

6-24-1986

Joint Hearing on the California State Lottery

Senate Committee on Governmental Organization

Assembly Committee on Governmental Organization

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ASSEMBLY AND SENATE COMMITTEES
ON
GOVERNMENTAL ORGANIZATION

TRANSCRIPT OF PROCEEDINGS

Joint Hearing on
THE CALIFORNIA STATE LOTTERY

STATE CAPITOL
JUNE 24, 1986



ASSEMBLY COMMITTEE MEMBERS PRESENT:

Gary A. Condit, Chairman
Frank Hill, Vice Chairman
Rusty Areias
Elihu Harris
Lucy Killea
Sunny Mojonnier
Maxine Waters

SENATE COMMITTEE MEMBERS PRESENT:

Ralph C. Dills, Chairman
Alfred Alquist
Robert Beverly
John Foran
Bill Greene

ASSEMBLY STAFF PRESENT:

KFC
22
L500
G68
1986
no.1
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del Hernandez, Principal Consultant
Hanna, Committee Secretary

SENATE STAFF PRESENT:

Lindsay W. Miller, Principal Consultant
Steve Hardy, Senior Consultant
Art Terzakis, Associate Consultant

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FRANK VICENCIA
MAXINE WATERS

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1986
no. 1

California Legislature

Assembly Committee

on

Governmental Organization

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September 4, 1986

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Honorable Willie L. Brown, Jr.
Speaker of the Assembly
State Capitol - Room 219
Sacramento, CA 95814

Honorable David Roberti
Senate President pro Tempore
State Capitol - Room 205
Sacramento, CA 95814

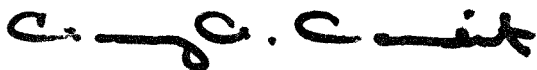
Dear Speaker Brown and Senator Roberti:

The Assembly and Senate Committees on Governmental Organization held an informational hearing in Sacramento on June 24, 1986. This joint hearing covered the operation of the California State Lottery.

The hearing received testimony on the status of major Lottery contracts, the level of participation by minorities and women in the Lottery contracts, the experience and plans for using competitive bidding procedures, and the level of revenues and expenditures by the State Lottery.

We have included in the attached publication the transcript of the hearing, the background paper prepared by our committee staff, and the background materials provided by the State Lottery staff.

Sincerely,



GARY A. CONDIT, Chairman
Assembly Governmental
Organization Committee



RALPH C. DILLS, Chairman
Senate Governmental
Organization Committee

GAC/RCD:tah

86-11-134

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ASSEMBLY AND SENATE COMMITTEES ON
GOVERNMENTAL ORGANIZATION
JOINT HEARING ON
THE CALIFORNIA STATE LOTTERY
JUNE 24, 1986

GARY CONDIT AND RALPH DILLS, CHAIRMEN

CHAIRMAN GARY CONDIT: I'd like to welcome everyone here today. Senator Dills and I will be co-chairing this informational hearing on the State Lottery. Included in today's agenda are the topics of major Lottery contracts and participation by minorities and women in Lottery contracts generally.

The State Lottery is expected to sell over 1.7 billion tickets by the end of this month. It is also expected to contribute about \$650 million to public schools and to expend about \$220 million for staff, retailers, commissions, equipment, advertising, and Lottery tickets.

Since the California State Lottery is such a major component of the state government and our state's economy, it's imperative that we, in the Legislature, periodically review its operation.

To ensure an orderly hearing, Senator Dills and I have agreed that he will chair Items I and III on the agenda and I will chair the other items. Now, Senator Dills will take Items I and III on the agenda. He will begin those at this time and I just want to tell you that it looks like it is kind of an empty committee. The Assembly is still in session. They have three or four items on call. Members will be joining us in the next few

minutes, so bear with us if you see commotion up here. On the Senate side, they are in committees over there and they will be joining us as well. So, we will begin the hearing. We will try and not duplicate questions as members come in so just bear with us.

At this time, I will turn the meeting for agenda Items I and III over to Senator Dills.

CHAIRMAN RALPH DILLS: Thank you, Chairman Condit. It often happens here at Sacramento -- we have so many things to be done in such a short period of time that there are conflicts all over the Capitol. We will proceed because the important information will be obtained from those whom we've asked to appear as witnesses. So, I would like to ask Mark Michalko to come forward and to take the stand and bring with him whomever he cares to as backup or supporting witnesses.

MR. MARK MICHALKO: Thank you very much, Senator. Senator, I have with me today several representatives. First of all, Mr. Chon Gutierrez who is the Chief Deputy Director of the California State Lottery. I also have Ms. Nancy Sweet. Ms. Sweet is Chief Counsel to the California State Lottery and to her right is Mr. Lou Ritter. Mr. Ritter is the Deputy Director for Security for the California State Lottery. Thank you for the opportunity to be here.

CHAIRMAN DILLS: Let's begin, Mr. Michalko, by going back a bit. First of all, I would like to inquire if you were aware of, or did you know of, the contract between the Dittler Brothers and Scientific Games with reference to the printing of

Scientific Games' Lottery tickets, the so-called "master agreement?" Have you had the opportunity to read that or are you aware of it?

MR. MICHALKO: Senator, to answer your question, I am aware of the fact that there is a contract, a master agreement if you will, between Scientific Games and Dittler Brothers. I have not had, yet, an opportunity to review the entire contract, but we requested just this morning that Scientific Games provide us with a copy of the entire document.

CHAIRMAN DILLS: There was testimony at a news conference which stated that 1979, I believe it was, that there was a contract entered into between those two entities and that it had a 25-year span to the contract. Was that information available to you at any time during the negotiations?

MR. MICHALKO: Senator, I was aware of the fact that the master agreement had a 25-year term and I learned of that very early on in my tenure as Director here.

CHAIRMAN DILLS: The State of California, however, is not a party to that contract?

MR. MICHALKO: That is correct, Senator. It is a contract between Scientific Games and Dittler Brothers, the printer.

CHAIRMAN DILLS: Now, shortly after you received information that you were placing on the calendar a question of the extension, either a six-months extension of the contract between the Lottery Commission and Scientific Games, apparently, on May 1, you sent out a memo to the Commission that outlined

rules by extending Scientific Games contract for six months, is that correct?

MR. MICHALKO: Senator, the answer to your question is that the document was prepared on May 1st. It was sent out to the Commission within a few days of that and basically contains the information that you just suggested it does.

CHAIRMAN DILLS: And you did post that on the calendar or agenda of business for May 14?

MR. MICHALKO: That is correct.

CHAIRMAN DILLS: At that time, you will recall that among others, I appeared at that hearing and presented to you the resolution, or at least, the content of a resolution passed by the Senate in which we in the Senate requested that you not give that extension or enter into that extension at this time. Nonetheless, that took place and we felt then and many of us still feel that it was rather precipitous action on your part because you didn't need at that time, because you had sufficient time thereafter, from May 14 until some time, July 3, as I recall, before you even had to give notice to Scientific Games. Do you care to address yourself to the reason why you felt that it should be done at that time?

MR. MICHALKO: Senator, as I mentioned to you at the time of the Commission meeting on May 14th, the primary concerns in whether or not to extend the contract revolved around, first of all, a financial issue, certain rebates if you will, that would accrue to the benefit of the California State Lottery for extending the contract for the six-month period. But more

importantly, and the one I would like to underscore today, is the reason that we faced, in my opinion, exceptionally grave operational concerns in going forward with a bidding process. In essence, I would summarize that by saying the primary focus of all of the staff of the California State Lottery today is on bringing up what are known as the on-line games that we're expecting to implement sometime later on this fall.

It was my opinion then and it remains my opinion today, that in light of those efforts, it would be extremely difficult from an operational and administrative standpoint, to divert the attention of staff from implementing the on-line games and having that energy channeled toward going through an extensive or exhaustive procurement process for the instant tickets. That operational concern, coupled with the financial incentive, in essence, the rebates which would accrue to the benefit of the California State Lottery, prompted me to make the recommendation to the Commission, which I did on May 14th and the Commission unanimously supported that position by adopting the six-month contract extension. So, it was an issue, quite frankly, of timing, an issue that revolved around operational and administrative concerns that caused me to take the issue forward at that time.

CHAIRMAN DILLS: Have you subsequently changed your mind as to the possibility or probability of being able to do that should it become necessary?

MR. MICHALKO: Senator, I still feel in my own mind that there is -- if not as great, maybe a greater concern about going

through a bidding process at this time. However, in light of the circumstances surrounding the recent developments in this case of Scientific Games and Dittler Brothers, we are at this point pursuing two avenues simultaneously; one of which is to have some staff prepare an RFP in the event that it's necessary to go forward with that document.

CHAIRMAN CONDIT: I have a couple of questions, Senator, if I may. I would like the Director to explain to me the process. You have five major contracts for the Lottery, correct? I'd like for you to explain to me the process in which you went about letting those contracts and maybe just give a brief description of each one of them, if you will.

MR. MICHALKO: Mr. Condit, Senator Dills, members, included in the packet of documents which was submitted to you in preparation for this hearing, is a section, I believe it is Section II which deals with the major contracts which the California Lottery has let to date. Those five major contracts basically involve the following, and I will try to explain each of the processes individually.

The five contracts involve a procurement for instant tickets. Second, a contract for courier delivery services to deliver the tickets to the retail locations. The third major contract is the advertising of the California State Lottery. The fourth was the procurement of vehicles for what's known as the district sales representatives and the fifth major contract is a contract for on-line gaming equipment and services.

Taking those one at a time, Mr. Condit, the first contract, that having to do with the instant game; last April, the California Lottery began developing an RFP for procurement of instant tickets. That was intended to be a competitive bidding process and was initiated, quite frankly, before I was ever appointed as Director, but in effect, was a competitive procurement according to the standards of the industry. Unfortunately, due to the exhaustive disclosure requirements of the California State Lottery Act of 1984, only one vendor, Scientific Games, Inc., was able to successfully comply with the disclosure requirements. In effect, what that meant was we had a single vendor who would be able to provide the equipment and services for the instant game contract. That process took place, as I suggested, last May. A contract was executed in June of 1985.

The second major contract, in answer to your question Mr. Condit, has to do with the courier delivery, the services to take the tickets to the retail establishments around the state. In May of 1985, the Lottery issued a request for proposals to various courier companies to contract with one of them for the delivery of instant tickets to the retail locations. The RFP basically complied with the state policies for competitive bidding and received two bids from vendors for this service and ultimately, the contract was awarded to Purolator Courier for a one-year term.

The third major contract, Mr. Condit, is for the advertising of the California State Lottery. Also in May of

1985, the Lottery issued a request for proposals to 150 advertising agencies to represent the California State Lottery for the forthcoming year. As a result of that RFP, 18 proposals were received by June 7th of 1985, which was the deadline. The top eight proposals were submitted to the Lottery's internal audits office for review relative to the financial statements of the different vendors who were proposing at that time. Ultimately, five agencies were asked to make oral presentations to the Lottery staff and we ultimately selected Needham Harper Worldwide to provide the contracting services for the first full year of the Lottery's operation.

Another major contract has to do with the procurement of vehicles for our district sales representatives. In February of 1986, the Lottery went out to bid for the acquisition of those vehicles. Twenty-two California auto dealers indicated an interest in supplying the vehicles to the Lottery. The contract was awarded to Center City Ford of San Diego and although they were not initially the low bidder, they became the low bidder with the application of the minority business allowance that the Lottery provided for in that bidding process.

The final contract, Mr. Condit, is for the procurement of on-line gaming system equipment and services. The RFP for that process was issued in October of 1985. Five firms responded to the RFP by submitting proposals and the Lottery conducted an exhaustive two-month evaluation process which reviewed evaluation points assigned for corporate experience, contract support, security, technical capability, price and minority and

women-owned business preferences. The Lottery complied with all the applicable state policies and procedures for competitive bidding and ultimately, we awarded the contract to GTECH Corporation of Providence, Rhode Island. Those are the five major contracts which are outlined in the document provided to you.

CHAIRMAN CONDIT: Okay. Out of the major contracts that you have, can you identify problems with any of those five that you've had?

MR. MICHALCO: I'm not sure what you would characterize as a problem, Mr. Condit. Obviously, in terms of operation...

CHAIRMAN CONDIT: Well, if they haven't met their contractual obligations or if you think there have been any other problems...

MR. MICHALCO: To the best of my knowledge, all of them have performed their contractual obligations as set forth in their contracts.

CHAIRMAN CONDIT: Okay, which contract does the Dittler subcontract fall under?

MR. MICHALCO: That would be the first one that I addressed, Mr. Condit, which is the contract for instant tickets that we have with Scientific Games of Norcross, Georgia.

CHAIRMAN CONDIT: So, my asking you if you had a problem with these contractors, you don't see that subcontractor concern as a problem?

MR. MICHALCO: The way I interpreted your initial question, Mr. Condit, was whether the contractual obligations had

been fulfilled. In that contract, Scientific Games, by utilizing the services of Dittler Brothers, has provided the California State Lottery with both the quantity and quality of tickets which were contracted for in the contract between the Lottery and Scientific Games.

The problem that you may be alluding to is one which has developed in recent days, relative to a finding in litigation between Scientific Games and Dittler Brothers, which is currently undergoing evaluation in the State of Georgia. The problem that I believe that you are addressing has to do with a finding by a court-appointed arbitrator in the litigation between Scientific Games and Dittler Brothers, that Scientific Games has been the victim of a fraud perpetrated by Dittler Brothers with respect to some pricing of foil, which is a component part of the instant Lottery tickets. That particular finding by the court-appointed arbitrator, which was subsequently reviewed by an auditor, also appointed by the court, caused concern on the part of the Lottery, because we have a statutory obligation, as you know, to administer the Lottery with the highest degree of integrity, honesty and security. So, in that respect, yes, I believe there may be a problem with that contract.

CHAIRMAN CONDIT: Okay, I'm going to defer to Senator Dills. He wants to go back to his questioning. But, when you use the term "we," we must protect the integrity of the Lottery, are you talking "we" in terms of you and who?

MR. MICHALKO: I'm talking about the Director of the Lottery and the California State Lottery Commission.

CHAIRMAN CONDIT: Who is it you actually work for?

MR. MICHALKO: That's an interesting question, Mr. Condit. I certainly work with the Commission, although I was appointed by the Governor and it all depends on how the statute is written. The statute provides that the Commission, the five member board, sets policy and approves contracts that I recommend.

CHAIRMAN CONDIT: Indeed, can you terminate contracts without the formal approval of the Commission?

MR. MICHALKO: I believe that's going to be a legal question that has to be resolved.

CHAIRMAN CONDIT: Did you do that in the case of the Dittler subcontract?

MR. MICHALKO: We have not terminated the contract whatsoever at this point, in fact today, even as we speak, there's a hearing taking place in the State of Georgia where the auditor is reviewing some motions made by both Scientific Games and Dittler Brothers and I'm awaiting the outcome of that at this very hour.

CHAIRMAN CONDIT: Well, I'm going to tell you that as one who hears a lot of issues dealing with the Lottery, it's a bit confusing sometimes when you send your representatives in here and you say the Lottery Commission supports or doesn't support something when they really haven't taken any kind of formal position at all. It's been your position and not theirs. So I think it's a bit confusing, to say the least, when we are notified that the Commission has supported something when they

really haven't taken an affirmative stand on it at all and it's been your stand. So I would appreciate when you come before the committee or you oppose a bill of mine, that you clarify that.

I'm going to defer to Senator Dills.

CHAIRMAN DILLS: Mr. Michalko, getting back to the question of the intent on the part of you to send a letter to Scientific Games in which you indicate that they are to come up with certain information and they are to lead Dittler Brothers out of the picture, I've before me a copy of the Lottery Commission's hearing, public meeting June 12 and in which you bring up the subject, you bring it up under the Lottery Director's report. It was not on the agenda as such, but your justification, at least your statement was, that this is generally where this takes place. Before bringing it up, you had received a letter dated June 10 from Scientific Games over the signature of one John R. Koza, Chairman and CEO. In that letter you will recall that he mentioned situations or mentioned what were alleged to be frauds, the Dittler's fraud, over-billing fraud, the termination of agreement with Dittler, Scientific's bid in Pennsylvania, attempted suppression of the arbitration decision and the auditor's opinion and so on, and in addition, several quotes from the auditor. Based upon that and upon your study of the actual auditor's report, you decided that you would recommend, or that you would send a letter, is that correct, to Scientific Games telling them that they must show evidence within one week's time, of the fact, that they were capable of continuing the printing and doing so about Dittler Brothers being involved in the printing.

MR. MICHALKO: That's essentially correct, Senator Dills. The key features that went into my decision-making had to do with two written documents and I want to make sure that I explain that fully.

The State of Georgia has a peculiar system with respect to arbitration. There's basically a three-tiered approach to reviewing this issue between Scientific Games and Dittler Brothers. The first party that was reviewing the foil fraud issue was known as the arbitrator. On April 30th of this year, the arbitrator issued a preliminary report which stated that in effect, Dittler Brothers had defrauded Scientific Games somewhere in the vicinity of \$1.1 million with respect to certain pricing on foil, again, a component part of the tickets. On June 3rd of this year, the auditor, also appointed by the judge in the court, independently issued a separate report which is known as Auditor's Pretrial Report No. 13. In that report, the auditor not only reviewed the decision of the arbitrator, but independently concluded the same that the auditor did, which is to say the finding of fraud perpetrated by Dittler Brothers.

CHAIRMAN DILLS: Who supplied these documents to you?

MR. MICHALKO: Those documents were supplied to me by Scientific Games, but they are the complete copies of the court records.

CHAIRMAN DILLS: Did you receive any information at all from Dittler Brothers or their parent company?

MR. MICHALKO: No Senator, I did not request that because this information came to me, as I said, on June 10th. At

that time there was only a day and a half before the Commission meeting and at that point, the documents which I had were court records and I didn't think it would be necessary to duplicate that effort by requesting those documents from Dittler Brothers.

CHAIRMAN DILLS: Were you aware of the fact that in the master agreement contract between Dittler and Scientific Games, that Dittler Brothers was prohibited from contacting the Commission or any of its employees?

MR. MICHALKO: Yes sir, I was aware of that.

CHAIRMAN DILLS: So that only one side of the story had been presented before you made your decision to recommend -- or rather to write a letter to Scientific Games?

MR. MICHALKO: Well Senator Dills, I'm not sure that I would agree that it was one side of the story. There certainly was a cover letter sent to me by Scientific Games. On the other hand, I had what I considered to be an independent decision of both the arbitrator and the auditor, so I presume that both of those gentlemen took neither one side nor the other. I don't think they can be characterized as having given one-sided information.

CHAIRMAN DILLS: Is either of these gentlemen, to your knowledge, a lawyer?

MR. MICHALKO: Yes, sir. I believe that one of the gentlemen is, indeed, a lawyer.

CHAIRMAN DILLS: Is it your opinion that the State of California, the Lottery Commission, is a party to that master agreement? I asked this question before, but now it seems to be considerably more pertinent.

MR. MICHALKO: Well Senator, as I answered before, the California State Lottery is not a party to the master agreement between Scientific Games and Dittler Brothers.

CHAIRMAN DILLS: You are an attorney at law to practice in Ohio, is that correct?

MR. MICHALKO: That is correct, Senator.

CHAIRMAN DILLS: Not in California? The State of California in this instance was a third party, was it not, with reference to that contract?

MR. MICHALKO: Well in the sense that the State of California ordered tickets from Scientific Games, I would say that it's a fair statement that we would be considered at least a third party beneficiary of the contract, if not a third party, in fact.

CHAIRMAN DILLS: But you're not a party to the contract.

MR. MICHALKO: Well Senator, as I mentioned a moment ago, we're not expressly a party to the contract.

CHAIRMAN DILLS: But you concluded, did you not, by the sending of the letter, that one of the two parties to a contract had committed a fraud, such a fraud as would make it necessary for you or advisable for you to send out a letter telling them to void or to get rid of and to terminate one of the two parties for a contract of which we were not a party.

MR. MICHALKO: Senator, the letter that I sent, I believe you have a copy of it, expressly states that we are asking Scientific Games, who is a party with the California State Lottery, to provide us with information about how they intend to

fulfill their contractual obligation to us. In that letter, I am simply asking how they will do so and based on the issue that I talked about with respect to the statutory mandate under which both the Commission and I operate, I do not feel it was allowable for the Lottery to have a contract with an entity who has been found to have perpetrated a fraud.

CHAIRMAN DILLS: However, in that letter did you not indicate to Scientific Games that they must provide that -- were able to provide the quality, the security and quantity of instant tickets with the California Lottery under the contract, including the extension period and you indicated that that extension period has not been entered into yet, but you include it as here on June 12 and two, the methods and printing facilities which you expect to use to comply with the contract terms as stated in existing contract with a six-month extension. And also, I think you further said in light of our statutory obligations and the findings of fraud in regard to Dittler Brothers, will require that in getting reassurances or performance as requested above, you do not include Dittler Brothers as a subcontractor or in any way involve Dittler or Scientific Games Inc., in future performance under the contract with the California State Lottery.

MR. MICHALKO: Senator, you've read the letter and that is absolutely correct and perhaps it might be in order for me to try to crystallize the rationale for that letter, although I believe it's contained adequately ...

CHAIRMAN DILLS: Well I would like you to discuss, as a lawyer, what authority do you think you have before Scientific

Games not to use Dittler Brothers under a contract that has lasted for 25 years?

MR. MICHALKO: I think the answer quite simply Senator, is based on the statutory language of the California State Lottery Act of 1984, that I have the obligation, along with the California State Lottery Commission as a Board, to operate the Lottery in accordance with the highest standards of integrity, honesty and security. And in my mind, Senator, it does not seem that we would be in accordance with that statutory mandate if we were to be in contract with an entity which had been found to have perpetrated a fraud.

CHAIRMAN DILLS: Is that finding final?

MR. MICHALKO: The finding, as I mentioned at the Commission meeting of June 12th, was final with respect to the arbitrator but obviously had the ability to be appealed to a judge who is the final overseer of this case.

CHAIRMAN DILLS: You said, and I want to make sure that everybody understands at this point, that the decision of the arbitrator, while binding, can be appealed through the court system of Georgia.

MR. MICHALKO: That is correct.

CHAIRMAN DILLS: And, in spite of that fact, you felt that you could intervene and in fact, maybe evolve a contract between two of the parties?

MR. MICHALKO: Senator, not only did I feel that I could intervene, I feel that my reading of the statute mandates that I intervene.

CHAIRMAN DILLS: You've heard that it mandates it? You're talking about the initiative act itself?

MR. MICHALKO: Yes, sir, the California State Lottery Act of 1984.

CHAIRMAN DILLS: I want to re-read it. I don't recall that it said any such thing, but nevertheless, from your standpoint, is it not true, again, that you heard only one side of this picture? In other words, you have used the words "guilty of fraud" I think three different times in your minutes; guilty in criminal courts is something else from having committed a fraud in civil action but perhaps that was a bad choice of words but, you came on to the Commission and there was one lawyer there on the Commission, as though this were in fact, criminal guilt.

MR. MICHALKO: Senator, as you read the transcript, that may have been an unfortunate choice of words for me to say, "had been found guilty of fraud." I do indicate very clearly in a sentence in that transcript and I advised the Commission that it is a civil case between Scientific Games and Dittler and not a criminal case.

CHAIRMAN DILLS: Did you make that distinction very clear to the Commission?

MR. MICHALKO: Senator, I believe I did and if you have reference to a copy of the transcript that you're reading from, I think you'll see a complete sentence in there that was one of the first things I told the Commission on that day.

CHAIRMAN DILLS: Do you feel that you have sufficient authority to make such a conclusion and a decision without the ratification or the vote of the Commission?

MR. MICHALKO: Senator, I'm not sure that I have an answer for this at this point. I think that, with respect to whether I can unilaterally terminate an agreement with Scientific Games, I would ask that my counsel be able to go back and research whether it's necessary to go back to the Commission for their ratification of that action. I also think, at this point, that it's premature for me to even speculate as to whether that will be a course of action that I may want to follow. As I told you, I'm awaiting, even now, a decision from the Auditor in the State of Georgia and once I have that report and am able to review it, I think it would be the proper time for me to make a decision about whether it's necessary to revoke the contract.

CHAIRMAN DILLS: You don't have to make the decision of whether or not you can break it unilaterally, or by yourself as the Director, because you received the unanimous vote of the Commission.

MR. MICHALKO: Well Senator, the Commission simply authorized, or supported I should say, not authorized, they supported my sending the letter out that you have been reading from and that's basically the extent of what the Commission did.

CHAIRMAN CONDIT: Did you send the letter, excuse me Senator, did you send the letter before you got approval from the Commission?

MR. MICHALKO: That's right, I went to the Commission and reviewed the issue with them and after the Commission meeting, I hand delivered the letter to Dr. Koza, the Chief Executive Officer of Scientific Games.

CHAIRMAN CONDIT: When you talk about Dittler and fraud and all that, is there some concern about Scientific Games overcharging for tickets in the same time period?

MR. MICHALKO: The issue relative to Scientific Games in any purported overcharge to the Lottery has been something that's under review by the Auditor in Georgia.

CHAIRMAN CONDIT: Did you find that to be correct? And is that fraud and is that the case for dismissal of their contract in the state?

MR. MICHALKO: Mr. Condit, there has been no finding by any of the judicial entities that I have addressed that speaks to the issue of fraud with respect to that particular action.

CHAIRMAN CONDIT: With Dittler, was there a judicial finding?

MR. MICHALKO: There was a finding by both the arbitrator and what's known as the auditor, that used that very term.

CHAIRMAN CONDIT: But not a court finding though.

MR. MICHALKO: I beg your pardon?

CHAIRMAN CONDIT: Not a court finding.

MR. MICHALKO: It is under the auspices of the courts of Fulton County, Georgia so it is absolutely a court finding, yes sir.

CHAIRMAN CONDIT: It's not. It's not a criminal or legal finding of these people.

MR. MICHALKO: Perhaps it would be in order for me to clarify that this is, again, a civil suit. There has been a

civil finding of fraud on the part of Dittler Brothers by two different entities, the arbitrator and the auditor. The final step of course, will be to go to the judge who is overseeing the case but has, in effect, had these other two parties hearing the case on his behalf.

CHAIRMAN DILLS: In that Number 30 document, they did make a finding that there was underpayment, did they not, an underpayment of over \$5 million on the part of Scientific Games to Dittler Brothers.

MR. MICHALKO: Senator, the issue of any alleged underpayment had to do with a withholding of payments by Scientific Games pending, as I recall, a judicial determination. There was no finding that the underpayment, to the best of my knowledge, was, in any sense, actionable or fraudulent or anything along those lines.

CHAIRMAN DILLS: An underpayment, while there was no finding of it, you don't see any distinction at all. One is a fraud and the other is not a fraud.

MR. MICHALKO: Senator, the best way I could answer that question for you is to tell you that the two reports, the April 30th Arbitrator's Decision and the June 3rd Auditor's Report, specifically (and I underscore specifically) conclude that there was fraud, and that's the only time it's used, fraud on the part of Dittler Brothers. No such finding has been made with respect to any withholding by Scientific Games.

CHAIRMAN DILLS: But this is still not final and will not be until October of this year when the court actually makes the final decision?

MR. MICHALKO: Senator, I'm not certain about the timeframes. As I said to you a moment ago and to the rest of the members of the committee, there is a hearing going on in Fulton County, Georgia, even as we speak and it may very well be that we have some case to incriminate ...

CHAIRMAN DILLS: That has to do with whether or not, whether or not they can use the Gilroy plant, whether or not the injunction will be sustained or abrogated.

MR. MICHALKO: Senator, I'm not certain that it's limited to whether or not Scientific Games can use the Gilroy plant. It may very well speak to the issue of the overall relationship between Scientific Games and Dittler Brothers and quite frankly, I don't have that answer for you.

CHAIRMAN DILLS: Well, even if it does, sir, you are a lawyer and you have said that this could be appealed and the hearings will not be held until October, isn't that correct, the final determination?

MR. MICHALKO: Well Senator, the issue, in a nutshell, and I'd like to characterize this for all of the members of the committee, had to do with two independent bodies, again, concluding that fraud had occurred on the part of Dittler Brothers.

CHAIRMAN DILLS: Yeah, but when is a conclusion a conclusion, Mr. Michalko?

MR. MICHALKO: Senator, obviously this situation can be appealed up through the court system of Georgia and as you and I both know, as we're both lawyers, that process can take years

literally. I felt extremely uncomfortable with continuing any contract which has as a, at least a subcontractor, a party who has been found to have perpetrated a fraud. And again, I'll emphasize that I feel that that's true in light of the expressed language of the California State Lottery Act.

CHAIRMAN DILLS: Did you have any other attorneys, other than Nancy Sweet, to assist you in making this decision, if she did at all?

MR. MICHALCO: The issue was reviewed by Ms. Sweet. I believe it also was, at least ...

CHAIRMAN DILLS: I'm talking about before you made the decision to write the letter.

MR. MICHALCO: Senator, I'm addressing that same timeframe. I believe that the issue was reviewed by Ms. Sweet. I also think it was reviewed, at least to some degree, by Mr. Ford and finally it was reviewed by Commissioner John Price who, as you know, was a 20-year Sacramento County District Attorney. So, in that respect, at least those lawyers did review it prior to my issuing the letter.

CHAIRMAN DILLS: Is the Attorney General of the State of California also an attorney for and on behalf of the Lottery Commission?

MR. MICHALCO: Senator, the answer to that is, yes, they are. They are, I understand, of the opinion that they represent the California State Lottery only in the event that there's litigation and I may turn to Ms. Sweet to ask her to clarify that.

MS. NANCY SWEET: I believe that from one state agency, the Attorney General's Office is involved in the legal activities of the state agency upon request for advice or upon mandatorily when it goes into court in a matter of litigation.

CHAIRMAN DILLS: It's your conclusion that the Attorney General is limited in giving advice?

MR. MICHALKO: No Senator, that's not my conclusion. I would like them to be involved from the get-go.

CHAIRMAN DILLS: Well let's get right to it. Did you ask any member of the Attorney General's staff what was his opinion or her opinion as to the legality of the action you were about to take?

MR. MICHALKO: Senator, the answer is that I conferred with Ms. Sweet who I believe had at least some contact with the Office of the Attorney General but I would have to ask her to give me some further clarification of that.

CHAIRMAN DILLS: Will you do that at this time?

MR. MICHALKO: I'm not sure she recalls the ...

SENATOR GREENE: (Inaudible - mike not on)

MR. MICHALKO: Well Senator, the answer from Ms. Sweet is that she had at least a brief contact with a representative assigned to the California State Lottery before the letter was issued.

CHAIRMAN DILLS: Does that representative have a name?

MS. SWEET: Yes he does, Senator. His name is Paul Dobson. He is the attorney from the Attorney General's Office who is assigned to the Lottery. I conferred with him briefly

when at one point, we were concerned that we might be involved in some type of litigation.

CHAIRMAN DILLS: Was it before or after the action of the Commission authorizing him to send the letter?

MS. SWEET: I believe it was the same day after the Commission meeting.

CHAIRMAN DILLS: After they had gone ahead and done it, a fait accompli.

MS. SWEET: Yes, after Mr. Michalko had delivered the letter.

CHAIRMAN DILLS: Well, there's some doubt in your mind then, huh?

MS. SWEET: No, actually there wasn't at the time on that particular issue. I hadn't called him on that issue specifically. I called him on a different issue and that was mentioned in passing because of the attention that the press was giving to the issue.

CHAIRMAN DILLS: I am committed to continue this. I know a couple of members wish the opportunity to ask if you'll just give me one more moment or two to run down one other aspect of this that has been a puzzlement to me.

At this Commission hearing that this matter arose, Commissioner Montgomery asked a question. I asked, if the acts occurred, talking about the alleged fraud, if these acts occurred in the time that Scientific Games was under contract with the California State Lottery or they were defrauded in two letters of specific recommendation of the Director. Director Michalko, I'm

going to ask the representative to give us the dates. Do you have the dates? This occurred over a period of time, I don't know if Dr. Koza has any information. Chairman Varner: Mr. Ritter, it might be better if you stand up only because the microphones aren't working and by standing, I think your voice might carry better to the rear. Mr. Ritter, Director of Lottery Security: These violations occurred over a fairly lengthy period of time. Some of them do fall within the timeframe that California was contracting with Scientific Games, however, it has been in litigation, litigation has just recently been terminated and we base our findings on the litigation. We asked a question of Dr. Koza, Dr. Koza is an executive officer of Scientific Games, he did not respond but one of your own employees, Mr. Ritter, who is here today, responded and he gave information that part of it was during the timeframe in which California was contracting with Scientific Games.

Mr. Ritter, (inaudible) ... how did you obtain that information and when did you get it before this particular day in which you gave it?

MR. LOU RITTER: I received it from two documents that have been referred to previously, the Auditor's Pretrial Report #13 as well as the Arbitration Report. In addition, I had received some information from Dr. Koza in regard to how he priced the California State Lottery contract.

CHAIRMAN DILLS: And so you had received that before or after you made that statement?

MR. RITTER: That was prior to.

CHAIRMAN DILLS: Thank you.

MR. RITTER: As you recall, the Auditor's Report indicated that the pricing violations occurred between 1982 and May of 1985. Previous testimony by the Director up here has indicated that our contracting process with the instant ticket contract began in April of 1985 which is an overlap. That's the first part of it.

The second part is that their price ...

CHAIRMAN DILLS: Just a moment. You say the contracting process, however, that contract was not entered into during that period of time, is that correct?

MR. RITTER: Yes, the contract was entered into on June 3rd, 1985, the formal contract.

CHAIRMAN DILLS: Effective on December 3rd.

MR. RITTER: Pardon me?

CHAIRMAN DILLS: Effective December 3rd.

MR. RITTER: October 3rd.

CHAIRMAN DILLS: October 3rd, pardon me.

MR. RITTER: But it was approved by the Commission on June 3rd, 1985.

MR. MICHALKO: Senator, the contract was entered into, as Mr. Ritter said, on June 3rd. The first tickets went on sale on October 3rd.

CHAIRMAN DILLS: Yes. Actually, so far as payment and all is concerned, that's the date. I think that we have ... in order to obtain some information here which is confusing to me as I read the transcripts, I heard the statement of the

representative of Dittler Brothers to the effect that at no time was this alleged fraud during the period of time in which they were under contract with California. So we have that difference of opinion and of course, someplace along the line that will be settled.

MR. RITTER: Senator, in my deposition for today's hearing in Atlanta, I explained the rationale for that comment. I'll be happy to reproduce those pertinent pages for you and present it to you for your record.

CHAIRMAN DILLS: Fine. One other thing before I terminate this particular aspect of the discovery proceedings here. Mr. Ritter, you had indicated that you had made several visits out to the Gilroy plant when Scientific Games was under a court order not to print any tickets, did you at any time, find that there had been tickets printed at that plant in Gilroy?

MR. RITTER: Yes.

CHAIRMAN DILLS: There had been tickets printed there? What happened to those tickets?

MR. RITTER: They were shredded.

CHAIRMAN DILLS: Do you know who ordered the tickets to be printed?

MR. RITTER: I don't know for sure but I assume that Scientific Games, on their own, printed the tickets but I do not know that to be a fact.

CHAIRMAN DILLS: Did you see the tickets at all?

MR. RITTER: Yes.

CHAIRMAN DILLS: And what were they for, the California Lottery?

MR. RITTER: Yes, they were but they were never delivered to California nor were they ever presented to us for use by the California State Lottery.

CHAIRMAN DILLS: Why, why not?

MR. RITTER: I have no reason, the issue, you could ask...

CHAIRMAN DILLS: Who ordered that they be shredded?

MR. RITTER: They shredded them on their own.

CHAIRMAN DILLS: Thank you very much. That concludes, for the moment, my examination. Mr. Areias.

ASSEMBLYMAN RUSTY AREIAS: Thank you very much, Mr. Chairman. I want to commend you and Assemblyman Condit for conducting these hearings. I know that there were a lot of concerns initially, when the Lottery was first introduced in California. As a result of the potential for undesirable elements coming into the state and it's all of our objective to insure that the integrity and the security of the Lottery is maintained at all times. I know that's your objective, Senator. It's mine also.

What was the size, the dollar size of the fraud that was perpetrated that led to your decision, the recommendation to the Commission, Mr. Michalko?

MR. MICHALKO: Mr. Areias, the dollar figure, as I recall from the report, was about \$1.1 million although the arbitrator also awarded punitive damages which were three times

the compensatory damages. He also awarded attorneys' fees and some other court fees so in total, it was about \$5 million.

ASSEMBLYMAN AREIAS: What was the arbitrator's justification for suspending the master agreement between Scientific Games and Dittler Brothers?

MR. MICHALKO: By way of clarification, it's my recollection that it was not the arbitrator who suspended anything in the litigation. It would have been the auditor who, in turn, went to the judge. The judge, in fact, was the final entity who allowed Scientific Games and Dittler to bid the Pennsylvania bid independently. They each, as I understand it, submitted bids in Pennsylvania. I think one reason was, quite frankly, the exigency of the issue, the timing, if you will, the matter was before the judge for a hearing and there was an extremely tight window to submit bids for Pennsylvania. So the judge, in effect, allowed both of the entities to bid Pennsylvania independent of one another but maintain the status quo as to the rest of the contract.

ASSEMBLYMAN AREIAS: What was the rationale behind that? What was the judge's rationale for allowing that?

MR. MICHALKO: I don't have the answer for that, Mr. Areias. I'm not sure that it was ever expressed in clear terms other than to indicate by way of an order from the court which is very brief. It's only two or three paragraphs and it says that as to the Pennsylvania bid, the master agreement, in effect, is terminated but only with respect to the Pennsylvania bid at that time.

CHAIRMAN DILLS: Excuse me, was that by mutual agreement of the two parties?

MR. MICHALKO: Senator, that was by order of the judge. I'm not sure if there was any mutual agreement at all.

ASSEMBLYMAN AREIAS: In terms of the, roughly, \$5 million dollars in compensatory as well as punitive damages relative to the fraud case, there was an order that Dittler would pay that to Scientific Games?

MR. MICHALKO: Mr. Areias, I'm not certain about the mechanics of getting the money from Dittler to Scientific Games. I'm not sure that that was addressed.

ASSEMBLYMAN AREIAS: So after reviewing that, you made a recommendation to the Lottery Commission. What was the vote on your recommendation?

MR. MICHALKO: I want to make sure that I clarify this for the record, Mr. Areias, the issue that I brought to the Commission was contained as part of the Director's report. It was not intended to be an action item, it was simply to advise the Commission of information that I had received on June 10th and had reviewed prior to the June 12th meeting. The Commission gratuitously, if you will, offered a motion in support of my position and it was unanimous. It was 5-0 in favor of sending the letter to Scientific Games.

ASSEMBLYMAN AREIAS: What do you plan to do, Mr. Michalko, there's a court, Scientific Games and Dittler Brothers have a master agreement, a 25-year master agreement that is now in question at least as it applies to the California Lottery and

any other lottery that either or both are involved in. What do you plan to do if the injunction on Scientific's usage of any other printer at least relative to that master agreement, whether that be the California facility that they've not opened up yet or contracting or subcontracting with some other printer? What do you plan to do if that injunction is not lifted? At that time, would you rebid?

MR. MICHALKO: I think, Mr. Areias, that we would very likely have no alternative but to bid at that point because we've already indicated to Scientific Games that we will not permit the use of Dittler Brothers for the balance of this contract. So, we're at this point, as I mentioned to Senator Dills already, in the process of developing an RFP to go out in the event that the Georgia court acts the way you suggested.

ASSEMBLYMAN AREIAS: Thank you very much.

MR. MICHALKO: You're welcome.

ASSEMBLYMAN AREIAS: Senator Greene.

SENATOR BILL GREENE: Mr. Michalko, when did you come aboard?

MR. MICHALKO: Senator Greene, I was appointed on May 13, 1985.

SENATOR GREENE: And when did you find out about the master agreement and the contents therein?

MR. MICHALKO: I probably found out about it on May 13, 1985 that there was a master agreement. I found out very early on in my tenure with the Lottery.

SENATOR GREENE: All right. Now that really is just coming to light. Did you advise the Commission of it and the contents of it, its full meaning and what have you?

MR. MICHALKO: Senator, I suspect that the Commission probably knew about the existence of the master agreement before I did. That information was provided probably before I ever got to California.

SENATOR GREENE: All right now. Why is it that this has been an item that has not generally been understood?

MR. MICHALKO: Senator, I'm not sure I understand your question.

SENATOR GREENE: Well, I think the existence of the master agreement and its provisions is just now generally coming to be understood and I'm asking why is that master agreement not better known and the contents of it not better known?

MR. MICHALKO: If I understand your question correctly, Senator Greene, the existence of the master agreement is something that's very well known. The California Lottery Commission, members of the media who have followed the ongoing litigation between Scientific Games and Dittler Brothers are well apprised of the existence of that master agreement. I think that the issue which is recently surfacing has to do with the finding of fraud. That's the new issue. It is not the existence of the agreement itself.

SENATOR GREENE: Well, that's not quite correct. Dittler Brothers built a plant and the idea was that they were going to print from that plant and that became an issue and was talked about and what have you ...

MR. MICHALKO: Senator, perhaps I can ...

SENATOR GREENE: ... so you know, we had some points of question concerning Dittler Brothers long before we had the question of fraud which may or may not be, and I understand it's civil ...

CHAIRMAN DILLS: Senator Greene ...

SENATOR GREENE: We understood that from some time ago so I still pose the same question.

CHAIRMAN DILLS: Senator Greene, may I correct you, the Dittler Brothers did not build the plant, it was Scientific Games.

SENATOR GREENE: Yes, but they are one and the same, really, as a result of that master agreement. Is this not correct?

MR. MICHALKO: Senator, I am not certain I understood your question and I apologize.

SENATOR GREENE: Well, I'm saying I'm going back to the master agreement. Why was there not a clear understanding of what that master agreement meant when the question of the plant being constructed here in California came up?

MR. MICHALKO: Senator, to the best of my knowledge, the existence of the master agreement and most of the major provisions therein were very well known at the time the plant was built in California. In fact, that was the issue concerning the litigation between Scientific Games and Dittler for the past year.

SENATOR GREENE: Well, why was it said then that that plant had to be used?

MR. CHON GUTIERREZ: Mr. Chairman, if I may. My name is Chon Gutierrez, I'm the Chief Deputy Director of the California Lottery.

When we were first talking to Scientific Games about tickets for California, the Gilroy plant was mentioned shortly thereafter. I don't recall specifically the time, it could have been May or June, so Senator Greene, there was at least in Scientific Games' mind the possibility they might be able to print tickets in Gilroy. I think the master agreement that existed is what precluded them from ever firing up the plant. But it was always an issue and we were always aware of it and we were aware that the master agreement had an impact on whether they could open it or not.

SENATOR GREENE: All right, so in other words, you're saying that Scientific Games was purposely entering into an act which it knew violated its master agreement with Dittler Brothers, is that what you're saying?

MR. GUTIERREZ: That's not what I said, no.

SENATOR GREENE: Well, but these scenarios that you've outlined, is it reasonable for me to conclude that that could possibly be the case?

You're saying the firm has got a 25-year contract with a person to do one segment of the work and they go and construct something which, if it were put into operation, would put them in violation of that contract? I mean, how else do I understand

your response, or if I'm incorrect, suggest to me a clearer understanding of it.

MR. MICHALKO: Senator, I might offer a clearer understanding which is that I don't think anybody on the Lottery staff is prepared to answer questions with respect to the intentions of Scientific Games in building the plant in Gilroy.

SENATOR GREENE: But, they did commit that act, is that correct?

MR. MICHALKO: Yes sir, they sure did.

SENATOR GREENE: Okay. Now, my question then is, why wasn't part of what you were saying or what we heard coming from the Commission, why wasn't it pointing out more clearly what Scientific Games was doing? You know, separate and apart from people having to go to court and what have you? My point is, why hasn't the Commission been more aggressive in these regards rather than waiting for them to surface and then reacting?

MR. MICHALKO: Okay. Excuse me for -- I'm not sure I understand your question, but if I do, the question about the existence of the Gilroy facility is something that was well known by the Commission, and, as I said, most of the members of the media long before the issue of the fraud surfaced in the court hearing in Georgia ...

SENATOR GREENE: I understand that sir. Why were you not raising the same kind of question with Scientific Games then that you are raising now, is my point? Because they were taking off in left field then, why weren't you referring back to their action as it relates to the master agreement?

MR. MICHALKO: I'm not certain I understand.

MS. SWEET: May I try and answer your question? The actual fact of building the plant in Gilroy, we weren't sure whether or not that, in itself, was a violation of the master agreement. As far as we knew, they weren't printing any of our lottery tickets there, so the existence of that building in Gilroy wasn't something we would use to say that Scientific Games was doing something in breach of our contract with them.

SENATOR GREENE: Did you believe that that was their intention?

MS. SWEET: I can't recall. I believe there was something to that effect in the press. But, they did not use it to print any tickets.

SENATOR GREENE: Did you query them on it?

MS. SWEET: I can't answer that. I would have to defer to Mr. Michalko.

SENATOR GREENE: Did you query them on it?

MR. GUTIERREZ: I'm sorry, Mark. I certainly did, Senator. I discussed the matter with them.

SENATOR GREENE: And what was their response?

MR. GUTIERREZ: Their answer was that the issue of whether they could operate the Gilroy plant or not was a matter that had to be addressed in Georgia by the court process and until that issue was resolved, they could not operate it in California. They would have to await that judgment and so it was not a matter of fraud at that point. It was a matter of them settling the dispute.

ASSEMBLYMAN AREIAS: As a point of clarification, Senator, I am somewhat familiar with Gilroy and that facility since it is in the 25th Assembly District, which I represent. As I understood it at the time, the concern was that that facility could be used more than just on lottery tickets. That that facility is equipped to print these coupons and the games that McDonald's and a lot of the fast food restaurants utilize. There was also concern as to whether or not Dittler Brothers could perform in terms of the obligations relative to the number of tickets that they'd have to put out for the California Lottery providing it was successful, as successful or more successful than expected and if they could not deliver those tickets then I felt like the builder of that plant would have a backup that they could utilize in that particular case. Those were the justifications, anyway, given at the time.

SENATOR GREENE: Would that violate the master agreement?

ASSEMBLYMAN AREIAS: Pardon me?

SENATOR GREENE: That would violate the master agreement that they had with ...

CHAIRMAN CONDIT: The Senator said would that violate the master agreement?

MR. MICHALKO: Senator, and Mr. Condit, I am trying to answer a question that I am not sure that is directed at the Lottery, but the mere existence of the plant in Gilroy, to my knowledge, does not violate the master agreement. It would only be through the utilization of those facilities to print tickets

for California, or any other state, that would potentially be in violation of the master agreement.

SENATOR GREENE: I'm speaking to the point that the Assemblyman made. He said that it was explained that the "intent" was. Now I understand that the existence does not in fact constitute anything questionable. But, if we take the Assemblyman's response as to what they said was their intent, had that been followed through with, that would have been in violation of the master agreement that you say exists. And you can give any kind of answer you want, you can't get around that if it had taken place. So, we either question their intent, or we question, or can then legally question, what the outcome would have been had that intent been followed.

MS. SWEET: Senator Greene, I have one more comment to make and I hope I am quoting this correctly. But, I believe in the master agreement there is some provision that if Dittler Brothers is unable to handle all of the tickets which Scientific Games has contracted with states to produce, that Scientific is allowed to go out on its own and produce the remaining tickets that Dittler cannot produce and that is under the master agreement. I hope that's correct, but I believe that's what our understanding of the agreement was.

SENATOR GREENE: Fine, and I certainly can't question that. But you need to make that plain when you explain what the master agreement says.

CHAIRMAN CONDIT: I just have, in addition to that, a question. I can understand that maybe the lack of confusion

about what they are building the building for and exactly what they're going to do with it, but I came to understand they printed three million California Lottery tickets there. Somebody printed them. Somebody authorized the printing -- thirty million, excuse me -- was I wrong?

MR. GUTIERREZ: Mr. Chairman, if I may, I was advised by Dan Bauer, the President of Scientific Games, that for the printing, I believe, of Instant Game Number 3, Instant Game Number 3 was an important game because the California citizens reacted so favorably to Instant Game Number 1 and Number 2, that there was a question as to whether or not there would be enough tickets available to implement Game Number 3.

CHAIRMAN CONDIT: Did they print the tickets there and how many were printed?

MR. GUTIERREZ: As I understand it, what I was advised by Dan Bauer is that they would start to print the back end of the tickets of Game 3, the tail end of that ticket delivery and hold it there if a Georgia court were to allow them to deliver them because Dittler Brothers could not produce them.

CHAIRMAN CONDIT: Why did they shred them? Did you tell them to shred them, or was it against the law for them to print the tickets without authorization? Did it violate the master contract?

MR. GUTIERREZ: I wanted to finish my point. We did not authorize the printing of those tickets. We did not condone them. We were simply advised of it. It was a precautionary measure being taken on their part in the event that they could

not deliver the tickets consistent with the terms of the contract.

CHAIRMAN CONDIT: You approved of that? You approved of them printing in Gilroy?

MR. GUTIERREZ: I tried to make that clear. They did not ask us to approve that.

CHAIRMAN CONDIT: Well, let me ask you when you don't approve of it and it violates the master contract, they have violated something. Have you investigated why they printed them, whether or not they have authorization to print them, and whether or not that's a good idea or not? I mean, has the Commission taken any position on that, on Gilroy printing?

MR. MICHALKO: Mr. Condit, let me attempt to answer that question. The issue that's being litigated right now in Georgia revolves around the use of, among other things, the use of the Gilroy facility. There is a provision, as I understand it, in the master agreement, that states, in effect, that Scientific Games can use alternative printing sources in the event that Dittler Brothers cannot supply the quantity of tickets required by any lottery ...

CHAIRMAN CONDIT: Okay, Mr. Director, do you believe that Dittler Brothers could not provide the quality and the quantity that was needed in this game?

MR. MICHALKO: I have no reason to make that judgment at this point because every order that we have placed has been fulfilled.

CHAIRMAN CONDIT: Okay, Mr. Areias has one final question. Do any other members want to speak to this particular issue on contracts, ticket contracts?

CHAIRMAN DILLS: I would just like to make an additional observation something along the line that Senator Greene did. It appears from what you just lately said that the two of you know quite a bit more about this agreement now than maybe you knew then. But the point is, didn't it occur to you lawyers that an operation which was under an injunction not to print anything might be committing a fraud had they not been stopped for whatever reason and that this was not such a fraudulent act as to cause you to want to write a letter to that party?

SENATOR GREENE: May I add to that which was built by the company using another name, attempting to keep it secret. So, you know, give us an answer.

UNIDENTIFIED VOICE: What name did they use?

SENATOR GREENE: What name did they use? They didn't use their own. They attempted to keep it quiet and I really wonder what kind of administrators you are, faced with that kind of thing that you don't smell a rat right then.

MR. GUTIERREZ: Senator Greene, and please I apologize if anyone should take offense by this, but there was a piece of legislation ...

SENATOR GREENE: Well, I wasn't referring to you.

MR. GUTIERREZ: ... last year at this time ...

SENATOR GREENE: I was referring to the Director. He's the one that's supposed to ...

MR. GUTIERREZ: There was a piece of legislation last year at this time, requiring that those tickets be printed at Gilroy.

CHAIRMAN CONDIT: Correction on that. Just in California.

MR. GUTIERREZ: Thank you. A requirement that they be printed in California. A failure to do that would constitute a misdemeanor.

SENATOR GREENE: It is the responsibility of that Commission, regardless of legislation or no legislation, to bring the appropriate facts forward. That's my point. Separate and apart from, you know, maybe that would not have happened, maybe it would have happened in light of it, but that kind of information was not made available to the Legislature by the Director.

MR. MICHALKO: Senator, I beg to differ on that. That issue was not only made available to everybody who wanted it, it was made available long before I got on the scene out here. I don't think that there was any question about the existence of the facility in Gilroy, and, quite frankly, I am a bit disturbed at your characterization that we didn't provide any information to that effect. The issue was widely discussed in the media. It was widely discussed at a variety of meetings and I am certain that everyone was very familiar with the existence of the Gilroy facility.

CHAIRMAN CONDIT: Mr. Areias.

ASSEMBLYMAN AREIAS: Yes, thank you, Mr. Chairman. I think that the point that Senator Greene brings up relative to the way Scientific Games operating in kind of a clandestine manner relative to building that plant is a good one and there is no way that I would ever try to rationalize that behavior on their part. But, the fact that this fraud was being perpetrated by Dittler Brothers against Scientific Games, I mean undoubtedly, Scientific Games knew that some time ago and had charted their legal course long before that and consistent with their contractual obligations to the California State Lottery, I can only speculate that they felt they had a pretty strong legal case and at least as of right now, it appears that they were right. As most of you know, I am on record as feeling very strongly that the Lottery was sold in the name of economic development, was going to provide jobs. It would also insure that it was going to be secure, it was going to be run in an honest, above board way, and that undesirable elements were going to be kept out of California. I think that that is Mr. Michalko's highest priority, as it should be all of ours. And I think the best way to secure the most fundamental part of the process, the printing of the tickets, is to be here in California. My preference, naturally, is Gilroy. It's in my district and we need those jobs there. But if it's not Gilroy, somewhere in California. That's economic development. (Woodland, Mr. Hill says.)

So anyway, if your action is a step in the direction of seeing to it that those tickets are printed here in California so we can best secure that process, Mr. Michalko, I applaud your efforts.

CHAIRMAN CONDIT: I have, before Senator Dills takes over, just one additional comment. You were aware of the charges against Dittler Brothers in April sometime -- is that correct?

MR. MICHALKO: I'm sorry ...

CHAIRMAN CONDIT: You were aware of the allegations against Dittler Brothers of fraud in April sometime?

MR. MICHALKO: Yes, sir, on April 30th.

CHAIRMAN CONDIT: Okay, you stated awhile ago that one of your major obligations in charging your responsibilities is to protect the integrity of the lottery system in California. From April to June, what did you do about it, and why did you wait until June to make the recommendation to the board?

MR. MICHALKO: The answer, quite simply, Mr. Condit is that in April, on April 30th in fact, when the arbitrator made his initial ruling, the only information I had about it was on the basis of a brief telephone call from Mr. Bauer, the President of Scientific Games. And, again, to emphasize the peculiar nature of the process in Georgia, it's a three-step process. There is a person known as the auditor. I waited until I received information about his ruling, where he not only upheld the arbitrator, but he independently concluded that the fraud occurred and more importantly, and Senator, this is directed to your question about the appeal process, more importantly, he made an explicit ruling in the auditor's report that there is a likelihood that Scientific Games would prevail ultimately on this issue when it was finally adjudicated in court.

CHAIRMAN CONDIT: So, you waited for two steps in the process?

MR. MICHALKO: Yes sir, I did.

CHAIRMAN CONDIT: Why didn't you wait for the third step?

MR. MICHALKO: The third step, Mr. Condit, could take a great deal of time. Based on the expressed language in the auditor's report, it is very clear that while there is an outside possibility of this decision being overturned on appeal, the likelihood, again, is very great that the auditor would be upheld.

CHAIRMAN CONDIT: Who advises you on the Georgia law?

MR. MICHALKO: That is a statement contained in the auditor's report. It is an expressed statement right in there. So, the auditor did.

CHAIRMAN CONDIT: Are they ever wrong?

MR. MICHALKO: Obviously you know the answer to that.

CHAIRMAN CONDIT: Well then, what is the liability to you and the Commission from Dittler Brothers?

MR. MICHALKO: What is the liability?

CHAIRMAN CONDIT: Yes.

MR. MICHALKO: I have no idea.

CHAIRMAN CONDIT: Well do you think there is some?

MR. MICHALKO: To the best of my knowledge ...

CHAIRMAN CONDIT: You terminated a contract running it through the two-step process. You didn't wait for the third: the court action. If they are found not to be fraudulent, are you liable for that contract?

MR. MICHALKO: To make it very clear to you, Mr. Condit and Members, there is a contractual provision that exists in our contract with Scientific Games that allows the Lottery to terminate for convenience, for any reason whatsoever, on 30-days notice. So, in my view, there is limited, if any, liability that's potential in this case.

CHAIRMAN CONDIT: Well, that might be debatable. I just have an additional request of you, both Senator Dills and I would like over the next few months to monitor this to see how it is moving along. Would you be willing to discuss it with us again?

MR. MICHALKO: I would be more than happy to provide you with updates on this information.

CHAIRMAN CONDIT: Thank you very much.

CHAIRMAN DILLS: One final comment -- having been the author of the bill that struggled and struggled and struggled to try to get through 1985, Senate Bill 35, and the last day we finally got it passed and then they had a glitch in it and so we started all over again with Senate Bill 34. And we found that we had a little kink in there too because we had endeavored to give the administration what we were told. They wanted two additional Lottery deputy directors and so we found that we couldn't do that by emergency statute so we had to start all over again with Senate Bill 34. Now if you think that some of us are a little bit impatient, you are right because we have been fighting for a year and one half to get one thing, one thing and that's open up the Lottery in California so that more than one bidder can bid. Now, you are in a big hurry. You are really in a big hurry.

Before the May 14th, or on the May 14th thing, you did not listen to the request, the petition of the Senate to not do it at this time. In other words, you had another million coming in in one month's time, you announced it then. We could have had that in July. You could have had it in June, your meeting in June. And you did have. And you didn't have to give notice of the extension of this contract, not until July 3rd. And that contract will go even without the extension. It would go into April of the following year, as I recall. So, you were in a very big hurry to get these things ahead of time so that we couldn't get to bidding. And that's what irritates a lot of us and what raises the anger and the frustration on the part of the Legislature. We had passed Senate Bill 34. It was signed by the governor on April 17 and in spite of that fact, in spite of our request for you to wait at least one more month, you could have done that, you went ahead and you extended the contract for reasons that were very, very urgent at that time. Now, you tell me that if, in fact, the decision doesn't come down either today or tomorrow or something, that prohibits you from doing so, that you would go to bid. Well glory be! If that ever happens, I want to be around! But so far, it appears to me, and I am speaking now for myself and a lot of colleagues of mine who have placed upon me the opportunity to get into the midst of this thing because I am chairing the committee as is Gary Condit.

What we are trying to do today is to get information as to how you think. What makes you think that one party has committed fraud without investigating what the other party has

done? And deleting one party from a contract of which you are not a member and setting yourself up for a potential lawsuit against the State of California, and I am talking about saving money for kids, that's the carrot that we hold out in front of the people, but this is for the benefit of kids (you've got a button on you right there that says "And the schools win too!") Actually, they are the only ones that should be winners. But, nonetheless, nonetheless, we will put ourselves into situations where it is going to cost us money to defend against an action which should not have been taken, at least so precipitously.

The attorney for Dittler Brothers would like to make a brief presentation to clarify some of Michalko's statements. The chair and I feel it is improper at this time to do that for the reasons that this an informational type of hearing for the benefit of the Legislature. The confrontational things, we'll see them in court. But, so far as the Legislature is concerned and the ongoing of this, we feel at this time that this is not the time and place. That isn't to say that there should not be an opportunity for them, because as of now they have not had an opportunity other than by the deposition.

Thank you very much, Mr. Chairman.

CHAIRMAN CONDIT: Well Senator Dills, I think while we are transcribing this hearing, we would take their testimony in writing. We have other subject matter and we think that if they want to submit something in writing we would certainly take it.

CHAIRMAN DILLS: Right.

CHAIRMAN CONDIT: From both Dittler and Scientific if they would like to do that.

We would like to move on. We have covered the Items I and III of the agenda. We are going to deal with the remaining portions beginning with Part 2: Participation by Minorities and Women in Lottery Contracts. I'd like for you to remain there to speak to this, Mr. Director.

MR. MICHALKO: Yes, I will, Mr. Condit. I've asked Ms. Terry Fontenette, who is the Chief of our Affirmative Action and Contract Compliance Office to join me at the podium to discuss this issue.

CHAIRMAN CONDIT: What we would like for you to do, if you would, is to give us a brief overview of the policies and experience to date, contracts to advertise the State Lottery, et cetera, and then we have a variety of Members who have already wished to ask questions regarding these items.

MR. MICHALKO: Mr. Condit, if you will, I have provided the Members with, again, an overview of this particular issue in the packages that have been submitted to you.

To briefly give an overview of the Lottery's history in regard to participation by minorities and women in Lottery contracts, let me start by telling you the basic policy of the California State Lottery. And that policy is to achieve the most feasible and practical level of participation by minority and women-owned business enterprises in lottery procurement programs.

The Lottery Commission adopted a specific policy, way back in June, 1985 regarding subcontracting with minority and

women-owned business enterprises for major contracts. And we define those as contracts exceeding \$100,000.

The policy language is expressed as contained in the Commission minutes and published by the California State Lottery, and I will summarize that very briefly for you and for the other Members. The policy statement is that it is the intent of the Lottery to require the vendor to subcontract with minority and women-owned business enterprises as defined by Streets and Highways Code, et cetera. The vendor shall describe the plans it has for contracting work with minority, women-owned, or small business concerns in the State of California. Joint ventures or ownerships including these features will be acceptable in lieu of subcontracting.

That basic policy has been in effect since June of last year and as a result of that policy the Lottery's experience to date is that approximately \$29 million of business has been subcontracted or contracted with minority and small-business enterprises representing about 8.7 percent of total contract dollars for the California Lottery.

In addition to that policy, the Lottery adopted an additional policy pursuant to the terms of SB 34, which has to do with specific plans by minority and women-owned business enterprises for participation in major Lottery procurements, those in excess of \$500,000, as required by SB 34.

I've included in the booklets that you have before you the extent of minority and women-owned business participation in the various Lottery contracts and I would be happy to answer any

questions that you have with respect to those, or if you would like me to continue with an overview, I would be pleased to do that.

CHAIRMAN CONDIT: Assemblywoman Waters.

ASSEMBLYWOMAN MAXINE WATERS: Now, I would suggest that you not continue with the overview because that doesn't tell us very much. I am particularly interested now in your \$29 million representation -- would you, in fact, break that down and tell us exactly what is represented -- who got the contracts and from whom?

MR. MICHALKO: Okay. Ms. Waters, I would ask that Ms. Fontenette address that since she has all the figures, I believe.

ASSEMBLYWOMAN WATERS: Okay.

MS. TERRY FONTENETTE: The prime contracts that included the ...

CHAIRMAN CONDIT: Please identify yourself.

MS. FONTENETTE: Terry Fontenette, Chief of the Contract Compliance Office for the Lottery.

The prime contracts that we're talking about that involved MBE/WBE dollars were the California Plant Protection contract that we have for security; the GTECH Corporation contract that we have for the on-line computer; Needham Harper Worldwide contract for advertising; Purolator contract for distribution of the tickets; Casada/Navarro and Company, which is an auditing firm; and Gail Deforest and Associates, which was an architectural firm.

ASSEMBLYWOMAN WATERS: All right, let me, if I may, take a little bit of time with this -- you did not mention Scientific Games.

MS. FONTENETTE: At this report, Scientific Games had not given me a report yet, but they have subsequently and they have two women-owned firms, one is a trucking firm and the other is a photo firm.

ASSEMBLYWOMAN WATERS: How much do they represent? And have they been signed? Are they operative?

MS. FONTENETTE: Those have been signed. I don't have the figure right here now to what it contains, but it was not in this report.

ASSEMBLYWOMAN WATERS: Can you guess, about how much?

MS. FONTENETTE: I think it's about five million.

ASSEMBLYWOMAN WATERS: And this is a trucking firm?

MS. FONTENETTE: It is a trucking firm that delivers the tickets to the Lottery.

ASSEMBLYWOMAN WATERS: And a photo firm?

MS. FONTENETTE: And a photo firm.

ASSEMBLYWOMAN WATERS: And both of these are women-owned?

MS. FONTENETTE: They are women-owned, yes.

ASSEMBLYWOMAN WATERS: All right. The courier service that has a major, well, small contract, that's Purolator?

MS. FONTENETTE: That's Purolator, yes.

ASSEMBLYWOMAN WATERS: Is there any minority participation in that one?

MS. FONTENETTE: Yes. Right now they have an Asian firm that is delivering some of the tickets to the outlets.

ASSEMBLYWOMAN WATERS: How much is that worth?

MS. FONTENETTE: It's per delivery of tickets and I haven't gotten their ...

ASSEMBLYWOMAN WATERS: What's the total amount?

MS. FONTENETTE: 500,000, approximately. They've been, they've had another minority from in the past that's in difficulty and they got this firm and they're looking for a Northern California firm.

ASSEMBLYWOMAN WATERS: Okay. Needham Harper?

MS. FONTENETTE: Needham Harper, to date, has approximately \$1.3 million worth of minority contracts.

ASSEMBLYWOMAN WATERS: Can you tell me what that represents in terms of the number of minority firms? Is that a contract with one minority firm?

MS. FONTENETTE: No, to contract each game, they receive a report and there's approximately eight to ten different companies that they use to produce a game.

ASSEMBLYWOMAN WATERS: I hear what you're saying.

MS. FONTENETTE: Each game is different. For the first game, prestart was approximately \$115,000 on production and media was about \$211,000 and they are for each game. The total is approximately \$945,000 for the production end of it and approximately \$1,592,000 for media.

CHAIRMAN DILLS: Let me interrupt you for an announcement. We've been informed that the Georgia court has

made a decision that the fraud charges have been stayed, that the injunction is preserved, and that Scientific Games cannot print in California.

ASSEMBLYWOMAN WATERS: Well, let me just interrupt this for one moment. We'll get back to the other questions in a second. I guess I've, this does not have to deal directly with minority participation but this interests me, this decision. Is Scientific Games in South Africa?

MR. MICHALKO: I do not know the answer to that. I believe we can check on that for you. We can check and get an answer for you.

ASSEMBLYWOMAN WATERS: Is someone here from Scientific Games?

MR. MICHALKO: I don't know that anyone's here in the room but I believe that we can try and find someone or make a phone call.

SENATOR GREENE: (Inaudible).

ASSEMBLYWOMAN WATERS: Have you been in discussion with anybody about their operations in South Africa at all? Has this subject come up before?

MR. MICHALKO: Has the subject of South Africa come up? It has not come up in any of the contract discussions that we've had at the Lottery.

ASSEMBLYWOMAN WATERS: Not contract discussions, any discussions.

MR. MICHALKO: With respect to any of the business of the California Lottery, it has not.

ASSEMBLYWOMAN WATERS: Not with respect to the business of the California Lottery and any discussions relative to Scientific Games. This is not the first time you've heard this, is it?

MR. MICHALKO: With respect to Scientific Games, it is.

ASSEMBLYWOMAN WATERS: It is the first time you've heard this?

MR. MICHALKO: Yes, it is.

ASSEMBLYWOMAN WATERS: Send me (inaudible).

ASSEMBLYMAN HILL: I wonder, if at the same time, we could check some of these women and minority-owned businesses that are contracting, that you mentioned, the \$29 million. Could we check and also see if any of those are doing business in South Africa at the same time?

MS. FONTENETTE: I can have those checked.

ASSEMBLYWOMAN WATERS: But first we'd like to establish that we have \$29 million. It's not adding up so far. I (inaudible) see what we can get to here. The Needham Harper contract is \$22 million, is that correct?

MS. FONTENETTE: Yes, depending on ...

ASSEMBLYWOMAN WATERS: Of that \$22 million, how much of that is contracted to minority-owned firms, women and minority-owned firms?

UNIDENTIFIED VOICE: I think it's better to answer on the production.

MS. FONTENETTE: Okay. For the production costs right now as to Game 6, it's \$945,000 which is approximately 23.6

percent of the total for all the games. Right now, their total for up to Game 6 is approximately four million.

ASSEMBLYWOMAN WATERS: Okay, and what do they project they're going to do?

MS. FONTENETTE: They projected that they were going to do about 20 percent. Not in the contract, they projected it in discussions with ...

ASSEMBLYWOMAN WATERS: No, I want to ask you about that because I've flipped through this information just briefly and have turned to what is called (inaudible) information relative to how you, in fact, realize your intent at minority participation. Do you require, prior to work contracting that any of these entities, that they identify in their contract any participation, who they're going to participate with and for how much?

MS. FONTENETTE: We do if it's known. Most of them have included them in, some of them say that "we are negotiating right now." We ask for those names immediately as soon as they make the negotiations. Similar to GTECH; GTECH had not identified all of the particular minority subcontracting companies. But, we are subsequently asking for each one ...

ASSEMBLYWOMAN WATERS: They are not required to, are they? You don't require that.

MS. FONTENETTE: If they are known, we require it. If they don't know them as yet, then they're not there.

ASSEMBLYWOMAN WATERS: I'm sorry, would you repeat that?

MS. FONTENETTE: If the company is known to them at the time of the contract, then we ask them for the name. In some

cases, it is not known. In the case of GTECH's, there's about 11 areas that they can have subcontracting in -- that they had not right then subcontracted with the minority but they had set aside a particular amount.

ASSEMBLYWOMAN WATERS: So in effect, what happens is that if I, as a majority company, and I wanted the contract and I just made the representation that I'm going to do business with minority contractors unknown, there would be no reason for you not to sign the contract with that particular company because they do not have to identify who the company is, or who the companies are, that they're going to contract with; is that correct?

MR. MICHALKO: We try, we make every attempt, Ms. Waters, to get the explicit name of the party prior to any entry into a contract.

ASSEMBLYWOMAN WATERS: Yes, but what I'm saying is, she explained that, I understood that. Ms. Fontenette did a good job with that. What I wanted to be clear about was if, in fact, there is no company shown in the contract and they say, "we intend to," that's good enough for you, is that correct?

MR. MICHALKO: That is not correct. They will have to make subsequent representations as to exactly who the party is. We would not just ...

ASSEMBLYWOMAN WATERS: You don't sign the contract until they actually give you the names?

MR. MICHALKO: We would not just take the word for the fact that they intend to do something in the future. We would

make every attempt to have the party identified by name and by dollar amount.

ASSEMBLYWOMAN WATERS: I guess you and I don't speak the same language. I'm aware of your intent and your desire because you've said that. You've stated it over and over again. I asked you a very direct question. There is nothing to prevent you from signing a contract with someone who simply said to you, "we intend to, we're good guys, we want to and we will make every effort to; we don't know the manager of the company's name but we'll give it to you later." There's nothing to prevent you from signing that contract. Now, if there's something different than that, let me know. Don't tell me about your intent anymore, just let me know if you sign contracts; if you can, without having minority or women-owned firms identified prior to your contracting with the company.

MR. MICHALKO: As I attempted to say, and I apologize for not making myself clear, we have signed contracts on the basis of the intent without having the specific party identified, that is correct.

ASSEMBLYWOMAN WATERS: I'm sorry. I didn't hear you. We better start with something right here because I've been sitting here listening to you for the better part of the afternoon, where you've been playing with a few members in the way you respond, and I'm very clear, and I do not wish you to do that with me. If, in fact, you sign contracts without having names, and there's nothing to prevent you from doing that, please just tell me so.

MR. MICHALKO: The answer to that is yes, we have that ability.

ASSEMBLYWOMAN WATERS: All right. Thank you. Let's go on past Needham Harper. Who is the next contract with? You show here that you have a contract for lease purchase of vehicles for sales representatives from Center City Ford in San Diego. That's in the amount of \$5.5 million?

MS. FONTENETTE: Yes.

ASSEMBLYWOMAN WATERS: Who are the minority participants with this contract?

MS. FONTENETTE: It is the owner of Center City Ford and it's 100 percent minority-owned.

ASSEMBLYWOMAN WATERS: Okay. So all \$5.5 million will be counted in the total amount of minority total you have today, is that correct?

MS. FONTENETTE: That \$29 million does not include that \$5 million. It was a contract after the date of this report.

ASSEMBLYWOMAN WATERS: So this \$29 million is before the \$5.5 million?

MS. FONTENETTE: Yes.

ASSEMBLYWOMAN WATERS: Okay. Before we get to the on-line, and they'll talk about that in a minute, I am trying in the best way that I can, to find the \$29 million. And I recognize that I've only gone through a few and we have named a couple of more, an auditing firm. How much does the auditing firm represent in actual dollars?

MS. FONTENETTE: The auditing firm right now represents, according to the report as of April, \$125,826. That contract has been ...

ASSEMBLYWOMAN WATERS: I'm sorry, let's back up. What is the amount of the total contract?

MS. FONTENETTE: \$125,000.

ASSEMBLYWOMAN WATERS: And what is the minority participation in that?

MS. FONTENETTE: One hundred percent.

ASSEMBLYWOMAN WATERS: One hundred percent. And in the architectural firm?

MS. FONTENETTE: It's \$7,000 and it's 100 percent. It's a woman-owned.

ASSEMBLYWOMAN WATERS: \$7,000?

MS. FONTENETTE: Yes.

ASSEMBLYWOMAN WATERS: I've missed something. Perhaps you can help me get to \$29 million. You go back now and do it for me, okay?

MS. FONTENETTE: Okay. With the California plant protection contract, it's \$157,000 that will be encumbered to minority or women-owned businesses.

ASSEMBLYWOMAN WATERS: What is this, a security grant?

MS. FONTENETTE: It's a security type grant ...
(inaudible - voices overlay) ... They have joint-ventured with a minority firm -- with a 100 percent minority firm.

ASSEMBLYWOMAN WATERS: Okay.

MS. FONTENETTE: And that's the amount of dollars going to the minority firm.

ASSEMBLYWOMAN WATERS: \$157,000?

MS. FONTENETTE: Yes.

ASSEMBLYWOMAN WATERS: Okay.

MS. FONTENETTE: In the GTECH Corporation contract, there's been \$27 million encumbered to go to minority and women-owned ...

ASSEMBLYWOMAN WATERS: GTECH is not on-line, is it?

MR. MICHALKO: It's not at this time. No.

ASSEMBLYWOMAN WATERS: On GTECH, I'm particularly interested because, again, when you talk about GTECH, you're talking about intentions, and I guess they have supplied you with the names of suppliers, past the point that you actually see in the contract, I don't know, since you would not have required that, so let's now start to count what (inaudible) in the future because, based on what you're describing to me, there appears to be minimum enforcement.

Let's talk about what's happened since the inception of the Lottery and let's get some numbers. I hope you're not counting GTECH in the \$29 million. You wouldn't do that to me, would you?

MS. FONTENETTE: I am counting GTECH because we have signed the contract and that's money encumbered.

ASSEMBLYWOMAN WATERS: Please do not include GTECH in what we're talking about in minority participation because I don't think -- unless you've done some follow-up past the time

you actually contracted with them and you have seen the names of the minority participants.

MS. FONTENETTE: I have. Right now, they have -- \$5.8 million has been spent for minority and women-owned businesses, so far, in the contract they have sent me. They have printers, paper stock -- there's a whole list; and the representative from GTECH is here and he's just given me ...

ASSEMBLYWOMAN WATERS: Terry, I don't want to belabor this point, and I suspect the intentions are good, but are you telling me that GTECH has already spent \$5 million in printing?

MS. FONTENETTE: Not just in printing. There's about six or seven areas that they've spent.

ASSEMBLYWOMAN WATERS: Well, what I'm going to do, I'm going to take that one off the board; I'm going to deal with that separately. I really want to get an idea of what has happened in terms of minority participation since the inception, up to the point where you signed the contract with GTECH, because it will give me a look at Scientific Games and Needham Harper, in particular -- some of the earlier ones that we've had complaints about. If they've done something, and we don't know about it, we should find out more today. Would you rather just conclude that you just didn't do very much in the first year and that you've gotten your act together and are wishing to comply with the intentions of the Legislature, and may be doing better. Maybe if you do that, we don't have any problems because I will get upset if you try and mislead me. Perhaps we better do that. Is that okay?

UNIDENTIFIED VOICES: (Inaudible)

ASSEMBLYWOMAN WATERS: Okay. Why don't we move forward and conclude that you haven't done very much but now you're on track. What are you going to do?

MS. FONTENETTE: In the area of the GTECH contract that was just signed, we are working with GTECH in order to (along with their consultant) to find and search out minority firms in a variety of areas. We've been working very close, and we've developed forms, procedures, and verification and certification of procedures that they will follow when they subcontract with minority firms, to ensure that the \$27 million mentioned in their contract is actually spent with minority firms.

ASSEMBLYWOMAN WATERS: So you have a better follow-up and monitoring system to make sure that ...

MR. MICHALKO: That's correct.

ASSEMBLYWOMAN WATERS: All right. All I can do is say, "Fine. We want you to do that and we're going to look very closely at that."

I'm concerned about this area of advertising. Needham Harper Worldwide does not have a good reputation in the minority community in terms of its participation with minorities to date. What do you do to keep this from happening? You have spoken to me about Needham Harper's involvement with minority contractors, based on six different games, and you have given me a figure of about \$945,000 out of the \$22 million. I'm not so sure that I understand, right now, what it means or what it's going to mean in the future, but the fact of the matter is, I think it's an

area that most reasonable people can conclude that there certainly should be substantial participation. What are we going to do in this area; how can we assure this area?

MS. SUSAN CLARK: My name is Susan Clark; I'm Assistant Director in charge of Marketing at the California State Lottery. I think you've asked a very good question about what steps have been taken with Needham Harper Worldwide to increase minority participation, and how we plan to proceed with this issue in the future.

I'd like to refer your attention to the chart on the easel. Ms. Waters, you're comparing two figures: a \$945,000 figure to a \$22 million figure; they're not the same type of figure.

ASSEMBLYWOMAN WATERS: Okay.

MS. CLARK: The \$945,000 is minority subcontracting expenditures for advertising production -- the production of commercials, radio commercials, posters, and so forth -- the actual materials. That is 23.6 percent of total such expenditures of about \$4 million (\$4,002,217 to be specific).

It is absolutely true that we were not particularly satisfied with the progress that the Lottery and Needham, together, made in subcontracting this type of expenditures in Games 1 through 3. As you can see, that is a lower percentage; in fact, that was only 16 percent. In Games 4 through 6, the percentage of these types of production expenditures has gone up to 36 percent, so the 23.6 percent average doesn't exactly lay out, for you, the type of progress we've made.

Why was the percentage for games 1 through 3 as low as it was? To do the type of outreach in identifying vendors the lead times that we had in games 1 through 3 -- I wasn't here, but I understand the games (because of the unprecedented record sales), the materials came up much more quickly; the deadlines; they felt the first priority was to deliver the materials to the Lottery.

Happily (if there is a happy side to sales slowing somewhat), we've been able to plan a little bit better, and Needham has taken several steps to do outreach to minority subcontractors. They keep a running log of every single phone contact with every minority subcontractor; with details of who spoke; what was the material in question; if, in fact, no job was awarded to that minority subcontractor, there is a reason why.

For instance, they did not have an appropriate kind of press to run the colors we needed for a poster, and the Lottery receives these logs. Before each invoice, for a poster, for a commercial, for whatever is signed, the vendor is identified on that invoice and again, a reason why it was not a minority vendor. So, we're pleased with the progress that's been made.

As we move to the future, this current contract expires at the end of October. As we move to gear to our advertising contract, the Lottery -- and I think it's the Lottery's responsibility to establish a percentage, if you will, or some type of program to even improve the way we reject the minority community for subcontracting.

CHAIRMAN CONDIT: Are you finished, Ms. Waters?

ASSEMBLYWOMAN WATERS: Let him go ahead.

CHAIRMAN CONDIT: We've got a list; Mr. Hill's on the list. Mr. Hill; same subject; do you have a question Mr. Hill? Or, do you want Mr. Harris to ask his?

ASSEMBLYMAN HILL: Mr. Michalko. As you know, Mark, I was very involved in the negotiations for full minority and women participation, as was Ms. Waters, and then Chairman of the G.O., Mr. Alatorre, literally months, and at the end, hour upon hour, trying to hammer this thing out. I can't remember all the provisions of the bill, but some of the things that were required of the Lottery Commission was the adoption of some policy statements in terms of what they were going to do for participation; I think contracts over \$500,000, the major vendors had to submit, to the Lottery Commission; essentially, what my question is, is have all those provisions -- the measure that I supported, Ms. Waters supported, in fact I think everybody on the panel, except for Mr. Harris, voted for -- have the provisions of that legislation been met?

MR. MICHALKO: The answer to that, Mr. Hill, is "yes; we've adopted -- the Commission has formally adopted the provisions of SB 34 (the ones you addressed)," and as Ms. Fontenette has been explaining, we are making every effort to meet the express provisions of that policy, as well as the Commission's own policy that they adopted over a year ago.

ASSEMBLYMAN HILL: But, your major subcontractor -- the \$500,000 and up contractor -- said they're doing what they're supposed to do; you passed the -- wasn't there some action the

Commission had to take in terms of -- all those provisions have been met?

MS. FONTENETTE: The Commission just passed that policy and procedures and process in their last meeting this month. They're in your packet.

ASSEMBLYWOMAN WATERS: Then let us not mislead Mr. Hill, and I think it's important for us to -- for me to say this while you're talking -- we certainly did pass that legislation; it is by no means the ideal; it is by no means what Maxine Waters really wanted; Mr. Elihu's vote was an accident vote that says this is not much of anything really because that language, that we ended up in a compromise with, in no way satisfied us when we were going at that 30 percent participation.

Because we have worked with affirmative action for so long, and trying to get participation by minorities in all kinds of procurement activities as it relates to government, we know that unless we can get legislation that strictly identifies what it is we think you should do, then we're going to have be in this business of following up on you and hammering and beating up on you all the time.

We would like to get out of that posture, so when Mr. Hill represents to you this wonderful piece of legislation that was passed, that we all supported, you must understand that we are not satisfied with that legislation; we are suspicious that your intent will not be good enough, and so we need those questions. It is because we know that we have the weakest language that you're working with and unless we really are very

active, we care about this area and nothing is going to happen and that's why we ...

CHAIRMAN CONDIT: (Inaudible) let Mr. Hill finish, and then we'll go to Mr. Harris.

ASSEMBLYMAN HILL: I guess Ms. Waters helped me with my conclusion. I think she is exactly right; there was a lot of compromises and it certainly wasn't the piece of legislation that I liked either.

I guess the next step is in terms of the direction that the Lottery Commission needs to go. If we're unsatisfied with the participation of women and minorities in the Lottery business and the way they conduct their business, I guess the next appropriate action is for the Legislature to carry forth some new legislation if we don't think this does enough. Obviously, the Lottery Commission has met all the requirements that we initially asked them to do; I mean, maybe we need to have another piece of legislation ...

UNIDENTIFIED VOICES: (inaudible - two voices)

ASSEMBLYMAN HILL: Maybe Ms. Waters would consider bringing that forth?

CHAIRMAN CONDIT: Well, I don't know, earlier testimony indicated that you didn't think you met all the minority requirements; is that right? Did I mishear that?

ASSEMBLYMAN HILL: I thought the question that I asked the Lottery Commission was "were all the requirements that we laid out in that legislation ..."

CHAIRMAN CONDIT: That's a contradiction then. You said "yes," but then the testimony indicates you're trying to do more and that you should be doing more.

MS. FONTENETTE: Since that legislation was passed, we have adopted additional policies per that legislation and have just begun to initiate that because it was just approved by the Commission this month, and we're coming with a report to the Legislature on the policy statement.

CHAIRMAN CONDIT: So your policies are new requirements within your own internal policy about minority hiring than what the legislation is; is that correct?

MR. MICHALKO: That is correct.

CHAIRMAN CONDIT: Well, maybe we ought to consider adopting your policy then.

ASSEMBLYWOMAN WATERS: No. Don't be too quick to jump at that. You see when you talk this language for years, Mr. Condit, you learn how to speak it and understand it very well. When you start to talk about policies that have been adopted -- that go above and beyond -- I don't really know that they are, but I know one thing for sure; that there's nothing in it that talks about absolutely, the example, the point that I made earlier, and show them that you never contract with anybody until they have demonstrated, in their contract, that they actually have minority participation.

You don't have an escape clause in a contract that will allow you to get out of it, if, in fact, that requirement, or that intent of yours, is not met; you see what I'm saying? So,

you know, we don't want to fool each other, and I understand all of this stuff very well.

Let me raise with you just one other thing, because, as you said, we intend to move forward and not only carry out the intent of the legislation (which I consider very weak), but you want to do more and you will be doing that within the contract. How long, for example, does the Needham Harper contract -- how long have you contracted with them for; for how long? Does that come up?

MR. GUTIERREZ: The contract expires in the first week of October; October 3rd is the official date; it has two six-month extensions which are available at the option of the Director.

ASSEMBLYWOMAN WATERS: All right. If, in fact, -- that would go out to bid, is that correct?

MR. GUTIERREZ: If the two contract extensions are not exercised, it will go out.

ASSEMBLYWOMAN WATERS: You have contract extension options with Needham Harper? Could you describe those to me and what's the reason for that?

MR. GUTIERREZ: All of the contracts that we entered into, when we first started the Lottery, had a six or twelve month extension. The thinking was that we were entering so many substantial contracts (big contracts), that we were afraid that twelve months later, when they all came due, we, literally, would be bombarded with trying to run the Lottery and trying to now reconsider these contracts. So, we tried to give ourselves a way

to stagger certain contracts, if the performance is satisfactory, and everything was working fine. That was ...

ASSEMBLYWOMAN WATERS: So we could possibly enter into an option of another twelve months, for example, with Needham Harper?

MR. GUTIERREZ: Yes, ma'am.

ASSEMBLYWOMAN WATERS: There isn't any reason for you to do that is there?

MR. GUTIERREZ: We will discuss that internally and make that judgment at the next Commission meeting.

ASSEMBLYWOMAN WATERS: I am interested in knowing if, in fact, you get a minority contractor who comes in for the major and you get an RFP out, and you have a minority contractor who comes in to bid, would that minority contractor be considered for the major contract?

MR. GUTIERREZ: If that's the way they applied, yes, ma'am.

ASSEMBLYWOMAN WATERS: You know why I ask that?

MR. GUTIERREZ: No.

ASSEMBLYWOMAN WATERS: Because all of the language on affirmative action applies to something in practice.

MR. GUTIERREZ: You know, we struggled with that issue, quite frankly, Assemblywoman Waters. If an owner comes in -- a major entrepreneur, a very, very large owner of a large corporation that happened to be women-owned, minority-owned, then what kind of point value does that deserve in an evaluation process, versus a smaller mom and pop type printing operation? We struggled with that.

ASSEMBLYWOMAN WATERS: Well, there should not be a struggle. As you struggle, some of us that struggled with all of this for a long time will give you the benefit of our advice.

MR. GUTIERREZ: Appreciate it.

ASSEMBLYWOMAN WATERS: First of all, even though we are attempting to ensure that you have minority participation, there should be nothing in your options that would exclude the possibility of minorities getting whatever they can get, based on the fact that they qualify, they can compete, and if they ended up providing 90 percent of the services for the Lottery, then what's wrong with that? You see what I'm saying? So, if you tell me that you've been struggling with, that if a black-owned advertising firm comes in -- and they, obviously, are better than Needham or anybody else, and you decide to contract with them for \$22 million, you would feel guilty because you're not able to give out ten \$5,000 contracts. Please don't feel that kind of guilt.

MR. GUTIERREZ: No. I don't think that's what I meant. I meant ...

ASSEMBLYWOMAN WATERS: You know what I'm saying?

MR. GUTIERREZ: We ...

ASSEMBLYWOMAN WATERS: What are you struggling with? What I want to know is, because you have known all along that to subcontract, wouldn't it tell you that there are persons who could supply goods and services to the Lottery; who might be interested in doing something like that?

MR. GUTIERREZ: I appreciate ...

ASSEMBLYWOMAN WATERS: They're majors.

MR. GUTIERREZ: I appreciate that part.

ASSEMBLYWOMAN WATERS: I don't mean I want them excluded (inaudible).

MR. GUTIERREZ: They will not be; that's an assurance. The thing we're struggling with is in setting up the evaluation, the points that we give in evaluating vendors. We ascribe "x" number of points to being a minority-owned business and do we give a sole owned, minority business the same points that we would a nonminority sub, I guess the answer is, "Yeah, we have to." We haven't faced that problem ...

ASSEMBLYWOMAN WATERS: Yes, but let me just tell you, if this -- you know I would like to be somewhat instructive, if I may ...

MR. GUTIERREZ: I appreciate that; yes ma'am.

ASSEMBLYWOMAN WATERS: If you have a minority-owned business who comes in for a major contract, and that person, obviously, can compete based on their qualifications and all the other things, you can treat them just like you treat a white-owned major company; require them to be (inaudible) participation of those who fall in the other category.

MR. GUTIERREZ: As a matter of fact, as I'm sitting here listening to you describe the situation, you're describing Center City Ford in San Diego.

ASSEMBLYWOMAN WATERS: Well, my point ...

MR. GUTIERREZ: That's exactly what we did.

ASSEMBLYWOMAN WATERS: Well, that's okay.

MR. GUTIERREZ: So we're no longer struggling with that issue; I guess we resolved it.

ASSEMBLYWOMAN WATERS: No, that's what you do.

MR. GUTIERREZ: That's what we did.

ASSEMBLYWOMAN WATERS: No. That is getting out of it. That's only \$5 million, you know. We want to look at some of the real money.

MR. GUTIERREZ: A million here, a million there, pretty soon you know.

ASSEMBLYWOMAN WATERS: A million here a million there - ha! But still, I don't want you to think \$5 million is major when you're dealing with \$121 million and you're dealing with, so what I'm saying is, you can just do it on the results. All right?

MS. FONTENETTE: In the criteria that I've set up, when we evaluate proposals for bidders and contractors, we assign percentage points based on the MBE or WBE participation. If it's a company owned by minority and women-owned, then they receive those assigned points, based on their dollar amount. If their dollar amount was \$5 million, they would receive a percentage of the -- let's say it's 10 points -- they'll receive the 10 points because all of their contract is within the MBE/WBE participation. If they were to subcontract -- let's say with a women-owned firm -- it would still come out to be 100 percent, because both are minority or women-owned.

CHAIRMAN CONDIT: Okay. Mr. Harris and then Senator Greene.

SENATOR GREENE: I have another question for him.
(inaudible) policy meeting, policy, policy. You can correct me if you want to but this does not appear to be a (inaudible) policy statement (inaudible).

ASSEMBLYMAN ELIHU HARRIS: It doesn't appear to me to be a policy statement -- I mean a policy. Could you correct me?

MS. FONTENETTE: In the packet. Inside of -- we intend to, for this particular policy statement that was prepared for the Commission -- that every contract that's over \$500,000 would say, "It is the policy of the California State Lottery to require all bidders ..." It would be a new subcontract or contract portion.

ASSEMBLYMAN HARRIS: But you do not have a well-articulated, specific, policy relative to affirmative action. I'm not talking about a statement, I'm talking about a manual -- a policy manual on affirmative action that says a number of things, including how, in fact, you're going to review those companies who, in fact, do not meet, or in terms of their performance, relative to meeting whatever they articulated in their proposals. In fact, articulated very clearly what the weight is for the minority for minority or women-owned participation in contracting opportunities. Seems to me what you have is a theoretical statement and not one that specifically articulates what the program is, how it's going to be reviewed and, in fact, what the impact will be on future contract considerations.

MS. FONTENETTE: Inside of that policy, we have the criteria that's set up and it gives an example of what we would do on a contract; it gives the small business preference point system that we would use; the contract terms; the contract compliance verification - a system that was already adopted this year, in February.

ASSEMBLYMAN HARRIS: Where is that? I see a policy statement.

MS. FONTENETTE: It's on page 4.

ASSEMBLYMAN HARRIS: On page 4 of the first section.

MS. FONTENETTE: Right. And in the bottom outline, at the bottom of 4, begins the process -- what each department in the Lottery is required to do prior to the release of any RFP or RFI or any negotiations that will lead to a contract exceeding \$500,000, and we will be putting those out in directives along with this policy and procedures to the Legislature and to MI-1.

ASSEMBLYMAN HARRIS: How is this reviewed in determination, for example, Needham Harper, which is going to be considered for recommendation for either a new contract being offered, or an exercise of the option by the Director. How is this policy going to be used in reviewing their performance in the past year?

MS. FONTENETTE: In reviewing the performance of Needham Harper, I, along with other programs of the advertising program and marketing program, would put in my assessment of what they have done in regards to minority and women participation.

ASSEMBLYWOMAN WATERS: Mr. Harris, I think you may want to know that Needham Harper is no longer owned by the same principals. Isn't that correct?

MR. GUTIERREZ: Needham Harper is involved in a buyout that will be ratified (if I remember correctly) sometime in September or October. Currently, they are still Needham Harper but they are undergoing a merger with two other major advertising agencies.

ASSEMBLYWOMAN WATERS: So they might be the same firm that you contracted with originally. Is that correct?

MR. GUTIERREZ: Yes, ma'am.

ASSEMBLYWOMAN WATERS: So, technically, you could not exercise your option.

MR. GUTIERREZ: There is a clause in the contract that says this contract that we have with them will go with Needham Harper Worldwide, or whoever assumes their ownership. The Director of the California Lottery must make a judgment, however, as to whether or not things have changed sufficiently to reconsider the extension.

ASSEMBLYWOMAN WATERS: Let me tell you, you'd better look at that very, very carefully, because I know this legislator (and I may be a rebel) would not take lightly that you're exercising that kind of option, when in fact the bottom line is the company has been sold, and there are other entities involved, we would feel that that should be an opportunity to open it up for a competitive bid.

MR. GUTIERREZ: I appreciate your point.

ASSEMBLYMAN HARRIS: May I ask a few more questions? What is, in terms of that, let me go back to that Needham Harper contract in particular, and tell me a number of things.

You mentioned the \$4 million figure as the amount that was spent on creative efforts. What's the remainder of the money and how was that spent?

MS. CLARK: Money encumbered to date and up through Game 6 is \$4 million total for advertising and part of sale production; and \$13.8 million for actual media placement.

ASSEMBLYMAN HARRIS: How much of that went into minority newspapers or radio stations, and the like?

MS. CLARK: \$1.6 million has gone into minority targeted television stations, newspapers, and radio stations, approximately 12 percent. The 11.2 percent you have in your folder, based on better information for Game 6, is now 11.7 percent.

ASSEMBLYWOMAN WATERS: Could you distinguish between minority targeted and minority owned? Because you see, we've had these discussions over the years, I know that you can buy, with a major owned, white-owned radio station, television station, whatever, who tells you that they can show you the figures where, supposedly, they may target the minority market and I think there should be some distinctions made here. Elihu has, Mr. Harris asked you about minority-owned.

MS. CLARK: Okay. I absolutely understand your distinction. When we lay out, from a marketing standpoint, we lay out what is the audience composition for a newspaper or

television audience. That is something we've been tracking very closely.

In terms of ownership of these different stations, two points. One is, in many cases, the small newspapers, radio stations (some of them are small), ownership changes hands frequently, and we often have to refer to Chamber of Commerce, non-unreported sources to determine exact ownership. But, an example is black-owned radio stations.

The National Association of Black-Owned Radio Stations report that there are 7 in California (that's out of 381 total radio stations in the state). We are currently advertising on 6 of those 7 stations. The reason we are not advertising on the 7th is it has a Christian religious format that was judged inappropriate for lottery advertising, so we are working to develop better information on the ownership of these stations but it is not available through normal published materials.

ASSEMBLYWOMAN WATERS: What about minority-owned newspapers? Do you advertise in newspapers?

MS. CLARK: Absolutely.

ASSEMBLYWOMAN WATERS: Oh, what about minority-owned newspapers?

MS. CLARK: All right, there are 50 black-owned newspapers in the state and we're currently advertising in 46 of those -- that's 90 percent. When we make a placement in either a Spanish language or black-targeted newspaper for each game announcement, we will make two insertions in the minority newspaper versus only one in the general audience newspapers, to

make sure we have adequate coverage of those minority communities.

ASSEMBLYWOMAN WATERS: I don't understand your last representation.

MS. CLARK: We're making two insertions in minority newspapers; we're only making one in the general audience.

ASSEMBLYWOMAN WATERS: That's over a specified period of time?

MS. CLARK: Each -- the newspaper advertising is run at the beginning of each game. It's kind of an "information only," here's a new game.

ASSEMBLYWOMAN WATERS: I see; I see. So there's two ads in the minority-owned newspapers?

MS. CLARK: Versus only one in the general audience.

ASSEMBLYWOMAN WATERS: Of equal balance amount?

MS. CLARK: The cost to place that ad varies dramatically.

ASSEMBLYWOMAN WATERS: Of course it does. So don't mislead me and don't talk about -- you can't even lead to -- so far, you're fine in terms of what you attempt to do, but we get confused if we allow you to say in so many words, we cannot do more in the minority papers because we place two as opposed to one in the majority papers, when in fact, there's a great difference between a \$100 ad in some small minority owned newspaper and a \$6,000 ad, or \$10,000 ad in the Los Angeles Times, so I ...

MS. CLARK: Let me give you another example ...

ASSEMBLYWOMAN WATERS: I'd prefer that you talk to me about how good you are in dollar amounts.

MS. CLARK: Fine. Total figure to date is \$1.4 million; 43 percent of that has been in minority newspapers.

ASSEMBLYWOMAN WATERS: I'm not going to carry this any further, but I will ...

CHAIRMAN CONDIT: Okay, thank you very much. Senator Greene.

ASSEMBLYWOMAN WATERS: ... follow up on it.

MS. CLARK: Okay.

SENATOR GREENE: Well, I -- one question arises. I look at several of the areas where you contract and I'm like my colleague, Assemblywoman Waters, here, and that's fine, your future plans and what-have-you, and it sounds good, but we also have a situation where there are minority firms in some of these areas that are capable of performing the services to the majority population as well; they're well-situated and suited within their particular industries and what-have-you, and certainly appreciate all the minority business going to service minorities, but of course we are members of the bigger and better society. How are we doing in that area?

And specifically, as I -- you know, when I think of minorities overall, there are some Asian firms that can do anything any Anglo firm can do. Increasingly, there are more Hispanic and Black firms that can do anything within the scope of their ability to function as any Anglo firm. To what degree are minorities getting in on the business that is targeted toward the

general population, rather than segregated just to -- and I'm not saying you're doing it to segregate -- but, rather than segregated just to the minority audience? How are your percentages there? I understand there are some areas where you will not find the same percentages, but when I look at things like trucking, photography, and certainly advertising, there are firms that have national contracts, and maybe no one who views their services -- in 9 chances out of 10, no one in these services are Black or Hispanic or Asian. Certainly, in architecture, in auditing -- those areas where, if you look across the board, Asian, Hispanic, Black firms, those are the firms who are capable of servicing the same population as any nonminority firms. So, how are we doing with that category?

MS. FONTENETTE: In the case of our advertising firm, everything has to go through Needham Harper; we can't, because of the contract, go out and ...

SENATOR GREENE: Okay, so they're the black-owned so who is buying them? Who is buying them out?

MS. FONTENETTE: There is a merger of three agencies ...

SENATOR GREENE: I asked you "who" -- you don't have to give me the circumstances -- "who," I want the names.

MS. FONTENETTE: (Inaudible) Pasteur ...

MR. GUTIERREZ: No. That's not the question. The question is who is buying Needham Harper? Needham Harper is being bought by BBDO; it's the world's largest advertising ...

SENATOR GREENE: What do those letters stand for?

MR. GUTIERREZ: Do you know, Terry?

UNIDENTIFIED VOICE: (Inaudible).

SENATOR GREENE: What is it?

MS. FONTENETTE: Barton, Burton ... -- in the industry they go by ...

SENATOR GREENE: Will you please come forward to tell us?

CHAIRMAN CONDIT: While this gentleman is coming up, I want to remind the committee that there are 5 or 6 people who've been sitting in the audience during this portion of the agenda who would like to come up and make some statements, so I would ...

SENATOR GREENE: He's going to write that name down.

CHAIRMAN CONDIT: Are you finished, Senator?

SENATOR GREENE: Yes.

CHAIRMAN CONDIT: What I would like to do, if I may, is bring them up.

ASSEMBLYWOMAN WATERS: Are any of these minority participants in this (inaudible).

MR. GUTIERREZ: I would have to direct that ...

CHAIRMAN CONDIT: Do you have an answer?

SENATOR GREENE: Where's their headquarters?

CHAIRMAN CONDIT: We have two questions that have not been answered for Ms. Waters -- the South African question and this ...

MR. GUTIERREZ: Mr. Condit, I just received the answer with respect to the South Africa question, and also, Senator Dills, I would like to correct the statement that you made with

respect to the Georgia litigation. I have just been handed a letter from Scientific Games, in response to my June 12th letter, and I would like to read that for the record to correct any.

CHAIRMAN CONDIT: Why don't you just tell us what the letter says and then submit it?

MR. GUTIERREZ: Okay. With respect to the South Africa question, neither Scientific Games nor its parent corporation, Bally Manufacturing Corporation does any business, whatsoever, in South Africa.

Secondly, in terms of the Georgia litigation, today, the Scientific Games people advise that they've just been advised, telephonically, that the auditor has denied the emergency motion of Scientific Games. The auditor did not discuss, nor disturb, the prior findings of Gott versus Dittler, and did not issue any new injunctions, so that is to correct the earlier statement that was made that the auditor, somehow, changed the findings of fraud. He did not even address those.

CHAIRMAN CONDIT: Well, it's the finding of fraud that are stayed at this point by the Court, is that correct? That doesn't change anything at all. I didn't hear that indication from him. Well, let's not get back into that. We have an enormous -- I mean you're going to come back at some time and we're going to talk about that some more.

I want to ask -- I know there are people in the audience that have been waiting a long time to come up. I would like to hear from several of you that have seen what's going on; try not to duplicate what you've heard said up here. If you've got a

problem, say what it is; or, if you have a positive point, let's make it as brief as possible so that we can move on. I'd like to ask, is John George, from Alameda County, here? And then, Frank Mingo next. And then, gentlemen, why don't you just come up, line up, and make your statements. Identify yourselves.

MR. JOHN GEORGE: My name is John George, member of the Alameda County Board of Supervisors.

I don't want to add anything but reinforcing questions by Assemblywoman Waters, Senator Greene, and I'm going to submit my statement, but I want to raise a few questions.

This will be focusing on the advertising contract. May I ask the members of the Committee to request answers to the following questions (even if they duplicate a little bit):

One, has the advertising agency, that's Needham Harper Worldwide, done any research to determine who's buying the lottery product and that would include also the successor? Who conducted this research, and for what source was this information required?

Is the advertising agency's media product reflective of the people who are buying the lottery product?

How much television has the advertising agency run? What percentage of its advertising rates is television, radio and print?

What involvement has Needham Harper had with black-owned firms in the development and execution of the lottery campaign?

This may be a duplication -- How many insertions have been made in black and (inaudible) as opposed to black directed

community in publication and communication companies in California? What is the minority staff composition working specifically with this account? In other words, how many professional staff members does Needham Harper employ? And, the successor situation.

I'm hopeful that these hearings serve as the beginning of an effort to synthesize the Lottery Commission, would stand and its contractors to reflect that there is a large, large community which participates in the lottery games. I would submit this and just raise those questions which are supposed to be inquiries and not accusations.

CHAIRMAN CONDIT: Thank you, Supervisor George. The sergeant will take your written testimony and it'll go in the record. We appreciate your waiting here today and making those remarks.

Do we have Frank Mingo, Chairman of Mingo & Jones Advertising Agency, here today to speak? Sir, would you come forward please?

And, Mr. Director, may I ask you to consolidate your staff to one side over here, just for this part of the testimony?

You gentlemen, if you like, may sit over here and you can, if all three of you are going to make statements, we'll just go right down the line, if you don't mind.

Would you, when you make your statement, not only be brief, but just identify yourself and who you're representing if you're representing an agency or ...

MR. FRANK MINGO: We'll be better than brief. Only one of us will speak. We hope that we can be helpful in an informational kind of way, and perhaps answer some questions if you have them.

The best way to do this, is probably to tell you a little bit about who I am and who my corporation is, and the kind of businesses we do, and talk a little bit about how major businesses, in our experience, contract with minority and women-owned businesses to advertise and market to minority communities.

My name is Frank Mingo. I am Chairman of Mingo & Jones Advertising, which is a 100 percent minority-owned company. It is also a woman-owned company. The Jones in Mingo Jones is a woman so that we are, to some extent, a double minority company. We've been in business approximately 10 years; our principal offices are in New York; we have one office here in Orange County, California (not here in Orange County but in Orange County, California), and, hopefully, we'll have another in Chicago, shortly.

We are an advertising agency; we are a marketing company. We have approximately 150 employees around the country, and do, as of last year, approximately \$55 million in billings. I, personally, have been in the advertising business some 22 years. I've worked for major multinational companies; have been in senior management in multinational companies; was, in fact, a Senior Vice President in the second largest advertising agency in the world prior to starting this company. So, that's our experience.

Our clients include, mostly, major Fortune 100 and Fortune 500 companies. Our major client list includes the Miller Brewing Company, the Kentucky Fried Chicken Company, the Seagram Corporation (for Chivas Regal, Myers Rum and Seagram's Gin), the Pepsi Cola Corporation, Westinghouse, the Equitable Insurance Company, Walt Disney Productions, and Pacific Bell Telephone. So, we do have major experience, both individually and professionally with many major corporations in the country.

I've been asked to talk a little bit about how we do this because we are a minority owned company and we do participate with these corporations in business activities that cover both general market and minority businesses.

We are contracted to be the minority supplier in some cases; in some cases we are the majority supplier; mostly, minority supplier. And, we've found a couple of things over the years. We've heard a lot of discussion here today about how business is being done and I have to say that in my experience over the last 20 years, generally, new companies or new organizations that are just beginning to get involved with the question of minority or women-owned advertising or marketing, generally have a fairly confused time, initially, because they do it in a lot of different ways, and it usually takes about a year to get it organized. But, once it gets organized, generally in year 2 on or year 3 on, it starts to fall into some fairly predictable categories.

One: you have to look at the total marketing picture in a very segmented kind of way: Blacks have to be seen as a

segment; Hispanics, where applicable, have to be seen as a segment; in some cases, women have to be seen as a segment; and in some cases, it gets even broader and wider than that, but our experience is, generally, with minorities.

We've seen companies attempt to address the question of minorities in a lot of different ways. One of the ways has been the way the California Lottery has done it, and that is to appoint a major supplier -- a major agency -- and ask them to contract for it. Frankly, we've never seen that work over time. Advertising agencies are very unique kinds of operations that include an awful lot of creative people and creative people, generally, don't report well to other creative people, so those kinds of things have tended to be a problem over time.

We have seen, most often, that companies come to the conclusion (major corporations, and this, we assume -- we look at the California Lottery as a major business and I just read where it's the 51st largest corporation on the Fortune 500 list), if we look at the billings, we would assume you would have to do it the same way.

And, generally, the way it is done is that companies contract with minority suppliers separately. Companies hire major agencies and then they hire minority agencies. Of all my clients (of all the companies I listed for you) in none of those situations do we contract through, or report to, another advertising agency. We have never done that. In point of fact, if we were asked to do that, we would not.

ASSEMBLYWOMAN WATERS: Very good point.

MR. MINGO: There are a lot of reasons for that. One of which is, one company would never have, if a major agency had the knowledge and the sensitivity to the community, and knew the kind of execution and nuances that have worked over the years in terms of providing advertising for minority communities, it wouldn't be a problem, and we probably wouldn't be discussing it here today, because they would've contracted with the requisite number of people; no one would complain about the executions; and we would see what had been done in the area of minority things.

So, that is one point, and I don't take that as a condemnation of anybody; I don't take that as saying that any one person or any one organization has not done it right; I'm only here to say that there are ways that it is done among major corporations; there are ways it is done that we have had experience with over the years, that appear to work better because they work better.

CHAIRMAN CONDIT: Mr. Mingo, you don't -- out of those corporations, don't take any direction from in-house agencies at all?

MR. MINGO: We have taken direction from in-house agencies. Let me explain what I mean about direction. One of the things you have to do in order to make any kind of advertising and marketing program work, is to set up a set of finite objectives as to what you want to achieve in a year; and then you have to look at the ways -- from a strategy development point of view that you want to achieve them. Now, unless you do that, then we really don't have anything to judge at the end of

the year. We don't know about the performance because we've set up no standards in advance, so that, generally, taking direction from in-house agencies is a function of working together with them to develop objectives, to agree on strategies, and then these objectives and strategies are executed by us as an agency. And, that is basically what it is. I think it is very, very important; it's something that we spend a lot of time doing -- is setting up those objectives so that we have a way, at the end of each year, to be able to determine whether or not we have done our job, and whether or not those objectives have been solved.

I had only intended to speak about 5 minutes; I brought my colleagues: Joe Muse, President of J. Melvin Muse, which is my California subsidiary; and C. Y. Jackson is the Director of Segmented Marketing at Flair Promotion. We would like to answer any questions you may have.

CHAIRMAN CONDIT: Thank you, sir. Mr. Hill has a question.

ASSEMBLYMAN HILL: I guess first, Mr. Mingo, I think I ought to say that I think you've made a very impressive presentation. Obviously, your corporation is very substantial, and seems to have a logical, laid out plan. Am I to understand, essentially what you're saying, is that fundamentally, what you see as a proper structure for the Lottery Commission, as opposed to going through a Needham Harper and then trying to contract with a firm; your suggestion is that somehow that Lottery Commission contract ought to be split off; that, in terms of dealing with the minority community -- let's say the advertising

for the minority community -- you ought to deal directly through somebody such as yourself because you're avoiding the creative differences, and that sort of stuff?

MR. MINGO: I must admit that we have very little experience in public sector advertising contracts. We have some; we've done some work for the U.S. State Department; done some work for the State of New York; and, we've done some work for the City of New York; but we really don't have a lot of expertise in that area, and I'm not sure I'm saying that. What I am saying, however, is, I'm saying that it has been my experience over time that this kind of situation has worked better than any other. I have never seen a situation in which an organized, advertising, sales promotion, and marketing agency reports through another agency of the same kind and have that situation work. Now, I don't know whether that applies here or not.

ASSEMBLYMAN HILL: I've got to be honest, one of the frustrations I think I've seen with the whole concept of the minority women thing is that you tend to get into, at least a lot of times, circumstances where you get shell corporations set up, dummy people, etc. etc. Obviously, that's not the situation with your company and I guess my next question is, Mr. Michalko, it seems to me the plan that Mr. Mingo here has laid out makes sense. Is there a structural reason why, let's say, business for the minority community, advertising business specifically, cannot be broken off and opened to bid to firms who have expertise in that area?

MR. MICHALKO: To the best of my knowledge, there would be no reason to say that that couldn't work. And that's something that I will tell you, we will explore as an alternative.

CHAIRMAN CONDIT: Any other questions of Mr. Mingo?

ASSEMBLYWOMAN WATERS: Well at least we make women something. (Laughter)

CHAIRMAN CONDIT: Thank you, sir. You made a great presentation. You got a commitment from the Director to explore that and we'll follow up on it. Thank you gentlemen, too, for being here. I appreciate your sitting here all afternoon.

MR. MICHALKO: Thank you.

CHAIRMAN CONDIT: We have Frank Moreno, Awards Media.

MR. FRANK MORENO: Good afternoon. Frank Moreno from Awards Media, a specialty advertising firm. First of all, let me say, I come here incensed at the comments that were made in the L.A. Times by Mr. Brad Fornaciari regarding undocumented workers. His comment, if I may just paraphrase it, was that if another undocumented worker won the Lottery, it would be a bad thing for the Lottery. Furthermore, he continued on to say that it would not be good, it would not be good for marketing. That was in Sunday's L.A. Times.

The Hispanic community, Brad Fornaciari, the Vice President of Needham Harper who is an advertising executive, I might add ...

SENATOR GREENE: I hope you noted that.

CHAIRMAN CONDIT: Just a moment, did you have a question for him?

ASSEMBLYWOMAN WATERS: I just want to be clear. One of our contractors said that?

MR. MORENO: Yes.

ASSEMBLYWOMAN WATERS: It was reported in the papers?

MR. MORENO: Yes, I have copies for your perusal.

ASSEMBLYWOMAN WATERS: Okay.

CHAIRMAN CONDIT: Sergeant, why don't you get that and Mr. Moreno, you can come up and finish your testimony so we can try to move through this.

(Multiple voices - inaudible)

CHAIRMAN CONDIT: We can make copies of it. That's fine. We'll actually take your word for it at this point.

MR. MORENO: It has to be circulated because I have quite a bit of information for this proceeding.

CHAIRMAN CONDIT: Well, finish your testimony first, sir.

MR. MORENO: The reason I am incensed is not only from my own personal perspectives with regards to this issue, but also, I come here as a spokesperson; a spokesperson for people within the Hispanic community which Mr. Alatorre represented very well and I'm sorry he's not here anymore; and I also represent six months of research into this contract. Six months ago, I sat down with some representatives of the Black community and Asian community, and we decided that what we would do is we would look very closely at this advertising, this \$22 million advertising

contract. What ensued was a study as soon as the reports came out from the Lottery Commission which at times took longer than usual but we got them nonetheless. We went through those numbers. Now, we all know what those numbers are. Mr. Michalko knows what the numbers are, I know what the numbers are, we both get the same reports. It is astonishing, at least to us, that our figures don't coincide. Maybe there's some information that we do not have. We certainly don't have the information with regards to Game 6. The most updated information I've received is Game 5 and I received that this morning.

The problem has been that the Hispanic community, the Black community and the Asian community do not believe that a serious effort has been put forth to let those communities know that these sales, that they can win. For example, there's no bilingual information in the Asian community and I can speak directly to that as I have confirmed with some people from the Asian community. The tickets in the back, for the winning people, are printed in English. There is concern in the Black community, for example, and I've spoken to several newspaper owners within the Black community, specifically the Southwest Way and the Los Angeles Sentinel, that are dismayed at the dollar amounts that have been spent. I think up to Game 4, the figures that I had come up with was about \$9,000. They were appalled really.

The Hispanic community has been looking at the dollar appropriations. I have been in consultation with people from the Hispanic Publishers Association and basically, what's been

happening is that we're beginning to see a pattern and that pattern is that we have, for example, what we call media production and the media advertising which everyone advertising buys a newspaper, etc. That, for example, media production, there's a larger chunk than your advertising in newspapers, in television, in radio. There's more dollar amounts in that production area.

Second of all, we came across a very startling thing, something that disturbed us. We came across a firm that I communicated with Terry Fontenette a couple of times asking whether or not this firm was, in fact, a minority firm. The question cannot be answered. Upon doing a little bit of my own research, I found out that at least up to 45 days ago, this company was not even a company in the State of California.

So, these questions have arisen and what we would like to see, and what we're seeing here today is part and parcel of what's happening, is that there should be a performance audit and a financial audit to make sure that these contracts are being allocated in the proper manners; that the Auditor General, for example, might take a closer look at this to make sure that there is a performance in the minority communities, that the actual, let's call it the goals, will show we've thrown 30 percent goal, 20 percent goal. The fact of the matter is we're looking at 12 to 13 percent. Well, what are goals for if you're not going to make them?

To close, I would like to further let you know that the Hispanic community, in general, after this comment was made in

Sunday's Times, is very, very incensed and if Needham Harper feels that there's going to be a marketing problem, just wait until the rest of the community reads that statement. Gentlemen, thank you very much.

CHAIRMAN CONDIT: Thank you for your time and thanks for waiting all afternoon. I appreciate it. You have a comment or question?

ASSEMBLYMAN HILL: Maybe just a comment.

CHAIRMAN CONDIT: Thank you very much, it's just a comment.

ASSEMBLYMAN HILL: You ought to hear it because it's directed to you. I guess it's like the "agony and the ecstasy." I think I just was very impressed with the previous presentation, and from the previous gentleman from New York, I think had some very constructive suggestions, some very constructive criticism. And now, I hear you come forward, basically, just complaining, whining, and sniveling about not getting a contract. The fact of the matter is the previous testimony, which I understand you sat through, very clearly laid out that the Lottery Commission is meeting all of its legal obligations in terms of issuing contracts and I would suggest that, if you're interested in getting a piece of the Lottery Commission action, maybe a better approach would be a positive approach that has something to offer as opposed to just a complaint session.

CHAIRMAN CONDIT: We're not into rebuttals here but if you would like ...

MR. MORENO: Just for the form, Mr. Hill, we did meet with the Lottery Commission on April 12th and we met with Needham Harper on May 28th.

CHAIRMAN CONDIT: Noted the gentleman said that he's met with the Commission plus Needham Harper as well.

MR. GUTIERREZ: To clarify for the Chairman, he met with the Lottery staff, not the Commission.

CHAIRMAN CONDIT: Thank you. We get confused about who's the staff or Commission ourselves.

Pauline Marzette, the Executive Director of Sacramento Connection, a businesswoman's magazine. Would you identify yourself for the record please?

MS. PAULINE MARZETTE: Good afternoon, Pauline Marzette, Executive Director of the Sacramento Connection Magazine and Executive Director of Marzette and Associates, Marketing Management Firm.

I'm here to specifically address some issues as it relates to women. One of the things that we would like to do is offer assistance rather than criticism. I think enough of that is going around today and I'm pretty sure they understand what their role is.

We have a magazine and I'd like to pass out copies to you. This is the only publication in the Sacramento area that addresses the needs of businesswomen in this community. One of the things that I found out is that there is not a real strong lobbying advocacy group for women. This is one vehicle and in the magazine, in this particular issue, it addresses local, state

and national concerns as it reflects to women-owned businesses. Also, two of the areas that an article listed in there that was prepared by the Department of Transportation on how to do business with the Department of Transportation's Minority and Women Business Program. I suggest that the California Lottery do something very similar. It's not using vehicles that are already in existence. I really, strongly feel that it's creating and our magazine is available. We'll be more than glad to publicize something to our readers regarding the California Lottery and how to participate. I also strongly feel that the California Lottery needs to specify participation in terms of goals. How much participation will be expected in terms of meeting minority goals for minorities and percentage for women. Many state agencies have a 13.3 percent participation goal. I have not heard that.

I also strongly feel that a monitoring system, certification, verification, evaluation and an investigation system needs to be set up. And, I think, as was mentioned earlier today, that will come about when you establish some type of a policy. I have a copy of what, maybe, two other agencies have put together in terms of their Minority and Women Business Enterprise Programs. They might be a good examples to follow. One is the procedures manual for MWBE participation with the Department of Corrections. It's very extensive. It even gives ideas on how to do outreach and recruitment of minority women business. I think that's one area that's been neglected.

The other one is Disadvantaged Business and Women Business Enterprise Program with the Department of

Transportation. This is public information. Interagency information, the Office of Small and Minority Business is equipped to help them prepare a manual. Again, another state interagency agreement to help you do something. These are services and programs already on line that are not being taken advantage of.

So basically, what I want to do is share and extend a vehicle by which to help them market specifically to the audiences that they are not addressing at this point in time.

CHAIRMAN CONDIT: Thank you very much. We appreciate your being here today. Any questions? Is there anyone in the audience that's not on the agenda who would like to speak on this particular issue? If you'd like to speak, this is your time to come forward and identify yourself. If not, we'll come back to the committee and if there are no other questions on this particular area of the agenda, we're going to move to Item IV. I'm just going to announce, with the permission of the committee, we're going to only take up Item IV, Revenues and Expenditures, the Items A and B, total revenues and expenditures and the most significant expenditures. We will delete from the agenda, Item V and Item VI for another time with the permission of the committee unless there is some reason for me not to do that. Frank would like to stay a couple of more hours. Okay, we'll take up Item IV, Revenues and Expenditures. Mr. Director, do you want to make your presentation as thorough and as brief as possible? Then, if there are any questions, we'll try not to go over what we've already discussed.

MR. MICHALKO: Mr. Chairman and members, included in your book of materials is an Item encaptioned IV, number of winners...I'm sorry...revenues and expenditures. There is an explanation of our most significant expenditures and revenues. We have some charts which may help explain the overall revenues and expenditures of the Lottery both this year, and our projections for next year.

If you'll bear with me for one moment, I will highlight those issues for you so we can expedite this process.

As you are all aware, the Lottery has three basic areas of expenditure as mandated by the California Lottery Act of 1984. Primarily, those speak to the issue of 50 percent of revenues must go back to the players in the form of prizes; 34 percent, at a minimum, plus all unclaimed prizes must go to public education in this state; and the remaining 16 percent has been set aside for administrative expenditures. Within that 16 percent, however, five percent is in the form of commissions for the retail sales agents who sell our tickets. So therefore, we're operating with an 11 percent true administrative expenditure level.

For Fiscal Year 1985-86, if I may briefly summarize this, the Lottery had total expenditures of approximately \$220 million representing about 12.6 percent of the projected sales totals for the Fiscal Year of \$1.74 billion.

The issue with respect to the next Fiscal Year, however, is something that we need to address. To put this matter in perspective, let me explain to you what's happening in the next

Fiscal Year starting July 1 as opposed to this year. For Fiscal Year '85-'86, our primary source of revenue was from the sale of what are known as "instant lottery tickets," the scratch off type. As we move into the Fall of this year, we will be instituting a second type of game called "the on-line games," the computerized ones that you've all heard about.

While the expenditure levels for administering an instant game program are significant, they are basically spread over time as opposed to the expenditure levels for initiation of the on-line games. The on-line games, because of the significant capital outlay for equipment, require an up-front, if you will, major expenditure level that we will experience in the first and second quarters of this Fiscal Year 1986-87. The upshot of this, members, is that while we had a significant cushion, if you will, that we operated well below the 16 percent administrative level of this year, it is not the same situation that we face going into Fiscal Year '86-'87.

First of all again, to reiterate, we've got a major expenditure in terms of on-line equipment. Secondly, and perhaps more importantly, the issue of revenue that we expect to realize in '86-'87 comes into play. We will have sold, by June 30th of this year, approximately \$1.75 billion worth of instant tickets. Instant ticket sales, however, are following a traditional pattern which is showing a decline in those sales over time. And historically in other lottery states, the level of stabilization of instant ticket sales is approximately 20-25 percent of their startup level. So, what we are estimating for the next Fiscal

Year is that instant game sales will average about 2.2 million tickets per day or a total of approximately \$800 million for Fiscal Year '87.

At the same time as the instant ticket sales decline is coming into play, however, the new game, the Lotto game, the on-line games will be initiated. Sales for the on-line games, in direct contrast to the instant games, start out at a very low level and gradually and progressively build over time. Our aggregate total sales figure for the on-line games for Fiscal '87 is also about \$800 million. So right now, we are projecting total sales of about 1.6 billion for Fiscal '87 where we are at about 1.7 for Fiscal '86.

Again, first of all, that decline in sales that we're talking about, coupled with the extensive equipment expenditures for the on-line games, tells me that we're going to be very close to the 16 percent administrative level for this coming year and it's going to be difficult for us to set up our budget. We've tried to make prudent and appropriate cuts wherever possible so that we can work within the 16 percent mandated by law.

By way of reference, Senator Dills and committee members, the transition year, the year that we are now entering where we transition from only an instant game into a multiple-game format, is the most difficult one for lotteries historically. And in fact, we have in the booklet that we have before you, some reference to the percentage of administrative expenses experienced in other lottery states during that transition year. Illinois spent about 18 percent in 1979-80; New

York State spent about 17 percent in 1979-80; and Ohio spent 22.7 percent in 1979-80, the year they transitioned to the on-line games.

The point I'm trying to make, Senator Dills and members, is that we have some significant expenditures this coming year. We will realize gross sales certainly below what we experienced this year during this transition period and our expenses will be higher. That's an overview of where we stand and these charts help break down the 11 percent administrative expenditures so that you can all see which areas they go to.

CHAIRMAN CONDIT: Are there any questions? Senator Greene.

SENATOR GREENE: So, Mr. Michalko, that will not necessitate any change in the structure in which you operate, will it?

MR. MICHALKO: It will not. We are trying to make every prudent effort to make sure the administrative costs are within the guidelines established by law.

SENATOR GREENE: Are you able to go outside of those guidelines?

MR. MICHALKO: We are not and that's why we are making every effort to make sure that we maximize the revenues for education, not only to live within the 16 percent, but to attempt to come in below that in terms of administrative expenses.

SENATOR GREENE: There's no provision in the initiative which allows for any change in that administrative cost, is there?

MR. MICHALKO: There is not, but my point was to contrast it with this year where we will give excess dollars to education because we're below the 16 percent.

SENATOR GREENE: Okay.

CHAIRMAN CONDIT: Education will lose about \$100 million in this budget?

MR. MICHALKO: Gordy, do you have dollar figures?

MR. GORDON JONES: I'm Gordon Jones, I'm the Finance Chief of the Lottery and I think it's a little closer to about \$60 million this year. I can compute it in about two minutes.

CHAIRMAN CONDIT: No, that's fine. We'll take your word for it. Senator Dills, did you want to add anything?

Okay, if there are no other questions, that concludes the agenda with the commission to the Director that we will take up those other two items at a later date and maybe review some of the things we talked about today if it's okay with you.

Mr. Michalko, I want to thank you and your staff for being with us all afternoon. It was most informative and we appreciate your being here. I appreciate the members for being here and Senator Dills for co-chairing this with me today.

Senator Dills, do you have anything you'd like to say?

CHAIRMAN DILLS: I just want to thank the staff and Mr. Michalko for coming and helping us. The Legislature desires and the Legislature needs this information and we appreciate getting it.

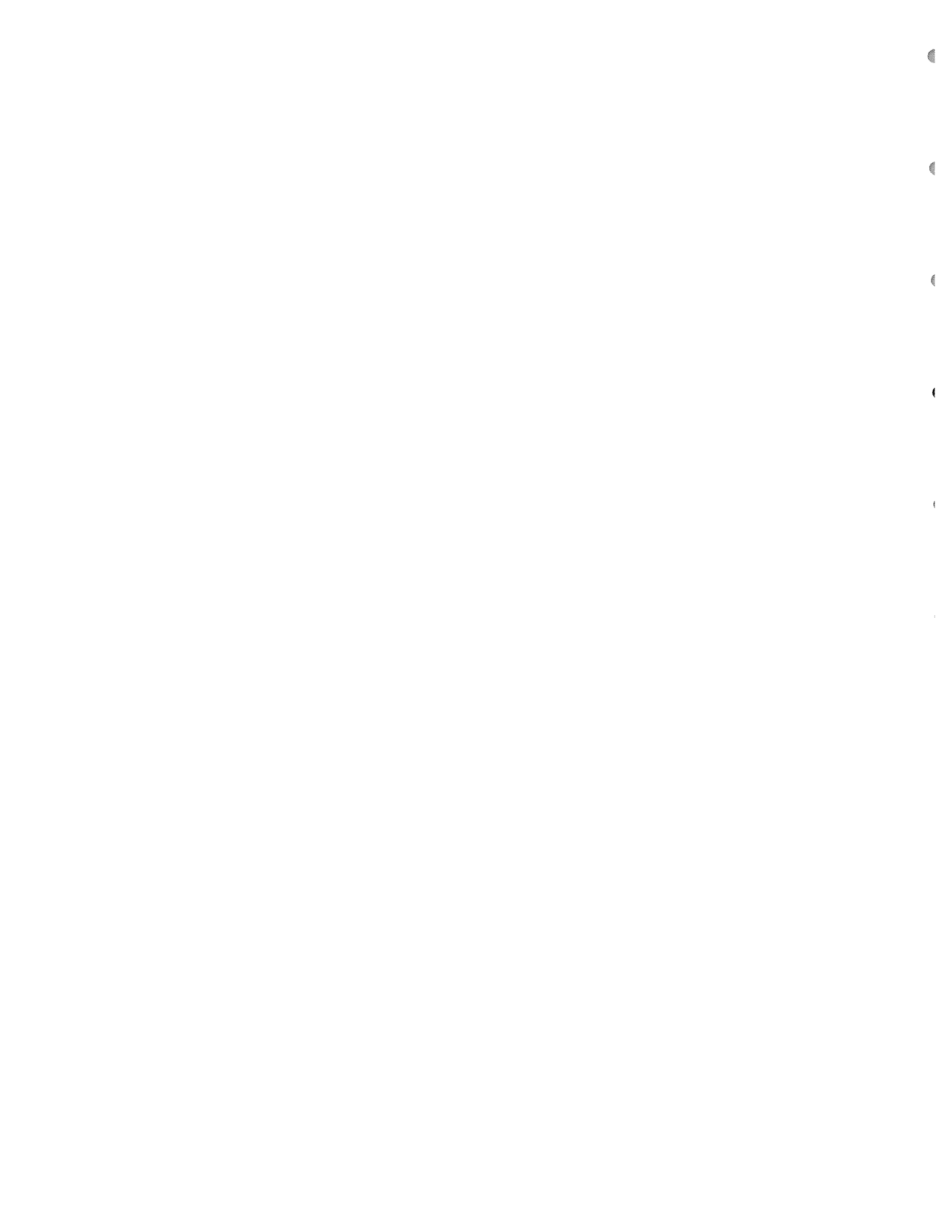
MR. MICHALKO: Thank you very much for the opportunity.

CHAIRMAN CONDIT: I was informed that the Controller's office has someone who maybe could speak to this portion of the agenda, is that correct, sir?

MR. PETER PELKOFER: Mr. Chairman, no, we don't have anything specifically to say. We were asked to stand by as a resource in case you wanted some questions answered.

CHAIRMAN CONDIT: I appreciate your being here today, too. Thank you very much. The meeting is adjourned. We will be talking to you a little bit later.

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June 24, 1986

BRIEFING PAPER ON THE CALIFORNIA STATE LOTTERY

Prepared by the Assembly and Senate Governmental
 Organization Committees

I. Major Lottery Contracts

The following are the five (5) major contracts entered into by the California State Lottery:

- 1) An Instant Ticket contract with Scientific Games, Inc. in the amount of \$40 million (variable).
- 2) A courier delivery service contract with Purolator Courier Service in the amount of \$5 million (depending upon deliveries).
- 3) An advertising agency contract with Needham Harper Worldwide in the amount of \$22 million (depending upon sales).
- 4) A contract for the lease/purchase of vehicles for sales representatives with Center City Ford of San Diego in the amount of \$5.5 million.
- 5) The On-Line Games contract with GTECH Corporation in the amount of \$121 million.

Attachment A contains information provided by the State Lottery on each of the above major contracts.

BRIEFING PAPER ON THE LOTTERY
JUNE 24, 1986

II. Participation by Minorities and Women in Lottery Contracts.

Policy: The California State Lottery reports its policy is to "achieve the most feasible and practical level of participation by minority/women-owned business enterprises in Lottery procurement programs."

In this regard, the Lottery Commission on June 19, 1985, adopted a policy statement which requires a portion of the Lottery's major contracts (exceeding \$100,000) for goods and services to be subcontracted to minority, women, or small business enterprises whenever reasonably feasible. Joint ventures or ownership including these features are acceptable in lieu of subcontracting.

In accordance with SB 34 (Dills) of this legislative session, the Lottery Commission on June 12, 1986, adopted a policy requiring bidders and contractors in major contracts (exceeding \$500,000) to include specific plans or arrangements to utilize subcontracts with socially and economically disadvantaged small business persons. These are defined as minorities, women, and other natural persons found by the Lottery Commission to be disadvantaged. In evaluating contract proposals, the Lottery plans to assign percentage points based on the participation level of these persons.

Overall Figures: During the first eight months of operation, the Lottery reports it has contracts or subcontracts with minority/women small businesses totaling about \$29 million, which is approximately 8.7% of \$325 million contract dollars.

In contrast, the average share of contracts received by minority and women small businesses in all other state agencies combined was 14.6% during FY 1984-85 according to the Office of Small and Minority Business.

Advertising: The State Lottery currently has a major contract with Needham Harper Worldwide for advertising services. This contract includes provisions for subcontracting with minority/women-owned firms in producing Lottery advertising as well as utilizing minority media.

The Lottery estimates that 23.6% of all production expenditures and 11.2 % of all media expenditures for advertising have been made through subcontracts with minority/women-owned firms.

Retail Contracts: A survey is being prepared regarding the number of minority/women-owned retailers in the State Lottery network.

III. Advertising for Contracts

The original State Lottery Act, passed by the voters, contained language which permitted the Director of the State Lottery to authorize the purchase or lease of such goods or services as necessary to operate the Lottery (Government Code §8880.56). This language meant the California State Lottery was basically exempt from standard state procurement requirements.

The enactment of SB 34 (Dills) in April of this year has resulted in significant changes to the Lottery's contract bidding policies and procedures, including:

- 1) Those already covered in the previous section (regarding minority, women, and other disadvantaged business persons).
- 2) The requirement that the State Lottery adopt competitive bidding procedures for contracts involving printing of tickets or the acquisition of electronic computer software.

The Lottery reports that it publishes a monthly updated list of all contracts executed during the fiscal year. This list is given to the Lottery Commissioners and is available to the public upon request.

IV Revenues and Expenditures

Revenues: The California State Lottery is expecting to sell over 1.7 billion tickets this fiscal year. These sales will represent about \$650 million in revenues for the state's public schools.

Next year the State Lottery estimates less ticket sales and the state's schools will receive about \$550 million. This projected sales decline in the second and subsequent years is based on the experience of other states.

Expenditures: Current law places a 16% ceiling on the amount the State Lottery may expend on administrative expenses, including retailer commissions. Any portion of the 16% ceiling which is not spent becomes available for public schools.

During fiscal year 1985-86, the Lottery is expecting total expenditures of about \$220 million, or 12.6% of the projected sales total of \$1.74 billion.

While the Lottery will not have a problem with this expenditure limit this fiscal year, next year is expected to be different. With the expected decline in instant ticket sales and the huge capital requirements of an On-Line system in California (over \$150 million for equipment and telecommunications) the Lottery is not assured of operating within its 16% spending limit. This is assuming the amortizing of the On-Line capital investments over a 4-5 year period.

V. Number of Winners and Odds of Winning Prizes by Category

The Lottery projects that about 232 million winning tickets will be sold by the end of this fiscal year.

With the exception of Game #3 which had about 1 in 5 odds due to the inclusion of free tickets, the odds for instant games are generally in the 1:8 to 1:9 range.

The Lottery states its primary objective in developing prize structures is to balance the appeal of the different prize segments in such a way as to attract the broadest possible range of players, rather than encouraging an inappropriate level of play within any one group.

Through Game #5 fully 48% of California adults were reported by the Lottery to be playing the instant games. This compares favorably with other states that report player percentages in the 30 to 40 percent range. More recently, however, the Field Poll disclosed that there has occurred a big drop in the proportion of the public who plays the State Lottery. In a survey conducted in May of 1986, the Field survey found that just 12% of the public accounts for 69% of the Lottery's total volume.

Moreover, a comparison of the demographic characteristics across the various categories of Lottery ticket purchasers shows that heavy players are more likely to be male, Hispanic or Black, and non-college graduates.

BRIEFING PAPER ON THE LOTTERY
JUNE 24, 1986

VI. Future Developments and Proposals

In late August or early September 1986, the State Lottery will initiate On-Line computerized gaming, starting with a game known as LOTTO. In approximately 5,000 retail locations throughout the state, players will choose six different numbers from 01 to 49, and these numbers will be entered by the clerk directly into the Lottery's computer system via an On-Line terminal. A ticket is produced at the terminal for the customer's receipt.

At the end of each week, the Lottery will randomly select six different numbers plus one bonus number, and prizes ranging from \$5 to millions of dollars will be awarded on the basis of correct player picks.

The Lottery estimates that LOTTO sales for FY 86-87 will total just over 800 million tickets.

Pages 25-27 of the report prepared by the State Lottery for this June 24, 1986 hearing provide background information on video lotteries, player activated games, and telephone lotteries.

Instant Ticket Contract

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At the May, 1986 CSL Commission meeting, the Director recommended that the Commissioners exercise their right to extend the contract with Scientific Games Inc. for a six-month period. This recommendation was based largely on the fact that the Lottery was in the process of initiating the start-up of On-Line Games (LOTTO) and that changing the supplier of instant tickets might disrupt this process and result in a delayed implementation of these games. (Each week that the Lottery is delayed in the starting of On-Line Games will result in an approximate \$5 million loss to the State Lottery Education Fund). Additionally, Scientific Games agreed to return two million dollars of its original start-up and implementation fees to the Lottery in exchange for the contract extension.

The Commission approved the Director's recommendation with the condition that, at the end of the six-month extension, the California State Lottery will definitely go out to bid for the printing of instant lottery tickets.

Courier Delivery Service Contract

In May, 1985, the CSL issued a Request for Proposal (RFP) for the services of a courier company to deliver instant game lottery tickets to its 20,000 retailers. The RFP complied with State policies for competitive bidding. Two vendors responded to the RFP. Based on a evaluation of both bidders and after points were awarded to both companies based of the participation of minority and small businesses, Purolator Courier Service was awarded the contract.

Advertising Agency Contract

In May, 1985, the CSL issued a RFP to 150 agencies for the contracted services of an advertising agency to represent the Lottery. Eighteen proposals were received by the June 7, 1985 deadline. A CSL evaluation committee reviewed and scored each proposal. Two agencies were disqualified for failure to submit the appropriate disclosure data. The evaluation process was completed on the remaining vendors, and the top eight (8) were submitted to the Lottery's Internal Audits Office for review of the vendor's financial statements. One agency failed this financial review. Five agencies were subsequently notified that they were finalists and asked to make an oral presentation.

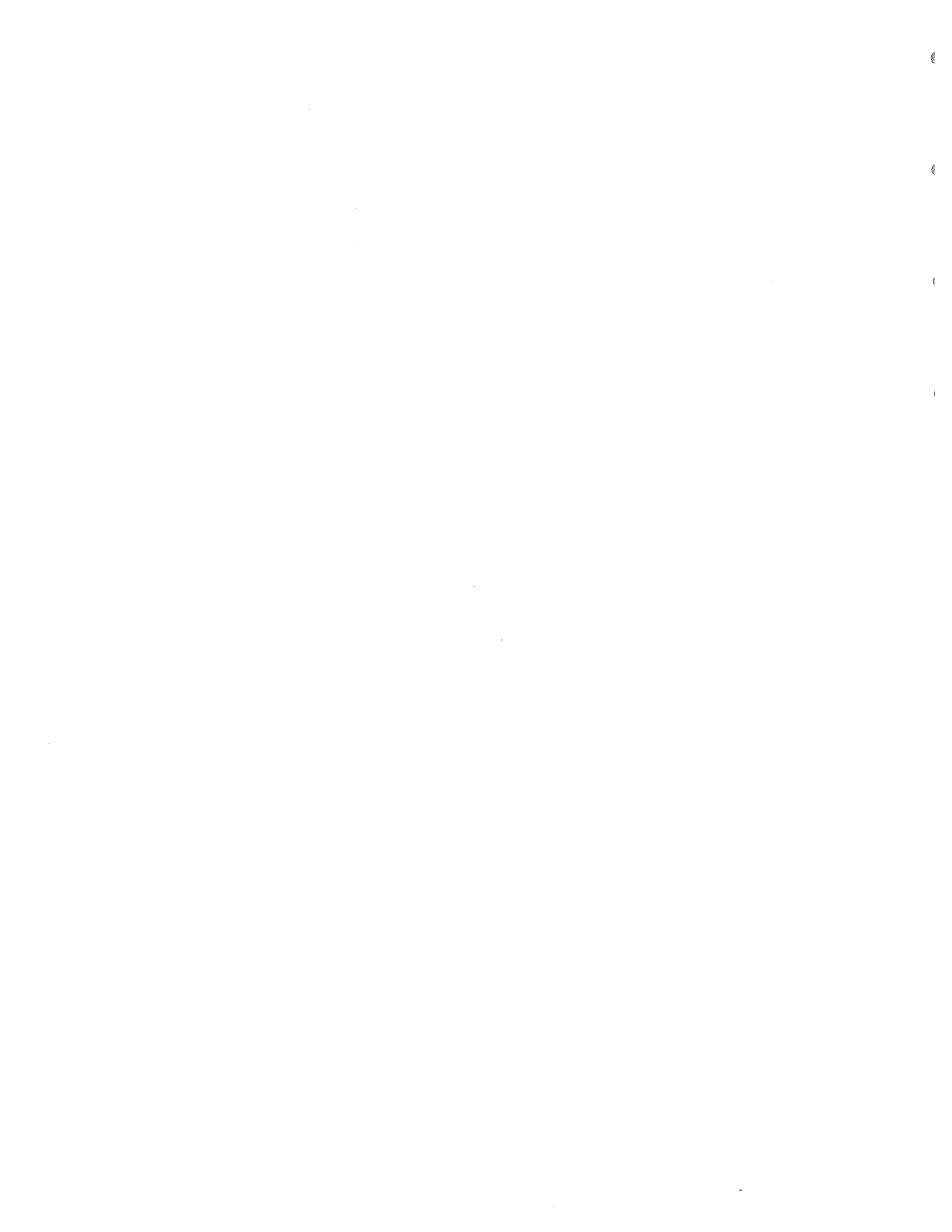
Needham Harper Worldwide was given the contract based on their oral presentation and on total points awarded from information provided in their written proposals. The entire RFP evaluation process and contract followed State policies for competitive bidding.

Procurement of District Sales Representatives Vehicles

In February, 1986, the CSL went out to bid for the acquisition of vehicles for Lottery District Sales Representatives. Twenty-two California auto dealers indicated an interest to bid and were sent formal bidding documents. The contract was for the lease/purchase of 200 mini vans. Vendor's were evaluated based on their responses in accordance with State policies for competitive bidding. The contract was awarded to Center City Ford of San Diego. Although this company was not initially the lowest bidder, with the application of the minority business allowance, they became the low bidder.

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With the goal of an On-Line Game start-up in the summer of 1986, the CSL took the necessary first steps twelve months ago toward procuring the On-Line computer system by developing and issuing a draft Request for Proposal (RFP) asking potential vendor's to propose a system that would achieve CSL objectives. Based largely on the information received from the informational responses, the CSL issued an RFP in October, 1985. Five separate firms responded to the RFP by submitting proposals. After the receipt of the proposals, the Lottery staff proceeded through a three-month evaluation process during which time evaluation points were assigned for corporate experience, contract support, security, technical capability, price and minority/women-owned business preference for proposed subcontracting. Again, the CSL complied with all applicable State policies and procedures for competitive bidding. The successful proposer was GTECH Corporation.



INTRODUCTION

The attached report follows the format of the agenda for the June 24, 1986 Joint Hearing of the Assembly and Senate Committees on Governmental Organization concerning the operations of the California State Lottery. This report provides important background information on these agenda items and, as appropriate, includes an explanation of Lottery policies and procedures pertaining to key issues relevant to the agenda topics.

PREPARED BY THE STATE LOTTERY, 6/17/86

I. PARTICIPATION BY MINORITIES AND WOMEN IN LOTTERY CONTRACTS

A. Policy and Experience to Date

It is the policy of the California State Lottery (CSL) to achieve the most feasible and practical level of participation by minority/women-owned business enterprises (MBE/WBE) in Lottery procurement programs.

To assist in the achievement of this goal, the CSL Commission adopted a policy on June 19, 1985 regarding subcontracting with MBE/WBE's for major contracts (contracts exceeding \$100,000). The policy statement adopted requires a portion of the Lottery's contracts for goods and services to be subcontracted to MBE/WBE and small business enterprises whenever reasonably feasible. The Commission recognized that in certain areas of contracting there is a greater likelihood of being able to successfully require subcontracting portions of a contract than in other areas. Therefore, in developing RFP/RFT's, Lottery staff, working with the assistance of the Chief, Contract Compliance Office, analyze the feasibility of requiring prime contractors to subcontract depending on the particular type of service/equipment that is requested.

The specific language adopted by the Lottery Commission for use in the California State Lottery's RFP process is:

It is the intent of the Lottery to require the vendor to subcontract with minority women-owned business enterprises as defined by Streets and Highways Code, Section 94.4, Subdivisions (d) and (e) and with small business concerns, as defined by Government Code, Section 14837 and Title 2 of the California Administrative Code, Section 1896.

The vendor shall describe the plans it has for contracting work with minority, women-owned, or small business concerns in the State of California. Joint ventures or ownership including these features will be acceptable in lieu of subcontracting.

As a result of this policy, the Lottery has contracts/subcontracts with MBE/WBE small business concerns totaling approximately \$29 million in the first eight months of operations, which is approximately 8.7 % of CSL total major contract dollars. According to the Office of Small & Minority Business, the State's average for a year is approximately 11 percent.

With the recent passage of SB 34, the Commission, in addition to its existing adopted policy, adopted a subcontracting policy for CSL contracts exceeding \$500,000 as required by this legislation. This policy and the associated implementation criteria and procedures are included at the end of this section.

1. Contract to Advertise the State Lottery

The CSL currently has a major contract with the firm of Needham Harper Worldwide (NHW) for advertising services. This contract includes specific provisions for subcontracting with minority/women-owned firms in the production of Lottery advertising products as well as utilization of minority media. Current estimates are that 23.6% of all production expenditures and 11.2% of all media expenditures have been made through subcontracts with minority/women-owned firms. The Lottery and NHW have consistently been working/meeting with various minority vendors and community organizations in addressing any suggestions or concerns to improve this performance.

2. Equipment and Supplies Contracts

To date, the CSL has encumbered approximately \$335 million in outside contract services. Of the \$335 million encumbered to prime contractors, \$29 million is slated to go to MBE/WBE's. This \$29 million represents approximately 8.7% of the total contract dollars.

In November of 1985, the Lottery's Contract Compliance Office reported that approximately 4% of the Lottery contract dollars had been encumbered for MBE/WBE's. The Office had, at that time, anticipated that the 4% figure would double by the end of the fiscal year. We have accomplished that goal.

It is important to note that the Lottery contracts with major telephone entities (e.g., AT&T and Pacific Bell) for a total expenditure of approximately \$63 million. These firms, because of the specialized work being performed, cannot in most instances utilize subcontracting options. Therefore, when the \$63 million is removed from the total contract dollar amount, the figure for MBE/WBE dollars encumbered increases to approximately 10.3%.

3. Retail Contracts

Of the CSL's total 20,000 retailer contracts, approximately two-thirds are with small businesses. Currently, there is a language survey being conducted to ascertain the number of Non-English speaking retailers as well as Lottery customers/callers. This survey information will assist the Lottery in determining the need for bilingual district sales representatives and/or staff support. A survey is also being prepared for release regarding the number of minority/women-owned retailers in the CSL network.

B. Plans for the Future

The CSL is not satisfied with its present level of MBE/WBE contracting, and plans to significantly increase MBE/WBE contract representation in the near future. Specific avenues for achieving this goal include:

- o "Splitting" more future contracts into various components (whenever feasible) thereby providing additional avenues for MBE/WBE business opportunities,
- o Continuing to work with minority/women vendors and community organizations to keep abreast of their concerns, suggestions, etc.,
- o Surveying the number of minority/women-owned retailers in the CSL network and identifying action plans for increasing such representation,
- o Continuing to develop a minority/women-owned vendors listing for use by Lottery staff in the dissemination of contract proposals,
- o Continuing to provide prime contractors with assistance in locating MBE/WBE subcontractors, and
- o Taking an active role with Governor's Small Business Roundtable.

POLICY STATEMENT

It is the policy of the California State Lottery (CSL) to achieve the most feasible and practicable level of participation by socially and economically disadvantaged small business concerns in its procurement programs.

Furthermore, it is the intent of the CSL to require all bidders or contractors to include specific plans or arrangements to utilize subcontracts with socially and economically disadvantaged small business concerns for contracts exceeding \$500,000. The subcontract plans shall specifically identify the feasibility of utilizing the subcontract services; indicate the percentage of contract dollars (or actual contract dollars) to be subcontracted; and identify the subcontractor(s), if known.

For the purpose of this policy, socially and economically disadvantaged persons include women, Black Americans, Hispanic Americans, Native Americans (including American Indians, Eskimos, Aleuts, and Native Hawaiians), Asian-Pacific Americans (including persons whose origins are from Japan, China, the Philippines, Vietnam, Korea, Samoa, Guam, the United States Trust Territories of the Pacific, Northern Marianas, Laos, Cambodia, and Taiwan), and other minorities or any other natural persons found by the Commission to be disadvantaged.

In addition, for the purpose of this policy, small business means a business in which the principle office is located in California and the officers of such businesses are domiciled in California, which is independently owned and operated, and which is not dominant in its field of operation.

To qualify as a socially and economically disadvantaged small business concern: (a) at least 51 percent of the concern must be owned by one or more women or minorities, or in the case of publicly-owned business, at least 51 percent of its stock; and (b) whose management and daily business operations are controlled by one or more women or minorities who own it.

PROCESS

Prior to the release of any Request for Proposals (RFP), Request for Information (RFI), or any solicitation/negotiation that may result in a contract exceeding \$500,000, CSL program staff shall notify the Chief of Affirmative Action/Contract Compliance Office (AA/CCO) in writing of the purpose of the proposed contract, estimated dollar amount and contract time period. The Chief, AA/CCO shall be responsible for:

1. Providing a listing of socially and economically disadvantaged small business concerns in the particular contract subject area.

Definition cited from Small Business Procurement and Contract Act, California Government Code, Section 14837(c).

Definition cited from A Guide to State Contracting published by the Department of General Services, Office of Small and Minority Business.

Lists will be developed utilizing minority publications issued by the Office of Small and Minority Business, national MBE/WBE directories, and companies pursuing business with the Lottery directly.

2. Assisting in the development of specific proposal language and evaluation criteria (including assignment of evaluation points/percentage to be awarded) for MBE/WBE subcontracting.
3. Ensuring the inclusion of standard nondiscrimination clause in all contracts in accordance with Government Code, Section 12990.
4. Participating as a member of contract proposal evaluation team for the purpose of evaluating such proposal in terms of nondiscrimination policy and subcontracting component.

CSL staff should, whenever feasible, publish Lottery's contract bidding procedures and opportunities utilizing the California State Contracts Register, the Minority Business Exchange, or any other contract publication which will assist in the dissemination of contract information to small businesses.

CRITERIA

The Chief, AA/COO, shall be responsible for the assignment of percentage and/or numerical points to be allocated to the minority subcontract component of the bidding process. The percentage/points will vary depending upon the assigned criteria points for other pertinent bidding requirements. (Example: cost, technical capability, experience, etc.). The AA/COO will work with the CSL program staff to arrive at a fair and equitable assignment of the total points to be awarded to bidders or contractors.

When evaluating the proposals, bidders and contractors will be assigned percentage/points based upon the level of MBE/WBE participation (measured in dollar value). The higher score will be assigned in proportion to the percentage of commitment.

Example: The MBE/WBE component for an EDP equipment RFP/RFI is assigned 10 points in the evaluation criteria. Therefore, if Firm A's minority commitment was \$80,000 (the highest proposed minority participation), it would score 100 points and that figure would be the base number. If Firm B's commitment was \$65,000, it would be divided by the base number (.80,000) and then multiplied by 100 ($65,000/80,000 \times 100 = 81.25$ or 81.00).

	<u>MBE/WBE Component</u>	<u>Score</u>	<u>Percent</u>
Firm A (Women/Minority Owned)	\$80,000	100	10.00
Firm B (Prime Contractor/Subcontractor)	65,000	81	8.10

Small Business Preference

In accordance with the Small Business Procurement and Contract Act as provided in Government Code, Section 14838, when a monetary amount is the sole determining factor, the California State Lottery will grant a preference in an

amount equal to 5 percent of the lowest responsible bid if the low bid has been submitted by a bidder who is not a small business concern. The 5 percent may not exceed \$500,000 on any one bid.

Example:

Bidder A \$19,879 (claims small business—verified small business)
Bidder B \$18,975 (not small business)

When the 5 percent preference is applied, Bidder B's bid would be computed as follows: $\$18,875 \times .05 = \948.75 . The small business verified bid would be reduced by \$948.75 which would result in the contract being awarded to Bidder A ($\$19,879 - \$948.75 = \$18,921.25$).

CONTRACT TERMS

In regard to the MBE/WBE component, contract terms will include the specific minority participation dollar or percentage amount as outlined in the successful bidder's proposal.

CONTRACT COMPLIANCE VERIFICATION

The current contract compliance verification procedures for monitoring/verifying contract payments to bona fide MBE/WBE was adopted by the Commission on February 14, 1986 and will remain in effect.

Any business who falsely obtains small business classification will be subject to the penalty provisions outlined in Section 14842 of the Small Business Procurement and Contract Act (California Government Code). Penalties may include ineligibility to transact any business with the CSL for up to 24 months and/or payment to the State of any difference between the contract amount and what the CSL's costs would have been if the contract had been properly awarded. Prime contractors may be penalized if they knowingly subcontract with nonbona fide small business concerns.

CONTRACT REPORT SYSTEM

The Director shall report to the Commission on a quarterly basis the level of participation of small businesses, socially and economically disadvantaged businesses and California businesses in all contracts awarded by the CSL. Furthermore, as part of the requirements of SB 34, the CSL shall report that level of participation to the Legislature by July 1, 1987.

II. ADVERTISING FOR CONTRACTS

A. Experience to Date

1. Background

The California State Lottery (CSL) was created in 1984 as a result of the passage of Proposition 37. In establishing the CSL, the law (as defined in Article 6, Section 8880.56), permits the Director of the CSL to authorize the purchase or lease of such goods or services as necessary to operate the Lottery. This Section has been interpreted to mean that the California State Lottery is basically exempt from standard State procurement requirements. This interpretation is shared by both Lottery house counsel and the Attorney General's Office.

The Department of Finance and the Department of General Services have general powers of review and supervision over the financial matters of the State. The State normally requires that at least three competitive bids or proposals be secured for all contracts except for EDP goods and services and Interagency Agreements (EDP services and goods require seven bids). Agencies are also required to advertise various types of contracts with a dollar value of \$500 or more in the Contract Register. In those instances where three bids or proposals cannot be obtained or a contract award is not made to the lowest monetary bidder or proposer, a full explanation and justification must be made to the Department of General Services and approval must be obtained before the contract can be awarded. General State law relating to contracting is found in the Government Code; however, specific State and Departmental policies are set forth in the State Administrative Manual (S.A.M.).

2. California State Lottery Procurement as Affected by SB 34

The recent passage of SB 34 (Dills) has had a significant impact on CSL competitive bidding policies and procedures. The following are some major provisions of this Bill:

- o By July 1, 1986, the California State Lottery must provide the Legislature with its plans to implement the bill's requirement that the CSL encourage participation by economically and socially disadvantaged small businesses in the award of CSL contracts. The plan must include the proposal evaluation criteria and sample contract terms. This requirement applies to contracts which are over five hundred thousand dollars (\$500,000).
- o The CSL must comply with the requirements of the Small Business Procurement and Contract Act except that the CSL is substituted as the agency designated to carry out any role, function or activity which that Act designates be performed by the Departments of Finance and/or General Services.

- o By July 1, 1987, the CSL must report to the Legislature on its record of contract participation with small businesses, economically or socially disadvantaged businesses and California businesses.
- o Prior law relating to bidder disclosure was amended to make discretionary (as determined by the Commission) the submission of the disclosure items which were mandatory under prior law.
- o The CSL is to adopt competitive bidding procedures for contracts involving printing of tickets or the acquisition of any electronic computer including software used in conjunction with a computer.
- o Bidder disclosure requirements are waived for contracts involving the purchase of prize annuities or for equipment, goods or services commonly acquired by State agencies.
- o The CSL is subject to State law relating to interagency agreements except that any approval, function or role which is the responsibility of the Department of Finance or General Services shall instead be the responsibility of the California State Lottery.

3. Commission Adopted Standards

On June 19, 1985, the CSL Commission adopted a policy regarding subcontracting with minority, women-owned, and small business enterprises. It is the policy of the CSL to require a portion of the Lottery's contracts for goods and services to be subcontracted to minority, women-owned, and small businesses whenever reasonably feasible.

On June 12, 1986, the CSL Commission adopted Rules and Regulations expanding the scope of the Commission's original (June 19, 1985) policy in order to further expand participation by economically and socially disadvantaged small businesses in the award of CSL contracts as required by SB 34.

4. California State Lottery's Contract Policies

The CSL has always strived to comply with standard state requirements, to the most feasible extent, in procuring the goods and services of private vendors. The CSL Commission has set forth the policy that all contracts being negotiated which exceed \$100,000 will be subject to public debate and must be approved by the Commission in public session. Additionally, the CSL publishes a monthly updated list of all Lottery contracts executed during the fiscal year. This list is given to the CSL Commissioners for their review and this information is available to the public upon request.

Following are the five (5) major contracts entered into by the California State Lottery and the specific procedures followed in these procurements.

Instant Ticket Contract

When the California State Lottery initiated invitations for bids for the printing of instant lottery tickets, only one (1) vendor, Scientific Games, Inc., complied with the disclosure requirements of the California Lottery Act of 1984. Scientific Games, Inc., was therefore awarded a one-year contract with extension provisions for supplying the CSL with lottery tickets.

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5. Emergency Procurements

Due to the tremendous implementation pressures and the unexpectedly high volume of instant ticket sales, the Lottery has admittedly encountered problems which required the acquisition of both equipment and professional or technical knowledge from private contractors on an emergency basis. One such contract was the procurement of 4-wheel drive vehicles which were not available in any form from the Department of General Services. The safety of our drivers was in jeopardy using the vehicles provided by General Services in geographical areas with heavy snowfall. In this instance, the bid process was initiated through informal telephone bids, which included General Service price book vendors. Thirteen dealerships participated in the bidding for the lease/purchase of 19 special-weather (4-wheel drive) vehicles. Based on an evaluation of the Lottery's emergency needs, Performance Ford was awarded the contract as the lowest bidder.

B. Future Plans and Policies

As the California State Lottery continues to recover from the initial and unexpected onset of high volume ticket sales, its operations are becoming more stable and predictable. With a stable operating system, the CSL will be able to better project its contracting needs, greatly decreasing the need for entering into high priority emergency contracts. The CSL has established policies and procedures that will enable this agency to meet or exceed the State's standard for competitive bidding and ensure an equitable ratio of minority and small business representation for contracted services.

III. REVENUES AND EXPENDITURES

A. Total Revenues and Expenditures

1. Lottery Revenues

Revenue for FY 85-86

The California State Lottery sold one billion tickets in its first four months of operation, more tickets than all other state lotteries combined for the previous twelve months. Sales for the fiscal year are estimated at slightly over 1.7 billion tickets, representing approximately \$650 million in net revenues for our State's schools.

Projected Revenue for FY 86-87

As was the case for all other lottery states, instant ticket sales in California have declined sharply since the first few months of operation. While almost 10 million tickets/day were sold in October 1985, sales for June 1986 are estimated at approximately 4 million tickets/day. For FY 86-87, the Lottery is estimating instant ticket sales averaging 2.2 million tickets/day, for an annual total of slightly over 800 million tickets.

In late August or early September of 1986, the CSL will initiate on-line computerized gaming, starting with a game known as LOTTO. In approximately 5,000 different retail locations throughout the state, players will choose six different numbers from 01 to 49, and these numbers will be entered directly into the Lottery's computer system via an on-line terminal. At the end of each week, the Lottery will randomly select six different numbers plus one bonus number, and prizes ranging from \$5 to millions of dollars will be awarded on the basis of correct player picks.

The Lottery is estimating that LOTTO sales for FY 86-87 will total just over 800 million tickets, with daily sales starting at an average of about 2 million tickets/day and finishing the fiscal year with an average of about 3 million tickets/day.

If the Lottery's FY 86-87 sales projections are achieved, the State's schools will receive almost \$550 million in Lottery-generated revenues from both instant ticket and On-Line Games sales.

Sales Trends

In all lottery states, instant ticket sales invariably start high and then sharply decrease over time. The typical sales decline bottoms out with sales averaging 20-25% of the initial high sales levels approximately 12-18 months after sales begin. California is following this same basic trend, although per capita sales were, and continue to be, far above the national average.

In direct contrast to instant tickets, on-line sales start slowly and build over time. For most mature lottery states, on-line sales eventually represent between 70% and 90% of all lottery sales. Should California follow this pattern, long-term annual Lottery sales should eventually exceed reach \$2 billion/year.

2. Lottery Expenditures

Definition

By law, the CSL operates under "generally accepted accounting principles", and its books and accounting records are maintained in virtually the same manner as privately-owned companies. From an expenditure standpoint, this means that purchased capital assets are expensed or written off over a period of years. Thus, if the Lottery purchases a \$6 million computer, for example, only the depreciated portion of this purchase is reflected as an expenditure or expense during any given time period. With on-line game capital equipment and telecommunications costs totaling over \$150 million, the use of "generally accepted accounting principles" allows these huge investments to be amortized as expenditures over a 4-5 year period.

Expenditure Limits

By law, Lottery operations must be funded from Lottery revenues, and total expenditures for any given year cannot exceed 16% of total sales for the same time period. Any portion of this 16% upper spending limit which is not used automatically becomes net revenue for our State's schools.

Expenditures Prior to Sales

Prior to the start of instant ticket sales on October 3, 1985, all Lottery operations were funded from a \$16.5 million General Fund temporary line of credit which was established by the California State Lottery Act.

The Lottery borrowed just over \$2.0 million from the General Fund prior to start-up, and this money, plus interest, was repaid in late October 1985.

Expenditures for FY 85-86

For FY 85-86, the Lottery is estimating total expenditures of approximately \$220 million, representing 12.6% of the projected sales total of \$1.74 billion. Approximately one-third of this \$220 million is for general operating expenses (e.g., personnel and associated operating expense and equipment), with the balance going for such major items of expense as retailer commissions, advertising, and ticket costs.

Revenue and Expenditure Comparisons

As mentioned earlier, the Lottery is required to fund its operations using no more than 16% of its total revenue base. This expenditure limit was not a problem for FY 85-86, as the volume of early instant ticket sales provided an ample expenditure cushion. However, for FY 86-87, the picture is quite different. As noted earlier, instant ticket sales have declined sharply, and on-line game sales typically start at relatively low levels. With the huge start-up cost associated with on-line games, the Lottery is not automatically assured of operating within its 16% statutory spending limitation. A number of other lottery states have experienced considerable difficulty in keeping expenditure levels low during the transition from instant to on-line games, with expenditure levels frequently exceeding 16% of sales*.

For FY 86-87, the Lottery has two primary fiscal goals: 1) maximizing revenues for education and, 2) operating within its 16% spending limitation. While, at first blush, these two goals would appear quite compatible, such is not the case.

Two of the most effective, but expensive, ways for the Lottery to increase sales are increasing the level of advertising and increasing the number of sales locations and/or on-line terminals. For private companies, decisions of this nature would be governed by the goal of maximizing net profits. At the point where additional marginal costs exceed additional marginal benefits, increases in advertising and/or market expansion would cease.

With its relatively high inherent profit margin, the Lottery would theoretically need only generate about \$3 in additional sales to justify a \$1 investment. For example, if a \$1 increase in advertising created \$3 worth of sales, the Lottery could net up to 29c in profit as follows:

	\$3.00	sales increase
less	1.00	direct advertising cost
less	1.50	in prize payment liability
less	.15	in retailer commissions
less	<u>.06</u>	in direct ticket costs
equals	.29	in net profit (assuming a negligible increase in other general operating expenses)

Using the above example, the Lottery would be legally obligated to transfer 34% of the \$3.00 in sales (or \$1.02) to the State's schools. Since the 29c net profit is not sufficient to cover this liability, the Lottery would have to absorb the 73c difference (\$1.02-.29 = .73) as a net loss to its 16% administrative spending allotment.

*For example, Illinois spent 18.0% in 1979-80, New York State spent 17.0% in 1979-80, and Ohio spent 22.7% in 1979-80.

Note: Administrative cost comparisons between lottery states are extremely difficult to make since administrative costs are defined differently in different jurisdictions.

In order for a lottery expenditure to generate additional revenue to the point where the 16% spending limitation is not taxed, a benefit cost ratio of 11-1 or greater must be achieved (see the following chart at the end of this section for a graphic display of this relationship). If the 16% limitation were decreased, the necessary benefit-cost ratio would necessarily increase, automatically decreasing the Lottery's ability to generate net revenues for the benefit of education.

For FY 86-87, the Lottery will operate under the assumption that its first and primary goal is to stay within its 16% spending limitation, and that the ultimate goal of maximizing revenues for education must be achieved to the extent possible within this expenditure limit.

B. The Most Significant Expenditures

1. Statutorily Required Expenditures

The California State Lottery Act requires that:

- o approximately 50% of total Lottery sales be returned to the public in the form of prizes,
- o at least 34% of total Lottery sales be distributed as revenue to the State's schools, and
- o not more than 16% of total Lottery sales be available for general Lottery administrative expenses.

Additionally, the California State Lottery Act requires that all unclaimed prizes and that all net Lottery revenues (i.e., the difference between actual administrative expenditures and the 16% maximum allocation) be transferred into the State Lottery Education Fund for distribution to the State's schools.

2. Major Expenditures for FY 85-86

For FY 85-86, the Lottery will spend approximately \$220 million for general administrative expenses. Of this amount, \$89 million, or slightly over 40%, represents retailer commissions. The balance of \$131 million is distributed as follows:

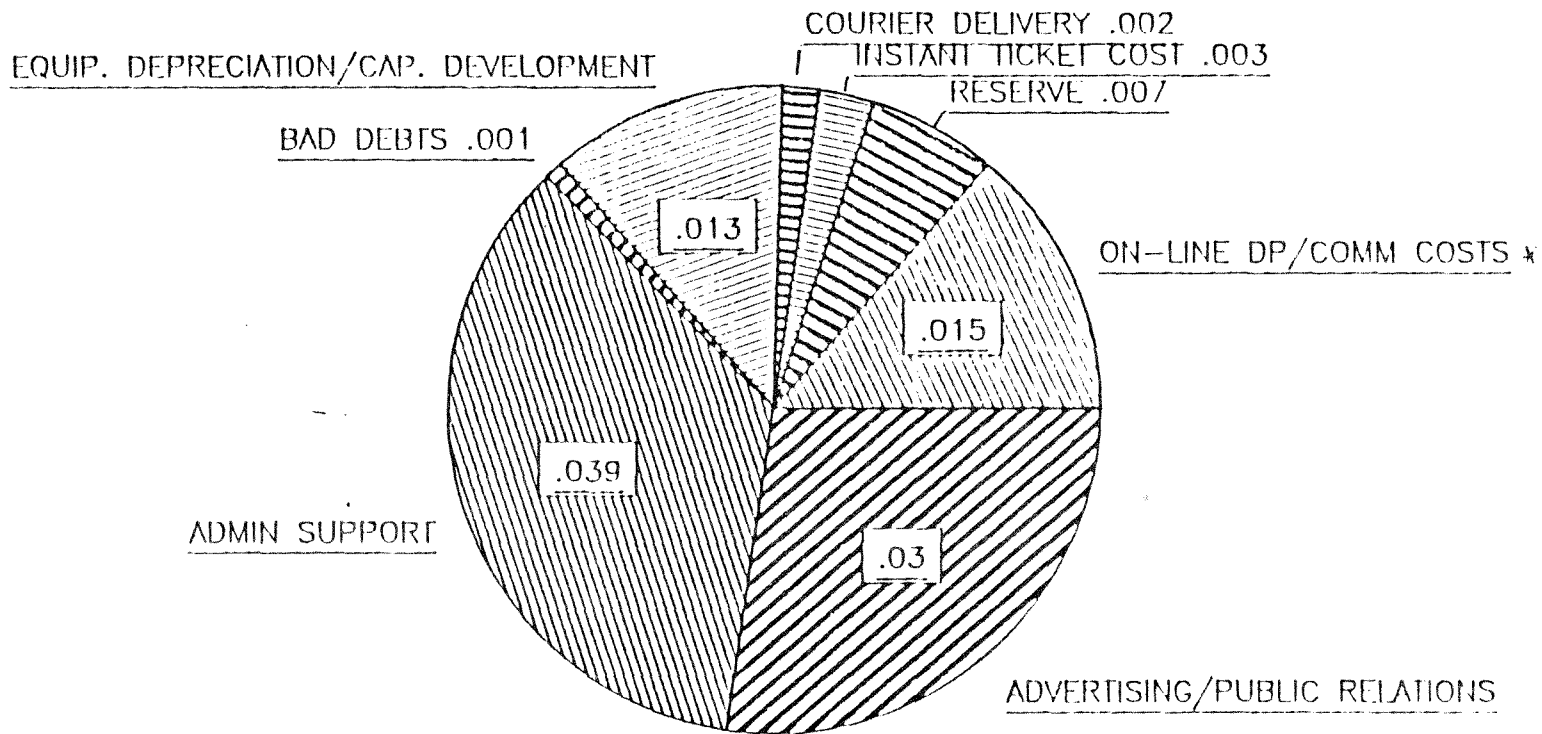
o Advertising/Public Relations	18%
o Ticket Costs	32%
o Ticket Delivery Contract	2%
o Employee Salary/Wages/Benefits	11%
o Other Administrative Expenses	<u>37%</u>
	100%

3. Major Projected Expenditures for FY 86-87

The Lottery's 16% maximum expenditure authority for FY 86-87 is estimated to equal approximately \$258 million based on sales of just over \$1.6 billion. Approximately \$248 million of this total is being budgeted for general administrative expenses, leaving a \$10 million reserve for revenue fluctuations. When retailer commissions totaling \$81 million, or 5% of sales, are subtracted from the \$258 million maximum expenditure limit, the Lottery has a potential operations budget of \$177 million of 11% of sales. The following chart details the projected distribution of this \$177 million.

General Administrative Expenditures (11%)

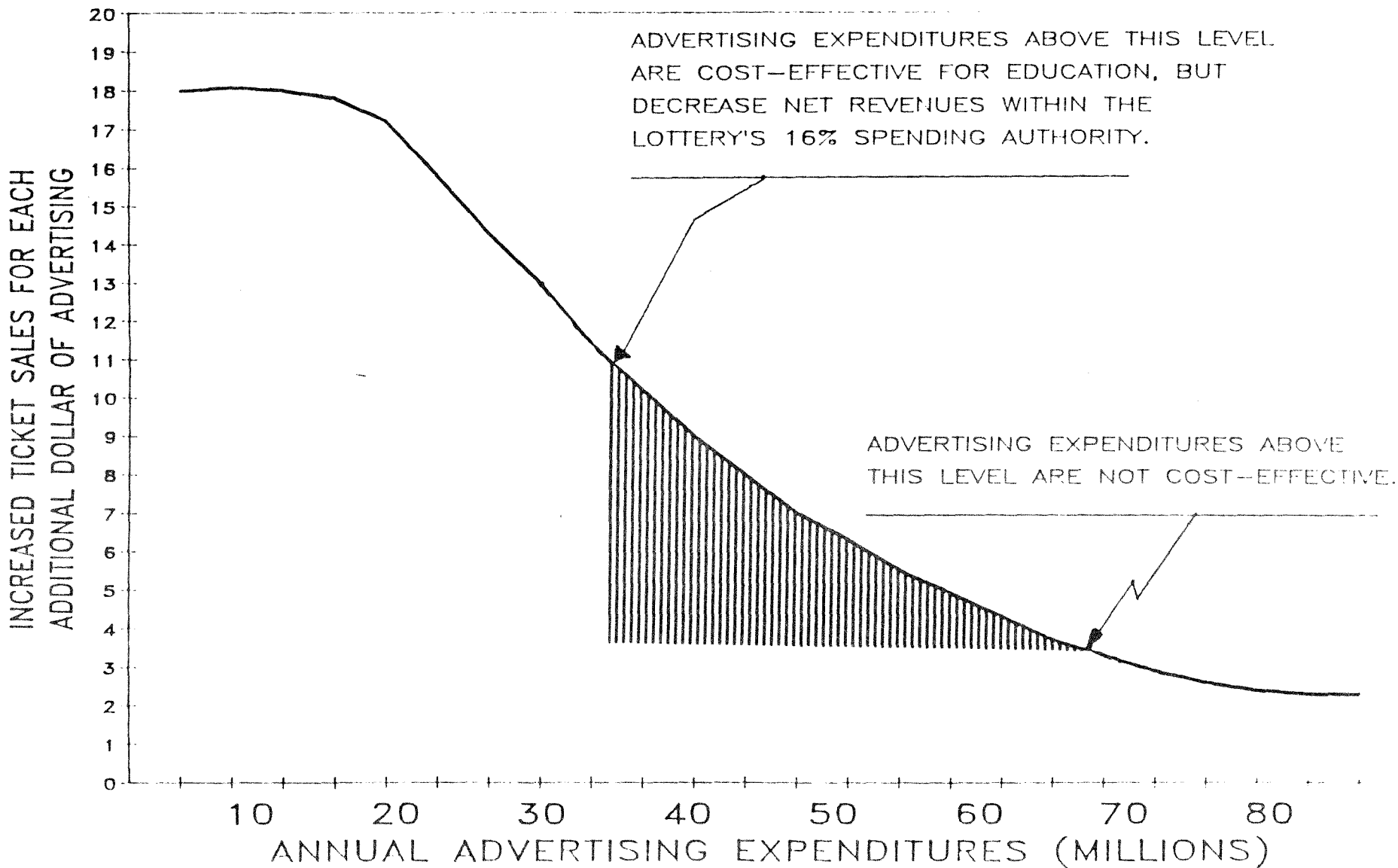
BASED ON ESTIMATE OF \$1,613,705,000.00
FOR FISCAL YEAR 86-87

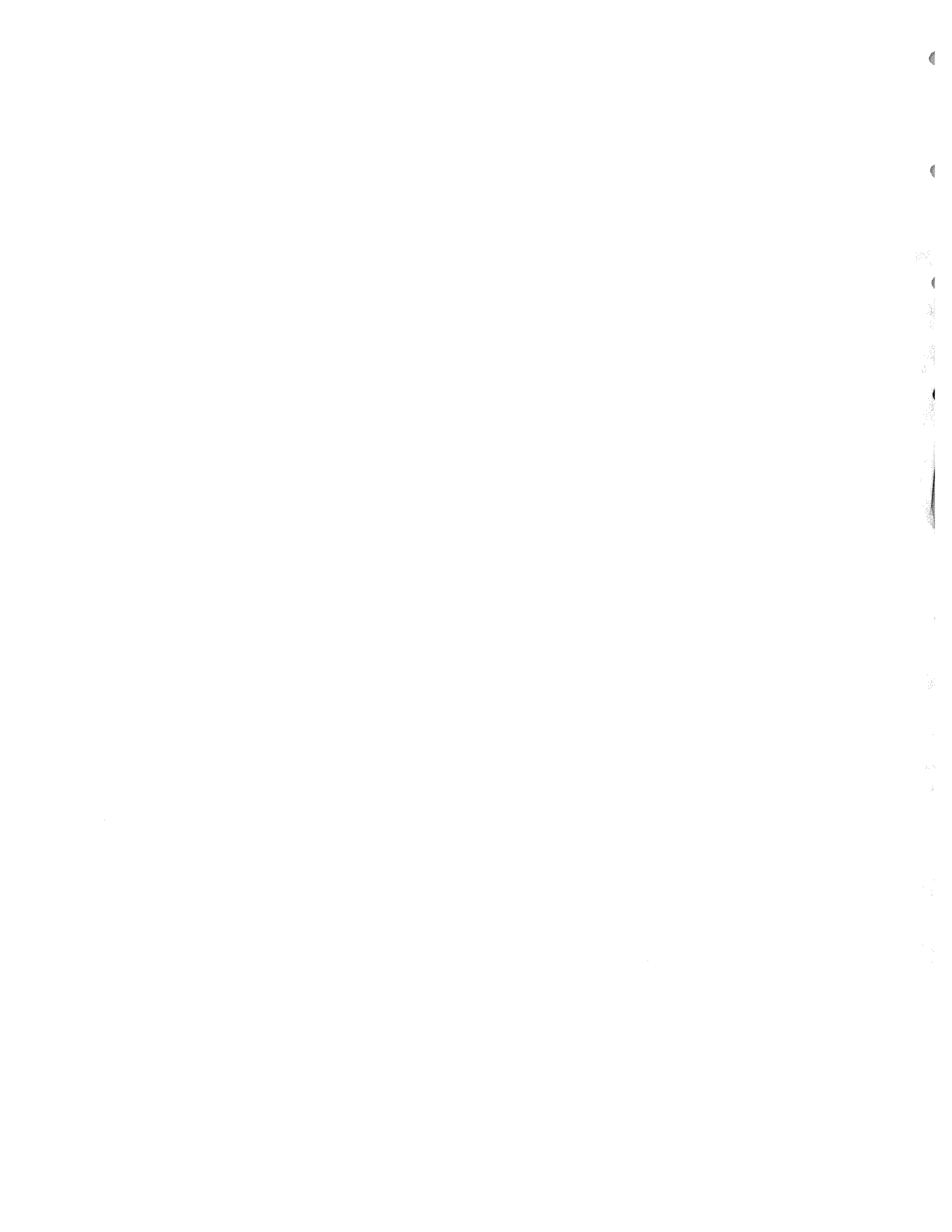


(*) ON-LINE DP/COMM CONTRACT IS ENTERED FOR A 4 YEAR PERIOD



EXAMPLE
RELATIONSHIP OF ADVERTISING TO TICKET SALES AND
THE ASSOCIATED IMPACT OF DIFFERENT ADVERTISING
LEVELS ON THE LOTTERY'S 16% SPENDING LIMITATION





IV. NUMBER OF WINNERS AND ODDS OF WINNING PRIZES BY CATEGORY

A. Total Number of Winners

Through the end of its first fiscal year of operation, the California State Lottery estimates it will have sold 232 million winning tickets as shown in the chart below. Given our estimate of 19 million adults aged 18 and over in California, this equates to each adult winning an average of over 12 times since the Lottery started last October.

LOTTERY WINNERS

<u>GAME</u>	<u>TICKETS SOLD</u>	<u>ESTIMATED # OF WINNERS</u>	<u>ODDS</u>
#1	371.1 M	41.7 M	1 in 8.90
#2	265.6 M	29.8 M	1 in 8.90
#3	306.7 M	59.1 M	1 in 5.19
#4	306.8 M	41.4 M	1 in 7.42
#5	285.0 M	35.5 M	1 in 8.02
#6	230.0 M est.	25.0 M	1 in 9.20
TOTAL	1,765.2 M	231.7 M	1 in 7.43

The chart shows that the total number of winners for any given game depends on two factors. The first and most important is the number of tickets sold in that game. Second, the number of winners is affected by the odds included in a game prize structure.

With the exception of Game #3 which had about 1 in 5 odds due to the inclusion of free tickets, odds are generally in the 1:8 to 1:9 range. The odds have always been better than 1 in 10 for California's instant games and the CSL plans to continue this policy for future games.

B. Odds by Category

Each instant game prize structure is characterized by four distinct categories: 1) the number of low-tier prizes paid by the retailer (\$2, \$5); 2) the number of mid-tier prizes that range between \$50 and \$5,000; 3) the top instant prize (which is currently \$100,000); and 4) the Grand Prize Drawing prize pool and procedures. Each of these four prize categories serves a distinct and important function in sustaining an appropriate level of play among California adults. Importantly, our primary objective in developing prize structures is to balance the appeal of the different prize segments in such a way as to attract the broadest possible range of players for the instant game - rather than encouraging an inappropriate level of play within any one group.

1. Low-Tier Prizes

The primary role of the low-tier prize is to ensure that all players have the opportunity to win on a relatively frequent basis. These prize amounts have typically been \$2 and \$5, and have been paid by the retailer at the store. As illustrated in the chart below, these prizes represent the majority of the prize fund available, consistent with the CSL's interest in giving players a positive experience.

ODDS OF WINNING LOW-TIER PRIZES

<u>GAME</u>	<u>PRIZE AMOUNTS</u>	<u>ODDS</u>	<u>PERCENT OF PRIZE FUND</u>
#1	\$2, \$5	1 in 8.9	52.0
#2	\$2, \$5	1 in 8.9	52.0
#3 a.	\$2, \$5 plus free tickets	1 in 5.2	48.8
b.	\$2, \$5 only	1 in 10.9	
#4	\$2, \$4	1 in 7.5	66.0
#5	\$2, \$5	1 in 8.1	64.8
#6	\$2, \$5	1 in 9.3	57.4

2. Mid-Tier Prizes

A key role of the mid-tier prize is to provide an interesting range of prizes for the player. Also, it ensures that there are several thousand significant winners in most large communities, generating good word of mouth awareness for the game. The prize amounts vary by game, depending upon the level of the top instant prize and other game features such as the "nugget" doubler in Game #4, as shown below. The complete range of prize amounts and odds of winning for Games #1-#6 are shown below.

ODDS OF WINNING MID-TIER PRIZES

<u>GAME</u>	<u>PRIZE AMOUNTS</u>	<u>ODDS</u>	<u>PERCENT OF PRIZE FUND</u>
#1	\$100, \$500, \$1,000	1 in 3,200	13.7
#2	\$100, \$500, \$1,000	1 in 3,200	13.7
#3	\$100, \$1,000	1 in 3,287	17.5
#4	\$100, (\$200), \$500, (\$1,000)	1 in 4,444	8.2
#5	\$100, \$500	1 in 8,000	4.0
#6	\$50, \$500, \$5,000	1 in 4,138	9.2

3. Top Instant Prize

The role of the top instant prize is to provide an incentive for a broad range of players to purchase instant game tickets. A normal phenomenon in instant games is the need to increase the top instant prize as the initial novelty of the instant game wears off over time. As the chart below indicates, California's top instant prize has grown from \$5,000 to \$100,000.

ODDS OF WINNING TOP INSTANT PRIZES

<u>GAME</u>	<u>TOP INSTANT PRIZE</u>	<u>ODDS</u>	<u>PERCENT OF PRIZE FUND</u>
#1	\$ 5,000	1 in 40,000	24.9
#2	\$ 10,000	1 in 80,000	24.9
#3	\$ 25,000	1 in 240,000	23.0
#4	\$ 50,000	1 in 960,000	10.2
#5	\$100,000	1 in 960,000	20.4
#6	\$100,000	1 in 960,000	20.7

While it is difficult to determine the "perfect" top instant prize, CSL research has indicated that the typical California adult is interested in playing for a top instant prize that is more than twice his/her annual income. Therefore, the CSL's plan is to maintain the top prize in the \$50,000 to \$100,000 range to ensure that we are appealing to high, as well as middle and lower, income players. We have received many suggestions to eliminate or significantly reduce the top instant prize, but we believe this would discourage play from the higher income groups.

Grand Prize

The role of the Grand Prize is to provide a long-term incentive for play of the instant game, especially among those in the more highly educated and higher income groups. Another piece of CSL research has indicated that to feel "truly rich", an average California adult would need an income of \$200,000 per year, which equates to \$4 million on an annuitized basis over 20 years. Since Game #3, the CSL has employed a grand prize wheel with a progressive grand prize that starts at \$3 million and grows by \$65,000 for each spin until it is won; once won, it reverts to \$3 million and begins to grow again. The average expected value of that prize is \$5.1 million. The current prize of \$14,245,000 is a statistical aberration.

Approximately 10 to 12 percent of the total prize fund has gone into the grand prize wheel. We believe this is the right amount based on our sales success to date and California's ability to maintain a player base that is highly representative of population.

The chart at the end of this section displays, by game, the number of winners and odds of winnings prizes in major prize categories.

Entry into Grand Prize Drawing

The final component of the prize structure is the actual means of entry into the grand prize drawing process. As shown below, the initial method of entry was via \$100 winners. In response to player concerns that a \$100 winner should not also receive a chance at the Grand Prize (i.e., winning twice), as of Game #3 a special ENTRY symbol has been used.

<u>GAME</u>	<u>METHOD OF ENTRY</u>	<u>ODDS OF BECOMING ELIGIBLE FOR PRELIM. DRAWING</u>	<u>ODDS OF AN ELIGIBLE ENTRANT BEING SELECTED FOR THE "BIG SPIN"</u>
#1	\$100	1 in 4,000	1 in 625
#2	\$100	1 in 4,000	1 in 625
#3	\$100	1 in 4,000	1 in 625
#4	ENTRY Ticket	1 in 2,000	1 in 1,250
#5	ENTRY Ticket	1 in 2,000	1 in 1,250
#6 a.	ENTRY Ticket	1 in 2,000	1 in 1,250
b.	3 nonwinning tickets w/JOKER symbol on each	1 in 10 (30% of nonwinners have JOKER symbol)	1 in 32,000 (approx.)

As indicated in the chart above, for the current Game #6, a new and additional means of player entry has been added via the Second Chance Drawing (SCD). This allows players to send in nonwinning tickets for a chance at the Grand Prize. The odds of winning via the CSD are determined by the number of SCD entries received.

The CSL Commission has just approved extending the SCD through Game #9, thereby allowing players the chance to improve their own odds of entering the Grand Prize drawing process.

Alternatives Considered

It is important to note that the actual number of mid-tier winners, and number of winners in any prize category, are largely dependent upon the number of tickets sold in a game. Therefore, California State Lottery Commissioners, the CSL staff, Legislators and public media are all hearing players and retailers commenting that there should be more prizes - in particular, more mid-tier prizes. Much of this is a function of the fact that the sales rate of an instant game typically slows and the rate of sales per unit of time declines.

Additionally, players often comment that they would be happy to receive a \$50 or \$100 prize and do not feel the need for a top instant or grand prize. This is because they believe their odds of winning will increase significantly if the grand prize or top prize were eliminated. However, in a game such as the current Game #6, if the top instant prize were eliminated and that portion of the prize fund converted to \$50 prizes, the odds of winning a prize would increase only from 1 in 9.2 to 1 in 9.0. The change would not be likely to offset the loss in sales which would result if the top prize were dropped.

The maintenance of a large top instant and attractive grand prize supports a broader playing population in California than experienced by any other state. Specifically, through Game #5, fully 48 percent of California adults are still playing the instant game. This compares to player percentages in the 30 to 40 percent range for other states at this same stage of instant game replay. Because of the large number of adults playing, we have found no statistically sound differences between players and the demographics of the total population.

NUMBERS OF WINNERS AND ODDS OF WINNING ACROSS INSTANT GAMES

PRIZE	Game 1		Game 2		Game 3		Game 4		Game 5		Game 6	
	Winners	Odds 1 in:	Winners	Odds 1 in:	Winners	Odds 1 in:	Winners	Odds 1 in:	Winners	Odds 1 in:	Winners	Odds 1 in:
Low Tier	41.6m	8.9	29.7m	8.9	28.1m*	10.9*	41.0m	7.4	35.2m	8.0	24.7m	9.2
Mid-Tier	116.0k	3.2k	83.0k	3.2k	93.3k	3.3k	69.0k	4.4k	35.6k	8.0k	55.6k	4.1k
Top Instant	9.3k	40.4k	3.3k	80.0k	1.3k	240.0k	320.0	960.0k	297.0	960.0k	239.0	960.0k

Legend: m= million
k= thousand

*Does not include free tickets

V. FUTURE DEVELOPMENTS AND PROPOSALS

Mature lotteries, both in the U.S. and around the world, generally sell their products through a combination of three (3) different methods: (a) a traditional or "draw" type game; (b) an "instant" or scratch off game; and (c) an "on-line" computerized game. Many of the older European and Canadian lotteries offered a traditional game as their first lottery product, followed by an instant game and finally, by a computerized game.

As the industry matures, there is less interest in the passive games where players have no control over their chances of winning. Consequently, most new lotteries, including California, have opted to start with instant games to be followed by a series of on-line games where players can actually choose their "lucky numbers".

The on-line games have emerged in the last decade as the main staple in the menu of gaming options offered by a lottery. As discussed earlier, the on-line games are played as follows: A player selects his or her number selections and a clerk, either manually or with the aid of an optical scanner, enters the wager into a computer terminal. The terminal is one of a series of terminals linked to a central computer over a vast telephone network. The wager is electronically recorded on the central computer and a ticket is produced at the terminal for the customer's receipt. Traditionally, the on-line systems have been operated by trained clerks who control the process.

In the past few years, technological advances have been made where some companies are now offering machines which permit the customer to enter the wager directly into a computer terminal, without the assistance of a trained operator. Three such innovations are video lotteries, player activated games, and telephone lotteries.

A. Video Lotteries

A video lottery is an on-line computer game where the player enters money into a computer terminal that looks very similar to a conventional video game unit such as a "PAC MAN" machine. Once the money is accepted, a central computer randomly decides if the player is a winner or a loser and, if appropriate, the prize amount. A video display then appears on the unit, and the player is typically forced into choosing among various options (e.g., doorways, passageways, etc.) until he/she either loses or wins the game. At the end of the game, a winning player will receive a winning ticket which can be redeemed by either an official Lottery retailer or via mail to the Lottery itself. The actual choices that a player makes during the course of a video game are completely irrelevant, since the winning or losing status of the particular game is determined before play actually begins.

A pilot test of this on-line gaming alternative was recently tested in the State of Illinois with mixed reviews. In this particular state, terminal locations were limited to nightclubs and bars to prevent minors from illegally participating in the game.

The CSL is certainly interested in exploring any legitimate alternatives for maximizing revenues for our schools and, therefore, the idea of video lotteries will be given consideration in the future. However, the Lottery's current basic strategy for increasing ticket sales is to stay with, and implement, proven lottery games for which success can be more reasonably assured.

Additionally, CSL management are extremely concerned about the risks of video games in terms of the potential access of these games to minors and the potential for unsupervised machines to be successfully manipulated to alter the odds of winning. Until and unless these concerns can be satisfactorily resolved, video lottery games will not be implemented in this State.

Finally, California law prohibits slot machine gaming and, because video lottery terminals provide an immediate win-loss status to the player, it could be argued that these terminals are little more than sophisticated slot machines. Should this interpretation prove to be correct, a video lottery game could not be implemented in this state.

B. Player Activated Games

A player activated game is any on-line lottery game where the individual player, as opposed to a retail clerk or machine operator, directly accesses a computer terminal for the purposes of making a wager. In the typical case, a player would: 1) insert money into a Lottery-owned computer terminal, 2) decide the specific game he/she wishes to play by pushing the appropriate keys, 3) select specific numbers as the basis of the wager by pushing the appropriate keys, and 4) receive a computer-generated ticket. The player would retain the ticket until such time as the Lottery announced the winning numbers for the game and, should the player be a winner, he/she could cash in the ticket at either a Lottery retail outlet (limited to relatively small prizes) or by sending the ticket and a claim form to Lottery headquarters for payment processing. It is important to note that, as generally defined, player activated terminals are little more than alternate ticket dispensing devices for standard on-line games, much like a bank Automated Teller Machine represents an alternative to direct contact with a bank teller.

While not the norm, a number of state lotteries do own player activated games. The advantage of these games over the more conventional clerk operated games rests almost solely with the retailer's ability to avoid the personnel costs associated with a clerk-operator attending the terminal. Retailer groups, such as supermarket chains, tend to be highly supportive of player activated games because these businesses generally pay their employees relatively high wages and because these businesses do not want to disrupt their normal marketing strategies by designating one cash register and clerk as the Lottery sales outlet.

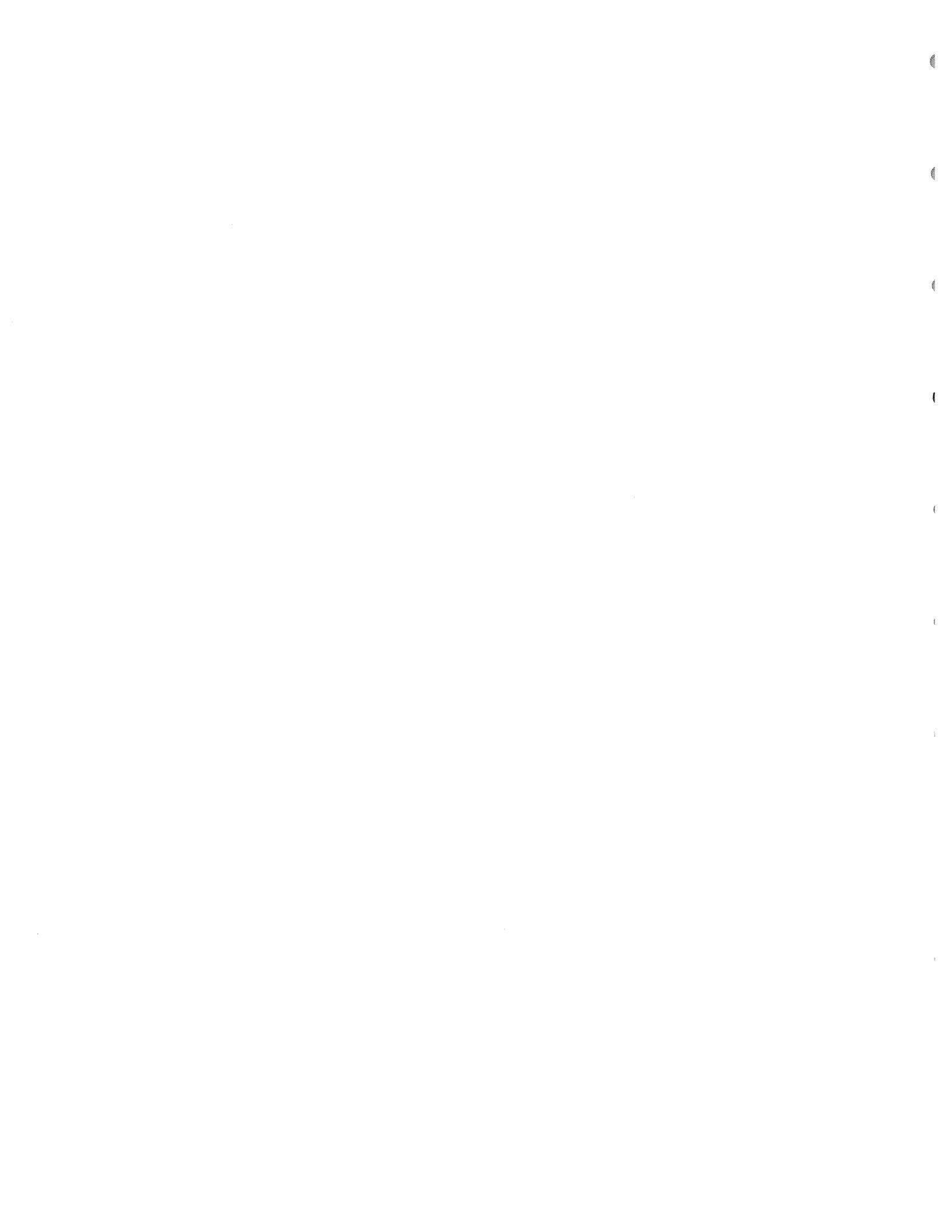
The CSL has already formally addressed the issue of whether to buy, or not buy, player activated games. However, due primarily to concerns regarding both the accessibility of these machines to minors and the relative profitability of these machines in comparison to conventional clerk-operated terminals, no procurement decision has been made to date.

C. Telephone Lotteries

A telephone lottery is a lottery game where the player uses a touchtone telephone to access the Lottery's central computer. In this type of game, the telephone essentially takes the place of a standard player activated terminal, with the touchtone keys being used in place of the terminal keys. The two obvious drawbacks of telephone lotteries in comparison to player activated games are: 1) the difficulties for the Lottery in securing payment prior to the wager, and 2) the absence of any ticket for the player to keep as proof of the wager. Presumably, these disadvantages can be overcome by requiring would-be telephone players to establish a line of credit with the Lottery or use a credit card number (subject to verification) and by mailing the player a computer-generated hard copy ticket after the wager is made and verified.

The main advantages of telephone lotteries relate strictly to costs. The Lottery need not purchase and maintain expensive computer terminals nor must the Lottery pay a retailer commission (which typically averages 5% of the wager).

At this point, telephone lotteries are viewed by the lottery industry as an experimental alternative to standard on-line games. The CSL shares this view. In particular, CSL management are extremely concerned about the security dangers inherent in allowing private telephones to access the Lottery's central computer. However, CSL management are not prepared to completely dismiss the concept of telephone lotteries and this alternative, along with many other gaming options, will be given consideration in the future. For the present, the CSL intends to focus its attention on establishing the type of sound, conventional on-line gaming operation that has proven to be extremely successful in many other lottery states.





BOARD OF SUPERVISORS

June 24, 1986

JOHN GEORGE
SUPERVISOR, FIFTH DISTRICT

Mr. Chairmen and Members of the Committee;

I sincerely appreciate the opportunity to make this presentation to you today regarding the issue of economic parity by women and minorities in lottery contracts. I applaud your committee for looking into this at an early stage so that for once, perhaps, a fair share of the taxpayer's dollar will be distributed on an equitable basis.

I have attached a copy of a letter to Mr. Howard Varner, Chairman, California State Lottery signed by the majority of federal, state and local elected officials in the Bay area raising these concerns in November, 1985. Our constituents were being given the run around, incorrect information, and little assistance as they attempted to participate in the business contracts issued by the lottery. These same concerns exist and millions of dollars continue to be spent.

There is a particular situation which I am keenly aware of regarding minority participation in the ongoing work of the advertising contract currently being performed by Needham Harper Worldwide. I am certain that the attitudes and resistance and lack of any real commitment to minority subcontracting displayed by Needham Harper is no different than those of the remaining 4 major contracts. Therefore, I would like to briefly focus on the advertising contract and ask that you request answers to the following questions:

1. Has the advertising agency done any research to determine who is buying the lottery product? Who conducted the research and from what source was this information acquired.

2. Is the advertising agency pleased with the results? Has it met with their expectations?
3. Is the advertising agency's media product reflective of the people who are buying the Lottery product?
4. How much television has the advertising agency run? What percentage of its advertising mix is television, radio and print?
5. What involvement has Needham Harper had with black owned firms in the development and execution of the Lottery campaign?
6. How many insertions have been made in Black-owned publications and communications companies in California?
7. What is the minority staff composition working specifically on this account? How many professional staff members does Needham Harper employ?

I am hopeful that these hearings serve as the beginning of an effort to sensitize the lottery commission, its staff and its contractors to the fact that there is a large minority community which participates in the lottery games in record numbers. I am also hopeful that these hearings will highlight the fact that there are minority suppliers and vendors who are qualified and capable to successfully perform on major portions of the contracts in more than just a token fashion.

Thank you for this opportunity for input into these important hearings and I look forward to their results.



BOARD OF SUPERVISORS

JOHN GEORGE
SUPERVISOR, FIFTH DISTRICT

November 1, 1985

Mr. Howard E. Varner, Chairman
California State Lottery
1303 J Street, Suite 600
Sacramento, California 95814

Dear Mr. Varner:

As elected officials who represent significant minority constituencies, we are deeply concerned about the disappointing level of commitment regarding the inclusion of minority and women owned businesses by the California State Lottery in its contracting work.

We are aware that the Commission has a policy to "require a portion of the Lottery's contracts for goods and services to be subcontracted to minority, women-owned, and small business enterprises, whenever reasonably feasible." However, we are also aware that this hortatory policy statement has insufficiently guided the Commission's staff to meet its obligation in this respect. Ironically, its recitation seems to provide an excuse for the failure of substantial minority business participation.

Our minority constituents are participating in the lottery games in record numbers. It would be unfortunate for the Commission to allow for the continued exclusion of the minority community from its fair share of the business contracts issued as a result of lottery activity.

We are requesting a meeting with you as soon as possible to discuss this troubling issue in detail. Alameda County Supervisor John George will be in touch with you to arrange for this meeting.

November 1, 1985

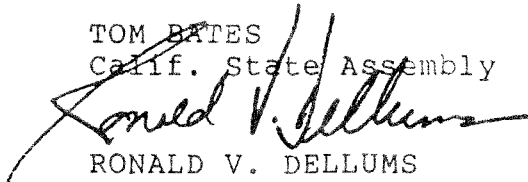
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We thank you in advance for your consideration and look forward to your cooperation.

Sincerely,



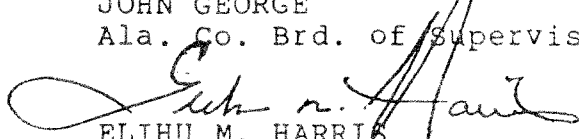
TOM BATES
Calif. State Assembly



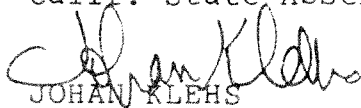
RONALD V. DELLUMS
Member of Congress



JOHN GEORGE
Ala. Co. Brd. of Supervisors



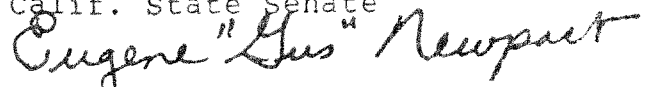
ELIHU M. HARRIS
Calif. State Assembly



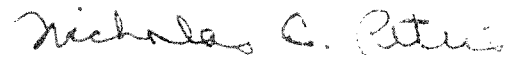
JOHAN KLEHS
Calif. State Assembly



BILL LOCKYER
Calif. State Senate



EUGENE "GUS" NEWPORT
Mayor, City of Berkeley



NICHOLAS PETRIS
Calif. State Senate



FORTNEY "PETE" STARK
Member of Congress



LIONEL WILSON
Mayor, City of Oakland

cc: William J. Johnston
Calif. State Lottery Commission

Laverta S. Montgomery
Calif. State Lottery Commission

John M. Price
Calif. State Lottery Commission

Kennard W. Webster
Calif. State Lottery Commission