PERFORMANCE AUDIT

LOTTERY COMMISSION

Report to the Arizona Legislature
By the Auditor General
February 1987
87-3

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STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

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Members of the Arizona Legislature
The Honorable Evan Mecham, Governor
Bill Henry, Executive Director
Arizona State Lottery Commission

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Lottery Commission. This report is in response to a July 26, 1985, resolution of the Joint Legislative Oversight Committee.

The report indicates that a greater proportion of Lottery revenues could be set aside for prizes and/or the designated revenue funds. In addition, the report addresses the need to strengthen legislative and executive budgetary control over Lottery operations.

My staff and I will be pleased to discuss or clarify items in the report.

Respectfully submitted,

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SUMMARY

The Office of the Auditor General has conducted a performance audit of the Arizona Lottery Commission in response to a July 26, 1985, resolution of the Joint Legislative Oversight Committee. This performance audit was conducted as part of the Sunset Review set forth in Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

The Arizona Lottery was proposed by initiative petition and approved by voters in the 1980 general election. The Lottery's purpose is "to produce the maximum amount of net revenue consonant with the dignity of the State." To do this, the Lottery operates an instant ticket game and a computerized on-line game. From its first game in 1981 through June 1986, the Lottery transferred $145,400,000 into the several statutorily designated funds, including the local Transportation Assistance Fund, the County Assistance Fund and the General Fund.

The Lottery Has More Administrative Funds Available Than It Needs (see pages 13 through 19)

A greater portion of Lottery revenues could be allocated to prizes and earmarked for designated revenue funds. Although the Lottery has 25 percent of total revenues available for general administration, it has spent less than 20 percent of total revenues to operate during its first five years. States with lotteries most comparable to Arizona's also spend less than 20 percent of revenues for administration. The percentage of Lottery gross revenues allowed for administrative expenses should be reduced from 25 percent to no more than 20 percent. This would allow increases in the percentage of revenues allocated for prizes and the percentage of revenues transferred to the General Fund and other designated revenue funds.

Even a relatively small increase in the revenue percentage allocated to prizes would produce noticeable effects. For example, during the recent Double Your Treasure instant game, increasing the prize allocation by 2.5 percent would have provided an additional $130,179 in prize money, for an

additional 32,828 winners. Similarly, if the Pick game had received an additional 2.5 percent from its inception, it would have paid two more $3+ million jackpots.

Budgetary Control Over Lottery Operations Needs To Be Strengthened (see pages 21 through 25)

The Lottery statutes should be revised to increase budgetary control over Lottery functions. The Lottery operates more autonomously than most agencies within State government. The Lottery is not subject to an annual appropriation of its operating funds by the Legislature, nor is it subject to executive control over its procurement and contracting activities. By contrast, 16 of 22 other states appropriate their lottery operating budgets. Further, although the initiative establishing the Lottery may have intended that the Commission provide oversight, the Commission has never been active in reviewing operating or construction budgets, or staffing levels. Establishing executive and legislative oversight would strengthen control over Lottery expenditures.

The Lottery Needs To Better Maintain The Appearance Of Impartiality And Fairness In Its Contract Selection Process (see pages 27 through 37)

The Lottery's contract selection process could be strengthened to better ensure its integrity and fairness. Maintaining integrity and fairness is essential due to the nature of the Lottery's activities, its potential vulnerability to the influence of organized crime, and its need to maintain public confidence. Aggressive gaming companies further underscore this need. For example, in one instance a gaming company threatened to expose how to compromise the security of a competitor's ticket.

Some Lottery contracts appear to have been awarded without appropriate competitive safeguards. For example, a series of four electronic data processing contracts worth an estimated $1.5 million were awarded to the same vendor. The vendor received the initial award to do a feasibility study and was allowed to bid on subsequent related work. This gave the vendor a considerable advantage over other bidders. In contrast, State

Purchasing Office policy discourages permitting vendors who have conducted a feasibility study to bid on subsequent related work, because of potential conflicts of interest. In three other cases, the competitive bidding process was circumvented through the use of subcontracts worth at least $450,000. Six other state lotteries use a central procurement office for contract selections and awards. Repealing the Lottery's exemption from the State procurement statutes and making the State Purchasing Office responsible for Lottery procurement would better insulate the Lottery from aggressive gaming companies and strengthen the Lottery's procurement procedures.

The Lottery Has Not Sufficiently Controlled Its New Building Costs (see pages 39 through 43)

The Lottery has not sufficiently controlled costs for its new building. Based on square foot costs, the Lottery building will cost over $440,000 more than other State buildings under construction. More elaborate interior and exterior features such as an exterior brick facade, brick planter walls and a cut stone walkway contribute to the higher cost. During the course of the audit, the Lottery rescinded its decision to replace its furniture. Replacement of most of its furniture is unnecessary and would have cost $600,000.

The Lottery Has Exceeded Its Authority To Investigate Lottery Violations (see pages 45 through 48)

Lottery investigators do not have statutory authority to conduct investigations. A.R.S. §5-510.C. limits the Lottery's law enforcement status to receiving investigative information pertaining to investigations of Lottery activities from law enforcement agencies. The Department of Public Safety, rather than the Lottery, is empowered by statutes to investigate Lottery violations. Despite this, Lottery personnel have conducted numerous investigations of such matters as fraud and ticket theft.

Lottery investigators have also violated State statutes by carrying concealed firearms. The Lottery's limited law enforcement status precludes carrying concealed firearms. According to the Legislative Council, only officials designated as peace officers can legally carry concealed firearms.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit of the Arizona Lottery Commission in response to a July 26, 1985, resolution of the Joint Legislative Oversight Committee. This performance audit was conducted as part of the Sunset Review set forth in Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

The Arizona Lottery was proposed by initiative petition (Proposition 200) and approved by voters in the 1980 general election. During its 1981 session, the Legislature enacted House Bill 2366 (Laws of 1981, Chapter 245) which established the Lottery in statute. The Lottery's purpose is "to produce the maximum amount of net revenue consonant with the dignity of the State."

Lottery Games

The Lottery currently operates an instant game and a computerized on-line game. The instant game involves purchasing a ticket and scratching off the coating to determine if it is a winning ticket. Prizes usually range from $2 to $100,000. Approximately six instant games are held per year. The instant game was the only Lottery game until the Legislature approved an on-line game that began in 1984.

The on-line game is played weekly and involves selecting six unique numbers between 1 and 39. At the end of the week a drawing determines the six winning numbers and the bonus number. Players selecting winning combinations share the prize money. If no player selects all six winning numbers, the grand prize is carried over until there is a winner. Grand prize winnings have ranged from $150,000 to $8.7 million.

Lottery tickets are sold by agents licensed by the Lottery. Each ticket sells for $1. Agents receive 6 percent of lottery ticket sales revenues. Tickets are warehoused and distributed to retailers by Lottery personnel.

Lottery Revenues And Distribution

A.R.S. §§5-505.B and 5-522 specify how Lottery revenues are distributed. Forty-five percent of revenues are paid out in prizes, at least 30 percent must be apportioned to the local Transportation Assistance Fund, the County Assistance Fund or the State General Fund, and the remaining 25 percent can be apportioned for payment of costs incurred in the operation and administration of the Lottery. Designated revenue fund distribution for fiscal years 1981-82 through 1985-86 is shown in Table 1.

TABLE 1

LOTTERY REVENUES TRANSFERRED TO DESIGNATED REVENUE FUNDS FOR FISCAL(1) YEARS 1981-82 THROUGH 1985-86

Fiscal Year	Local Transportation Assistance Fund	General Fund
1981-82	$14,000,000	$22,600,000
1982-83	20,500,000	11,300,000
1983-84	18,000,000	0
1984-85	22,000,000	0
1985-86	23,000,000	14,000,000

(1) Transfers to the County Assistance Fund will begin in fiscal year 1986-87.

Source: Arizona Lottery Commission Annual Reports for fiscal years 1981-82 through 1985-86.

For the first year the Arizona Lottery's instant game sales were relatively high, but have declined and stabilized at approximately $5 to $6 million per game. Weekly on-line game sales have ranged from $300,000 to $6 million per week, and account for the significant upsurge in Lottery sales in the past two years. Annual Lottery revenues since fiscal year 1981-82 are shown in Table 2.

TABLE 2

ARIZONA LOTTERY REVENUES AND EXPENSES
FISCAL YEARS 1981-82 THROUGH 1985-86

	Fiscal Year 1981-82	Fiscal Year 1982-83	Fiscal Year 1983-84	Fiscal Year 1984-85	Fiscal Year 1985-86
REVENUES					
Ticket sales instant	$114,143,431	$ 74,892,648	$ 59,275,035	$ 46,217,404	$ 34,578,266
Ticket sales on-line				26,657,995	86,374,157
Retailer license fees	61,699	9,788		7,375	8,700
Other revenue			53,708	34,005	35,984
Total revenues	114,205,130	74,902,436	59,328,743	72,916,779	120,997,108
EXPENSES					
Prizes	51,441,369	36,370,619	25,987,156	33,467,842	55,135,210
Administrative expenses (see Table 2)	16,327,767	15,562,016	13,432,630	16,804,780	23,591,845
Total Expenses	67,769,136	51,932,635	39,419,786	50,272,622	78,257,182
Net income before transfers	46,435,994	22,969,801	19,908,957	22,644,157	42,270,053
Unusual item - forgiveness of debt			1,400,551		
Net income before transfers to other State of Arizona funds	46,435,994	22,969,801	21,309,508	22,644,157	42,270,053
Transfers to other State of Arizona funds	(36,600,000)	(31,800,000)	(18,000,000)	(22,000,000)	(37,000,000)
Income before cumulative effect of change in accounting principle	9,835,994				
Cumulative effect of change in accounting principle	654,883				
Net Income	10,490,877	(8,830,199)	3,309,508	644,157	5,270,053
Retained revenues (deficit) beginning of year	(1,472,032)	9.018,845	188,646	3,498,154	4,142,311
Retained revenues, end of year	$ 9,018,845	$ 188,646	$ 3,498,154	$ 4,142,311	$ 9,412,364

Source: Arizona Lottery Commission Annual Reports, fiscal years 1981-82 through 1985-86.

Organization And Budget

The State Lottery Act established a Commission consisting of five members appointed by the Governor to five-year terms. Two members of the Commission must have at least five years' experience in law enforcement, and one must be a certified public accountant. The Lottery Commission is authorized to make recommendations to the Lottery Director and to set policy.

The Executive Director is also appointed by the Governor, to exercise immediate supervision over the Lottery and promulgate rules under authorization from the Commission. The Executive Director currently supervises approximately 120 staff working in five divisions. The Executive Director also acts as the secretary and executive officer of the Commission.

As shown in Table 3 (page 5), the Lottery spent more than $23 million to support its operations in fiscal year 1985-86. The Lottery initiative exempted the Lottery from the State budget and appropriations processes for determining State agency operating budgets. The Lottery determines its own operating budget within the parameters set by statute. Although the Lottery can expend up to 25 percent of revenues for administrative expenses, not more than 4 percent may be spent on advertising.

Audit Scope And Purpose

Our audit focused on the Lottery's ability to perform its functions effectively and efficiently. The report presents findings and recommendations in five areas.

- Whether the Lottery has more administrative funds available than it needs.

- Whether additional legislative and executive oversight of the Lottery is needed.

- The adequacy of the Lottery's contract selection process.

TABLE 3

ADMINISTRATIVE EXPENSES
FISCAL YEARS 1981-82 THROUGH 1985-86

CATEGORY	Fiscal Year 1981-82	Fiscal Year 1982-83	Fiscal Year 1983-84	Fiscal Year 1984-85	Fiscal Year 1985-86
Retailer commissions	$ 6,127,019	$ 4,679,135	$ 3,931,696	$ 4,553,037	$ 7,316,728
Advertising & promotion	4,432,372	3,310,135	2,377,539	2,688,849	3,931,143
Tickets purchased	3,097,973	2,596,098	2,582,771	2,594,817	1,748,941
On-line system				1,135,288	4,518,403
Wages & employee related	1,406,861	2,260,297	2,869,202	3,243,303	3,174,722
Contract services	438,998	261,571	391,494	637,537	807,149
Unusual item(1)		1,529,323			
Other administrative	824,544	925,457	1,279,928	1,951,949	2,094,759
TOTAL	$16,327,767	$15,562,016	$13,432,630	$16,804,780	$23,591,845

(1) Reimbursement to vendor for on-line game expenses incurred prior to original contract being adjudged null and void.

Source: Arizona Lottery Commission Annual Reports, fiscal years 1981-82 through 1985-86.

- Whether the Lottery has sufficiently controlled its new building costs.

- Whether Lottery Security Staff should be conducting investigations and carrying concealed firearms.

In addition, we developed other pertinent information concerning combining gambling regulatory functions (see page 49).

Our audit scope was limited to the extent we could not review lottery commission executive session meeting minutes. The Lottery could not locate any of these meeting minutes from its first executive session through June 1986.

Due to time constraints we were unable to address all potential issues identified during our audit. The section Areas for Further Work (page 57) describes these potential issues.

Our audit was conducted in accordance with generally accepted governmental auditing standards.

The Auditor General and staff express their appreciation to the Lottery Commission, Executive Director and staff for their cooperation and assistance during the audit.

SUNSET FACTORS

In accordance with Arizona Revised Statutes (A.R.S.) §41-2354, the Legislature should consider the following 12 factors in determining whether the Arizona Lottery Commission should be continued or terminated.

1. The objective and purpose in establishing the Lottery

   The Arizona Lottery Commission was proposed by initiative petition (Proposition 200) and approved by voters in the November 1980 general election. The Lottery Commission's purpose is "to produce the maximum amount of net revenue consonant with the dignity of the state." This is currently accomplished by offering the public an instant ticket game and an on-line game.

2. The effectiveness with which the Lottery has met its objective and purpose and the efficiency with which it has operated

   The Lottery has produced a significant amount of net revenue since it began operations in 1981. The Lottery is required by statute to distribute at least 30 percent of wagers to three designated funds, which are the Local Transportation Assistance Fund, the State General Fund and the County Assistance Fund. During its first five years of operation, ending June 30, 1986, the Lottery distributed $145,400,000 into these funds.

   Although the Lottery has produced much net revenue, its operations in some cases have not been efficient. Efficiency of operations is especially critical for the Lottery because any monies saved can be distributed to the designated funds. Our audit found that the Lottery's building costs are excessive. Based on square foot costs, the Lottery building will cost over $440,000 more than other State buildings under construction, according to construction estimates. The Lottery felt a more elaborate building was necessary to project a proper Lottery image.

3. The extent to which the Lottery has operated within the public interest

The Lottery has operated within the public interest by generating substantial net revenues which are apportioned to the State and to local governments.

4. The extent to which rules and regulations promulgated by the Lottery are consistent with the legislative mandate

The Lottery has promulgated rules and regulations that are consistent with its legislative mandate. The Attorney General's Office reviews and certifies all proposed rules.

5. The extent to which the Lottery has encouraged input from the public before promulgating its rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public

The Commission has adequately encouraged input from the public before promulgating its rules and regulations. Proposed rules are summarized in the Administrative Digest. Any proposed rule is placed on a regular Commission meeting agenda for consideration. Meeting notices are posted at the Lottery and in the Senate Press Room. In addition, the Department of Administration is notified. The Lottery also notifies industry and retailer representatives of proposed rules and regulations affecting them.

The Lottery has not complied with the statutory requirement to keep Commission executive session meeting minutes. State boards and commissions are required by statute to keep records at all meetings, including executive sessions. During the course of the audit the Lottery could not locate any of its executive session minutes from the Lottery's first meeting through June 1986.

6. The extent to which the Lottery has been able to investigate and resolve complaints that are within its jurisdiction

Since the Lottery is not a regulatory agency, per se, its enabling legislation did not include a formal complaint process. Statutes authorize the Department of Public Safety to conduct investigations into any violations of statutes pertaining to the conduct of the Lottery. However, we found that the Lottery has exceeded its authority to investigate Lottery violations (See Finding V, pages 45 through 48).

7. The extent to which the Attorney General or any other applicable agency of State government has the authority to prosecute actions under its enabling legislation

A.R.S. §5-512.01 provides both the Attorney General and county attorneys concurrent prosecution authority for any offense arising out of or in connection with the formation, management, operation or conduct of the State Lottery.

8. The extent to which the Lottery has addressed deficiencies in its enabling statutes which prevent it from fulfilling its statutory mandate

Since its inception in 1981, the Lottery has been active in submitting legislation to increase its effectiveness. Legislation addressed:

- Percentage of revenues allowed for advertising,
- Limited peace officer status for the Assistant Director of Security and Licensing,
- Authorizing on-line games,
- Confidentiality in procurements,
- Allowing redemption centers,
- Authorizing facilities construction, and
- Clarifying various items relating to Lottery games.

In addition, according to the Lottery Director, statutes limiting the number of drawings for on-line games should be repealed to permit additional drawings and the introduction of new games. The Lottery proposed legislation to this effect in the last legislative session but it did not pass.

9. The extent to which changes are necessary in the laws of the Lottery to adequately comply with the factors listed in the sunset law

Based on our audit work, we recommend that the Legislature consider the following changes to the Lottery Commission's statutes.

- Amend A.R.S. §5-505.B, reducing the percentage of wagers allowed for Lottery administrative expenses from 25 percent to no more than 20 percent, and increasing the percentage of wagers to be transferred to the designated revenue funds and/or the prize fund. (Efficiency of Operations - Sunset Factor 2).

- Amend A.R.S. §5-509, repealing Lottery's exemption from the State procurement statutes and making the Department of Administration-State Purchasing Office, responsible for all Lottery procurement. (Effectiveness of Operations - Sunset Factor 2)

In addition, we recommend that conflicting statutes relating to revenue distribution be amended. It appears that when A.R.S. §5-522 was amended in 1986 to establish a County Assistance Fund, A.R.S. §5-505.B was not similarly amended to reflect this change. Further, according to Legislative Council, these statutes also appear to conflict in terms of revenue distribution amounts. A.R.S. §5-505.B requires that "not less than 30 percent" of revenues be transferred, whereas A.R.S. §5-522 does not indicate a minimum percentage.

10. The extent to which the termination of the Lottery would significantly harm the public health, safety or welfare

Terminating the Lottery would not have a deleterious effect on the public health, safety or welfare. However, terminating the Lottery would eliminate a significant amount of revenue made available to the State. Since its inception in 1981, the Arizona Lottery has raised

more than $145 million in net revenues distributed to the Local Transportation Assistance Fund, the Highway User Revenue Fund, the County Assistance Fund and the State General Fund.

11. The extent to which the level of regulation exercised by the Lottery is appropriate and whether less or more stringent levels of regulation would be appropriate

The Arizona Lottery is not a regulatory agency. However, the agency must ensure that Lottery retailers comply with Lottery statutes, and rules and regulations promulgated thereunder. According to the Lottery Director, the level of regulation currently provided in this regard is appropriate and requires no change.

12. The extent to which the Lottery has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished

The Arizona Lottery makes extensive use of private contractors in the performance of its duties. Private contractors provide instant game tickets; on-line game systems, services and tickets; drawing equipment; and annuities to fund grand prizes. In addition, the Lottery uses private contractors for advertising and promotion, auditing, overseeing drawings, and data processing. We did not identify any other areas for the Lottery's use of private contractors.

FINDING I

THE LOTTERY HAS MORE ADMINISTRATIVE FUNDS AVAILABLE THAN IT NEEDS

The Lottery's administrative portion of revenues could be reduced. Its current apportionment is more than ample to meet all its needs and is more than most other state lotteries spend. If the Lottery's administrative portion were reduced, more funds would be available for prizes and for remittance to the General Fund.

Administrative Portion Is Higher Than Necessary

The Lottery's percentage of total revenues allowed for operating expenses is higher than is necessary to meet its needs. The Lottery has never expended all of the 25 percent of revenues allowed and has carried forward large amounts annually. Further, as the Lottery matures, large initial expenditures for capital improvements and electronic data processing (EDP) systems development should decrease. Most other states spend considerably less than 25 percent of their total revenues to operate their lotteries.

Portion available not needed - Although the Lottery has 25 percent of total revenues available for general administration, it has needed considerably less to operate during its first five years. As shown in Table 4 (page 14), the Lottery has actually spent less than 20 percent of its total revenues on administrative expenditures. In fiscal year 1985-86, for example, the Lottery spent approximately $23 million although more than $30 million was available for Lottery operations.

If Lottery revenues continue to increase, the percentage of revenues required to cover administrative expenditures can be expected to decrease. During the three fiscal years in which Lottery revenues were less than $75 million (fiscal years 1982-83, 1983-84 and 1984-85), the percentage of revenues spent on Lottery administration has ranged from

20.8 percent to 23.0 percent, with an average of 22.1 percent. For the two years in which total revenues were greater than $110 million, administrative expenditures constituted 14.3 percent and 19.1 percent of total sales, respectively. This indicates that as revenues increase, a smaller percentage of revenues is needed for administration.

TABLE 4

LOTTERY ADMINISTRATIVE APPORTIONMENT AND EXPENDITURES
(IN MILLIONS OF DOLLARS)
FISCAL YEARS 1981-82 THROUGH 1985-86

Fiscal Year	Total Revenues	Admin. Portion 25% of Total	Admin. Expenditures	Expenditures As Percentage Of Total Revenue
1981-82	$114.2	$ 28.6	$ 16.3	14.3%
1982-83	74.9	18.7	15.6	20.8
1983-84	59.3	14.8	13.4	22.6
1984-85	72.9	18.2	16.8	23.0
1985-86	121.0	30.2	23.1(1)	19.1
TOTAL	$442.3	$110.5	$ 85.2	19.3% (Average)

(1) This was the first full year the Lotto (Pick) game was in operation. The addition of the Pick game is primarily responsible for the sharp increase in administrative expenditures.

Source: Arizona State Lottery Annual Reports

Although some of the excess administrative monies have been remitted to the General Fund, monies carried forward each year have been substantial. As shown in Table 5 (page 15), for example, approximately $10 million of revenues have been accumulated through fiscal year 1985-86 and are being carried forward to the current fiscal year. Carry forwards of this magnitude indicate that revenues earmarked for administrative expenditures are more than adequate to meet the Lottery's needs.

TABLE 5

CUMULATIVE RETAINED REVENUES
FOR FISCAL YEARS 1981-82 THROUGH 1985-86

Fiscal Year	Retained Revenues
1981-82	$9,018,845
1982-83	188,646(1)
1983-84	3,498,154
1984-85	4,142,311
1985-86	9,412,364(2)

(1) Because of the severe fiscal crisis experienced by the State during fiscal year 1982-83, the Lottery transferred all possible monies (including all retained revenues from the previous fiscal year) to the General Fund.

(2) The fiscal year 1985-86 retained revenues figures are based upon the Lottery's fiscal year-end income statement. Included in this estimate is $4,733,500 that has been placed in an obligated capital expenditures fund to cover construction costs of the new building.

Source: Arizona State Lottery Annual Reports.

Capital improvement and EDP systems development costs should decrease - As the Lottery matures, administrative expenditures may decline. Large initial expenditures for capital improvements and EDP development should decrease. Land acquisition and construction of the Lottery's building, estimated to cost $5.2 million, will be fully paid for with retained revenues from fiscal years 1985-86 and 1986-87. The Lottery's main frame computer, purchased in fiscal year 1985-86 at a cost of $85,000, should be sufficient to meet its needs for the foreseeable future.* Most system development and conversion work - totaling approximately $1.5 million - should be completed during 1987.

Other states spend less - Other states spend considerably less than 25 percent of their total revenues for administration. On the average, the percentage of total revenues spent by other state lotteries for administrative costs during fiscal year 1984-85 is 14 percent.** Of the

* The Lottery recently purchased a used mainframe computer from the Department of Revenue.

** This figure includes the District of Columbia lottery.

18 other state lotteries in operation during fiscal year 1984-85, only Vermont spent more than 25 percent of its revenues on lottery administration.*

On the average, states with lotteries most comparable to Arizona's spend or will expect to spend less than 20 percent on administration.** Since 1982, six states with populations comparable to or smaller than Arizona have instituted lotteries. In the aggregate, these state lotteries, as shown in Table 6 (see page 17), spend or will expect to spend 18.3 percent of their revenues on lottery administration.

More Could Be Set Aside For Prizes And The General Fund

If the Lottery's administrative portion were reduced by 5 percent, more monies - an estimated $6.2 million in fiscal year 1986-87 - would be available for other purposes.*** These additional monies could be used to increase the prize pools and/or transferred to designated Revenue or General Funds.

More prize money - Increasing the percentage of revenues designated for prizes by 2.5 percent for the instant and Pick games would put the Lottery more in line with other state lotteries.**** Arizona ranks low in the percentage of revenues allotted to player prizes. In Arizona, 45 percent of instant and Lotto (Pick) revenues are allocated for prizes. An Auditor

* The Vermont lottery is the lowest revenue producing lottery in the nation. During fiscal year 1984-85 Vermont's lottery revenues totaled $5.2 million.

** These lotteries were chosen for two reasons. First, given their infancy, one can expect them to be incurring development costs similar to that of the Arizona State Lottery. Second, actual or projected revenues for these lotteries are comparable to or smaller than the Arizona State Lottery.

*** We estimate fiscal year 1986-87 revenues will be approximately $123 million based on actual revenues of $61.5 million for the first six months of the fiscal year.

**** The following analysis assumes that the 5 percent reduction would be divided evenly between the prize and revenue funds. How this money is actually allocated is a legislative policy decision.

General staff survey of other state lotteries indicates that, on the average, 49.1 percent of revenues are allocated for prizes.

TABLE 6

PERCENTAGE OF TOTAL LOTTERY REVENUES SPENT ON ADMINISTRATIVE EXPENDITURES AMONG SMALL TO MEDIUM POPULATION STATES THAT HAVE INSTITUTED LOTTERIES SINCE 1982

State	Year Instituted	Population	Annual Revenue (in Millions)	Percentage of Revenues(1)
ARIZONA	1981	2,718,215	72.9(2)	23.0
Washington	1982	4,132,156	150.0	17.6
District of Columbia	1982	638,333	112.7	17.2
Colorado	1983	2,889,964	105.3	18.6
Iowa	1985	2,913,808	82.5	20.0(3)
Oregon	1985	2,633,105	42.2	15.3
West Virginia	1986	1,949,644	24.0	21.0(4)

Average percentage of revenues excluding Arizona set aside for administrative expenditures - 18.3 percent.

(1) For fiscal year 1984-85 unless otherwise noted.
(2) Arizona Lottery revenue for fiscal year 1985-86 was approximately $121 million.
(3) Percentage of revenues to be spent on Lottery administration during fiscal year 1985-86.
(4) West Virginia is in its first year of lottery operation. During the first three years, this lottery is permitted to spend up to 21 percent of revenues for administrative expenditures. After three years, this will drop to 15 percent.

Source: State Lottery Annual Reports and Auditor General survey of state lotteries.

Increasing the percentage of revenues allocated for prizes would have a significant impact on the number and size of purses awarded. An increase in the prize allocation by 2.5 percent would have meant an additional $130,179 in prize money for the Double Your Treasure instant game conducted from May to June, 1986. Assuming no changes in the prize structure, this could have translated into approximately 32,786 additional low-tier winners ($2-$20), 40 medium tier winners ($50-$100), and two additional high tier winners ($5,000).

An increased allocation to the Pick prize fund of 2.5 percent would have also had a an impact on the number of big jackpots won. This would have resulted in two more $3+ million jackpots since the game's inception in October 1984.

Furthermore, research indicates that increasing the percentage of Lottery revenues designated for prizes may increase interest in the Lottery among Arizona residents. Surveys conducted by Behavior Research Center and Arizona State University's Survey Research Laboratory in 1984 and 1985, respectively, found that reasons given by Arizona residents for not playing the Lottery include a perception that there are too few winners, that odds are too heavily weighted against the players, and that not enough revenue is allocated for prizes.

Designated revenue and General Funds - More revenues could be transferred to the designated Revenue and General Funds. During its five-year existence, the Lottery has transferred almost 33 percent of its revenues to the Local Transportation Assistance, County Assistance or General Funds. However, in the past three years the Lottery has transferred slightly more than the minimum 30 percent required by statute. In contrast, other state lotteries transferred approximately 36 percent of lottery revenues to state coffers during fiscal year 1985. If 2.5 percent more were remitted to these funds in fiscal year 1986-87, $3.1 million in additional funds would be available to support public programs and projects.

CONCLUSION

The percentage of Lottery revenues set aside for administrative expenditures should be reduced. This percentage is higher than necessary. Reducing the percentage of total revenues earmarked for administrative costs would permit the Legislature to commit more revenues for prizes, designated revenue funds and the General Fund.

RECOMMENDATIONS

1. The Legislature should consider reducing the percentage of Lottery revenues earmarked for administrative expenditures from 25 percent to no more than 20 percent.

2. The percentage of revenues allocated to prizes and transferred to the State Treasury should be increased as the State Legislature deems appropriate to reflect changes in the allocation of revenue for Lottery administration.

FINDING II

BUDGETARY OVERSIGHT AND CONTROL OVER LOTTERY OPERATIONS NEEDS TO BE STRENGTHENED

Arizona Lottery Commission statutes should be revised to increase control over Lottery functions. Under the Lottery's current autonomous structure, budgetary oversight of Lottery operations is weak. Revising Lottery statutes would improve both legislative and executive oversight.

Budgetary Oversight Over The Lottery Is Weak

The Lottery operates more autonomously than most agencies within State government. Both the Legislature and the executive branch are limited statutorily in the amount and nature of oversight they can exercise over the Lottery. Moreover, the Lottery Commission has exercised a limited role and cannot effectively oversee the Lottery's administrative operations. As a result, the Lottery Director has broad discretion and authority to operate independently.

Legislative and executive oversight limited - The 1980 initiative that established the Lottery limited oversight of Lottery operations. Unlike most State agencies, the Lottery is not subject to an annual appropriation of its operating funds by the Legislature, nor is it subject to executive control over its procurement and contracting activities.

The Lottery Act (H.B. 2366 Laws 1981, Ch. 245) enacted in 1981 established the Lottery pursuant to an initiative approved by the voters in November 1980. A private gaming company, which later became a major Lottery contractor, financed the drafting of the Lottery initiative.* The framework for the Lottery's autonomous structure was established in the initiative and so was not a legislative policy decision.

* The same private gaming company supporting the Arizona Lottery initiative later supported similar initiatives for California and Oregon. These initiatives also limited legislative and executive oversight.

Under the provisions of the Lottery Act, the Lottery has a statutory exemption from the State appropriations process. Unlike most State agencies, it sets its own budget and staffing levels. The Attorney General, in Opinion I81-022 dated January 13, 1981, ruled that the Lottery Act:

> . . . read as a whole, clearly expresses a direction to the Commission and Executive Director to spend or dispose of all the monies raised from the sale of lottery tickets for the purposes described in the Act, and that it does not contemplate that any further legislative action will be necessary for the expenditure or disposition of those monies.

The Attorney General, in the same opinion, also ruled that the continuing appropriation so stipulated is constitutional. This exemption from the annual appropriation process essentially prohibits the Legislature from exercising one of its strongest oversight powers over the lottery.

Further, the Lottery is exempt from executive budget oversight. The Lottery is not required to submit its budget to the Executive Budget Office for review.

Commission's role - The Lottery Commission also has a limited role in overseeing the Lottery's operations. The initiative establishing the Lottery may have intended for the Commission to provide oversight. However, the Commission has not been able to fulfill this function effectively.

According to a Legislative Council Opinion dated August 29, 1986, it appears that the Lottery Act intended for the Commission to "exercise general and overall control" over the Lottery's operations. The Commission has the authority to approve or disapprove the Lottery Director's actions. According to the Legislative Council, this appears to give the Commission authority over the Lottery's budget and staffing levels, although the language of the Lottery Act is not clear on this point.

In practice, the Commission is limited in its oversight role. First, it has never been active in reviewing the Lottery's operating or capital construction budgets and staffing levels, even though it appears to have oversight authority in this area. Second, the Commission has limited statutory authority in other areas. For example, it only has the power to disapprove contracts within 14 days of the Director's order awarding the contract. It cannot award contracts to the bidder it feels is most qualified.

The nature of the Commission further inhibits its ability to oversee the Lottery. One Commission member stated that being part time and unpaid provides the Commissioners with little opportunity or motivation to closely monitor Lottery operations. At its monthly meetings, the Commission is dependent on information provided by Lottery employees. Another Commissioner stated that the Commission is little more than "a rubber stamp for the Director's decisions."

Limited in its role, the Commission has become less involved in Lottery operations in recent years. From 1981 through 1983, the Commission averaged 18 meetings per year. For 1984 and 1985 the average meetings per year dropped to 13. As of August, the Commission had met only four times in 1986. Further, the Commission subcommittees, originally formed to provide close scrutiny of specific functional areas within the Lottery, are almost inactive. According to two Commissioners interviewed, the subcommittees have met only once in the past year.

Director authority - Because oversight is lacking from the legislative and executive branches, and from the Commission, the Director has extensive authority to operate the Lottery independently. The Director prepared and had final approval over a budget of approximately $23 million for fiscal year 1985-86. The Lottery budget was not required to be reviewed by the Executive Budget Office (EBO) or the Joint Legislative Budget Committee (JLBC), yet 80 agencies with equal or lesser budgets were required to submit to this budget review process.

Revising Lottery Statutes Would Increase Oversight

Lottery statutes could be revised to increase control over and accountability for its operations. Establishing executive and legislative oversight would strengthen control over Lottery expenditures.

The Legislature has the authority to restructure the Lottery if it chooses. According to a Legislative Council Opinion dated August 29, 1986, the Legislature may amend the Lottery Act and modify the structure and authority of the Lottery Commission, because the Lottery initiative did not receive a majority of the vote of qualified electors.

> Article IV, part 1, section 1, subsection (6), Constitution of Arizona, prohibits the legislature from amending or repealing initiated or referred measures which receive a majority vote of the qualified electors. The phrase 'majority of qualified electors' means the majority of those eligible to vote, not those actually voting. Adams v. Bolin, 74 Ariz. 269, 247 P.2d 617 (1952).

According to the Secretary of State's Office, 412,992 people voted in favor of the Lottery initiative; enough to pass the measure, but not a majority of more than 1.1 million qualified voters.

Greater control over expenditures - Establishing legislative oversight and EBO review of Lottery budgets would provide greater control over Lottery expenditures. Currently, the Lottery determines its operating budgets without any outside review. Requiring the Lottery to participate in the executive budget and legislative appropriations processes would provide increased control over expenditures. Under the budget and appropriations process, all items, including furniture purchases and professional and outside services, would be reviewed by EBO and JLBC staff and would require legislative approval.

Revising Lottery statutes to improve central oversight would be consistent with practices in other states. Currently, 16 of the 22 states (excluding Arizona) operating lotteries appropriate their lotteries' operating budgets.* Of the 12 states that have established their lotteries as stand-alone agencies, eight appropriate the lotteries' operating budgets through legislative action. The other ten states that operate lotteries have made the lottery subordinate to a larger agency, such as the Department of Revenue.

CONCLUSIONS

The Lottery could be restructured to improve control over Lottery operations. At present, the Lottery is free from the restrictions under which most State agencies must operate. Subjecting the Lottery to the executive budget and legislative appropriations processes would provide increased oversight over Lottery expenditures.

RECOMMENDATION

The Legislature should consider revising Lottery statutes to require the Lottery to participate in the executive budget and legislative appropriations processes.

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* Some states appropriate personnel and administrative costs, but not those costs which are a fixed percentage of revenues, such as retailer commissions, vendor commissions and advertising. However, Michigan also appropriates its lottery's advertising budget. Regardless of the form of implementation, all of the states interviewed allow access to supplemental and emergency funding if there is a budget shortfall.

FINDING III

THE LOTTERY NEEDS TO BETTER MAINTAIN THE APPEARANCE OF IMPARTIALITY AND FAIRNESS IN ITS CONTRACT SELECTION PROCESS

The Lottery's contract selection process could be strengthened to better ensure its integrity and fairness. The gaming environment requires diligence in maintaining the integrity of the Lottery's contracting process. Some contract selections appear to have been made without adequate safeguards to ensure fair and open competition. Placing the Lottery under the authority of the State Purchasing Office (SPO) would help ensure impartiality and fairness in the contract selection process.

Gaming Environment Requires That Integrity Be Maintained

Maintaining the integrity and fairness of the contract selection process is essential due to the nature of the Lottery's activities and its potential vulnerability to the influence of organized crime. The aggressiveness of some vendors providing gaming services further demonstrates the need to vigilantly guard the Lottery's integrity and impartiality in selecting contractors.

Maintaining Integrity - Maintaining procedures to ensure fairness and integrity of governmental agencies involved in gaming or wagering is especially important due to the nature of their activities. While discussing the need for careful control of legalized gaming, the Nevada Supreme Court* found that the gaming industry is susceptible to corruption by organized crime. The Court further concluded that since gambling is often considered a vice, a government must strive to promote and operate its gaming venture in a way that is inoffensive to its constituents. Finally, to ensure the success and growth of its gambling organization, a government must maintain the appearance as well as the fact of honesty and fairness with respect to its gaming operations.

* Nevada Tax Commission vs. Marion B. Hicks, 73 Nev. 115, 119, 310 P.2d 852 (1957).

Maintaining the integrity of the Lottery's contract selection and award process is especially critical to maintain public confidence in the Lottery. Lottery contracts involve millions of dollars in public funds which need to be safeguarded. Moreover, the nature of the Lottery's activities make it a particularly sensitive and visible public entity. In fact, the special need to maintain the integrity of the Lottery's contracting process was recognized in the Lottery's enabling legislation. Arizona Revised Statutes (A.R.S.) §5-509, subsection D, states:

> . . . In all awards of contracts pursuant to this section, the director shall take particular account of the sensitive and responsible nature of the commission's functions and the paramount considerations of security and integrity.

Aggressive Vendors - The aggressiveness of some gaming companies that serve the lottery industry further underscores the need to maintain integrity and impartiality in selecting contractors. The following incident illustrates this aggressiveness.

- A single vendor has produced tickets for 31 of 33 instant games offered by the Lottery. This vendor was instrumental in the passage of the Lottery initiative, expending approximately $200,000 for writing the initiative, establishing support groups and petition signature gatherers, and media advertisement. According to the vendor's Chief Executive Officer, in 1980 his company financed public opinion surveys in several states, identified Arizona as a likely market for a lottery, and began the initiative effort. This vendor was subsequently awarded the first contract to produce lottery tickets for Arizona.

  In February 1982 the Lottery awarded its second contract for instant game tickets to a competitor of the vendor behind the initiative. However, before production began on the first game under the second contract, the vendor behind the initiative sent a letter to Lottery officials stating that it had found a way to compromise the security of the tickets offered by the vendor selected. Later, the Lottery Commission voted to cancel the winning vendor's contract and issue a new request for proposals (RFP). The vendor behind the initiative was awarded the contract under the second RFP.*

* This vendor has engaged in similar conduct in other lottery states after losing contracts, including Connecticut and Illinois. The vendor aroused public concern over the "security" of the tickets to be supplied by a competing vendor.

Lottery's responsibility - The Lottery bears responsibility for maintaining the integrity and impartiality of its contracting process because it is exempt from the State Procurement Code. Of all State governmental units, only ten were given exemptions from these regulations. A.R.S. §41-2501.F stipulates:

> The Arizona state lottery commission is exempt from the provisions of this chapter for procurement relating to the design and operation of the lottery or purchase of lottery equipment, tickets and related materials.

The former Director interpreted this to mean that any procurement, other than for office supplies, is exempt from Procurement Code requirements because all such purchases relate to the operation of the Lottery. The Lottery makes purchases through the State Procurement Office only when the Director feels it has a greater expertise than Lottery staff in acquiring a certain item.

Although the Lottery is exempt from the State Procurement Code, A.R.S. §41-2501.F (as amended 1985) requires the Lottery Director to promulgate procurement rules and regulations "substantially equivalent" to the Code. Prior to this enactment, the Lottery did not have rules and regulations governing its procurement process. The Lottery adopted procurement rules in June 1985.

Some Contract Awards Made Without Adequate Competitive Safeguards

Some Lottery contracts appear to have been awarded without appropriate safeguards to ensure competition because poor procedures were followed.* A series of electronic data processing contracts have been awarded to the same contractor who conducted the feasibility study on which subsequent work was based. In addition, a vendor questioned the fairness of some instant game contract awards. Finally, some subcontract awards were made without adequate procedures to ensure a fair and competitive selection.

* Our review of this area was limited by the fact that the Lottery was unable to provide any of its executive session minutes from the Lottery's first meeting through June 1986. According to regular meeting minutes, issues concerning suits filed over gaming contract disputes were discussed during executive sessions.

Electronic Data Processing (EDP) contracts - The Lottery awarded a series of four EDP contracts worth an estimated $1.5 million to the same vendor over the past three years. The first contract was to perform a feasibility study for an automated accounting system. Two additional contracts were awarded to implement portions of the feasibility study. A fourth contract was awarded to convert the Lottery's accounting and management systems to a new computer system. These contracts were awarded by the Lottery Director because he believed the vendor was the best qualified company to perform the work.

- In December 1983 the vendor was awarded a contract for approximately $215,000 to begin work implementing the Lottery's new automated system. The Lottery attached to its RFP a brief management overview of the feasibility study, but not the study itself, which included detailed information required by prospective vendors. One potential bidder wrote to Lottery officials indicating it could not respond to the RFP because the scope of work was too broad and loosely defined. The only response to the RFP was from the vendor who conducted and wrote the feasibility study.

  Comment: A clause in the request for proposals stated the full specifications would be made available to the winning vendor. Thus, the vendor selected had an advantage over other bidders since it was the only firm with an advance copy of the full feasibility study. A current SPO policy recognizes the potential conflict of interest and fairness issues which may arise in situations such as this. In its own procurements, SPO will not permit vendors who do a feasibility study to bid on subsequent related work. SPO encourages other state agencies to follow the same rule.

- A second contract to implement the feasibility study was awarded in July 1984 to the same vendor. This contract was worth approximately $750,000 to $1 million. Although the Director did not establish a formal evaluation committee, he asked two Assistant Directors to evaluate the proposals informally. However, one of the two, the EDP Director at the time, did not review the proposals.

  Comment: Again, the vendor selected had an advantage over other vendors because of its involvement in the feasibility study. In addition, although not required at the time by law or rule, a formal technical evaluation of proposals was not conducted. Given the size of this contract, a formal evaluation of the proposal would have been appropriate and beneficial. Such an evaluation could have provided documentation that each proposal was given fair consideration.

Instant game contracts - A vendor questioned the fairness of some instant game contract awards. Allegations made by an unsuccessful instant game bidder were investigated by the Department of Public Safety (DPS) and found to have merit. However, the Lottery took little or no action as a result of the DPS investigation.

- In April 1981 the Lottery awarded its first contract for instant game tickets. A major evaluation criterion was the security of tickets produced. However, official bid samples were not solicited in the Lottery's RFP. Instead, the Lottery's Director of Security traveled to states in which various vendors' tickets were being used and purchased samples for testing by the Department of Public Safety. However, sample tickets purchased for one vendor were actually produced by a predecessor company and were printed by a different method than the method presented in the vendor's proposal. The vendor did not receive the contract and protested the Lottery's decision.

  Comment: The Lottery's proposal evaluation process was flawed in that the Lottery did not purchase and test the same quality ticket the vendor specified in its proposal. In addition, the Lottery did not formally respond to the vendor's protest.

- As mentioned previously, in 1982 the Commission canceled a vendor's instant ticket contract because its tickets were compromised by a competing vendor. As a result, a second RFP was issued. The proposals submitted by the vendors in response to the second RFP differed little from the proposals submitted to the first RFP except in the area of pricing. The vendor originally awarded the contract submitted a bid considerably lower than the competing vendor. In addition, DPS evaluated the vendors' tickets and found them to be of similar quality and resistant to compromise. However, the Lottery awarded the contract to the competing vendor.

  Comment: It is unclear why the Lottery changed its original decision and awarded the contract to the competing vendor. Although there was no requirement to do so at the time, there was no written justification of the Lottery's decision.

- In October 1984 the Lottery hired an independent evaluator to review instant game contract proposals. A vendor complained that the evaluator had a prior business relationship with the company that had been producing lottery tickets for Arizona. Lottery officials did not agree with the vendor. The vendor, which filed the complaint, withdrew its proposal and the contract was awarded to the company that had been producing Arizona's tickets.

  Comment: At the request of the governor's office and the Lottery, DPS conducted an investigation into allegations made by the losing vendor. The DPS investigator responsible for the investigation

concluded that the available documentation tended to support the losing vendor's contention of an ongoing business relationship between the individual acting as the independent evaluator and the winning vendor. The DPS investigator stated that the independent evaluator's role was "highly questionable."

Subcontracts - The Lottery's practice of entering into subcontracts through its main advertising contract, although not illegal, has been carried out without adequate procedures to ensure fair and open competition. According to the Director of SPO, such use of subcontracts violates the spirit and intent of the State Procurement Code and is not good procurement practice.

- In April 1985 the Lottery Director instructed the Lottery's advertising agency to subcontract for the services of a particular eastern lottery consulting firm and bill the Lottery for the services. A competitive bidding process was not used. According to the former Director, this was done because the recently hired advertising agency had no lottery experience and he wanted them "up to speed" as quickly as possible. Furthermore, according to the former Director, there were few firms that had the experience necessary to provide assistance to the Lottery's advertising agency. The contract terms between the advertising agency and the consultants were for a flat fee of $10,000 per month, plus travel expenses. The contract ran for a period of approximately one year, totaling more than $120,000. For this fee, the consultants would be available for consultation and would develop marketing plans. On June 1, 1986, the contract with the consulting firm was extended for an additional seven months, making the total estimated cost of consulting services more than $190,000.

  Comment: By subcontracting through its advertising agency, the Lottery was able to bypass a competitive bidding process, thereby failing to ensure fair and open competition for a consulting contract valued at over $190,000. Furthermore, subcontracting resulted in additional charges to the Lottery. The advertising agency charged a 13.24 percent commission on the subcontract, resulting in a payment of over $25,000 to the agency.

- Based on the recommendations of the subcontracted consulting firm, the Director instructed the advertising agency to subcontract for a survey of lottery players (market segmentation study). In February 1986 a subcontract worth $200,000 was awarded to another eastern firm to conduct the survey.

  Comment: As in the previous example, the Lottery bypassed a competitive bidding process and failed to ensure open and competitive bidding for a $200,000 market segmentation study. Although proposals were solicited from selected vendors, an RFP was

not advertised in any newspapers or trade journals. Additionally, the consulting firm had a previous working relationship with the firm hired to conduct the survey. Moreover, Lottery officials instructed that a reputable local firm be excluded from the competition. Lottery officials disagreed with the firm's findings on the Lottery as reported in a 1984 news article.

- A $60,000 subcontract was awarded to a film production company to produce a speaker's film. Competitive proposals were not solicited. The Lottery Director at the time instructed the advertising agency to subcontract with the film company.

  Comment: By subcontracting through the advertising agency, the Lottery was able to bypass a competitive bidding process and award a $60,000 contract without fair and open competition.

Putting Lottery Under State Purchasing Office Would Improve Controls

Placing the Lottery under the authority of the State Purchasing Office would better ensure the integrity of the contracting process. The Lottery's current exemption from the State Procurement Code is not necessary. SPO involvement would better insulate the Lottery from potential outside influence. In addition, it would strengthen procurement procedures and provide for an independent appeals process.

Exemption Unnecessary - The Lottery's existing exemption from the State Procurement Code is unnecessary. The extensive procurement independence granted to the Lottery has resulted in problems in the past and does not sufficiently insulate the Lottery from potential outside influence. While Lottery officials contend that procurement independence is necessary for the Lottery to function, a recent procurement of instant tickets indicates that Lottery procurement under SPO supervision can be successful.

The Lottery is not sufficiently insulated from potential outside pressures and influence. As a result of the Lottery's exemption from the State Procurement Code, statutory authority is granted to the Director to solicit bids and award contracts. A.R.S §5-509 empowers the Director to solicit bids and contract for the design and operation of the Lottery and the purchase of Lottery equipment, tickets and related materials. This

authority gives the Director a great deal of discretion in soliciting bids and awarding contracts, including the following areas.

- Determining whether a competitive sealed bid is not practical and calling for the use of an RFP process.
- Determining the methods by which proposals will be evaluated. For example, whether an evaluation committee will be used and who will sit on the committee.
- Determining whether cost or pricing data should be included in the RFP.
- Determining the relative importance of the individual criteria used to evaluate the proposals.
- Determining whether an administrative hearing officer will be used if a protest is filed.
- Making the final determination as to who will receive a contract.
- Making the final determination if a protest is filed by a vendor.

Currently, only the Commission serves as a buffer between the Director and Lottery vendors, but its role is weak. A.R.S. §5-509.C. stipulates that any award made by the Director becomes effective unless the Commission rejects the award within 14 days of receiving notification of the award. The Commission has exercised this authority only once in the last five years, during which time 58 contracts were awarded.

Lottery officials contend that procurement independence is necessary for the Lottery to function properly. According to Lottery officials, changing market forces within the lottery industry could require immediate response through the procurement process. However, since 1984, the Lottery has let two and three year contracts for its gaming services. In addition, according to the Director of SPO, emergency procedures exist that would allow the Lottery immediate, yet legal, response to a crisis situation.

The recent award of a contract for Lottery instant game tickets illustrated the benefit of SPO involvement in the procurement process. At the request of the Lottery Director at the time, SPO was asked to

supervise the procurement process for the instant ticket contract. SPO issued the RFP, received the responses and appointed a committee to evaluate the bidder's responses. The committee was made up of two Lottery Assistant Directors and three officials from other state lotteries. The committee conducted its evaluation and made its recommendation to the Lottery Director, who accepted the recommendation and awarded the contract. According to a SPO official, Lottery officials were heavily involved throughout the process, while SPO acted to ensure compliance with the Lottery's procurement regulations.

SPO Involvement Would Insulate the Lottery - Six lottery states utilize a central procurement office for contract selection and award, thus more effectively buffering the lottery itself from outside influence.*

The Connecticut and Massachusetts lotteries, for example, rely on their state purchasing offices for contract selection and award, including gaming contracts. In both states, lottery officials are heavily involved in drafting RFPs, establishing evaluation criteria and determining qualified vendors. However, state purchasing officials oversee the process, thereby ensuring compliance, and make the final award decision. Further, state purchasing hears and rules on any protests filed by vendors. According to a Connecticut lottery official, his agency feels it has had fewer problems with major gaming vendors because of the third party insulation provided by the state purchasing office.

As a third party in the procurement process, SPO would be less susceptible to the influences of the large vendors who tend to dominate the lottery industry, particularly gaming vendors. For this reason, SPO's involvement in contract awards would help ensure that selection decisions are based on the vendors' compliance with the criteria expressed in the RFP.

* These states are New Jersey, Connecticut, Colorado, Massachusetts, West Virginia and Missouri.

SPO would strengthen procedures and provide appeals process - The involvement of SPO would strengthen the Lottery's procurement procedures and provide an independent appeals process. Involving SPO would ensure: 1) the use of an RFP process, including the development of relevant evaluation criteria, 2) the use of an evaluation process, including the establishment of a committee to evaluate proposals submitted in response to RFPs and the selection of committee members, and 3) the written documentation of the rationale used to award contracts.

SPO's participation in Lottery's procurement process would also provide a third party to hear appeals filed by losing vendors. Currently, the Director of Lottery has decision authority over appeals. However, most vendor appeals to the Director over his decisions have received little or no response. As previously mentioned, in one specific case a vendor's protest over the use of a particular independent evaluator was found not to have merit by the Director, although a DPS investigator later concluded that the vendor had sufficient grounds for a protest.

CONCLUSIONS

The Lottery's contract selection process should be strengthened to ensure integrity and fairness. Some contract selections were made without adequate procedures to ensure a fair and open competitive selection.

RECOMMENDATIONS

1. The Legislature should consider:

    a. Repealing the Lottery's exemption from the State procurement statutes, and

    b. Making the Department of Administration-State Purchasing Office responsible for all Lottery procurement.

2. If the Lottery retains its procurement responsibility, it should:

   a. Follow State Purchasing Office policy excluding vendors conducting feasibility studies from bidding on subsequent related work, and

   b. Follow State Purchasing Office Guidelines concerning the use of subcontracts.

FINDING IV

THE LOTTERY HAS NOT SUFFICIENTLY CONTROLLED ITS NEW BUILDING COSTS

The Lottery has not sufficiently controlled costs for its new building. Based on square foot costs, the Lottery building will cost over $440,000 more than other State buildings under construction. In addition, the Lottery had planned to replace its furniture, at an estimated cost of $600,000.

Lottery Building Expensive Compared With Other State Construction

The Lottery building is expensive compared with other current State building construction. Several design features contribute to increased costs. In addition, the Lottery incurred unnecessary communications consultant expenses for the new building.

The Lottery is constructing a 38,650 square foot building on a three-acre site near the intersection of the Hohokam Expressway and University Drive in Phoenix. The construction began in mid-1986 and is estimated to be completed in April 1987. The building will house the Lottery's administration, warehouse and prize redemption functions in Phoenix, which are currently separated and housed in leased commercial space. The total cost for the Lottery building and furnishings is estimated at approximately $5.2 million. The Lottery is paying for the building with excess monies retained from the percentage of wagers allowed for administrative expenses. Building plans are not subject to review by the Department of Administration's Facilities Planning and Construction Office (DOA-FPC). In contrast to most State agencies, the Lottery is exempt from appropriations and review processes for capital construction. However, statutes did require the Lottery obtain legislative approval for any capital construction.

Lottery building cost high - When compared with current State building construction, the Lottery building is expensive. We compared Lottery building cost estimates with two State buildings currently under construction by the Department of Public Safety (DPS) and the Department of Revenue (DOR). Our analysis found that the Lottery building will cost at least $16 per square foot more than either the DPS or the DOR buildings.* If built for $16 per square foot less, the Lottery could have saved more than $440,000. Table 7 (see Page 41) compares Lottery, DOR and DPS building costs.

Reasons for increased cost - Design factors may contribute to the Lottery building's higher costs. The Lottery desired a more elaborately designed building, feeling such a building would project a more positive image of the Lottery to the public. More elaborate exterior and interior appointments help contribute to increased costs. The building will have a brick facade applied to the exterior concrete block walls. Although this feature adds aesthetically to the motif, it has little functional value.

* "Finished shell cost" was used as the basis for comparing costs between buildings because it excludes costs of special systems or requirements unique to any of the buildings. These include security systems, cafeteria equipment, emergency generators and other items. In addition, several other costs were not included because of differences in the building sites, designs and special needs. These include costs for land, architectural and engineering fees, other administrative costs, site development, and parking and warehouse facilities. Another building recently under construction, the Capitol Center, was also analyzed to determine finished shell cost. The Capitol Center construction was a private venture, purchased by the State upon completion. The Capitol Center's finished shell cost was $58 per square foot, or at least $9 per square foot lower than the Lottery building. The Capitol Center's finished shell per square foot cost may be even lower than $58. However, we were unable to verify this because detailed cost information was not available. Some special systems and features costs could not be deleted as was done with the other buildings.

TABLE 7

COMPARISON OF ESTIMATED BUILDING COSTS
FOR LOTTERY, DOR AND DPS BUILDINGS

	Finished Shell Cost	Building Square Feet(1)	Cost/Square Foot
Lottery	$1,854,826	27,650	$67.08(2)
DOR	9,645,187	191,992	50.23
DPS	3,142,217	61,730	50.90

(1) Warehouse space was excluded because of lower costs as compared to office building construction. The Lottery's project manager estimated the Lottery's 11,000 square foot warehouse cost at $35 per square foot.

(2) Total building costs, including warehouse space, are $58.37. Office building costs, the focus of our analysis, are $67.08.

Source: Lottery, DOA, construction and architect documents, and interviews with staff.

Other exterior items planned are brick planter walls and a cut stone walkway. Although aesthetically pleasing, these features are not necessary. The building's interior will have higher grade carpet, ceilings, doors and floor tile. In contrast, both the DPS and DOR buildings will have standard interior finishes except for the public areas and some offices. Two other states' lotteries contacted indicated that a more elaborate public and media area within a building is beneficial for public relations purposes. However, an elaborate building and furnishings are not needed to operate successfully.

We did not find that special security needs, a factor cited by the Lottery Director in testimony before the Joint Committee on Capital Review (JCCR), accounted for the increased costs of the Lottery's finished shell. Special security systems were factored out of our analysis. Moreover, specifications do not indicate that the building structure is different than other office building construction using masonry walls.

Some communications consultant expenses unnecessary - The Lottery has also incurred some unnecessary communications expenses for its building. The Lottery retained a communications consultant to analyze communications

needs in the new building, write the request for proposals for the phone system, and oversee and assist in the bidding and review process in selecting a phone system. The Lottery will pay approximately $13,750 for these services. Communications consulting, however, is provided as a service free of charge to State agencies by the Department of Administration. In addition, the State Procurement Office will oversee the acquisition of the system, minimizing the consultant's role in this area.

Lottery Planned
To Replace Furniture

The Lottery had planned furniture replacement to coincide with the move to its new building. The State Purchasing office issued a request for proposals in December 1986 for the major portion of the new furniture. According to the construction project manager, furniture replacement was estimated to cost about $600,000, and included 110 workstations and other items.

We found that the Lottery did not need to replace its furniture. According to an analysis done for our Office by DOA staff, the Lottery's furniture is in good condition, requiring little repair.

- None of the wood furniture showed more than minor wear.
- Metal desks, file cabinets and tables were sound.
- Panels were in exceptionally good condition.
- The majority of the chairs were excellent quality, needing only some reupholstering.

DOA staff also noted that Lottery's furniture is only five years old and probably still under a 12-year warranty. Other State agencies contacted stated that they usually replace furniture after 15 to 20 years.

During the course of the audit, the Lottery rescinded its decision to replace its furniture. The Lottery will now continue to use its existing furniture and supplement as necessary from existing State purchasing contracts. The request for proposals issued by the State Purchasing Office was cancelled.

CONCLUSIONS

The Lottery has not sufficiently controlled costs for its building. Based on square foot costs, the Lottery's new building will cost at least $440,000 more than other State buildings that are under construction.

RECOMMENDATIONS

1. The Lottery should determine ways to minimize its building construction costs, eliminating any unnecessary design features.

2. The Lottery should consider using State provided services whenever possible rather than retaining consultants.

FINDING V

THE LOTTERY HAS EXCEEDED ITS AUTHORITY TO INVESTIGATE LOTTERY VIOLATIONS

The Lottery has exceeded its authority to conduct investigations. Although the Lottery's Security and Licensing Division has conducted extensive investigations of Lottery related violations, it does not have statutory authority to do so. In addition, Lottery investigators have violated State statutes by carrying concealed firearms.

The Security and Licensing Division has conducted extensive investigations of Lottery violations. According to Lottery records, the Division conducted more than 170 investigations during 1985.* These investigations involved ticket fraud and tickets stolen from retailers. The Division currently employs ten investigators to conduct such investigations and other security and licensing functions.**

Lottery Has Exceeded Authority

The Lottery does not have statutory authority to conduct investigations of Lottery violations. Rather, the Department of Public Safety (DPS) is responsible for such investigations.

Although investigations are being conducted, the Lottery does not have statutory authority to do so. Arizona Revised Statues (A.R.S.) §5-510 authorizes the Lottery to create a Security and Licensing Division under the supervision of an Assistant Director appointed by the Lottery Director. The statute further designates the Security and Licensing Division to be a law enforcement agency and the Director of the Division a peace officer. However, these designations are limited by A.R.S. §5-510.C, which states, in part:

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* 1985 is the latest year for which data are available.

** Other responsibilities of the Security and Licensing Division include: issuing licenses, conducting criminal and financial background checks, conducting compliance visits of licensees, and providing security over Lottery facilities, tickets and drawings.

> Such law enforcement agency and peace officer status shall be for the limited purpose of receiving investigative information from law enforcement agencies pertaining to investigations of lottery activities.

According to a Legislative Council memorandum dated November 26, 1986, this limitation means the Lottery does not have statutory authority to conduct investigations of Lottery violations.* The Lottery attempted to gain statutory authority to conduct investigations and peace officer status for investigators through legislation it proposed in 1982. However, the legislation failed to pass.

According to Legislative Council, DPS, rather than the Lottery, is empowered and required by statute to conduct lottery investigations. A.R.S. §5-511 states, in part:

> The director of the department of public safety shall order an investigation into any violation of a statute of this state which pertains to the conduct of the state lottery. [emphasis added]

According to a Security and Licensing Division official, when the Lottery first began, DPS conducted investigations of Lottery violations. However, Lottery officials were unhappy with the quality and costs of the investigations being conducted and unilaterally established their own investigative staff within the Security and Licensing Division.** According to the Director of DPS, he removed his investigators from Lottery investigations because Lottery officials told him they were no longer needed.

Investigators Should Not Carry Concealed Firearms

Lottery investigators have violated State statutes by carrying concealed firearms. The Security and Licensing Division's limited law enforcement and limited peace officer status precludes carrying concealed firearms.

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* See Appendix for full text of the opinion.

** As noted in Finding II (page 21), current law allows the Lottery authority to establish its own budget and staffing levels as long as its administrative budget does not exceed 25 percent of gross revenues.

Lottery investigators have been observed by Auditor General staff carrying concealed firearms while conducting Lottery business. According to the Division Director, investigators carry concealed firearms when accompanying daily cash deposits, for security of Lottery facilities, and in the event of potentially dangerous situations. However, according to the Legislative Council, only officials designated as peace officers can legally carry concealed firearms.

The Director of the Security and Licensing Division contends that he can delegate his peace officer status to Division investigators. However, the Division Director's peace officer status is limited by A.R.S. §5-510 to receiving investigative information from law enforcement agencies conducting Lottery investigations. According to the Legislative Council, this authority cannot be delegated.

CONCLUSION

The Lottery's Security and Licensing Division has exceeded its statutory authority to conduct investigations. According to the Legislative Council, the Division's law enforcement powers are limited to receiving information from law enforcement agencies conducting investigations of Lottery violations. As a result, the Division lacks the authority to conduct Lottery investigations. Furthermore, because Division investigators lack peace officer status, they have violated State statutes by carrying concealed firearms while conducting Lottery business.

RECOMMENDATIONS

1. If the Lottery wants to conduct investigations, it should petition the Legislature to amend the statutes to grant Lottery investigators peace officer status.

2. Until Lottery investigators are statutorily granted peace officer status, the Lottery should:

   a. Comply with A.R.S. §5-510 and discontinue conducting investigations of lottery violations.
   b. Direct Security and Licensing Division investigators to stop carrying concealed firearms.
   c. Reduce Security and Licensing Division staffing levels appropriate to its remaining work load.

3. The Department of Public Safety should resume conducting investigations of all Lottery related violations until Lottery investigators are granted peace officer status.

OTHER PERTINENT INFORMATION

During the course of our audit, and in response to legislative interest, we examined the feasibility of combining State gaming related regulation in a single agency. The following section presents information we gathered during this audit and during prior audits of the Department of Racing and Department of Revenue-Bingo Section.

Organization Of Public Gaming Regulation

We are unable to clearly determine whether combining gaming regulation into a single agency would result in a more efficient or effective regulatory program. All three agencies responsible for public gaming regulation perform licensing and investigative functions; however, according to officials of the three agencies, there is currently no overlap in the types of licensees. Also, the type of investigations conducted differ. Although public gaming regulation involves some common activities, only a few states have combined the regulation of two or more gaming functions. The Department of Public Safety (DPS) has proposed consolidating gaming investigative staff in Arizona; however, gaming officials have identified potential problems with this plan.

Regulation of Public Gaming in Arizona

Three separate agencies are responsible for the regulation of public gaming in Arizona. They include the Department of Racing, the Department of Revenue and the State Lottery. All three agencies perform licensing and investigative activities as part of their regulatory duties. However, the volume and nature of these activities differ. The agencies issue licenses to different types of licensees, and vary to some degree in licensing unit staffing and procedures. Investigative staff, on the other hand, are comparable among these agencies, although the types of investigative duties reflect the particular needs of each agency.

Licensing - The Department of Racing issues the most licenses each year and has the most extensive category of licensees compared to Bingo and Lottery. According to Department of Racing records, in fiscal year 1985-86, 9,308 licenses were issued in 26 licensure categories.* These categories include stables or kennels, owners, trainers, jockeys, agents, grooms, exercise riders, veterinarians, mutuel clerks, concession workers, maintenance workers and security officers. According to a Department official, almost everyone connected with the operation of a horse or dog track is licensed.

o The Department of Revenue-Bingo Section is responsible for issuing bingo licenses. Presently, the two categories of licensure are large and small game licenses. As of October 1986 there were approximately 675 licensees, slightly more than one-half holding small game licenses. Large game licenses are limited to qualified organizations such as churches or nonprofit organizations, as defined by Arizona Revised Statutes (A.R.S.) §5-401. Small game licenses can be issued to any organization or individual who has the approval of the local governing body and is deemed of good moral character.

o The Lottery licenses retailers to sell lottery tickets, both instant game and Pick tickets, issued by the Lottery. As of August 1986 there were approximately 2,000 licensed Lottery retailers. A.R.S. §5-512.A states that before issuing a license to sell lottery tickets, the Lottery must take into consideration such factors as the applicant's financial responsibility, nature of business, community background and reputation, business accessibility, and expected sales volume.

According to officials of the three agencies, there is currently no overlap in licensees. Although the possibility exists that an individual could hold multiple gaming related licenses, officials were unable to identify any common licensees.

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* Racing issues licenses valid for three-year periods, and fiscal year 1985-86 was a renewal year.

Table 8 summarizes the similarities and differences between the licensing activities of the three agencies.

TABLE 8

COMPARISON OF LICENSING WORK LOAD, STAFFING AND PROCEDURES

	RACING	BINGO	LOTTERY
Number of licensees	9,308	675	2,000
Number of licensing categories	26	2	1
Types of licensees	primarily individuals	qualified individuals & organizations	commercial retailers
Number of licensing staff	6	5	(*)
Type of staff	exam technicians, investigators	clerks, investigators	marketing representatives, investigators
Nature of background checks	fingerprint checks through DPS & FBI	none currently done	NCIC/ACIC/ACCH name checks through DPS
Unique aspects	racing rulings checks through national data base		credit checks

(*) Lottery involves numerous marketing and investigative staff in the licensing process.

Source: Data compiled by Auditor General staff from Department of Racing, DOR-Bingo Section and State Lottery records, fiscal year 1985-86.

Investigations

All three agencies also conduct investigations to enforce compliance with statutory requirements. Investigative staff are similar in classification and status; however, the volume and type of investigations differ and reflect each agency's particular enforcement needs. All three investigative staffs do receive support from DPS and the Attorney General's Office.

- The Department of Racing has a staff of six investigators (Investigator III and Investigator II). All have prior law enforcement experience and have limited peace officer status. The staff is currently in the process of being certified by the Arizona Law Enforcement Officers Advisory Council (ALEOAC).*

In fiscal year 1986, the Racing Department opened 404 cases. Most investigations involved false applications. Other investigations focused on criminal background, criminal activity, possession of drugs and other matters.

- The Bingo Section has seven investigators, most of whom are classified as Investigator IIIs. All have limited peace officer status and are ALEOAC certified. Thus, they are similar to the Racing Department investigative staff. Three of the Bingo Section investigators have ten or more years of prior law enforcement experience.

Bingo investigators perform a variety of functions related to regulation of the bingo industry. Investigators review new license applications and conduct desk reviews of quarterly financial reports submitted by licensees. Investigators also conduct compliance checks. Investigators visit licensees while games are in progress and assess whether they are being operated in compliance with regulatory requirements. Approximately 200 compliance checks were made in fiscal year 1985-86.

Investigators also conduct extensive investigations of criminal activity in the bingo industry, usually in conjunction with DPS. The Bingo Section opened 95 such investigations during fiscal year 1985-86.

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* ALEOAC is a body of law enforcement officials created to establish minimum qualifications and training for law enforcement officers.

- Lottery's investigators, like their counterparts in Racing and Bingo, are in a similar classification series. Several investigators have extensive prior law enforcement experience. However, Lottery investigators have more limited authority than Racing and Bingo investigators in that they are statutorily restricted to licensing and employment investigations. As a result, the Lottery's investigative staff are not ALEOAC certified and do not have peace officer status.

Lottery investigators conduct criminal background checks supporting the licensing function and compliance checks to determine if retailers are complying with applicable requirements in selling instant game and Pick tickets. In addition, although not authorized by statute, the Lottery has conducted investigations involving questionable tickets, or ticket fraud, and stolen tickets.

Table 9 summarizes the similarities and differences between the investigative staff of the three agencies.

TABLE 9

COMPARISON OF RACING, BINGO AND LOTTERY INVESTIGATIVE STAFF

	RACING	BINGO	LOTTERY
Number of investigators	6	7	10
Principal classification of staff	Investigator IIs and IIIs	Investigator IIIs	Investigator IIIs
Peace officer status	yes	yes	no
ALEOAC certification	in progress	yes	no

Source: Data compiled by Auditor General staff from Department of Racing, DOR-Bingo Section and State Lottery records.

Beyond these three agencies, DPS and the Attorney General's Office provide support for the enforcement of public gaming in Arizona. DPS assists Racing and Lottery in conducting criminal history background checks for licensure. DPS has also assisted these agencies or independently conducted criminal investigations of potential public gaming violations. For example, through an agreement with DOR, DPS has two investigators assigned to assist in bingo investigations. One recent bingo case assisted by DPS investigators resulted in 69 felony counts against ten individuals. DPS laboratory facilities are continuously used by the Lottery to evaluate instant ticket security, and occasionally used by the Department of Racing to conduct drug screening tests.

The Attorney General's Office provides assistance to all three agencies in their efforts to regulate public gaming. The Office's Organized Crime and Racketeering Division has prosecuted criminal cases involving public gaming. In the last three years, the Division has been involved in the prosecution of two Bingo cases involving fraudulent activities of bingo operators, and one Lottery case involving the fraudulent redemption of a lottery ticket. The Attorney General's Office has also conducted investigations and intelligence gathering activities in the areas of public gaming.

Gaming Regulation in Other States

Although gaming agencies perform some similar activities, few other states have combined the regulation of two or more gaming functions. However, there is some reported benefit among those states consolidating regulatory functions.

Only four of 33 states responding to the 1986 survey of the National Association of Gambling Regulatory Agencies (NAGRA) have consolidated the regulation of two or more gaming activities under a single agency. As shown in Table 10, Connecticut, Massachusetts and Michigan regulate lottery and bingo under the same agency. In addition, Connecticut's Department of Revenue Services also regulates pari-mutuel wagering. New York regulates both racing and bingo through its State Racing and Wagering Board.

TABLE 10

CONSOLIDATION OF GAMING REGULATION IN FOUR STATES

STATE	GAMING ACTIVITIES	RESPONSIBLE AGENCY
Connecticut	lottery, bingo,(1) pari-mutuel wagering, off-track betting	Department of Revenue Services
Massachusetts	lottery, bingo	State Lottery Commission
Michigan	lottery, bingo	Bureau of State Lottery
New York	pari-mutuel wagering, bingo	New York State Racing and Wagering Board

(1) Bingo licensing and enforcement authority effective October 1987.

Source: Data compiled by Auditor General staff from NAGRA survey.

States that have combined gaming regulatory agencies may still maintain separate regulatory units for each gaming activity; thus, the actual amount of functional consolidation and coordination may be limited. In New York, for example, the Racing and Wagering Board maintains separate racing and bingo licensing and regulatory units. Furthermore, the Michigan and Massachusetts lotteries maintain separate licensing and regulatory units. Lottery officials in Michigan feel it is easier to regulate and license the two activities with separate staff, each with personnel who are familiar with the particular gaming function. As a result, only certain administrative functions such as personnel, payroll and purchasing are consolidated and shared between Michigan's lottery and bingo functions.

Connecticut, by contrast, has been able to achieve some functional consolidation with reported benefits. According to a Division of Special Revenue official, gaming enforcement activities have been combined under a single security section. This has eliminated overlap of some activities associated with separate licensing and regulatory units. For example, according to the Connecticut official, security staff can conduct enforcement and licensing duties for all forms of gaming regulated by the division. As a result, staff members' time can be utilized in whatever gaming area has the greatest need.

Feasibility of Consolidation Needs Further Study

Because gaming agencies in Arizona perform some common functions such as criminal background checks and have somewhat comparable investigative staff, consolidation of some activities may be feasible. However, objections to such consolidation by some gaming officials need further study and consideration.

DPS has proposed consolidating gaming enforcement activities within DPS. Current efforts involve transferring the bingo licensing authority from DOR to DPS. Studies conducted by both agencies conclude that DPS is better suited to license and regulate bingo operators. In the future, the Director of DPS envisions the possible establishment of separate bingo, lottery and racing sections with permanently assigned positions under a single enforcement unit within DPS. According to the DPS Director, this organizational arrangement would have several benefits. First, DPS has the manpower and equipment necessary to conduct statewide gaming enforcement. For example, DPS has investigative staff assigned throughout the State. The current regulatory agencies have staff only in Phoenix and Tucson. Second, DPS can enhance career paths for investigators. Investigators would be part of a larger law enforcement agency that could offer more career opportunities. Finally, DPS has access to several background investigative sources not available to the current regulatory agencies.

Officials of two gaming agencies, however, point out potential problems with consolidating gaming enforcement within DPS. For example, DPS investigators may tend to focus on criminal investigation and prosecution rather than administrative actions. According to an Attorney General official, taking administrative action such as suspending or revoking a license can be a more effective enforcement action than a criminal sanction, while less difficult and costly to achieve.

In addition, DPS investigators assigned to the agency would have two bosses, according to one critic. This raises the concern on the part of the agency directors that the investigators would be more responsive to DPS than to the Director of their assigned agency.

AREAS FOR FURTHER AUDIT WORK

During the course of the audit, we identified several potential issues that we were unable to pursue because they were beyond the scope of our audit or we lacked sufficient time.

- Should retailer commissions be restructured?

Retailers selling lottery tickets receive a 6 percent commission on their ticket sales. Most other states provide retailers with a 5 percent commission, and only a few states give higher commissions. Reducing retailer commissions by 1 percent of revenue would have provided an additional $1.2 million to the Lottery during fiscal year 1985-86. These monies could be transferred to the designated revenue funds. Further audit work is needed to determine whether retailer commission amounts should be restructured.

- Should the Lottery be allowed to conduct additional games?

Currently, the Lottery is allowed by statute to conduct an instant ticket game and an on-line Lotto game. Several other states have added additional games to their product mix as their lotteries have matured. In fact, the Arizona Lottery was not able to reverse declining sales until it began the on-line game. To increase player interest, other states have introduced a variety of on-line games. Further audit work is needed to determine whether the Lottery should be authorized by law to conduct additional games.

- Should the Lottery use government securities to better insure grand prize payments over time?

Many state lotteries, including Arizona's, finance grand prizes through annuities purchased from private insurance companies. Using annuities gives the appearance of a larger prize. The Arizona Lottery has companies bid so the most beneficial annuity can be obtained. Some states (New York, Rhode Island and Maryland), however, are turning to government

securities rather than private company annuities because rates are similar and provide more security. Some insurance companies have either gone bankrupt or have shown significant financial losses. One firm with significant financial losses held annuities for several state lotteries (not Arizona). Although the question has not been addressed legally, it may be possible that the Lottery could be held liable for any remaining monies on annuities held by companies that went out of business. Further audit work is needed to determine whether the Lottery should annuitize grand prizes using government securities.

- Should the Arizona Lottery award instant game ticket contracts more frequently and use different vendors?

The Lottery has used the same instant game ticket vendor for 30 of the 32 instant games played since the Lottery's inception. In addition, the Lottery has not awarded an instant game contract since 1984. Some other states' lotteries let contracts for one-year periods only. Other states have let contracts to more than one vendor over the same time period. Officials from some of these states have indicated that shorter contracting periods and awarding concurrent contracts to more than one vendor help promote competition and lower ticket costs. According to some other states' officials, there are now several instant game ticket vendors that can provide secure, quality tickets. This was not true a few years ago. Further audit work is needed to determine whether the Arizona Lottery should use shorter contract periods and different vendors to lower instant game ticket costs.

- Is the amount of revenue allowed for advertising excessive?

The Lottery is allowed 4 percent of total wagers for advertising expenditures. Previously, the Legislature reduced and then increased the advertising allowance as the popularity of the games fluctuated. With the advent of the on-line game, which dramatically increased Lottery revenues, the Lottery's potential advertising budget has grown proportionately.

However, the Lottery still runs the same number of instant games in a year. Further, the on-line game is less advertising intensive than the instant games. Further audit work is needed to determine whether the Lottery's advertising allowance could be reduced.

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ARIZONA LOTTERY

FEB 1987
RECEIVED
AUDITOR
GENERAL

Bill Henry
Executive Director

February 4, 1987

Douglas R. Norton, Auditor General
Office of the Auditor General
2700 North Central Avenue, Suite 700
Phoenix, AZ 85004

HAND DELIVERED

Re: Response Of The Arizona State Lottery Commission To The Auditor General's Performance Audit

Dear Mr. Norton:

The Response of the Arizona State Lottery Commission as drafted by Charles E. Buri, Executive Director March 14, 1983 to January 5, 1987, are enclosed for inclusion in the published report of the Performance Audit you conducted on this agency.

As you know, I was appointed to the position of Executive Director of the Arizona Lottery on January 8, 1987 and assume full responsibility for what we do or fail to do as an agency. However, as your audit was conducted prior to my appointment, I believe it is important and fair that the Commission's response, as drafted by Mr. Buri, be forwarded to you intact and unedited by me.

I have noted with interest the full text of your Performance Audit and as I become more firmly familiar with the facts and issues pertinent to the successful management of this agency over the next several months, I will be reviewing your recommendations again for appropriate action where merited.

Your Finding (V) concerning the investigative authority of the Lottery is of such compelling importance to me, as Executive Director, that some immediate action was deemed necessary. My opinion is that the Lottery has not exceeded its statutory authority. However, I agree with your recommendation that the Legislature amend the statutes to more specifically and clearly define our investigative responsibilities. Accordingly, I have asked the Senate Finance Committee to introduce such clarifying language.

Respectfully submitted,

Bill Henry

Bill Henry
Executive Director

BH:nh
Enclosures
cc: Members of the Commission
Charles E. Buri

RESPONSE OF THE ARIZONA STATE LOTTERY COMMISSION TO THE AUDITOR GENERAL'S PERFORMANCE AUDIT

Drafted by
Charles E. Buri, Executive Director
March 14, 1983 - January 5, 1987

INTRODUCTION

The following memorandum represents the response of the Arizona State Lottery Commission to the Auditor General's Performance Audit.

PURPOSE

The Arizona Lottery, as established by voter initiative in the general election of November, 1980, has a singular purpose and that is "to produce the maximum amount of net revenue consonant with the dignity of the state."

EFFECTIVENESS AND EFFICIENCY

Given this purpose, the effectiveness and efficiency of the Arizona Lottery are best measured by net revenues, and, judged accordingly, the Arizona Lottery has proven exceedingly successful.

In its first five Years (July 1, 1981 through June 30, 1986), the Lottery accrued $442,350,196 in gross revenues. From that total, it realized $156,284,407 in net revenues. That amounts to a return on sales of better than thirty-five percent (35%).

Impressive in their own right, these figures take on special significance when contrasted with the performance of others. For example, if ranked among Business Week's Top 1,000 Companies for calendar year 1985, the Arizona Lottery would be 980 in terms of gross revenues. In terms of net revenues, however, it would climb dramatically ... to 656. In other words, the Arizona Lottery has been able to realize a substantially greater return on sales than most businesses.

This result is underscored by the fact that, if measured against the Fortune 500 Companies for calendar year 1985, the Arizona Lottery would rank first in terms of return on sales at

thirty-five percent (35%). If measured by sales per employee for calendar year 1985, the Arizona Lottery would also prove exceptional with sales of nearly $887,000 per employee; making it eighth best among the Fortune 500 Companies. Similarly, if considered from the vantage of change in sales, between calendar years 1984 and 1985, the Arizona Lottery would be eight among the Fortune 500 Companies with an increase of over seventy percent (70%). And, during the same period of time, net revenues increased by an even greater margin -- namely, eighty-three percent (83%). To say the least, the Arizona Lottery has proven exceedingly efficient and economical in its operations.

PUBLIC INTERESTS SERVED

The primary beneficiaries of net revenues produced by the Arizona Lottery are Arizona's incorporated cities and towns, which receive these monies through the Local Transportation Assistance Fund. As of June 30, 1986, the Local Transportation Assistance Fund had received $88,500,000 in Lottery revenues; the distribution and use of which was overseen by the Department of Transportation.

In addition, prior to the creation of the Local Transportation Assistance Fund, $22,600,000 in Lottery revenues were transferred to the State's General Fund, and, by Session Law, another $11,300,000 was transferred to the General Fund in Fiscal Year 1982-1983. A more recent change in the Lottery Act resulted in an additional $14,000,000 of Lottery revenues going to the General Fund in Fiscal Year 1985-1986. All totaled, the State's General Fund has received $47,900,000 in Lottery revenues.

When combined, Lottery monies flowing to the Local Transportation Assistance Fund and the General Fund amount to $145,400,000 or about $12,700,000 above and beyond that required by law ... for the Lottery was only required to apportion thirty percent (30%) of gross revenues for transfer to the Local Transportation Assistance Fund and the General Fund. Yet, by focusing on "the bottom line," it has been able to do much, much better.

Moreover, this Fiscal Year should be the Lottery's best

ever. When all is said and done, the Lottery will gross approximately $130,000,000 and, from those revenues, remit $23,000,000 (the maximum permitted by law) to the Local Transportation Assistance Fund, $7,650,000 to the County Assistance Fund (again, the maximum permitted by law), and about $15,000,000 to the General Fund. Obviously, the Lottery serves the public's interests well.

PUBLIC'S PERCEPTION

But, how do Arizonan's feel about their Lottery? The answer is very favorably.

Last year, as a part of the Lottery's ongoing market research efforts, Arizona State University's Opinion Research Laboratory completed a survey of Arizona residents, concerning their attitudes toward and opinions about the Lottery. In the course of that survey the following questions were asked with the noted results.

"Overall, do you think the Lottery is a good thing, a bad thing, or are you not sure?"

Good Thing	78%
Bad Thing	11%
Not Sure	11%

"If an election were to be held today, do you think you would vote to continue the Lottery?"

Yes	80%
No	15%
Not Sure	5%

"In general, how beneficial is the Lottery to the State?"

Very Beneficial	27%
Somewhat Beneficial	57%
Not At All Beneficial	7%
Don't Know	9%

Clearly, Arizonan's regard their Lottery with extreme favor.

SUNSET FINDINGS

Even the Auditor General ... in evaluating the Lottery

against the twelve "sunset" factors prescribed by A.R.S. §41-2354 ... recognizes that the Lottery is a successful organization.

He writes that (1) "The Lottery Commission's purpose is to produce the maximum amount of net revenue consonant with the dignity of the state" and that (2) "The Lottery has produced a significant amount of net revenue since it began operations in 1981." Accordingly, the Auditor General finds that (3) "The Lottery has operated within the public interest ...."

In terms of operations, the Auditor General states (4) "The Lottery has promulgated rules and regulations that are consistent with its legislative mandate" and that (5) "The Commission has adequately encouraged input from the public before promulgating its rules and regulations." He also remarks that (6) "Since the Lottery is not a regulatory agency, its enabling legislation did not include a formal complaint process," but that (7) "A.R.S. §5-512.01 provides both the Attorney General and County Attorneys with concurrent prosecution authority for any offense arising out of or in connection with the formation, management, operation or conduct of the State Lottery."

Regarding legislation, the Auditor General notes that (8) "Since its inception in 1981, the Lottery has been active in submitting legislation to increase its effectiveness," but recommends that (9) "[T]he Legislature consider reducing the percentage of [revenue] allowed for Lottery administrative expenses ... and repealing the Lottery's exemption from the State procurement statutes."

As for termination, the Auditor General opines that (10) "Terminating the Lottery would eliminate a significant amount of revenue made available to the State." And, in response to the final two criteria, the Auditor General simply reports that (11) "The Arizona Lottery is not a regulatory agency" and that (12) "The Arizona Lottery makes extensive use of private contractors in the performance of its duties" and that "no other areas for the Lottery's use of private contractors" were identified.

Clearly, the Lottery passes muster under the "sunset" criteria.

AUDITOR GENERAL'S RECOMMENDATIONS

Yet, having said all this, the Auditor General then goes on to make five recommendations, to wit: (1) The percentage of Lottery revenues set aside for administrative expenditures should be reduced, permitting more revenues to be earmarked for prizes, designated revenue funds and the General Fund; (2) The Lottery should be subjected to the executive budget and legislative appropriation process to provide increased oversight; (3) The Department of Administration's Purchasing Office should be made responsible for Lottery procurements; (4) The Lottery should determine ways to minimize its building construction costs; and (5) The Lottery should seek peace officer status for its investigators.

In support of these recommendations, the Auditor General attempts to fault the Lottery on a number of grounds. Nevertheless, this tact was not wholly unexpected, as his staff were quite open in defining their charge as "finding something wrong" (See, Appendix One). What is surprising, however, is the minutiae and inexpert analyses (See, Appendix Two) that the Auditor General uses in pursuing this goal.

Understandably, the Auditor General does not mention his editorial bias or the intellectual shortcuts used in preparing his Report ... but the Lottery must. In addition, the Lottery is compelled to respond to each of the Auditor General's five recommendations -- not because it disagrees with all of the recommendations (it does not) -- but, rather, to provide the balance and symmetry needed to form a fair and objective opinion.

ADMINISTRATIVE FUNDS

The Auditor General first asserts that the Lottery has 25% of total revenues available for general administrative expenses and that this is more than needed. Unfortunately, the Auditor General's figures are in error.

The expenditure of Lottery revenues is governed in large measure by statute and regulation. Specifically, statute directs that 45% of the revenues accruing from the sale of lottery tickets be returned to players in the form of prizes, that no less than 30% go to the State of Arizona, and that no more than

4% be used for advertising and promotion. In addition, regulation specifies that retailers receive a commission of 6%. Totaled, 85% of all Lottery revenue has been specifically allocated by statute and regulation.

This leaves 15% of revenue over which the Lottery has some discretion; the qualification being that market prices, for such things as tickets and on-line game processing systems, dictate to a degree how this money is spent. In fact, this past year, the cost of those two items (i.e., instant tickets and the on-line game processing system) amounted to almost 6% of revenue, which left only 9% of revenue with which to administer the Lottery -- not 25% as the Auditor General asserts.

It also bears mentioning that the Lottery did not spend the full 9% on administrative expenses. Charged with the responsibility to produce the maximum amount of net revenue, the Lottery was able to hold these expenses to only 4% of revenue. This allowed it to realize an additional 5% in net revenue ... bringing the total to 35%.

So, although his figures are wrong, the Auditor General is correct in saying that the Lottery, through efficient management, has realized savings in its administrative expenses and that these savings might be used for other purposes.

It is the Auditor General's recommendation that these savings be split between the State and Lottery players. However, if this money is to be reallocated, the Lottery recommends that it be allocated entirely for the payment of prizes; bringing the players' share of Lottery revenues up to 50%. Why ... because it would allow the Lottery to produce even greater net revenues for the State.

Additional prize money would allow for more prizes which, in turn, would better the odds of winning. Better odds of winning translate into more winners and the more people win, the more people play. In other words, with more prize money, the Lottery could enhance its games, which would result in more tickets being sold. And, since the State receives not less than 30% of every dollar spent on Lottery tickets, this means more money for the State.

BUDGETARY CONTROL AND OVERSIGHT

The Auditor General's second recommendation is that Legislative control and oversight be increased by subjecting the Lottery to the appropriation process.

Again, however, it must be noted that statute, regulation and market forces dictate how 91% of all Lottery revenues are expanded. This fact, coupled with the suggestion that the Lottery Act be amended to allocate an additional 5% of revenue for the payment of prizes, leaves only 4% that would be subject to the appropriation process.

Given this small percentage and the frugality exercised by the Lottery in its operations, there is little reason to go through the appropriation process. It would be absolutely futile to allocate this money on a lump sum basis, for statute, regulation and market forces already do exactly that. On the other hand, to appropriate this money on a line item basis would be unduly restrictive and impair the Lottery's ability to react to changes in the marketplace in a timely, business-like manner.

Furthermore, the Legislature is fully apprised of the Lottery's expenditures through its monthly financial reports and annual report. Indeed, these reports provide greater and more timely accountability than the budget process, for they permit ongoing oversight and control.

LOTTERY PROCUREMENTS

The Auditor General's third recommendation is that Lottery procurements be handled by the Department of Administration's Purchasing Office. In his estimation this would, "help ensure impartiality and fairness in the contract selection process."

In support of this recommendation, the Auditor General points to the potential influence of organized crime and the aggressiveness of some vendors providing gaming services. Yet, with a Security and Licensing Division, the Lottery is better able than the Department of Administration to guard against the influence of organized crime. Likewise, the Lottery is just as able as the Department of Administration to deal with the aggressiveness of vendors.

Perhaps knowing this, the Auditor General suggests that some contracts may have been awarded without appropriate safeguards to ensure competition "because poor procedures were followed." In support of this assertion, the Auditor General points to a series of electronic data processing consulting contracts, which were awarded to one company, and complains that the company was allowed to propose on this work even though it did the feasibility study. At that time, however, there was no policy to the contrary. Only recently, with the adoption of the Uniform Procurement Code, did the Department of Administration's Purchasing Office adopt such a rule, and, today, the Lottery has the very same rule.

Furthermore, each of these procurements was conducted in strict accordance with the statutes relating to "Contracts For Outside Professional Services" then in effect (A.R.S. §41-1051 et seq.) ... and the Auditor General recognizes this. Nonetheless, he compares what was done under these statutes to what is currently required under the Uniform Procurement Act (A.R.S. §41-2501 et seq.) and then chastises the Lottery because, in one instance, it did not prepare a formal technical evaluation which comports with the standards of the Uniform Procurement Act. What he neglects to state is that these standards had not even been developed at the time. As such, his criticism is inherently unfair. Currently, however, formal technical evaluations are prepared and documented.

Pertaining to the instant ticket procurements referenced by the Auditor General, the highly competitive nature of the Lottery industry results in controversy no matter who is doing the procuring. Contracts for instant tickets involve large amounts of money and there are only a very few such contracts let every year. Accordingly, the competition for these contracts is exceptionally heated.

Yet, given this environment, the Lottery has fared extremely well. Out of five procurements, only one was protested. To intimate that the Department of Administration may do better is sheer speculation. Furthermore, it bears noting that the incidences the Auditor General cites are five years old

-- occurring in 1981 and 1982. Apparently, these "aggressive gaming companies" are not much of a problem today.

It must also be noted that the Auditor General mischaracterizes the Lottery's use of an independent outside evaluator in its 1984 procurement of instant game tickets. The investigator for the Department of Public Safety did not conclude that the evaluator had a prior business relationship with a competing company. And, although this investigator personally felt that the use of the evaluator was questionable, his official conclusion was, "In this investigation, the charges of 'conflict of interest' do not exist." Again, the Auditor General conveniently neglects to paint the whole picture.

With respect to contracts entered into by the Lottery's advertising agency, the Auditor General feels that this practice reduces open competition. However, he does not say that the Lottery did anything wrong. Indeed, he cannot, for these subcontracts were authorized by a contract approved by the Attorney General's Office. And why did the contract contain provisions permitting subcontracts of the sort ... because that is the industry standard.

The Auditor General would have the Lottery ignore this convention so that it might save the commissions paid to its advertising agency for time spent in directing and supervising these subcontractors. What he fails to recognize, however, is that an advertising agency receives its compensation through commissions in matters of this sort. Had the Lottery bid these contracts itself and denied the agency a commission, it would have had to pay the agency for its services on an hourly basis -- unless the Auditor General is suggesting that the Lottery's agency should work for free. Of course, that is ludicrous.

Finally, as a make-weight argument, the Auditor General notes that six lottery states utilize a central procurement office for contract selection and award. But, when one considers that there are now twenty-three jurisdictions in the United States that have lotteries, this approach is in the minority ... and with good reason. Just as lotteries can best protect their own integrity and security, they possess the greatest expertise

to evaluate lottery equipment, tickets and related materials.

Notwithstanding, the lottery has made use of the Department of Administrations's Purchasing Office and it will continue to do so in appropriate circumstances. The Lottery must, however, retain the authority to protect its own integrity and security and to exercise its expertise in procurement matters so that it can be assured it is getting the most for its money. After all, it is the Lottery -- not the Department of Administration -- that is responsible to maximize net profits and no one takes that responsibility more seriously than the Lottery.

BUILDING COSTS

The Auditor General next opines that the Lottery has not sufficiently controlled costs for its new building. However, others ... in particular, the Legislature ... do not agree.

The Lottery received approval from the Joint Legislative Budget Committee to construct its building and, following receipt of that approval, again appeared before the J.L.B.C. and the Joint Committee on Capital Improvements to provide progress updates. Neither committee ever expressed any concern about the cost of the building. And with good reason.

Professional analysis of the building's shell cost produces a figure of $58.66 per square foot -- not $67.08 (See, Appendix Three). Likewise, the Auditor General wrongly estimates the cost of the Department of Public Safety's building. To quote the Project Manager on that project, Reese-Carr:

> "[The Auditor General's] report indicates that the DPS Building received bids at a cost/sf of $50.90. As the design phase Project Manager on that project, it is important to note that the low base bid plus alternatives was approximately $3,769,000 or $61.06/sf. Deducting costs of site improvements and special systems, the "building shell" cost were more accurately in the range of $55.00/sf.

Thus, the Lottery's building cost per square foot is only $3.66 higher than that of the Department of Public Safety. this

variance is certainly not exorbitant ... especially given the difference in purposes.

As for the Auditor General's comparison of the Lottery's building cost to that of the Department of Revenue, it is simply unreasonable. The Department of Revenue's building is approximately seven times larger than the Lottery's building and, or course, many more economies of scale could be realized. For instance, a $3.00 per square foot single-ply roof on a 27,650 square foot, two-story building will average $1.50 per square foot of building area, whereas the same roof on a 192,000 square foot, six-story building will average only $0.50 per square foot of building area. In other words, the Auditor General is comparing apples-to-oranges and to suggest on this basis that the Lottery's building costs are excessive or uncontrolled is irresponsible.

INVESTIGATORY AUTHORITY

Lastly, predicated upon an opinion of Legislative Council, the Auditor General charges that the Lottery has exceeded its authority, by investigating violations of the Arizona Lottery Act. However, lawyers do disagree and in this instance it appears as if Legislative Council differs with the Attorney General.

A.R.S. §5-508, which is overlooked by Legislative Council, explicitly requires that the executive Director of the Lottery conduct investigations to guard against organized gambling, crime, and to ensure that the Lottery Act is administered to serve its intended purpose. To this end, the Security and Licensing Division has been directed to conduct necessary inquiries and, when a problem is detected, to refer the matter to the local law enforcement agency having jurisdiction. This mode of operation is legally permissible and absolutely necessary to protect the security and integrity of the Lottery.

Notwithstanding, the Lottery concedes that the statute cited by Legislative Council and relied upon by the Auditor General is subject to conflicting interpretations and, accordingly, joins with the Auditor General in recommending that it be amended to clearly confer upon the Lottery's Security and

Licensing Division the authority to conduct investigations.

Such authority is necessary to ensure the integrity and security of the Lottery and no other agency possesses greater competence to do so. This is universally recognized and accepted in law enforcement circles. The Federal Bureau of Investigation, the Attorney General's office, the Department of Public Safety and virtually every other law enforcement agency in the State have worked with and supported the Lottery in these efforts.

CONCLUSION

Regrettably, it has been necessary to go beyond the Auditor General's Report and examine many details in order to set the record straight. However, the Auditor General's Report could not be left unchallenged.

By focusing upon minutiae, distorting fact and presenting incomplete analyses, the Auditor General paints a biased picture and then calls for changes ... some of which are neither necessary nor helpful.

The Lottery has been extraordinarily effective and efficient in serving the public interest prescribed by the electorate ... producing revenue for the State of Arizona ... and it should be recognized as such. Sure, it has encountered some problems along the way, but, then again, who hasn't!

The Auditor General's recommendations for change must be considered in light of the Lottery's overall record and, when weighed against the many accomplishments the Lottery has achieved, the problems highlighted by the Auditor General certainly do not warrant all the changes he suggests.

Simply put, "If it isn't broken ... don't fix it!" Yes, the Lottery's games can be improved, by returning more money to players in the form of prizes, and any ambiguity concerning the authority of Lottery investigators to conduct investigations must be resolved. But, beyond that, no other changes are required.

M E M O R A N D U M

DATE: June 23, 1986

TO: Charles E. Buri, Executive Director

FROM: Hugh Ennis, Assistant Director for Security/Licensing

RE: **SUNSET REVIEW**

During a recent inspection trip of Scientific Games facilities in Atlanta, Georgia, I was accompanied by * * of the Auditor General's office. Also present on this trip was Ms. Nena Dawson, the internal auditor for the Arizona Lottery.

On one occasion during this trip there was discussion by * about his recent audits of Revenue and the Department of Racing. He informed Ms. Dawson and me that he had the number one finding in one of these audits and that that was "better than being the boss". He displayed obvious pride in discovering problems in the agency. He gave an account of how he was randomly going over some printouts and discovered an obvious shortcoming.

On another occasion we were discussing audit philosophy and he gave the impression that he saw it has his responsibility to "find things wrong". He was asked by Ms. Dawson if he should just determine how things operated and report them, good or bad. His response was that he felt his charge from the legislature was to "find something wrong".

These discussions took place between May 19 and May 21, 1986.

HE:lw

* Staff name has been deleted.

Charles E. Buri
Executive Director

301 East Virginia
Suite 1200
Phoenix, Arizona 85004
(602) 255-1470

M E M O R A N D U M

DATE: June 23, 1986

RE: Sunset Review

TO: Charles E. Buri

FROM: Nena Dawson

Most of the leisure time conversations that took place in Atlanta, Georgia between * Hugh Ennis and myself related to findings in other performance audits * has performed. * displays an attitude of pleasure and self satisfaction by bragging about his ability to make people being audited uncomfortable and to find problems within an agency. He likes to describe his methods as being cunning.

One instance in particular, * said he couldn't make a director understand that he had to find something derogatory. It was the legislatures intent that he find what is wrong in an agency. I commented that perhaps he was to report his findings regardless of the outcome; if an agency has a good system, then he should write a good report, and if an agency has certain inefficiencies he should write a negative report. * said "No, you don't understand. The assumption or expectation is that everything is right, its our job to prove it is not". He said all agencies had inefficiencies, he was suppose to find them. They all thought they were unique but they are not. His attitude is that any negative findings were performed intentionally by employees.

On another occasion * was discussing the Racing Commission Performance Audit in rather general terms. He was unhappy because the audit team was meeting with a superior that day on the final audit report and he was going to miss it. That evening he was elated, he had called the office and found out he had "finding number one". His comment was "That's better than being boss."

Nena Dawson

Nena Dawson

ND:da

* Staff name has been deleted.

EXHIBIT TWO
PAGE ONE

Suite [illegible]
Phoenix, Arizona [illegible]
(602) 255-[illegible]

ARIZONA LOTTERY

Charles E. Buri
Executive Director

It's working for Arizona!

August 29, 1986

William Thomson, Director
Performance Audit Division
Office of the Auditor General
2700 North Central Avenue, Suite 700
Phoenix, Arizona 85004

Re: Lottery Performance Audit

Dear Mr. Thomson:

Earlier this week, I attended the "exit conference" that was conducted by representatives of your office. As I understood the purpose of this conference, it was to present your auditors' preliminary findings relative to their performance audit, correct factual inaccuracies and comment on the direction or "tone" of the findings.

Various factual inaccuracies were, indeed, noted. Some were corrected on the spot and others will, hopefully, be corrected through additional study on the part of the auditors. However, as regards the direction or "tone" of the findings, a fundamental point of contention was left unresolved.

The findings are, for the most part, opinions. And, as I am sure you can well appreciate, it is difficult at best to judge the merit of an opinion without knowing the qualifications of the individual to render that opinion.

With this in mind, I asked that we be informed of the education, training and experience of the auditors. However, I was told your office will not release information of this sort.

To say the least, I think this is very unfair. How are we -- or, for that matter, the Legislature -- to come to an informed decision on your auditors' opinions without knowing anything about the auditors?

If your auditors have particular expertise in the subject matter, certainly that would lend credibility to their opinions. On the other hand, if they lack education, training or experience in the subject matter, their opinions are entitled to little deference.

For this reason, I am, again, requesting that we be provided with vitae on the auditors involved in this performance audit.

Sincerely,

Charles E. Buri
Executive Director

CEB:cb

RECEIVED
SEP 11 1986
DIRECTOR
ARIZONA LOTTERY

DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

September 10, 1986

Charles E. Buri, Director
Arizona Lottery
301 E. Virginia - Suite 1200
Phoenix, Arizona 85004

Dear Mr. Buri:

We are apparently suffering from some miscommunication regarding the release of background information on our staff. We are not simply refusing to release the information, we do not maintain such information for external release. As an organization, the only resumes we have for our staff are those submitted when applying for employment. Not only are these resumes outdated, we believe it inappropriate for us to release information submitted to us for employment purposes. The resumes often contain personal information employees may not want released to outside parties.

Even if the information was available, we question the usefulness of providing it. Ultimately, the report will stand or fall on the facts contained in the audit. If the facts support the conclusions, a review of the education, training and experience of the auditors will do little to add to or strengthen the conclusions. If the facts do not support the conclusions, then no amount of staff education, training or experience will overcome that flaw.

Sincerely,

William Thomson

William Thomson, Director
Performance Audit Division

WT/jr

2700 NORTH CENTRAL AVE. ● SUITE 700 ● PHOENIX, ARIZONA 85004 ● (602) 255-4385

ARIZONA LOTTERY BUILDING
10/17/86

CONSTRUCTION COSTS OF PROJECT

TOTAL COST (Base Bid & Alternates)		$2,845,958 ($73.63/sf)
Less Site Improvements/Permits		
-Site Paving/Utilities (On/Off)	($166,800)	
-Landscaping/Irrigation (3 ac)	(93,900)	
-Car Shelters	(19,300)	
-Development Fees	(25,000)	
-Sales Tax (4.22%)	(12,900)	
		(317,900)
Total Building Costs (Shell & Interiors). . .		**$2,528,058 ($65.41/sf)**
Less Special Systems/Eqpt		
-Security System	($ 50,000)	
-UPS & Emerg Generator	(125,000)	
-Access Flooring (Computer Rm)	(11,000)	
-Computer Cabling System	(75,000)	
		(261,000)
Adjusted Total Bldg Costs (Shell & Int). . .		**$2,267,058 ($58.66/sf)**

NOTE: Typically, the costs of a Building Shell in the speculative commercial office building market range from a low of $38/sf to a average high of $55/sf. Assuming average Tenant Improvements for professional office space, you would experience a low of $14/sf to approx $22/sf. (Corporate office spaces will often times be much greater than $25/sf.) Adding both costs together it would be reasonable to experience combined Shell and T.I. costs in the range of $52/sf to $77/sf.

The Lottery Building, as shown above, has an adjusted Shell and T.I. cost of $58.66/sf. This building is a masonry and steel frame structure with a decorative brick-veneer facade and insulated glass windows. The mechanical and electrical systems are top quality and highly efficient systems, as compared to what is typically installed in speculative office buildings. The interior finishes will be highly durable and will withstand the demand placed on them for a great number of years. Overall, the Lottery will be receiving a lot of building for the money, and once completed, the State should have a facility of which they can be proud.

EXHIBIT THREE
PAGE TWO

J.R.Porter Construction Co.,Inc. **Ruscilli**

APPLICATION FOR PAYMENT

TO: EXECUTIVE DIRECTOR OF THE AZ STATE LOTTERY
301 E VIRGINIA
PHOENIX AZ 85004

PROJECT: AZ LOTTERY BUILDING
4740 E UNIVERSITY
PHOENIX AZ

APPLICATION NO 02

FROM: 08-01-86
TO: 08-31-86

FROM: J. R. PORTER-RUSCILLI CONSTRUCTION CO INC
11201 N 23RD AVENUE
PHOENIX AZ 85029

CONTRACT DATE: JUNE 5, 1986

CHANGE ORDER SUMMARY

	ADDITIONS	DELETIONS
APPROVED PREVIOUS MONTHS	0.00	0.00
APPROVED THIS MONTH:		
NUMBER DATE		
TOTALS	0.00	0.00
NET CHANGE BY CHANGE ORDERS		0.00

ORIGINAL CONTRACT AMOUNT	$ 2,845,958.00
NET CHANGE BY CHANGE ORDERS	$ 0.00
CONTRACT SUM TO DATE	$ 2,845,958.00
TOTAL COMPLETED AND STORED	$ 290,280.00
LESS RETAINAGE:	
10% RETAINAGE	29,028.00
TOTAL EARNED LESS RETAINAGE	$ 261,252.00
LESS PREVIOUS APPLICATIONS	$ 94,351.00
CURRENT AMOUNT DUE	$ 166,901.00

THE UNDERSIGNED CONTRACTOR CERTIFIES THAT TO THE BEST OF THE CONTRACTOR'KNOWLEDGE , INFORMATION ANG BELIEF THE WORK COVERED BY THIS APPLICATION FOR PAYMENT HAS BEEN COMPLETED IN ACCORDANCE WITH THE CONTRACT DOCUMENTS, THAT ALL AMOUNTS HAVE SEEN PAID BY THE CONTRACTOR FOR WORK FOR WHICH PREVIOUS APPLICATIONS FOR PAYMENT WERE ISSUED AND PAYMENTS RECEIVED FROM THE OWNER, AND THAT CURRENT PAYMENT SHOWN HEREIN IS NOW DUE.

J. R. PORTER-RUSCILLI CONSTRUCTION CO., INC.

BY: Charles M Wiseman Exec. VP DATE: 8/29/86

ARCHITECT'S CERTIFICATE FOR PAYMENT

IN ACCORDANCE WITH THE CONTRACT DOCUMENTS, BASED ON ON-SITE OBSERVATIONS AND THE DATA COMPRISING THE ABOVE APPLICATION, THE ARCHITECT CERTIFIES TO THE OWNER THAT TO THE BEST OF THE ARCHITECT'S KNOWLEDGE, INFORMATION AND BELIEF THE WORK HAS PROGRESSED AS INDICATED, THE QUALITY OF THE WORK IS IN ACCORDANCE WITH THE CONTRACT DOCUMENTS, AND THE CONTRACTOR IS ENTITLED TO PAYMENT OF THE AMOUNT CERTIFIED.

AMOUNT CERTIFIED: $ 166,901.00

ARCHITECT: PETER A. LENDRUM ASSOCIATES, INC.

BY: DATE: 9-3-86

11201 North 23rd Avenue • Phoenix, Arizona 85029-4885 • (602) 997-6201
Offices in Phoenix, Arizona and Columbus, Ohio

CONTINUATION SHEET JOB NUMBER 86005 APPLICATION NO 2 PAGE 2 OF 2 PAGES
ARIZONA LOTTERY BUILDING

	DESCRIPTION OF WORK	SCHEDULED VALUE	PREVIOUS APPLCTNS	THIS APPLICATION WORK IN PLACE	THIS APPLICATION STORED MATERIALS	TOTAL COMP AND STORED	PERCENT	BAL TO FINISH
1	MOBILIZATION	18862	9431	5659		15090	80	3772
2	PERMITS,FEES,BONDS	66138	66138	0		66138	100	0
3	UTILITY ALLOWANCE	8000	0	0		0	0	8000
4	TESTING ALLOWANCE	6000	0	0		0	0	6000
5	ARTWORK ALLOWANCE	20000	0	0		0	0	20000
6	SITEWORK(ON/OFF)	166799	25020	11676		36696	22	130103
7	LANDSCAPE/IRRIGATION	93864	0	0		0	0	93864
8	CONCRETE	127620	0	89334		89334	70	38286
9	MASONRY	407904	0	20395		20395	5	387509
10	STEEL	273916	0	10957		10957	4	262959
11	CARPENTRY	54266	0	0		0	0	54266
12	THERMAL/MOISTURE PROTECT	89973	0	0		0	0	89973
13	SKYLIGHTS	22367	0	0		0	0	22367
14	DOORS/FRAMES/HARDWARE	36476	0	0		0	0	36476
15	GLASS	151507	0	0		0	0	151507
16	STUD/DRYWALL/PAINT/PLASTR	139094	0	0		0	0	139094
17	FLOORING	106465	0	0		0	0	106465
18	ACOUSTIC CEILING TILE	22877	0	0		0	0	22877
19	ACCESSORIES	27781	0	0		0	0	27781
20	SIGNAGE	15374	0	0		0	0	15374
21	CAR SHELTER	19264	0	0		0	0	19264
22	ELEVATOR	28205	0	1410		1410	5	26795
23	PLUMBING	64280	0	12856		12856	20	51424
24	HVAC	290886	0	0		0	0	290886
25	SPRINKLERS	31550	0	0		0	0	31550
26	HALON	13757	0	0		0	0	13757
27	ELECTRICAL	427497	0	25650		25650	6	401847
28	SALES TAX @ 4.222	115236	4245	7509		11754	10	103482
	TOTALS	2845958	104834	185446	0	290280	10	2555678

RESPONSES BY AFFECTED AGENCIES TO OTHER PERTINENT INFORMATION ON ORGANIZATION OF PUBLIC GAMING REGULATION

The Department of Public Safety, the Department of Revenue-Bingo Section and the Department of Racing are all potentially affected by the information presented on the organization of public gaming regulation. As affected parties, each was given the opportunity to review and respond to that portion of the report. The Department of Racing chose to provide the following written comments. The other agencies reviewed the draft, but did not choose to provide written comments.

ARIZONA DEPARTMENT OF RACING

January 13, 1987

JAN 1987
RECEIVED
AUDITOR
GENERAL

Linda J. Blessing, Deputy Auditor General
Office of the Auditor General
2700 North Central, Suite 700
Phoenix, Arizona 85004

Dear Ms. Blessing,

I appreciate the opportunity to comment on the draft report regarding consolidation of gaming regulation.

First, the following items should be clarified:

1. Fingerprint checks are run through the FBI as well as through DPS (page 51).

2. The Department has nine FTE's in the investigative area, three of which are vacant pending the opening of Rillito Downs in Tucson. Current staffing consists of the Chief Investigator, Investigations Supervisor, two Investigator III's, one Investigator II and one Undercover Security Investigator. All have ten or more years experience in law enforcement (page 52).

3. In addition to investigative case work, the investigators assist in licensing and observe activities at the tracks to detect violations of racing laws and rules (page 52).

Second, I believe that combining gaming regulation under a single agency could be beneficial, especially if the consolidation took the structural approach used by Connecticut. However, that single gaming agency should be separate from DPS. In addition to the valid concerns raised in the report, consolidation within DPS could result in gaming becoming "lost in the shuffle", with less emphasis placed on gaming investigations than would occur if these investigations were conducted by an agency whose sole focus was on these particular activities.

Sincerely,

Tim

Timothy A. Barrow
Director

TAB/as

800 W. Washington
Room 400
Phoenix, Arizona 85007
(602) 255-5151

"EQUAL EMPLOYMENT OPPORTUNITY/AFFIRMATIVE ACTION EMPLOYER"

ARIZONA LEGISLATIVE COUNCIL

MEMO

August 29, 1986

TO: Douglas R. Norton, Auditor General

FROM: Arizona Legislative Council

RE: Request for Research and Statutory Interpretation (O-86-6)

This memo is sent in response to a request made on your behalf by William Thomson in a memo dated August 12, 1986.

FACT SITUATION A:

Arizona Revised Statutes (A.R.S.) section 5-505, subsection B deals with apportionment of revenues of the state lottery. The subsection provides that:

> B. As nearly as is practicable, forty-five per cent of the total annual revenue, computed on a year-round average basis for each type of lottery game, accruing from the sale of lottery tickets or shares shall be apportioned for payment of prizes to the holders of winning tickets or shares, except that not less than thirty per cent of the total revenues accruing from the sale of lottery tickets or shares shall be apportioned for transfer to the local transportation assistance fund or the Arizona highway user revenue fund as provided in section 28-2601.

Currently, the lottery determines its own budget and staffing levels without legislative involvement. In addition, the lottery determines the amount of any additional monies distributed to the prize fund and to the designated revenue funds in excess of minimum statutory requirements.

QUESTIONS PRESENTED:

A. 1. What authority does the legislature have to appropriate the lottery's operating budget derived from the twenty-five per cent of lottery revenues not directed to either the prize fund, the local transportation assistance fund or the Arizona highway user revenue fund?

A. 2. If the legislature has no authority over appropriating this portion of revenues, what actions would the legislature need to take in order to acquire such authority?

A. 3. Does the legislature have the authority to establish staffing levels for the Arizona lottery?

A. 4. Does the legislature have the authority to modify the apportionment of lottery revenues from the structure outlined in the above fact situation? More specifically, can the legislature change the apportionment formula from its current structure (forty-five per cent to prizes, thirty per cent to the state, and twenty-five per cent to operations) to some other formula?

A. 5. If the legislature does not have the authority to modify the apportionment of the revenues, what would be required for the legislature to obtain such authority?

ANSWERS:

A. 1. See discussion.

A. 2. See discussion.

A. 3. No.

A. 4. Yes.

A. 5. See discussion.

DISCUSSION:

A. 1. The legislative authority to appropriate the lottery's operating budget depends on whether the people, in adopting the lottery act through the initiative process, intended to establish a continuing appropriation. This type of an appropriation does not require any further legislative action by the people for the legislature to be effective.

The prize fund, according to A.R.S. section 5-523, is to be used only for payment of prizes. The lottery fund, according to A.R.S. section 5-522, is used to pay the lottery commission's expenses incurred in carrying out its powers and duties and in operation of the lottery pursuant to A.R.S. section 5-506.

A portion of the remaining monies are then to be used for transportation assistance and county assistance. Any remaining monies are deposited in the state general fund.

The lottery act, therefore, directs the commission and the director on how to use all of the annual revenue it receives from the sale of lottery tickets. Based on these facts the Attorney General concluded 81 Op. Att'y Gen. 022 (1981) that the people, in adopting the initiative, intended to establish a continuing appropriation and did not contemplate that any action by the legislature would be necessary for the commission and director to spend or dispose of the lottery ticket revenues as directed by the act.

The opinion does take note, however, that subsection A of A.R.S. section 5-522 states that monies in the lottery fund "shall be appropriated only" for purposes listed in the section. Additionally A.R.S. section 5-523 states that monies in the prize fund "are not appropriations by the legislature, and . . . are not subject to appropriation by the legislature."

Attorney General Opinion I81-022 states:

> The language of A.R.S. section 5-523, A [now section 5-522, subsection A] may imply, by use of the phrase "shall be appropriated only" for certain purposes, that some further and future legislative action will be necessary to effect the appropriation for and among the purposes expressed, particularly when read in conjuction with the above-quoted language in A.R.S. section 5-524, [now section 5-523], which might contain the negative implication that lottery fund, as opposed to prize fund, monies were meant to be subject to appropriations by the Legislature.

> We think that this was not the people's intent, however. Although the phrase "are appropriated" might have been preferable to "shall be appropriated" to express the people's intent, we think the latter phrase was used simply because the expenditures from the lottery fund would not begin until a future time when the lottery fund would come into existence and monies thereafter would be deposited in it.
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> * * *
>
> Nothing that has just been expressed is inconsistent with our original conclusion that the people intended to effect a continuing appropriation of monies in the lottery fund as well as the prize fund. The only difference between the two funds is that the people contemplated that the Legislature could amend the Act's lottery fund provisions, but not the Act's prize fund provisions. But, unless and until the Legislature acts with respect to the lottery fund provisions, they should be construed as effecting a continuing appropriation.

A. 2. The lottery act was established by an initiative petition approved by the people at the general election on November 4, 1980.

Article IV, part 1, section 1, subsection (6), Constitution of Arizona, prohibits the legislature from amending or repealing initiated or referred measures which receive a majority vote of the qualified electors. The phrase "majority of qualified electors" means the majority of those eligible to vote, not those actually voting. Adams v. Bolin, 74 Ariz. 269, 247 P.2d 617 (1952).

Therefore, the lottery act may be amended by the legislature since it received approval from less than a majority of the qualified electors.[1]

If the legislature wished to acquire the authority to appropriate the twenty-five per cent of lottery revenues not directed to the prize fund or transportation uses they could do so by legislative action.

A. 3. As to the question of whether the legislature has the authority to establish staffing levels for the lottery, it is not clear from the act. However, according to A.R.S. section 5-506, paragraph 3, the director has the power to "/h/ire such professional, clerical, technical and administrative personnel as may be necessary to carry out this chapter." This language, combined with the fact that the lottery controls its annual revenues as a continuing appropriation, leads to the conclusion that the people intended that the lottery director establish staffing levels.

A. 4. The legislature has the power pursuant to Adams supra to amend the lottery act. Therefore, they may change, by legislative action, the apportionment of lottery revenues from its current structure to some other formula.

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[1] According to the secretary of state's office, the number of qualified electors for the November 4, 1980 general election was 1,121,169, and only 412,992 persons voted in favor of the act, which is less than a majority of the qualified electorate.

FACT SITUATION B:

A.R.S. section 5-504 provides in part that:

A. The commission shall meet with the director not less than once each quarter to make recommendations and set policy, approve or reject reports of the director and transact other business properly brought before the commission.

B. The commission shall establish and operate a state lottery at the earliest feasible and practical time. The commission shall establish and operate the lottery to produce the maximum amount of revenue consonant with the dignity of the state. To achieve these ends, the commission shall authorize the director to promulgate rules in accordance with title 41, chapter 6, article 1.

Currently, budget and staffing levels are established by the director and his assistants. They are presented to the commission for the commissioners' information, but the commissioners do not exercise either approval or disapproval authority over either the budget or staffing levels.

QUESTION PRESENTED:

What authority does the commission have over the operations of the Arizona state lottery? Specifically, does the commission have authority over the operating budget and the establishment of staffing levels?

ANSWER:

See discussion.

DISCUSSION:

It is not clear from the language of the lottery act whether the commission has authority over the operating budget and the establishment of staffing levels.

A.R.S. section 5-504 gives the commission the power to operate the lottery, to make recommendations and set policy of the lottery and to approve or reject reports of the director. In addition, the director must report to the commission on a regular basis. The director may only promulgate rules for lottery operation with authorization from the commission.

The commission is responsible for apportioning annual revenues, unless it authorizes the director to do so. A.R.S. section 5-505.

It appears that although the director was given day-to-day control over the operation of the state lottery the act intended the commission to exercise general and overall control over its operation. Additionally, the commission has the power to approve or disapprove the director's actions. This seems to give the commission the authority over the operating budget and staffing levels.

FACT SITUATION C:

The lottery act was enacted by initiative petition approved at the November 4, 1980 election. The lottery commission and related statutes are scheduled for termination under the sunset law on July 1, 1988 and January 1, 1989, respectively, unless continued.

QUESTIONS PRESENTED:

C. 1. Since the lottery was enacted by voter initiative, does the legislature have the authority to sunset the Arizona state lottery?

C. 2. Since the lottery was enacted by voter initiative, does the legislature have the authority to rearrange the structure and authority of the commission?

C. 3. What would the legislature need to do to gain such authority?

ANSWERS:

C. 1. Yes.

C. 2. Yes.

C. 3. See discussion.

DISCUSSION:

C. 1., C. 2. The discussion in the first fact situation with respect to the Adams case applies to this fact situation as well. Since the initiative did not receive a majority of the vote of the qualified electors, the legislature may amend the lottery act. Additionally, A.R.S. section 41-2351 gives the legislature the authority to sunset any state agency. "Agency" is defined in A.R.S. section 41-2352 to include any commission.

Therefore, the legislature has the authority to sunset the Arizona state lottery. Additionally, through legislative action, the legislature has the authority to rearrange the structure and authority of the lottery commission.

FACT SITUATION D:

A.R.S. section 41-2501, pertaining to the applicability of the state procurement code, states in subsection F that:

The Arizona state lottery commission is exempt from the provisions of this chapter for procurement relating to the design and operation of the lottery or purchase of lottery equipment, tickets and related materials. The executive director of the Arizona state lottery commission shall promulgate rules substantially equivalent to the policies and procedures in this chapter for procurement relating to the design and operation of the lottery or purchase of lottery equipment, tickets or related materials. All other procurement shall be as prescribed by this chapter.

Currently, the lottery make some purchases under the procurement code, but handles its own contracting for instant game tickets, on-line game services, advertising services, and electronic data processing consulting. Advertising services have included contracts worth

several million dollars with advertising firms, a subcontract with an advertising consultant for approximately one hundred ninety thousand dollars and a marketing research subcontract for approximately two hundred thirty thousand dollars. The electronic data processing contracts have amounted to approximately 1.5 million dollars over the last four years.

QUESTIONS PRESENTED:

D. 1. What is the extent of this exemption? More specifically, can this exemption be construed to mean that all procurements made by the lottery are exempt from the state procurement code?

D. 2. Is the lottery exempt from the state procurement code for procurement of:

(a) Outside data processing consultants with contracts worth more than ten thousand dollars?

(b) Marketing research consultants with contracts worth more than ten thousand dollars?

D. 3. Does the legislature have the authority to rescind this exemption? If not, what must the legislature do in order to gain such authority?

ANSWERS:

D. 1. See discussion.

D. 2. (a) See discussion.

(b) See discussion.

D. 3. Yes.

DISCUSSION:

D. 1., D. 2. According to A.R.S. section 41-2501, subsection F, the lottery commission is exempt from the provisions of the procurement code for "procurement relating to the design and operation of the lottery or purchase of lottery equipment, tickets and related materials." The somewhat broad term "design and operation" is not defined in the lottery act. Therefore, the extent of the commission's exemption is unclear. However, the director of the state lottery is given the authority, in A.R.S. section 41-2501, to promulgate rules for its procurement policies and procedures. Therefore, until the legislature takes action to clarify the lottery's exemption, it must be left to the director and commission to determine the extent of its exemption, based on the statutory language, with respect to the procurement code for data processing consultants and marketing research consultants.

D. 3. If the legislature wished to rescind or modify the lottery's exemption to the procurement code, it would simply need to take legislative action.

CONCLUSION:

Since the people intended annual lottery fund revenues to be a continuing appropriation, the legislature has no authority to appropriate these monies. If they wanted to acquire this authority, however, the legislature could take action in that regard.

The lottery director currently has the authority to establish staffing levels of the lottery. The legislature could acquire the authority through legislative action.

The legislature may amend any statute relating to the lottery act including changing the apportionment formulas, rearranging the structure and authority of the lottery commission and clarifying or rescinding the lottery's exemption from the procurement code.

The lottery commission currently has authority over the operating budget and staffing levels of the lottery. This could also be clarified or amended through legislative action.

ARIZONA LEGISLATIVE COUNCIL

MEMO

November 26, 1986

TO: Douglas R. Norton, Auditor General

FROM: Arizona Legislative Council

RE: Request for Research and Statutory Intrepretation (0-86-8)

This memo is sent in response to a request made on your behalf by William Thomson in a memo dated November 14, 1986.

FACT SITUATION:

Arizona Revised Statutes (A.R.S.) section 5-510 empowers the state lottery commission to create a security and licensing division under the supervision of an assistant director appointed by the lottery director. A.R.S. section 5-510, subsection C establishes the security and licensing division as a law enforcement agency and designates the director of the division as a peace officer. Further, that subsection limits the law enforcement agency and peace officer status to "receiving investigative information from law enforcement agencies pertaining to investigations of lottery activities."

A.R.S. section 5-511 empowers and requires the director of the department of public safety (DPS) to investigate "any violation of a statute of this state which pertains to the conduct of the state lottery."

Currently, the security and licensing division of the state lottery commission maintains a staff of investigators who conduct investigations of lottery violations. Examples of such investigations include theft of tickets from retailers, forgery or alteration of tickets (to create winners) and sales of tickets by retailers to minors. In calendar year 1985, the lottery commission conducted 172 investigations of this nature. Many investigations are prepared for criminal prosecution.

QUESTIONS PRESENTED:

1. Does the state lottery have statutory authority to conduct investigations of lottery violations? What difference, if any, exists between the lottery's statutory authority to conduct investigations for criminal prosecution and administrative actions, i.e., license revocation?

2. Is DPS given sole authority and responsibility for conducting investigations of lottery violations? Does this authority include investigations for both criminal prosecution and administrative actions?

3. Do investigators in the security and licensing division have statutorily granted peace officer status? Can the peace officer status granted

to the director of the division be delegated to the investigators and, if so, is that status limited by the provisions of A.R.S. section 5-510, subsection C? If the investigators have peace officer status, should they be certified by the Arizona Law Enforcement Officer Advisory Council (ALEOAC)?

4. Do lottery investigators have statutory authority to carry concealed firearms when acting in their official capacity? If not, what official status is necessary for lottery investigators to carry concealed firearms?

ANSWERS:

See discussion.

DISCUSSION:

1. An examination of A.R.S. sections 5-501 through 5-525 relating to the state lottery indicates that a distinction exists between statutory duties relating to the administrative investigation authority of the executive director of the lottery and his assistant director of security and licensing and the lottery criminal investigative authority of the director of DPS. The statutes appear to limit the lottery director and his assistant to investigation of matters relating to licensing of agents to sell tickets or shares and checking the backgrounds of prospective employees. (A.R.S. section 5-504, subsection B, paragraph 11; section 5-506, paragraphs 2, 3 and 8; section 5-510; section 5-512.) The investigative authority of DPS pertains to violations of statutes relating to "the conduct of the state lottery." (A.R.S. section 5-511. Emphasis added.)

The security and licensing division of the lottery is designated as a law enforcement agency but "for the limited purpose of receiving investigative information from law enforcement agencies pertaining to investigations of lottery activities." (A.R.S. section 5-510, subsection C.) If the "activities" were meant to include investigation of criminal activities, the division would not have been limited only to receipt of information. This information is important, however, for use in background and ongoing checks of ticket sales licensees. A.R.S. section 5-512, subsection A requires the lottery director to "consider factors such as the financial responsibility and security of the person and the nature of his business activity" before issuing a sales license.

If the statutes had intended to convey general criminal investigative authority to the lottery security and licensing division, there would be no reason to give the identical authority to DPS in A.R.S. section 5-511. This limited nature of the use of criminal information in licensing investigations is further emphasized in Executive Order No. 81-2 which authorizes "the Criminal Identification Section of the Department of Public Safety to provide, and the Arizona State Lottery to receive, criminal history record information for purposes of employment and licensing in accordance with rules and regulations issued by the Department of Public Safety." (Emphasis added.)

2. Sole authority for investigations into any violation of a statute pertaining to the conduct of the lottery is given to DPS in A.R.S. section 5-511.

This language is broad enough to include investigations of violations of both criminal provisions and administrative provisions of A.R.S. title 5, chapter 5.

3. Investigators in the security and licensing division of the state lottery do not have statutorily granted peace officer status. A.R.S. section 5-510, subsection C provides in pertinent part:

> The security and licensing division shall be a law enforcement agency and the director of security and licensing is designated a peace officer.

Only the division director has peace officer status. In a closely similar situation, the director of the former Arizona criminal intelligence system agency (ACISA) asked for an opinion from the attorney general on whether he had the authority to grant peace officer status to his intelligence-gathering personnel. The following response was received from the attorney general:

> In Ariz. Atty. Gen. Op. I80-169, we said that peace officer status is conferred by a statute which either directly designates persons as peace officers or authorizes an agency to commission officers. A copy of that opinion is attached for your reference. A.R.S. section 41-2152 provides that "/a/gency personnel shall engage in gathering intelligence information and shall not otherwise engage in law enforcement activities." This provision by its terms, permits agents of ACISA to engage in specified activities but does not designate them as peace officers. The ACISA Board's powers and duties, set forth in A.R.S. section 41-2154, do not establish the Board as a commissioning agency. We therefore conclude that ACISA agents may not be "commissioned" peace officers.
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> 82 Op. Att'y Gen. 007 (1982).

H. Similarly, A.R.S. section 5-510 does not designate employees of the lottery security and licensing division as peace officers and their law enforcement function is limited to receiving investigative information. Because no statute grants these employees peace officer status, the director of the division has no authority to delegate the status and the employees may not carry concealed weapons pursuant to A.R.S. section 13-3102. The official status of peace officer is necessary for carrying a concealed weapon.

CONCLUSION:

The state lottery does not have statutory authority to conduct investigations of lottery violations but is limited to licensing and employment investigations. DPS has authority to conduct investigations of violations of all state lottery statutes. Investigators of the security and licensing division of the state lottery do not have peace officer status, cannot be granted peace officer status by the division director and do not have the authority to carry concealed weapons.

cc: William Thomson, Director
Performance Audit Division