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2/16/87
Date

MINUTES OF THE SENATE COMMITTEE ON FEDERAL AND STATE AFFAIRS

The meeting was called to order by Senator Edward F. Reilly, Jr. at
Chairperson

11:00 a.m./p.m. on February 12, 1987 in room 254-E of the Capitol.

All members were present. ~~except~~

Committee staff present:

Mary Galligan, Legislative Research
June Windscheffel, Committee Secretary

Conferees appearing before the committee:

Mr. Harley Duncan, Secretary, Department of Revenue and Taxation.

The Chairman asked the Committee to turn its attention to HB 2043, concerning establishing a state lottery. He stated that Secretary Harley Duncan was present to go through the bill with the Committee. A copy of Mr. Duncan's Memorandum dated January 14, 1987, concerning House Bill No. 2043 - Lottery Enabling Legislation (Attachment #1) was also before the Committee to assist in the presentation.

Secretary Duncan explained the bill and answered questions from Members. He introduced Mr. Dan E. Walstrom, the Lottery Coordinator for the Department, who was also present to assist in any questions.

There was discussion among the Committee, and questions were answered by the conferees.

The Chairman thanked the Secretary for appearing. He stated there are a number of persons who have asked to appear tomorrow and there will be some proposed amendments.

With regard to the proposals of the Liquor Law Review Commission, the Chairman has asked staff to prepare information for Monday and Tuesday for the Committee's benefit to know what other changes it wants to introduce concerning recommendations by the Liquor Law Review Commission.

The meeting was adjourned at noon.

2-12-87

Kansas Department of Revenue
State Lottery Overview
January 14, 1987

INTRODUCTION

Kansas was one of six states which considered the issue of whether to adopt a state operated lottery during the last general election. Initiatives were approved in Florida (64-36), Idaho (60-40), Montana (69-31), South Dakota (60-40), and Kansas (64-36) with North Dakota (56-44) being the only state to defeat the issue. These states join 22 existing lottery states, plus the District of Columbia, in what was a \$10.16 billion dollar business in calendar year 1985.

This presentation updates the paper presented during the last legislative session and covers the areas of game design, start-up, allocation of lottery revenue, functions a state agency must perform, estimated state revenue, and enabling legislation.

GAME DESIGN

Lottery games can be divided into two categories, active and passive. Active games are those in which the player participates in the bet by choosing a number or set of numbers. Passive games are those in which the player takes no action to determine whether he has won or lost; instead a ticket is purchased and the outcome is then revealed.

There are currently several types of lottery products being played. The first is what is commonly referred to as the weekly game or draw lottery. Though rare in the United States, this is the game which was used when the modern lottery first started in 1964 in New Hampshire and remains the main game in overseas lotteries. Similar to a raffle ticket in appearance and in play, the player purchases a pre-numbered ticket and waits for a weekly drawing.

The second type of lottery product is the instant lottery ticket. The instant ticket has play data which is concealed by a removable latex material. A player buys the ticket, usually for \$1, and scrapes off the material to reveal whether or not it is a winner. As an example, a game may have a match three theme; match three dollar figures and you win that amount as a prize.

In addition, states have introduced jackpot prize drawings which use the instant ticket as a method to gain entry. Players are entered in a weekly drawing and if selected can participate in a televised event to "spin the wheel" for prizes such as \$5,000, \$10,000, \$25,000, or a jackpot which increases each week if not won.

The third type lottery product involves an on-line system. This was introduced in the mid-1970s. The on-line system is a series of computer terminals which are similar to cash registers in appearance and are geographically located throughout a state. The terminals are linked to a central computer site, usually in the state capital. There are currently three on-line games. The first on-line game to be introduced was the three-digit game, commonly referred to as the numbers game. Numbers games were originally designed to compete directly with Eastern illegal numbers games. A player approaches the agent who has a terminal and selects three digits. The agent enters those three digits at the terminal and the play is recorded at the central site. Every day there is a random drawing of a number and matching that number in prescribed ways wins prescribed prizes. The second game is the pick four or four-digit game, which is basically run the same way as pick three.

The third on-line game is the increasingly popular lotto game. A player picks six numbers out of a specified field of numbers, such as 36, 40, or 44. A certain percentage of the revenues is placed in a grand prize fund which is only paid when an exact match of the six digit numbers is made. Drawings of the winning numbers are held once or twice a week and if there is no winner, the jackpot "rolls over" to the next drawing. If no one wins for several weeks, the jackpot can become enormous, as evidenced by New York's \$41 million lotto jackpot. Most lotto games also include lesser prizes for matching four or five out of six numbers, for instance.

START-UP

Without exception, new lottery states have started with instant games. State lottery directors testify that to ensure successful start-up, instant games have proven to be the most efficient direction to take. With the timely passage of the enabling legislation and the seed money appropriation, plans call for instant game tickets to go on sale in September 1987 and the introduction of an on-line game six to eight months later.

A seed money or start-up appropriation is needed to allow the lottery to make payments for goods and services rendered before it generates its own cash flow. The funding is necessary primarily for salaries, consultant services, facility leases, office equipment, and computer hardware and software as well as capitalizing an initial prize pool. The lottery should be able

to negotiate a schedule of deferred payments to the successful instant game vendor to minimize the required funding. State General Fund appropriations will be needed in both FY 1987 and FY 1988 with prompt payback once lottery revenues are received.

Total required seed money will be between \$2.5 and \$3 million.

ALLOCATION OF LOTTERY REVENUE

Lottery gross sales are divided into three expenditure categories: prize payments, net proceeds, and operating expenses. Operating expenses include commissions to retailers (usually 5-6%), and actual administrative costs such as ticket production, consulting services from private lottery firms, advertising, computer services, salaries, and other support services. These costs will vary with size of the state and maturity of the lottery, but commonly run 10 to 15% in addition to the retailer commissions. After deducting operating costs, and prize payouts (45-50%), the remaining portion (30-40%) represents the net proceeds to the state.

In reviewing the administrative cost proportions of the lottery states, administrative expenses of the smaller states are well above the national average, and the costs of the larger states fall well below the average. There appears to be evidence of economies of scale, especially in advertising and computer expenses. Therefore, it is inappropriate to take at face value, the administrative costs of a large, mature lottery such as New Jersey and New York and compare that to a new lottery state.

FY 1985				
Total Sales (\$ Millions)	State(Population)	Prizes % Sales	Net Rev % Sales	Expenses % Sales
0 - 199	Vermont(.5)	49.6	23.7	26.7
	New Hampshire(.95)	42.3	31.5	26.2
	Maine(1.1)	52.6	25.8	21.6
	Delaware(.6)	49.7	39.0	11.3
	Oregon(2.6)	50.6	34.1	15.3
	Rhode Island(.96)	47.5	35.7	16.8
	Arizona(2.9)	46.7	30.2	23.1
	Colorado(3.0)	46.8	33.2	20.0
	Washington D.C.(.63)	47.9	34.8	17.3
	Washington State(4.2)	47.6	34.7	17.7
200 - 399	Connecticut(3.2)	46.8	43.2	10.0
400 - 599	-	-	-	-
600 - 799	Maryland(4.3)	53.6	38.7	7.7

800 - 999	Ohio(10.8)	49.1	39.6	11.3
	Michigan(9.1)	47.5	40.6	11.9
	New Jersey(7.4)	48.5	42.3	9.2
	Massachusetts(5.8)	55.1	34.7	10.2
1000 & Over	Illinois(11.4)	48.4	43.0	8.6
	New York(17.7)	47.5	41.8	10.7
	Pennsylvania(11.9)	46.7	44.2	9.1

In FY 1985, in the ten lotteries with less than \$200 million in gross sales, net proceeds amounted to less than 35% in six cases and less than 30% in two other. Only Delaware which began a lottery in 1975 and Rhode Island which started games in 1974 approached the 40% mark.

FUNCTIONS A STATE AGENCY MUST PERFORM

State lotteries are operated in generally the same way with the day-to-day administration of three major organizational divisions resting with a Lottery Director appointed by the Governor. The attached organization chart reflects a staffing proposal for 119 positions. This is consistent with the staff size in Iowa (131) and Missouri (210).

Security will be responsible for employee background checks and facility security; ticket security and procedures for receiving, handling, distributing and storing tickets; game security and monitoring access to computer software and hardware; retailer and vendor background investigations; and breach of security issues and investigation of invalid claims because of ticket tampering.

Administration will be in charge of all accounting systems, ticket accounting and validation systems, payment of prizes, procurement and contract services, facilities management, personnel, data processing, and network telecommunications.

Marketing will have primary responsibility for the design, distribution, promotion, and sale of all lottery products. This will include the management of a comprehensive retail sales network, regional offices, and lottery sales representatives.

ESTIMATED STATE REVENUE

Projecting revenues from a state lottery is precarious and difficult because there are so many unknowns and no objective data upon which to base calculations. Factors that influence the estimate include economies of scale, population distribution, population mobility, types and number of games played, operating expenses, public education and acceptance, and interstate competition.

Nonetheless, we have estimated that a lottery could generate roughly \$30 to \$35 million in net revenues annually. This is based primarily on experience in Colorado and estimates in Iowa and should be considered to reflect primarily the operation of an instant game. Essentially they equate to \$40 to \$50 per capita purchases annually with a net take of 30 to 35%.

The operation of an on-line game and some maturity in the lottery could increase the gross revenues and reduce the operating costs, thus increasing the projected revenues. One should be extremely cautious, however, for several reasons:

1. Until recently, lotteries tended to be concentrated in more populous urban, and/or Eastern states.
2. We will be competing with another state having twice our population for our largest market. This may significantly affect our ability to sell both instant and on-line tickets in Johnson and Wyandotte counties.
3. Since Kansas is grappling with a series of long-term serious economic problems, the projected per capita sales may not develop.

ENABLING LEGISLATION

A lottery is a unique entity in state government, in that it is the only state agency with a mission identical to a private business - selling a product in a fashion which maximizes revenue. In drafting the enabling legislation, three key ideas were consistently addressed: flexibility, integrity, and security. Fortunately, we can learn from the mistakes made by established lottery states.