> <p>At the time of our 2016 review, Georgia spent \$3.12 per capita on advertising. Georgia was ranked 5<sup>th</sup> highest in per capita advertising expenses, but 10<sup>th</sup> lowest in advertising expenses as a percentage of sales (0.8%). GLC described its advertising strategy as "high reach" and "high frequency," "maximum exposure" and "always on." GLC enlisted an advertising agency to conduct a comparative Return on Investment analysis on various media types. It also conducted market research on individual campaigns and overall brand awareness to assess the quality of the advertising. It had not commissioned a study to identify the optimal level of advertising.</p> <p>We recommended that GLC assess the benefit of including advertising expenditures in the prize payout study to identify an optimal advertising expenditure level.</p>	<p><b>Partially Addressed</b> – In response to our original recommendation, GLC indicated that while advertising expenses were not included in the most recent study, the GLC will assess the benefit of including advertising expenditures in future prize payout studies. These studies are typically conducted every 5 years, with the most recent occurring in 2016 (before the release of our report).</p>
<b>Free Tickets as Prizes</b>	
<p><b>The return on the investment of free tickets as prizes is unknown.</b></p> <p>Georgia offers "free tickets" as prizes that can be cashed in for another lottery ticket. At the time of our 2016 review, approximately 1:10 instant tickets were free ticket prize winners. In fiscal year 2015, GLC gave away approximately \$292 million in free ticket prizes (face value of the free ticket the player claimed). Because there is a cost associated with free tickets, sales must increase to cover these costs; otherwise, the higher expenses from offering free tickets reduce returns to the state. While GLC stated that offering free tickets did not add costs, our analysis identified \$20.5 million in vendor and retailer compensation because of free tickets in fiscal year 2015. At that time, GLC offered free ticket prizes at a rate of 7% of gross sales but did not verify an optimal free ticket payout rate. Additionally, no empirical research was conducted on the use of free tickets in Georgia.</p> <p>We recommended that GLC conduct research to determine how the use of free tickets impacts sales in Georgia. Additionally, we recommended GLC determine the optimal rate of free ticket prizes to ensure profit is maximized (i.e., costs are offset by additional revenues generated by new sales).</p>	<p><b>Not Addressed</b> – GLC indicated that it transitioned from variable to fixed rates of free tickets as prizes for \$1 and \$2 instant ticket games and reduced the payout percentage to 10% to maintain a consistent profit margin. The adjustment to 10% also made the payout percentage consistent with the percentage allocated for all other instant ticket price points. GLC also indicated that research on the impact of free tickets on sales and the optimal rate for free tickets as prizes has not been conducted. GLC plans to analyze the optimal rate and sales impact of free tickets as prizes in future optimization studies.</p>

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<b>Original Findings/Recommendations</b>	<b>Current Status</b>
<b>GLC's current accounting practice regarding free tickets is reasonable.</b>	No Action Required.
<b>13 Findings</b>	<b>3 Fully Addressed</b> <b>4 Partially Addressed</b> <b>1 Not Addressed</b> <b>5 No Recommendations</b>

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