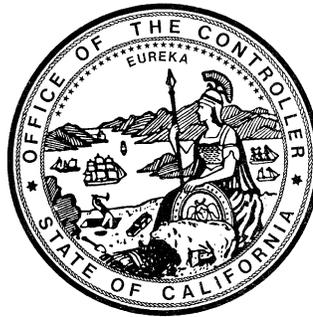


CALIFORNIA LOTTERY

Audit Report

Procurement and Contract Processes

July 1, 2010, through June 30, 2013



BETTY T. YEE
California State Controller

May 2016



BETTY T. YEE
California State Controller

May 23, 2016

California Lottery Commission
700 North Tenth Street
Sacramento, CA 95811
ATTN: Nathaniel Kirtman III, Chair

Dear Commissioners:

The State Controller's Office audited the California Lottery's (Lottery) procurement and contract processes for the period of July 1, 2010, through June 30, 2013. The purpose of the audit was to determine whether the Lottery is maintaining effective systems of internal control over its procurement and contract processes.

Based on our audit, we noted the following deficiencies:

- The Lottery has inadequate bid opening procedures. There was only one Lottery staff member at the initial bid opening; the bid opener did not log the bid package documents as the packages were being opened; and the Lottery allowed bidders to resubmit and/or correct mandatory bid package submittals.
- The Lottery does not have contract amendment limitations regarding monetary and duration-of-time increases.

On October 9, 2015, Paula D. LaBrie, Chief Deputy Director, responded to the draft report on behalf of the Lottery. The response is included as an attachment to the report.

If you have any questions, please contact Andrew Finlayson, Chief, State Agency Audit Bureau, by phone at (916) 324-6310 or by email at afinlayson@sco.ca.gov.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

JVB/as

Attachment

cc: Gregory Ahern, Vice Chair
California Lottery Commission
Rowena Libang-Bobila, Commissioner
California Lottery Commission
Connie M. Perez, Commissioner
California Lottery Commission
John Smolin, Commissioner
California Lottery Commission
Hugo López, Director
California Lottery
Paula D. LaBrie, Chief Deputy Director
California Lottery
Nicole Soluri, Chief Counsel, Executive Division
California Lottery
Terry Murphy, Deputy Director, Operations Division
California Lottery
Michelle Tong, Assistant Deputy Director, Sales and Marketing Division
California Lottery
Roberto Zavala, Deputy Director, Internal Audits
California Lottery

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Audit Report

Summary

We audited the California Lottery's (Lottery) procurement and contract processes for the period of July 1, 2010, through June 30, 2013. The purpose of the audit was to determine whether the Lottery is maintaining effective systems of internal control over its procurement and contract processes.

Based on our audit, we noted the following deficiencies:

- The Lottery has inadequate bid opening procedures. There was only one Lottery staff member at the initial bid opening; the bid opener did not log the bid package documents as the packages were being opened; and the Lottery allowed bidders to resubmit and/or correct mandatory bid package submittals.
- The Lottery does not have contract amendment limitations regarding monetary and duration-of-time increases.

Audit Authority

Government Code section 12410 states, "The Controller shall superintend the fiscal concerns of the state. The Controller shall audit all claims against the state, and may audit the disbursement of any state money, for correctness, legality, and for sufficient provision of law for payment." In addition, Government Code section 12411 stipulates that "... the Controller shall suggest plans for the improvement and management of revenues."

Pursuant to Government Code section 8880.46.6, the SCO may conduct special post-audits of the Lottery, as the State Controller deems necessary. The Controller or his/her agents conducting an audit under this chapter shall have access and authority to examine any and all records of the California Lottery Commission.

Background

Proposition 37, the California State Lottery Act of 1984 (Lottery Act), amended the California Constitution to authorize the establishment of a statewide lottery, to create the California Lottery Commission, and to give the commission broad powers to oversee the operation of a statewide lottery.

Contract Development Services of the Legal Services and Contracts Unit of the Lottery's Executive Division is responsible for overseeing all procurement and contract functions. Each contract is assigned a contract manager and a contract administrator. Contract managers are responsible for initiating contracts, monitoring contractors' performance, and serving as a liaison between the Lottery and contractors.

Contract Administration Services of the Lottery's Operations Division provides contract administration guidance and assistance to all contract managers in the pre- and post-award phases to help ensure that Lottery contracts incorporate adequate administration controls.

As of February 2015, the Lottery has about \$2 billion in active contracts.

Objectives, Scope, and Methodology

The audit period was July 1, 2010, through June 30, 2013. The purpose of the audit was to determine whether the Lottery is maintaining effective systems of internal controls over its procurement and contract processes

The objectives of the audit were to determine whether the Lottery:

- Maintains adequate internal controls over its procurement and contracts processes to safeguard the state against theft, abuse, or losses; and
- Abides by applicable laws, rules, regulations, policies, and procedures in regards to processes over procurement and contracts.

Audit procedures included the following:

- Reviewing the California State Lottery Act of 1984, the California Government Code, the State Administrative Manual, and the Lottery's internal policies and procedures over procurement and contracts processes;
- Reviewing prior work performed by the SCO and the Lottery's Internal Audits Unit;
- Interviewing and observing Lottery staff involved in the Lottery's procurement and contract processes and other related Lottery activities and operations;
- Analyzing and evaluating policies, procedures, and compliance with laws, rules, and regulations as they related to procurement functions; and
- Performing tests to determine if control objectives are properly achieved.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Conclusion

Based on our audit, we noted the following deficiencies:

- The Lottery has inadequate bid opening procedures. There was only one Lottery staff member at the initial bid opening; the bid opener did not log the bid package documents as the packages were being opened; and the Lottery solicited and allowed bidders to resubmit and/or correct mandatory bid package submittals.
- The Lottery does not have contract amendment limitations regarding monetary and duration-of-time increases.

These findings are detailed in the Findings and Recommendations section of the report.

**Views of
Responsible
Officials**

On October 9, 2015, Paula D. LaBrie, Chief Deputy Director responded to the draft report on behalf of the Lottery. The response is included as an attachment to this report.

Restricted Use

This report is intended for the information and use of the California Lottery, the California Lottery Commission, and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of the final report, which is a matter of public record.

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

May 23, 2016

Findings and Recommendations

FINDING 1— Inadequate bid opening procedures

At one of the Lottery's bid openings, we noted the following internal control weaknesses relating to the process:

- There was only one Lottery staff member at the initial bid opening;
- The bid opener did not log the bid package documents as the packages were being opened; and
- The Lottery allowed bidders to resubmit and/or correct mandatory submittals.

California Public Contract Code (PCC) section 10341 states:

Bids shall be publicly opened at the time stated in the invitation for bids, and the dollar amount of each bid shall be read. No bids shall be considered which have not been received at the place, and prior to the closing time for bids, stated in the invitation for bids.

The Lottery contends that it is not required to follow the procurement policies set forth by the Department of General Services (DGS) or the PCC and that it has the ability to create its own procurement procedures. In order to uphold good internal controls and demonstrate sufficient transparency in the competitive bidding process, the SCO believes that the Lottery should adopt procurement practices that are in line with the PCC and DGS by conducting bid openings that are open to the public. At the very least, the Lottery should adopt practices that require more than just a single person be present at each bid opening to observe the proceedings.

In addition, bid package contents should be logged immediately after packages are opened. By documenting what is received, this reduces the risk of disputes or confusion as to what each bidder has submitted.

In order to uphold fairness in the process, the Lottery should also prohibit bidders from submitting, resubmitting, or correcting mandatory information and documents past the submission deadline. Contract awards should only be considered for responsible bidders with complete bid packages that contain all of the required information and documents.

Holding public bid openings, recording contents of bid packages upon their opening, and disallowing further information and documents to be provided past bid submission deadlines will help ensure that the Lottery upholds fair and transparent bid openings.

Recommendation

In order to strengthen controls and promote a competitive, fair, and transparent bid opening environment, the Lottery should adopt policies that are in line with PCC and DGS by conducting public bid openings or, at the very least, require that openings be witnessed by one or more people. In addition, bid package contents should be recorded immediately after opening, and the Lottery should not accept the submission of late or missing required bid documents.

Lottery Response

The Lottery is exempt from the provisions of the PCC and is not subject to the DGS's oversight. However, the Lottery agrees with certain aspects of this finding and recommendation and will review current practices in light of this finding.

See attachment for the Lottery's full response.

SCO Comment

The Lottery indicated that it will implement corrective actions and evaluate its current practice to strengthen the bid opening process.

We concur with the Lottery that it is not required to follow the PCC or the procurement policies set forth by the DGS. However, it should develop policies and procedures that are in line with the PCC and the DGS's policies in order to strengthen controls and promote a competitive, fair, and transparent bid opening environment.

FINDING 2— Lack of contract amendment limitations

We noted that the following contracts significantly increased in dollar amounts and terms as a result of amendments to their initial contract amounts and terms:

- A four-year contract (July 2005 – June 2009) for \$33 million increased to \$73 million and was extended for additional four years and four months (July 2009 – October 2013)
- A four-year contract (June 2005 – May 2009) for \$28 million increased to \$46 million and was extended for additional two years and seven months (June 2009 – December 2011)
- A four-year contract (July 2005 – June 2009) for \$4 million increased to \$40 million and was extended for additional four years and four months (July 2009 – October 2013)
- A four-year contract (July 2005 – June 2009) for \$2 million increased to \$12 million and was extended for additional four years and four months (July 2009 – October 2013)

These increases in amounts and terms indicate major deviations from the intentions of the original contracts in which new, competitively bid contracts should have been established.

The Lottery's Contract Manager's Handbook, Chapter 7 states, in part, that "Changes which would dramatically alter the objective or scope of the original contract or the monetary size or duration of the contract must be accomplished by a new contract using the Lottery's Competitive Bidding Procedures." The Lottery should adhere to its contracting policies. Furthermore, the Lottery should enrich Contract Manager Handbook policies by establishing specific amendment limitations in terms of monetary and duration of contract increases.

The State Contracting Manual (SCM) Section 3.09 states, in part:

Contracts awarded on the basis of a law requiring competitive bidding may be modified or amended only if the contract so provides or if so authorized by the law requiring competitive bidding. Contract language authorizing an amendment must be specific (such as an express option year at the same rates and terms), not generic (such as merely stating generally that the parties can amend).

In addition, SCM Section 5.81 states, in part:

The amendment does one, but not both, of the following, and there is no change in the scope of work: i) Adds time only to complete performance, not to exceed one year. Note: “time only” means time to complete performance of the original agreement, such as extending the due date for a final report on a fixed-fee agreement. An amendment that provides for additional as-needed services (such as extended use of hourly fee or pay-per-service type arrangements) is not “time only” within the meaning of this exemption; or ii) The amendment adds not more than 30% (not to exceed \$250,000) of the original contract. Note: this increase must be supported by specific business reason, such as in a unit rate contracts (e.g. per test, per sample, etc.) usage was higher than the original good-faith estimates/multipliers used in the solicitation. This permits flexibility when exceptional unanticipated circumstances warrant; but it should not be used in circumstances such as paying a contractor more on a fixed fee bid, and should not be standard operating procedure.

The Lottery contends that it is not required to follow the SCM or any other procurement policies promulgated by the DGS as all other California state agencies are mandated to. However, in order to uphold fairness and sufficient competition in regards to its contracts, we believe that the Lottery should update the Contract Manager Handbook and institute procurement practices that are in line with DGS by establishing amendment limits on dollar amount and time increases.

Recommendation

In order to promote fair and competitive contracting practices, the Lottery should establish and adhere to policies that limit dollar amount and time increases of contract amendments.

Lottery Response

The Lottery respectfully disagrees with the finding and recommendation, because the Lottery’s current practices promote fair and competitive contracting practices.

See attachment for the Lottery’s full response.

SCO Comment

We included, for clarity, additional description of the contracts that significantly increased in amounts and terms. Although these procurements serve unique purposes, such as Scratchers games, with a limited number of available vendors, the Lottery should establish and adhere to policies that limit dollar amounts and time increases of contract amendments in order to promote fair and competitive contracting practices.

Also, the Lottery stated that when considering whether to exercise its right to extend the contacts, it determined that it would do so in one contract because the pricing was very favorable. It also invited two other contractors to present a pricing model that would fix printing costs and guarantee a reduction in those costs in exchange for a contract extension. While these actions may have reduced costs, we believe that without competitive bidding, the Lottery cannot ensure that it is receiving the best value for its contracting dollar.

**Attachment—
California Lottery’s
Response to Draft Report**

700 North Tenth Street
Sacramento, CA 95811
calottery.com



October 9, 2015

Mr. Andrew Finlayson, Chief
State Agency Audits Bureau
State Controller's Office
Division of Audits
P.O. Box 942850
Sacramento, CA 94250-5874

RE: Procurement and Contracts Processes Audit

Dear Mr. Finlayson,

The California Lottery (Lottery) offers the following comments regarding the recently concluded audit of the Lottery's Procurement and Contracts Processes for the period July 1, 2010, through June 30, 2013. As stated in the audit report dated September 15, 2015, the purpose of the audit was to determine whether the Lottery is maintaining effective systems of internal controls over its procurement and contract processes.

We thank you for the opportunity to respond to the draft audit report. We are pleased that the audit did not identify significant internal control issues; however, the audit did identify opportunities to improve the current practices in the procurement and contract process.

Finding 1

Inadequate bid opening procedures and acceptance of clarifying information

Recommendation

"In order to strengthen controls and promote a competitive, fair, and transparent bid opening environment, we recommend that the Lottery adopt policies that are in line with PCC and DGS by conducting public bid openings, or at the very least, require that they be witnessed by one or more people. In addition, bid package contents should be recorded immediately after opening, and the Lottery should not accept the submission of late or missing required bid documents."

Response

The Lottery agrees with certain aspects of this finding and recommendation and will review current practices in light of this finding.

The Lottery is exempt from the provisions of the Public Contract Code and is not subject to Department of General Services' oversight. The Lottery Act places responsibility for competitive bidding with the Lottery Commission and the Commission has adopted procedures pursuant to regulations. The Lottery has developed practices around competitive bidding with a commitment to obtaining the best bargain for the Lottery by establishing an open and fair bid process. While there has never been an irregularity or complaint concerning its bid openings, the Lottery is receptive to suggestions that might strengthen its process. For this reason, the Lottery will implement the practice of requiring the attendance of at least two persons at bid openings and immediately inventorying bid documents at the bid opening.

With respect to the third recommendation, the Lottery will evaluate its bid documents to identify changes that might reduce the incidence of bidder confusion or clerical error. It will also evaluate its practice of allowing bidders to clarify aspects of bids to ensure that it does not undermine the fairness of the bid process.

Finding 2

Lack of contract amendment limitations

Recommendation

In order to promote fair and competitive contracting practices, the Lottery should establish and adhere to policies that limit dollar amount and time increases of contract amendments.

Response

The Lottery respectfully disagrees with the finding and recommendation, because the Lottery's current practices promote fair and competitive contracting practices.

The finding identifies four contracts with respect to which expenditure authority increased significantly. The SCO concludes that these increases "indicate major deviations from the intentions of the original contracts in which new, competitively bid contracts should have been established and not circumvented."

The Lottery understands and shares the SCO's concern that competitive bid requirements not be circumvented by (1) material changes in scope that could result in would-be bidders being effectively cut out of the competition, or (2) extensions of time not anticipated by the terms of the original contract and infusions of funds that eliminate competition in favor of an incumbent. It would also be a concern if the Lottery were not obtaining the best product at the best price because it used contract amendments where it should have gone out to bid. However, for the reasons set forth below, the Lottery respectfully disagrees with the SCO's findings regarding the four

contracts in question, i.e., that significant increases in dollar amounts over the life of the contracts necessarily evidences a circumvention of competitive bidding and that the Lottery failed to adhere to its Contract Manager's Handbook.

Scratchers Contracts

A key component of the Lottery's product line is its instant games, known as Scratchers®. Since 2007, there are only three manufacturers of Scratchers games: Scientific Games International Inc. (SGI), Pollard Banknote Ltd. (Pollard) and GTECH Printing Corporation (GTECH). All lotteries in North America rely on these three companies to provide them with their instant games. Best practice and the current trend is to contract with all three ticket vendors at the same time. This ensures capacity, reduces cost by encouraging competition and allows lotteries to fully leverage the proprietary printing technologies and game features offered by individual vendors.

Scratchers contracts are unique in that they are intended to ensure a continuous supply of tickets as required to meet the Lottery's needs for the duration of the contract. This broad scope has no limits on the number of tickets produced by the vendors or purchased by the Lottery. If demand for Scratchers tickets increases by tens of millions of tickets due to marketing efforts, an economic boom, a change in the law (e.g., AB 142 which resulted in a dramatic increase in sales of more expensive-to-produce, higher pay-out tickets) or other factors, the Scratchers vendors must keep pace with demand and the Lottery must pay for the additional tickets. In this environment, the expenditure authority established at the outset of the contract term is based on an educated guess as to the Lottery's future needs. The Lottery and the bidders knew all of this when the contract was competitively bid in 2005 and the bidders took all of this into account in preparing their bids. As it was never intended that the expenditure authority be a cap on spending under the contracts, significant increases in expenditure authority do not indicate major deviations from the intentions of the original contract.

Further, it should be noted that substantial increases in expenditure authority were occasioned by the Lottery's exercise of its option to extend each of the Scratchers contracts for four additional years on the same terms. This unilateral right to extend was a term of the original, competitively bid contracts so bidders were aware of it when they bid. Consequently, extension of the contract term does not indicate a major deviation from the intentions of the original contract. Of course, additional expenditure authority was needed to cover the additional four years. It would not have been reasonable to include this authority in the original contract because, at that time, it could not have been known whether the option would be exercised.

When considering whether to exercise its right to extend the contracts on the same terms, the Lottery determined that it would do so in the case of the SGI contract because, among other things, the pricing was very favorable. With respect to the

Pollard and GTECH contracts, the Lottery was not satisfied with potential volatility of pricing that characterized ticket-by-ticket bidding and leveraged its option by inviting the contractors to present a cost per thousand pricing model that would fix printing costs and guarantee a reduction in those costs in exchange for a contract extension. Both did so.

By extending the contracts, the Lottery was able to ensure SGI's bargain pricing for four additional years. In addition, Pollard and GTECH submitted their best "offers," precisely what they would have done were the contract rebid.

And incidentally, because all Scratchers vendors serving North American lotteries were already under contract with the Lottery, no would-be bidders could have been adversely affected by the dollar increases or contract extensions.

For the reasons set forth above, the Scratchers contracts did not involve a circumvention of competitive bidding nor did they violate the provision in the Lottery's Contract Manager's Handbook. The objective and scope of the original, competitively bid Scratchers contracts never changed. The monetary size of the contracts was not dramatically altered because the initial authorized expenditures were never intended to be a cap. Rather, it was understood from the outset that the monetary size of the contracts ultimately would be dictated by consumer demand. And finally, the exercise of the 4-year option to extend did not dramatically alter the duration of the contract because a contract term providing for the extension was part of the original, competitively bid contract.

It is noteworthy that Lottery regulations contain safeguards that ensured that the Lottery Commission was aware of and approved all monetary increases and time extensions relative to the Scratchers contracts. The regulations require that (1) amendments that bring the cumulative value of a contract to \$250,000 or more require Commission approval. (Lottery Regulation 8.6.3.A) and (2) amendments to contracts previously approved by the Commission which extend the term of the contract by 25% or six months, whichever is shorter, or that add funds to the contract that increase the total amount obligated by 10% or \$250,000, whichever is less, require Commission approval. (Lottery Regulation 8.6.3.B).

Hispanic Marketing Contract

The fourth contract identified by the SCO, the Lottery's Hispanic Marketing Contract, was competitively bid in 2005. A four-year contract (from June 1, 2005 to May 31, 2009) with expenditure authority of \$28 million was awarded. The contract scope anticipated that the successful bidder would handle all aspects of the Lottery's Hispanic Marketing. The \$28 million was based on the Lottery's best estimate of the cost of Hispanic-focused marketing over a four-year period based on past experience and informed projections. As in the case of the Scratchers contracts, this was not a cap. The contractor was expected to meet all of the Lottery's needs as determined by

focus groups, studies, market forces, marketing initiatives, sales projections, etc. and the Lottery would pay for the work based on contract pricing. The contract provided that the Lottery had the option of unilaterally extending it for two additional years on the same terms as the original contract. There was no augmentation of expenditure authority during the initial 4-year term.

On March 25, 2009, the Lottery Commission authorized the Lottery to exercise its option to extend the contract (from June 1, 2009 to May 31, 2011) because the contractor had performed well. Of course additional dollars (\$12 million) had to be added to the contract because the original expenditure authority was intended to cover only the initial four years of the contract and at the time of award it could not be known whether the option would be exercised. The scope and terms remained the same except that, at the Lottery's request, an option for Emergency Extended Service for up to nine months was added.

The emergency extension authority was added in anticipation of a shortage of resources and a longer than normal solicitation process resulting from changes in solicitation procedures. The Lottery was working with a consultant to revamp the General Marketing contract solicitation in ways that would also benefit the Hispanic Marketing solicitation. The Lottery had to stagger the two procurements to allow for adequate staffing and adequate time to implement new procedures. A seven-month extension was ultimately obtained.

As noted above, Lottery regulations contain safeguards that ensured that the Lottery Commission was aware of and approved all monetary increases and time extensions relative to the Hispanic Marketing contract.

If you have any additional questions, please contact the Internal Audit's Deputy Director, Roberto Zavala at (916) 822-8358.

Sincerely,


Paula D. LaBrie
Acting Director

**State Controller's Office
Division of Audits
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