

**REPORT BY THE STATE AUDITOR
OF CALIFORNIA**

**RESTRICTIVE IMPLEMENTATION SCHEDULES
EFFECTIVELY LIMITED COMPETITION FOR THE
CALIFORNIA STATE LOTTERY'S
NEW ON-LINE GAMING SYSTEM**

Restrictive Implementation Schedules
Effectively Limited Competition for the
California State Lottery's
New On-Line Gaming System

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Summary	
Background	The California State Lottery (lottery) originated with the passage of Proposition 37 in November 1984. The primary purpose of the proposition was to provide additional moneys to benefit education

without the imposition of additional or increased taxes. On October 14, 1986, the lottery began selling tickets for California's first on-line lottery game "Lotto." On-line games are sold from lottery computer terminals installed at retail locations throughout California. A communications network links these computer terminals to a central data system. The terminals, communications network, and central data system comprise the lottery's on-line gaming system.

Until late June 1992, one of the lottery's primary objectives was to independently manage and own its on-line gaming system. The lottery intended to achieve its independence from lottery vendors by owning its central data system computers, terminals, and software and by using its staff, with assistance from one or more lottery vendors, to operate the system. At some point between late June 1992 and mid-October 1992, lottery management decided to move away from owning its on-line gaming system. The decision meant that instead of the lottery owning its system, the lottery would seek one vendor who would provide its own system, including a central data system, software, and lottery terminals.

The lottery issued a request for proposal (RFP) on January 27, 1993, that reflected its change in direction for the on-line gaming system. In return for providing a new system, the lottery would pay the winning vendor a percentage of the sales generated from the on-line games.

The RFP required the winning vendor to replace the lottery's old on-line gaming system using either a preferred or an alternative implementation schedule. Under the lottery's preferred implementation schedule, the lottery required a vendor to replace the old lottery-owned on-line gaming system by October 14, 1993, that is, within 175 days, or approximately six months, from the date the lottery commission approved the contract. The RFP also stated that the lottery could assess liquidated damages of up to \$250,000 per day for each day the vendor did not have the new vendor-owned on-line gaming system operational after October 13, 1993. Under the lottery's alternative implementation schedule, the final RFP required a vendor to replace the lottery-owned central data system by October 14, 1993, and replace the 12,000 lottery-owned terminals by January 30, 1994. From the date the lottery commission approved the contract, this schedule allowed a vendor 175 days to install a vendor-owned central data system and software and an additional 109 days to replace the lottery-owned terminals with vendor-owned ones. The final RFP stated that the lottery could assess liquidated damages of up to \$250,000 per day for each day the vendor did not have the central data system and software operational after October 13, 1993, and for each day the vendor did not have all the lottery terminals replaced after

January 30, 1994. Furthermore, if the winning vendor opted to use the alternative implementation schedule, for each lottery-owned terminal that the vendor had not exchanged with a vendor-owned terminal by October 14, 1993, the lottery would pay the vendor only half of the negotiated percentage of sales generated from those terminals. The RFP required vendors to submit their proposals by February 17, 1993. Of three vendors that the lottery identified as likely bidders, only the lottery's incumbent vendor, GTECH Corporation (GTECH), submitted proposals.

Results in Brief The purpose of this audit was to review the lottery's entire procurement process for awarding a contract for its new on-line gaming system. We found that competition for the contract was limited to a single vendor by the restrictive implementation schedules the lottery included in the RFP. This was not consistent with lottery policy that prohibits the drafting of an RFP that limits bidding to a single vendor. Because it was too short, the lottery's preferred implementation schedule was restrictive to two of the three vendors interested in the procurement. The lottery's alternative implementation schedule was restrictive to the two nonincumbent vendors because it was not viable.

Reasons why the lottery issued an RFP with restrictive implementation schedules include the lottery's failure to question the advice of its consultant, the lottery's questionable decision to not pursue negotiations to extend the contract for the old on-line gaming system with its incumbent vendor, GTECH, and the lottery staff not fully recognizing that two of the three vendors had raised serious concerns about the RFP and had indicated they might not submit proposals. Because the restrictive implementation schedules limited competition to a single vendor, the lottery could not be assured that it had received the best on-line gaming system at the best price.

Although the lottery's restrictive implementation schedules limited competition during the procurement of its on-line gaming system, other aspects of the procurement process appeared adequate. For example, we reviewed certain experience and technical requirements the lottery established during its development of the RFP to determine whether the requirements were reasonable, allowed competition, and were in the best interests of the State. Our review indicated that the requirements appeared to have been reasonable and did not limit competition. Further, we found no indication that they were not in the State's best interests.

In addition, although it received proposals from only one vendor, the lottery's procedures for evaluating these proposals appeared to be

adequate. We also reviewed the procedures the lottery used to negotiate the contract price with the winning vendor to determine whether the actions the lottery took preparing for and conducting the negotiations were reasonable. Our review indicated that the procedures used by the lottery to negotiate the contract for the on-line gaming system appear to have been reasonable. We also found that the lottery complied with applicable contract approval requirements. Finally, to determine whether the lottery was adequately monitoring the implementation of the on-line gaming system contract, we reviewed the procedures the lottery used to track the items it wanted the contractor to deliver.

Recommendations To ensure competition during future procurements and to ensure that it receives the best goods and services at the best price, the lottery needs to improve the oversight of its procurement process. Specifically, the lottery should take the following actions:

- Critically review the advice it receives from consultants hired to assist the lottery during the procurement process, especially when lottery staff raise concerns;
- Foster an environment of open communication with vendors; and
- Develop contingency plans when vendors raise concerns about elements of the procurement process, and implement those plans when necessary.

Agency Comments Although the lottery does not fully agree with all of the conclusions in our audit report, it does agree with our recommendation that it take additional steps to ensure maximum competition in future procurements.

Introduction

The California State Lottery (lottery) originated with the passage of Proposition 37, the State Lottery Initiative Constitution Amendment and Statute (lottery act) in November 1984. The primary purpose of the lottery act is to provide additional moneys to benefit public education without the imposition of additional or increased taxes. The lottery act requires the lottery to be operated so as to produce the maximum amount of net revenues to supplement the total money allocated for education in California.

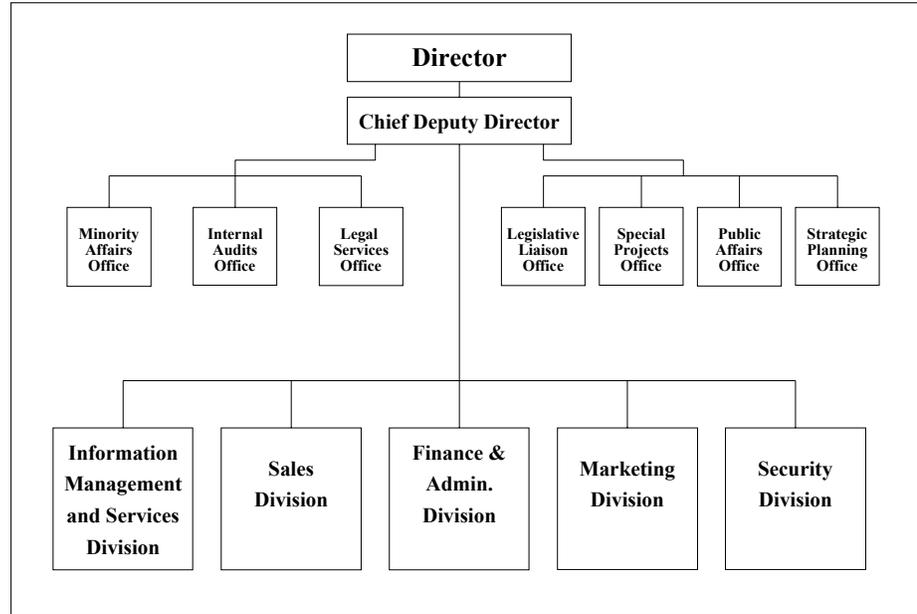
**Organization of
the California
State Lottery**

The lottery is administered by a five-person commission appointed by the governor with the concurrence of the Senate. Commissioners are appointed for five-year terms. At least one of the commissioners must have a minimum of five years' experience in law enforcement, and at least one of the commissioners must be a certified public accountant. No more than three commissioners can be members of the same political party.

The commission has final approval in setting policy direction within the constraints of the lottery act and must consider the particularly sensitive nature of the lottery in all its decisions. Commissioners meet monthly to approve game rules and the way prizes are paid, to approve major contract awards, and to decide critical policy issues. The commission receives only per diem as payment.

When it was procuring its new on-line gaming system, the lottery was organized into an executive office and five divisions. The executive office consisted of the director, the chief deputy director, and seven offices: Minority Affairs; Internal Audits; Legal Services; Legislative Liaison; Special Projects; Public Affairs; and Strategic Planning. The director supervises and administers the operation of the lottery in accordance with the lottery act and the rules and regulations promulgated by the commission. The chief deputy director advises and assists the director in project planning and policy monitoring, and in budgetary decisions to achieve the lottery's mission. The chief deputy director also has overall responsibility for the lottery's daily operation. Figure 1 shows the lottery organization as of January 1993.

Figure 1 The Organization of the California State Lottery as of January 1993

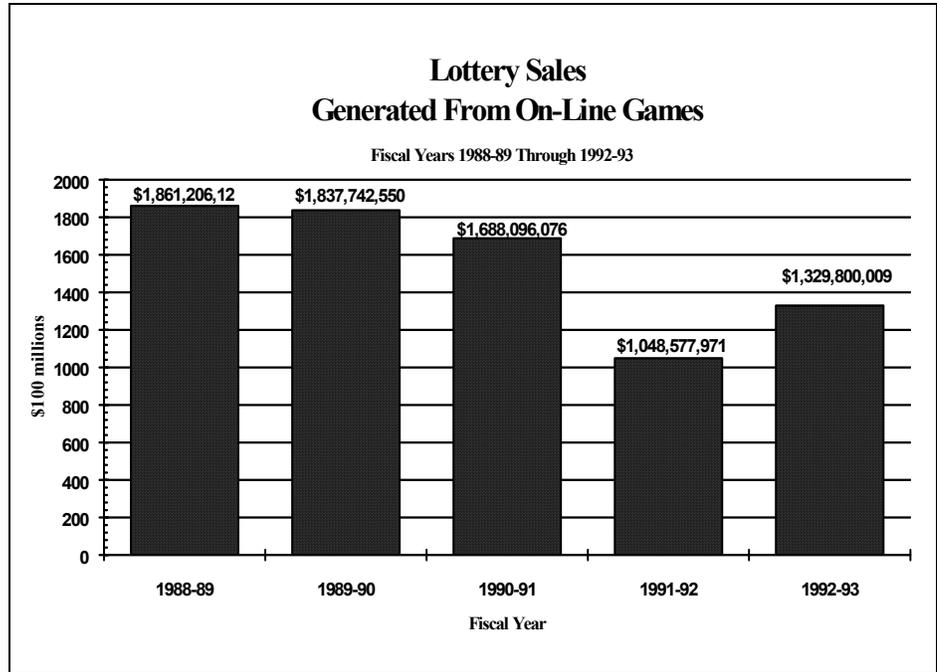


The Lottery’s Games

On October 3, 1985, the lottery introduced its first game, “California Jackpot,” starting with 21,000 retailers selling scratcher tickets. On October 14, 1986, the lottery began selling tickets for California’s first on-line lottery game, “Lotto.” On-line games are sold from approximately 13,000 lottery computer terminals installed at retail locations throughout California. A communications network links these computer terminals to a central data system. The terminals, communications network, and central data system comprise the lottery’s on-line gaming system. The system currently dispenses tickets for five different on-line games: Super Lotto, Fantasy Five, Decco, Daily 3, and Keno.

Total sales generated from on-line games from fiscal year 1988-89 through fiscal year 1992-93 are shown in Figure 2 on the next page.

Figure 2



Procurement of the On-Line Gaming System

The lottery act grants the lottery broad powers to oversee operations including the purchase of whatever goods or services are necessary to carry out lottery objectives. According to a 1984 legal opinion from the Legislative Counsel, the lottery’s procurement activities are exempt from the procedures set forth in the State Contract Act. These procedures normally require oversight by the Department of Finance and the Department of General Services. However, the lottery act requires the commission to adopt its own competitive bidding procedures to ensure the fullest competition on all procurements and contracts. Furthermore, the lottery’s acting interim director stated that responsibility for oversight of the lottery’s procurement process rests with lottery management and the lottery commissioners.

Until late June 1992, one of the lottery’s primary objectives was to independently manage and own its on-line gaming system. The lottery intended to achieve its independence from lottery vendors by owning its central data system computers, terminals, and software and by using its staff, with assistance from one or more vendors, to operate the system.

From February 1991 until at least June 24, 1992, the lottery’s efforts to develop a request for proposal (RFP) to operate its on-line gaming system were consistent with its desire to own and operate its system. For example, by January 1992, lottery staff had developed a draft RFP that enabled vendors to submit proposals for work that was then being provided by GTECH Corporation (GTECH). This work consisted of

maintenance and operation of the central data system, maintenance and development of the computer software, and maintenance of the terminals. This RFP presumed the lottery's continued ownership of the hardware and software. Ultimately, the lottery did not issue this RFP because the lottery commission approved a final one-year extension to GTECH's original contract for the on-line gaming system.

On September 27, 1991, Sharon Sharp was appointed lottery director. At some point between late June 1992 and mid-October 1992, lottery management decided to move away from owning and operating its on-line gaming system. It would instead contract with a single vendor to provide a new system, entirely replacing the old. The decision meant that instead of the lottery owning its system and hiring vendors to operate some components, the lottery would seek one vendor who would provide its own system, including a new central data system, software, and lottery terminals. According to former director Sharp, she decided to change the direction of the on-line gaming system because the lottery's goal was to increase on-line gaming sales. She also stated that a new state-of-the-art gaming system would help the lottery achieve that goal by developing timely promotions, a necessity in the lottery business. Furthermore, she believed that lotteries are in the business of product development, marketing, and sales, and the lottery should not own or operate its on-line gaming system.

From August 1992 through December 1992, the lottery, with assistance from its consultant, Battelle Memorial Institute (Battelle), developed an RFP to reflect the change in the lottery's direction. Until early December 1992, the lottery had planned on requiring vendors to implement the new system during the four months from mid-June 1993 through mid-October 1993. However, on or about December 3, 1992, in response to concerns raised by lottery staff, the lottery decided to allow vendors an additional two months to implement the new system.

The lottery issued a draft RFP on December 30, 1992, that reflected its change in direction for the on-line gaming system. The draft RFP allowed vendors to ask questions while they developed their formal responses. To install the new system, the draft RFP required the winning vendor to complete a number of actions by October 14, 1993, the day after the existing contract for the system expired. These actions included replacing the lottery's old on-line gaming system, including the installation of a new vendor-owned central data system, a new backup data system, and all the related software; replacing the existing lottery-owned terminals with 12,000 new vendor-owned terminals; providing the ability to display Keno winning numbers; providing the software for five on-line lottery games, including Keno with five-minute draws; installing a communications interface to

another vendor's cross-validation system for scratcher tickets; and installing communication interfaces from the central data system to the following:

- Three data systems for lottery management;
- Ten thousand "low-volume" lottery terminals to be provided by High Integrity Systems, Inc. (HISI); and
- As many as 650 self-service lottery terminals supplied by either the winning vendor or another vendor.

In return for completing these actions, the lottery would pay the vendor a percentage of the sales generated from the on-line games.

In a letter dated January 15, 1993, one vendor, Automated Wagering International (AWI), asked the lottery to consider two alternatives to the 175-day implementation schedule contained in the draft RFP. First, AWI asked whether the lottery would consider amending the RFP to allow the winning vendor approximately one year to replace the old on-line gaming system. Next, AWI asked whether the lottery would allow the winning vendor to replace the central data system by October 13, 1993, and to replace the lottery terminals within a mutually agreeable time period after October 13, 1993. In response to AWI's first request, the lottery stated that it had used all extensions available to it under the terms of the existing contract.¹ In response to AWI's second request, the lottery stated that it was not convinced that allowing such a conversion plan was in its best interests.

The lottery held a vendors' conference on January 20, 1993. During this conference, AWI asked the lottery why the implementation schedule was so short compared to those schedules recently used in other states. In response, the lottery stated that the existing contract terminates on October 13, 1993, and again pointed out that it had used all extensions available to it under the terms of the existing contract. Also, AWI again asked whether the lottery would consider allowing vendors to replace terminals after October 13, 1993. Although the

¹ The existing contract with GTECH allowed three one-year extensions that the lottery could choose to use after the expiration of the original five-year contract term. On January 17, 1992, the lottery commission approved the use of the final one-year contract extension from October 14, 1992, through October 13, 1993.

lottery again stated that it did not believe such a conversion plan was in its best interests, the lottery did agree to take the request under advisement.

In a letter dated January 25, 1993, AWI stated that the restrictive implementation schedule and the possible exposure to significant liquidated damages may make it impossible for AWI to respond to the RFP. AWI also asked the lottery to, among other things, extend its current contract with GTECH from October 14, 1993, through mid-April 1994. This would give the winning vendor approximately one year to convert the on-line gaming system.

On January 27, 1993, the lottery issued the final RFP. In response to AWI's requests that the lottery allow the winning vendor to replace the lottery terminals after October 13, 1993, the lottery included in the final RFP an optional alternative implementation schedule that the winning vendor could choose to use. The final RFP, therefore, allowed the winning vendor to install its new system using either a preferred or an alternative implementation schedule. Under the lottery's preferred implementation schedule, the lottery required the winning vendor to implement the entire on-line gaming system by October 14, 1993. From the date the lottery commission approved the contract, this schedule required the winning vendor to install the entire system within 175 days (approximately six months). The final RFP also stated that the lottery could assess liquidated damages of up to \$250,000 per day for each day the vendor did not have the new on-line gaming system operational after October 13, 1993.

Under the lottery's alternative implementation schedule, the final RFP required the winning vendor to install its central data system and software by October 14, 1993, and replace the 12,000 lottery-owned terminals by January 30, 1994. From the date the lottery commission approved the contract, this schedule allowed a vendor 175 days to install its central data system and software and an additional 109 days to replace the lottery-owned terminals with vendor-owned ones. The final RFP stated that the lottery could assess liquidated damages of up to \$250,000 per day for each day the vendor did not have the central data system and software operational after October 13, 1993, and for each day the vendor did not have all the lottery terminals replaced after January 30, 1994. Furthermore, if the winning vendor opted to use the alternative implementation schedule, for each lottery-owned terminal that the vendor had not exchanged with a vendor-owned terminal by October 14, 1993, the lottery would pay the vendor only half of the negotiated percentage of sales generated from those terminals.

The RFP required vendors to submit their proposals by February 17, 1993. Of three vendors that the lottery identified as likely bidders, only the lottery's incumbent vendor, GTECH, submitted proposals. On April 21, 1993, the lottery signed a contract with GTECH to provide the new on-line gaming system using the preferred implementation schedule. On this date, the lottery also canceled its contract with HISI to provide the 10,000 low-volume terminals and the scratcher cross-validation system. As a result, GTECH did not have to provide the interfaces with these two systems as the RFP originally required.

In return for GTECH providing a new on-line gaming system, the lottery agreed to pay GTECH 2.895 percent of sales from on-line games. Assuming an estimated \$1.4 billion in annual on-line game sales, GTECH would earn \$40.53 million per year or almost \$203 million over the contract's five-year term. If the lottery chooses to exercise the option for all five one-year extensions after the expiration of the initial five-year term, the contract could be worth more than \$405 million to GTECH over the ten-year term of the contract.

Scope and Methodology

The purpose of this audit was to review the lottery's entire procurement process for awarding a contract for its new on-line gaming system. In conducting this audit, we reviewed regulations and laws and the lottery's procurement procedures. We also interviewed personnel in the lottery's Legal Services, Internal Audits, and Special Projects offices and personnel in its Finance and Administration, Information Management and Services, and Marketing divisions. We also interviewed commission members and former lottery staff, including former director Sharon Sharp, the former chief deputy director, and the former chief counsel.

To begin our audit, we identified and reviewed the lottery's actions during six phases of the procurement process: developing strategic goals and objectives; planning the procurement; developing and issuing an RFP; evaluating proposals; issuing a contract; and monitoring the contract's implementation.

To evaluate the steps the lottery took to develop its strategic goals and objectives and to plan the procurement of the on-line gaming system, we interviewed the former lottery director and former chief deputy director. We also interviewed representatives of Battelle, including the manager of its lottery consulting group. We also reviewed the lottery's business plans for fiscal years 1990-91 through 1993-94, reviewed the

minutes of commission meetings, and asked the lottery to provide any feasibility studies or other analyses that they or Battelle prepared related to the procurement of the on-line gaming system.

To evaluate the steps the lottery took to develop and issue the RFP for the on-line gaming system, we identified and interviewed those individuals and consultants who were involved in developing the RFP, and we determined their roles. We also reviewed working papers, memoranda, and reports issued by Battelle concerning the RFP's development. To review the steps the lottery took to evaluate the proposals it received, we interviewed the manager of the lottery's Special Projects Office, who chaired the evaluation committee, and we reviewed the procedures the committee used during its evaluation.

To evaluate the steps the lottery took to negotiate and issue the contract, we interviewed the former director, former chief deputy director, former chief counsel, the manager of the Special Projects Office, the chief of the lottery's finance department,² and staff of GTECH. We also reviewed an analysis of a "hypothetical price" expected from GTECH prepared by the chief of the lottery's finance department. Finally, we reviewed the minutes of commission meetings.

To determine whether the lottery properly issued the RFP and the contract for the on-line gaming system, we compared the lottery's actions to applicable policies and procedures. To assess the lottery's monitoring of GTECH's implementation of the new on-line gaming system, we first identified the monitoring procedures by interviewing staff such as the manager of the lottery's on-line management section. We then reviewed a report dated May 25, 1994, that identified the status of each of the deliverables that GTECH was to provide under the terms of the contract. Finally, we determined whether the lottery assessed GTECH liquidated damages for the late delivery of any deliverables.

In addition to reviewing the lottery's actions during the six phases of the procurement process, we reviewed several other aspects of the lottery's procurement of its on-line gaming system. For example, we reviewed several specifications that the lottery included in the RFP to determine whether they were necessary and appropriate and whether they unnecessarily restricted competition. Specifically, to determine whether the experience requirements identified in the RFP, certain key design and technical specifications included in the RFP, and other RFP elements such as length of the contract and the number and length of

² The lottery's finance department is located within its Finance and Administration Division.

any available extensions to the contract were necessary and appropriate and whether they unnecessarily restricted competition, we compared these specifications to those of eight other lotteries in the United States that converted their old on-line gaming systems to new ones within the last five and one-half years. We further tested the experience requirements by researching the availability of vendors who met the requirements. To further test the key design and technical specifications, we also compared the key specifications to those of the lottery's old on-line gaming system.

As part of our efforts to assess the reasonableness of the process the lottery used to negotiate the rate it agreed to pay under the new system, we compared the rate with the effective rate paid under the old system. We first identified the process by interviewing several lottery staff such as the former director, former chief deputy director, and the manager of the lottery's Special Projects Office. We then reviewed a "hypothetical price" expected from GTECH that was prepared by the chief of the lottery's finance department and other documentation prepared by the lottery to assist it in the negotiations. Further, we compared the negotiated rate with the effective rate paid under the old system. We also compared the rate the lottery agreed to pay under the new system with the rates paid by other United States lotteries.

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Chapter 1 The California State Lottery’s Restrictive Implementation Schedules Effectively Limited Competition for Its New On-Line Gaming System

Chapter Summary

During the procurement of the California State Lottery’s (lottery) new on-line gaming system, competition for the contract was limited to a single vendor by the restrictive implementation schedules the lottery included in the request for proposal (RFP). This was not consistent with lottery policy that prohibits the drafting of an RFP that limits bidding to a single vendor. Because it was too short, the lottery’s preferred implementation schedule was restrictive to two of the three vendors interested in the procurement. The lottery’s alternative implementation schedule was restrictive to the two nonincumbent vendors because it was not viable. Reasons why the lottery issued an RFP with restrictive implementation schedules include the lottery’s failure to question the advice of its consultant, the lottery’s questionable decision to not pursue negotiations to extend the contract for the old on-line gaming system with its incumbent vendor, GTECH Corporation (GTECH), and the lottery staff not fully recognizing that two of the three vendors had raised serious concerns about the RFP and had indicated they might not submit proposals. Because the restrictive implementation schedules limited competition to a single vendor, the lottery could not be assured that it had received the best on-line gaming system at the best price. (See page 6 of the Introduction for descriptions of the preferred and alternative implementation schedules.)

Why Competitively Bid a Procurement Project?

To ensure the fullest competition when procuring goods and services, the California State Lottery Initiative Constitution Amendment and Statute (lottery act) required the lottery commission to adopt and publish competitive bidding procedures for the award of any procurement or contract involving the expenditure of more than \$100,000. The lottery commission approved the latest version of these

procedures on November 14, 1991. These procedures state, in part, that the lottery must not draft or cause to be drafted an RFP that directly or indirectly limits bidding to a single vendor and that, with specified exceptions, the lottery must secure at least three competitive proposals

for each procurement or contract. These exceptions include a situation where the lottery has solicited all known potential vendors but received less than three bids.

Competitive bidding of procurement projects provides at least two benefits to public agencies. First, competitive bidding helps public agencies avoid perceived and actual favoritism, fraud, and corruption. Second, when procuring goods or services for which it is difficult to estimate value, competitive bidding allows public agencies to compare different products and the costs associated with those products to help them make informed decisions, thus enabling the agencies to obtain the best products for the best price.

**The Lottery's
Preferred
Implementation
Schedule Was
Restrictive**

During the procurement of its new on-line gaming system, the lottery received proposals from only the incumbent vendor then operating the lottery's old on-line gaming system. Although the lottery appropriately notified several potential vendors about the RFP, we believe that competition for the contract was limited by the two restrictive implementation schedules the lottery included in the RFP. The lottery's preferred implementation schedule required the winning vendor to completely install a new on-line gaming system within 175 days of the signing of the contract. A combination of three reasons led us to believe that the preferred implementation schedule did not allow the winning vendor sufficient time to completely implement the project. First, two of three vendors interested in the RFP raised concerns that the preferred implementation schedule was too short. Second, the results of our survey of eight other lotteries in the United States showed that, while California required its vendor to take more key actions than the other lotteries to convert the old on-line gaming system, California's 175-day implementation schedule was shorter than the schedules for all but two of the lotteries. Finally, the winning vendor, GTECH, did not completely implement all contractual requirements by the deadline of October 14, 1993.

Automated Wagering International, Inc. (AWI) and High Integrity Systems, Inc. (HISI) were both interested in submitting proposals for the lottery's new on-line gaming system. However, on at least three occasions before proposals were due, these vendors expressed concern about the short implementation schedule. Two days before the lottery issued the final RFP, these concerns caused AWI's chief executive officer to tell the lottery that the restrictive implementation schedule and the possible exposure to significant liquidated damages may make it impossible for AWI to submit a proposal in response to the RFP. Approximately one week before proposals were due, an attorney for AWI told the lottery that AWI was precluded from submitting a

proposal in response to the RFP, in part, because of the restrictive implementation schedule and the high liquidated damages. Nine days before bids were due, HISI's president also told the lottery that the restrictive implementation schedule and the possible exposure to significant liquidated damages may make it impossible for HISI to submit a proposal. Neither company ultimately submitted a proposal.

In addition to the concerns raised by the two vendors, the results of a survey we conducted indicated the lottery's 175-day preferred implementation schedule was too short. We identified eight other lotteries in the United States that had converted their old on-line gaming system to a new system within the last five and one-half years. We contacted staff of these lotteries to identify the implementation schedules that vendors used to convert the systems and to determine the key actions the lotteries required their vendors to take. We defined the implementation schedule as the number of days from the date the lottery signed a contract with the vendor to the date the system was completely operational.

The results of our survey show that the lottery's 175-day preferred implementation schedule was shorter than the actual schedules used by vendors in six of the eight other lotteries and that California's RFP required the winning vendor to take more key actions to replace the on-line gaming system. The actual implementation schedules experienced by vendors at the eight other lotteries ranged from 98 days to 259 days. The average number of days for the implementation schedules was 199. Only the Maryland Lottery and the West Virginia Lottery had shorter implementation schedules than California's (98 and 149 days, respectively). However, California required its vendor to take more key actions to convert its system than did the other lotteries.

To convert California's on-line gaming system, the lottery required its vendor to provide a communications interface between its central data system and at least 10,000 terminals that were to be provided by HISI and to replace up to 12,000 lottery-owned terminals. In contrast, none of the other lotteries required its vendor to interface with terminals supplied by other vendors. Also, although the vendor for the New York Lottery used 259 days to convert New York's on-line gaming system, it replaced only 7,800 terminals (65 percent of the amount to be replaced in California). Moreover, the vendor did not have to develop communications interfaces with terminals supplied by other vendors or with a scratcher cross-redemption system. We summarize the key conversion requirements for the California Lottery and eight other lotteries in the United States in Figure 3.

Figure 3

**Key Conversion Requirements for Nine Lotteries,
Including California, in the United States**

	California	Maryland	West Virginia	Missouri	Pennsylvania	Washington	Illinois	Tri-States	New York
		<u>Background</u>							
Implementation schedule (days)	175	98*	149*	181*	210*	212*	228*	258*	259*
Daily liquidated damages (in thousands)	\$250	\$150	\$100	\$100	\$100	\$250	\$150	N/A	\$100
Number of vendors submitting proposals	1	2	1	3	4	5	2	3	2
		<u>Key Conversion Requirements</u>							
Number of terminals replaced	12,000	2,000	900	1,500	3,200	950	4,300	2,550	7,800
Number of other vendor terminals to interface	10,000 (minimum)	0	0	0	0	0	0	0	0
Number of on-line games	5	4	4	3	4	2	4	6	5
Keno with 5-minute draws	Yes	No	No	No	No	No	No	No	No
Dual-duplex to triplex	Yes	No	No	No	No	No	No	No	Yes
Backup site	Yes	Yes	No	No	Yes	No	Yes	No	Yes
Interface with scratcher cross-redemption system	Yes	No	Yes	Yes	Yes	No	No	No	No
Number of interfaces with other lottery systems**	3	2	1	2	1	1	1	1	1

* Actual number of days used to convert the system.

** These systems include accounting and management systems.

Our final indicator that the lottery's 175-day preferred implementation schedule was too short is that GTECH did not provide all required deliverables by their due dates, and the lottery did not completely accept all deliverables by the due dates.³ According to the contract, GTECH was to provide and the lottery was to accept 467 deliverables by October 13, 1993. As of May 25, 1994, more than seven months after the deadline, the lottery still had not accepted 89 (19.1 percent) of the 467 deliverables. Included in the 89 deliverables that were not accepted by the lottery were 8 items GTECH had yet to provide.⁴

**The Lottery Failed
To Provide a
Viable Alternative
Implementation
Schedule**

Because of the concerns raised by two of the three vendors and by lottery staff that the preferred implementation schedule was short, the final RFP, issued on January 27, 1993, allowed vendors to submit proposals in which the vendor could use an alternative implementation schedule. The final RFP required the winning vendor, if it chose to use the alternative implementation schedule, to install its new central data system and the related software by October 14, 1993, and to replace the lottery-owned terminals with vendor-owned ones by January 30, 1994. This alternative schedule provided the winning vendor an additional 109 days to replace terminals. Under this alternative implementation schedule, the RFP required the winning vendor's new central data system to communicate with the lottery-owned terminals provided by the lottery's incumbent vendor, GTECH, until the winning vendor replaced these terminals with vendor-owned ones. The alternative schedule in the RFP, therefore, required the winning vendor's new central data system to be able to communicate with not only the vendor-owned terminals, but also the lottery-owned ones.

This alternative implementation schedule, however, was not viable to nonincumbent vendors (those other than GTECH). After reviewing the requirements imposed by the alternative implementation schedule, AWI

³ After GTECH provides a deliverable, the lottery must test the deliverable to determine whether it meets requirements. If the lottery does not accept the deliverable, GTECH must correct any problems with the deliverable and resubmit it to the lottery.

⁴ Although the lottery had not accepted these 89 items, according to the manager of the lottery's on-line management section, the lottery began sales under the new on-line gaming system on October 9, 1993, five days ahead of schedule. She further stated that the lottery determined that the gaming operations functioned as required, that the system was secure, and that the absence of the 8 items on October 9, 1993, did not prevent the lottery from selling tickets under the new system.

asked the lottery when it would provide access to certain GTECH software and related documentation. Representatives of AWI stated that, because no vendor had ever successfully interfaced with GTECH-supplied terminals, it would need access to this information before it submitted its proposal to determine whether its new central system could communicate with the lottery-owned terminals supplied by GTECH and to estimate the amount of time necessary to develop the software that would enable this communication. Staff from the State's Stephen P. Teale Data Center confirmed that a vendor would not be able to determine the degree of difficulty, if any, of creating the communications interface until it reviewed the relevant software. They also stated that the vendor might have to develop software and possibly hardware to allow reliable use of the lottery-owned terminals. The lottery denied nonincumbent vendors access to this information because the terms of the existing contract prohibited such disclosure of the information. The lottery further stated that it would provide access to only the winning vendor; in other words, it would provide access only after the vendors submitted their proposals.

Because the lottery did not allow nonincumbent vendors access to the software and related documentation, the lottery gave GTECH, the incumbent vendor, an advantage over the nonincumbent vendors. Since GTECH already possessed access to the software and related documentation, it had the opportunity to review this information before it submitted its proposal to determine whether its new central data system could communicate with the lottery-owned terminals and to estimate the amount of time necessary to enable its new central data system to communicate with both the lottery-owned terminals and the new ones. Nonincumbent vendors did not have this opportunity. Furthermore, AWI's attorney stated that, without a reliable estimate of the amount of time necessary to develop the software, it could not determine whether it could implement a new central data system by October 14, 1993, thus exposing it to significant liquidated damages.

**Several Lottery
Actions Led to
the Lack of
Competition**

The lottery missed several opportunities during this procurement to more fully respond to the concerns raised by the two vendors about the feasibility of the 175-day preferred implementation schedule. Had the lottery taken advantage of these opportunities, we believe that it would have increased the likelihood of receiving competing proposals. We found that the restrictive implementation schedules in the RFP resulted in limited competition because of the former director's unwavering belief in the adequacy of the 175-day preferred implementation schedule, because of the lottery's questionable decision to not pursue negotiations with GTECH to extend the existing contract beyond October 13, 1993, and because lottery staff did not fully recognize that

two of the three vendors had raised serious concerns about the RFP and had indicated they might not submit proposals.

**The Former
Director's
Unwavering
Belief in the
Adequacy of the
Implementation
Schedule**

Throughout the procurement process, former director Sharp held to her belief that the 175-day schedule was sufficient time for the winning vendor to implement California's new on-line gaming system even though two potential proposers and the chief of the lottery's finance department had expressed concerns about the feasibility of the schedule. Former director Sharp relied on advice provided by Battelle Memorial Institute (Battelle), the lottery's consultant for the procurement of the new on-line gaming system, regarding the sufficiency of the preferred implementation schedule. In mid-November 1992, before the lottery issued the draft RFP for the on-line gaming system, Battelle concluded that the lottery should receive proposals from at least three vendors in response to the RFP. Battelle later described the schedule as "aggressive" but "very reasonable."

However, before it issued the draft RFP, the lottery did not properly critique Battelle's advice. Former director Sharp told us that she did not question Battelle's advice about the number of vendors that would bid because she believed the lottery's RFP would be impossible for at least three vendors to resist bidding on. She also stated that AWI and HISI demonstrated their interest in formal presentations and informal meetings and that, by mid-December 1992, the lottery believed that AWI and GTECH would compete. According to the manager of Battelle's lottery consulting group, Battelle based its statement about the number of vendors submitting proposals on the interest shown by the three vendors and on the history of vendors submitting proposals in other states. He further stated that Battelle staff did not contact any of the vendors to determine their bidding plans. The lottery and Battelle also stated that "it was Battelle's best determination that the schedule was doable for any major vendor who had previously provided on-line gaming systems and who had made the normal preparations for the California opportunity."

We believe, however, that because of the lottery's statutory priority to ensure the fullest competition during the procurement of goods and services, lottery staff should have questioned Battelle about the support for its advice before the lottery issued the draft RFP. Furthermore, on at least five occasions from November 3, 1992, through December 4, 1992, the chief of the lottery's finance department issued memoranda to either or both former director Sharp and the former chief deputy director. In these memoranda, he questioned whether the four-month implementation schedule originally planned by the lottery was long

enough to ensure that the lottery received proposals from more than one vendor. On at least two occasions after the lottery adopted a six-month implementation schedule, the chief issued memoranda in which he questioned the adequacy of a six-month schedule. For example, in the memorandum dated December 8, 1992, to the former chief deputy director, the chief stated that he was concerned that the selected vendor would have a monumental contractual obligation to acquire, test, and install 12,000 lottery terminals and 8,000 Keno television monitors within a maximum of approximately six months. He added that, if the lottery keeps these requirements, it might easily scare away one or more vendors that were unwilling to risk significant penalties for not completing such a demanding project in a very brief amount of time. He warned that the end result might well be that the lottery receives only one responsive proposal or, worse yet, no proposals at all.

If the lottery had questioned Battelle about the source of its advice before the final RFP was issued, the lottery would have found that Battelle's information was not based on any critical analyses. It could also have taken any of several actions to determine whether the implementation schedule was adequate and whether it would receive proposals from more than one vendor. These actions included conducting a formal analysis of the implementation schedules used by other lotteries in the United States and questioning the vendors about their abilities to meet the 175-day implementation schedule.

After the lottery issued the draft RFP, it appears that former lottery director Sharp was not going to be easily dissuaded from her belief that the 175-day implementation schedule was reasonable. At a commission meeting on January 27, 1993, in response to a question from one of the commissioners, the director of operations support from AWI stated that, while AWI agrees with the time to complete the conversion, AWI is concerned about the time allowed to plan the conversion. In response to this, former director Sharp stated that a major vendor would have teams of staff working on all aspects of the procurement when the lottery began drafting the RFP and that most lottery companies begin planning as soon as they know that a contract period is about to end. The former director stated this belief, even though on this procurement, the lottery did not make public the specifics of the new on-line gaming system it wanted from a new vendor until December 30, 1992, when it released the draft RFP. In fact, former director Sharp told us that it is typical in the lottery business to keep RFPs secret before they are released. Therefore, in this procurement, major vendors could not begin detailed planning until December 30, 1992, approximately one and a half months before proposals were due. Finally, in our view, it is entirely unreasonable for the lottery to rely on the statements made by the vendors before they

knew the specific requirements of what the lottery wanted in its new on-line gaming system as conclusive evidence that the vendors would submit proposals in response to the RFP.

**The Decision To
Not Pursue a
Contract Extension
With GTECH**

The lottery's second opportunity to better ensure the receipt of competing proposals came after vendors had received the draft RFP and reviewed it. After the lottery issued the draft RFP, representatives of AWI asked the lottery to amend the draft RFP to allow the winning vendor one year to implement the new system. AWI later amended its request, specifically asking the lottery to extend its contract with GTECH from October 1993 through mid-April 1994 thus giving the winning vendor one year to implement the project. Representatives of HISI also asked the lottery to extend its contract with GTECH through mid-April 1994.

The lottery, however, chose not to comply with the vendors' request to extend GTECH's contract. As we discussed on page 5 of the Introduction, the lottery had already used the three one-year extensions allowed by its existing contract with GTECH. Therefore, any attempts to extend the contract beyond October 13, 1993 (the expiration date of the existing contract), would have involved negotiations between the lottery and GTECH. The lottery's former chief counsel told us that an earlier attempt by the lottery to negotiate a contract extension with GTECH resulted in an offer that he described as unacceptable. In early December 1992, before the lottery issued the draft RFP, according to the manager of the lottery's Special Projects Office, lottery staff approached GTECH about the possibility of extending its contract in case of unforeseen delays caused by events such as a vendor protest of the bid award or litigation arising from the award. According to the lottery's former chief counsel, GTECH's offer required the lottery to pay GTECH \$5 million for the right to call upon GTECH to provide services after October 13, 1993. He also stated that GTECH's offer further required the lottery to pay GTECH additional moneys for any services actually provided beyond October 13, 1993. The offer also contained a provision that stated that GTECH would provide the additional services only if the lottery replaced the vendor who failed to implement the new on-line gaming system by October 13, 1993. The former chief counsel stated that GTECH made it clear that the purpose of the extension offer was to give the lottery time to acquire a replacement vendor, not for allowing the existing vendor additional time to correct faults or perform the contract. He concluded that these provisions were highly improper, if not illegal, and that it did not appear likely that the lottery and GTECH could reach agreement on an acceptable contract extension. The lottery allowed GTECH's offer to lapse.

The lottery's decision to not pursue an extension of GTECH's contract when asked to by two of the three potential proposers was questionable. We believe that, if the lottery was serious about pursuing an extension of its contract with GTECH, either former director Sharp or the former chief deputy director should have contacted GTECH's headquarters once the lottery concluded that GTECH's offer was "highly improper, if not illegal." Statements obtained from both Sharp and the former chief deputy director indicate that this was not done. Furthermore, statements by one of GTECH's attorneys indicate that the document the lottery considered to be an offer was, in fact, not an offer and should not have been regarded as one. He stated that the document to which the former chief counsel referred consisted of a "rough attempt" by a GTECH staff person "to commit to paper some thoughts on the subject." The attorney stated that the lottery did not pursue further discussions with GTECH about the matter and that, had these discussions continued, an authorized GTECH representative would have submitted an offer to the lottery.

Failure To Fully Recognize Concerns

During a commission meeting on February 10, 1993, seven days before proposals were due, the manager of the lottery's Special Projects Office, in response to a question from a commissioner, stated that she expected three vendors to submit proposals in response to the RFP. She stated that her belief was based on the number of vendors that were asking questions about it. Although the commissioners had been made aware of AWI's concerns during the commission meeting on January 27, 1993, she did not mention that, as of February 8, 1993, both AWI and HISI had submitted letters to the lottery stating that they may not submit proposals because of the short implementation schedule and the high liquidated damages. At this time, the manager could have mentioned that two of the three vendors who were once considering the submission of proposals were now considering not doing so. If the manager had done so, the commission could have ordered lottery staff to delay the procurement of the on-line gaming system while it explored options that would have ensured competition.

Conclusion

During the procurement of the lottery's new on-line gaming system, competition for the contract was limited to a single vendor by the restrictive implementation schedules the lottery included in the RFP. This was not consistent with lottery policy, which prohibits the drafting of an RFP that limits bidding to a single vendor. Because it was too short, the lottery's preferred implementation schedule was restrictive to two of the three vendors interested in the procurement. The lottery's alternative implementation schedule was restrictive to the two

nonincumbent vendors because it was not viable. Reasons why the lottery issued an RFP with restrictive implementation schedules include the lottery's failure to question the advice of its consultant, the lottery's questionable decision to not pursue negotiations to extend the contract with its incumbent vendor, GTECH, and the lottery staff not fully recognizing that two of the three vendors had raised serious concerns about the RFP and that they had stated they might not submit proposals. Because the restrictive implementation schedules limited competition to a single vendor, the lottery failed to meet its legal mandate to ensure competition and could not be assured that it received the best on-line gaming system at the best price.

Recommendations

To ensure competition during future procurements and to ensure that it receives the best goods and services at the best price, the lottery needs to improve the oversight of its procurement process. Specifically, the lottery should take the following actions:

- Critically review the advice it receives from consultants hired to assist the lottery during the procurement process, especially when lottery staff raise concerns;
- Foster an environment of open communication with vendors; and
- Develop contingency plans when vendors raise concerns about elements of the procurement process and implement those plans when necessary.

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Chapter 2 The California State Lottery Adequately Performed Other Procedures Pertaining to The Procurement of its On-Line Gaming System

Chapter Summary

Although the California State Lottery's (lottery) restrictive implementation schedules limited competition during the procurement of its on-line gaming system, other aspects of the procurement process appeared adequate. For example, we reviewed certain experience and technical requirements the lottery established during its development of the request for proposal (RFP) to determine whether the requirements were reasonable, allowed competition, and were in the best interests of the State. Our review indicated that the requirements appeared to have been reasonable and did not limit competition. Further, we found no indication that they were not in the State's best interests. In addition, although it received proposals from only one vendor, the lottery's evaluation procedures for those proposals appeared to be adequate. We also reviewed the procedures the lottery used to negotiate the contract price with the winning vendor to determine whether the actions the lottery took preparing for and conducting the negotiations were reasonable. Our review indicated that the lottery's procedures for negotiating the contract for the on-line gaming system appear to have been reasonable. We also found that the lottery complied with applicable approval requirements.

Certain RFP Requirements Appear Reasonable

During development of the RFP for its on-line gaming system, the lottery established certain minimum qualifications it wanted the proposers to meet and included certain design and technical specifications for its new on-line gaming system.

Experience Requirements Appear Reasonable

To be a qualified vendor, the RFP required vendors to have an on-line gaming system in operation somewhere in the world on the date proposals were due. Furthermore, a vendor could meet the experience requirements by relying on the on-line gaming experience of a subcontractor to qualify, thus allowing consortia of smaller companies to submit proposals. In addition, a vendor could meet the experience requirement so long as the vendor was operating an on-line gaming system at the time of the bid submission deadline, rather than having to have several years of such experience. The RFP also required that the vendor be capable of demonstrating the proposed equipment and software to verify the vendor's ability to meet the lottery's requirements for an on-line gaming system.

As part of our survey of eight other lotteries, we asked what experience requirements these lotteries placed on their vendors. We found that the experience requirements stated in the California Lottery's RFP were less restrictive than five of the eight lotteries in our survey. Specifically, four lotteries required a vendor to have experience operating an on-line gaming system anywhere in North America (thus excluding at least one vendor from competing for these states' RFPs because this vendor does not operate in North America). One lottery required five years' experience in the lottery industry.

Two lotteries with less restrictive experience requirements than the California Lottery were the New York Lottery, which only required vendors to demonstrate an ability to provide an on-line gaming system, and the Illinois lottery, which only required general lottery industry experience; neither required the vendor to have any experience actually operating an on-line gaming system. Because the final lottery in our survey had its on-line game system converted in year four of a five-year contract, we did not request its experience requirements.

In addition to reviewing the experience requirements found in the RFP for California's on-line gaming system, we researched the availability of vendors who have installed on-line gaming systems to determine the number of companies that could meet the lottery's experience requirements. We noted the following eight vendors of on-line gaming systems in the *Handbook of Lottery Operations & Statistics*, published by the Public Gaming Research Institute, Inc., 1992 Edition:

- Automated Wagering International, Inc./Video Lottery Consultants, Inc.;
- Canadian Bank Note International (CBNI);

- Essnet AB;
- General Instrument Corporation/Amtote International (AI);
- GTECH Corporation;
- International Totalizator Systems, Inc. (ITS);
- Scientific Games, Inc.; and
- Telecredit Lottery Services (now High Integrity Systems, Inc.).

According to Battelle Memorial Institute (Battelle), the lottery's consultant for the procurement of the on-line gaming system, only Automated Wagering International, Inc. (AWI) and GTECH Corporation (GTECH) have recently submitted proposals for on-line gaming systems in the United States. Battelle also stated that Essnet AB runs lotteries in Europe but, to its knowledge, has never bid in the United States. Also according to Battelle, Scientific Games, Inc., left the on-line lottery business in 1991. Regarding two of the remaining four vendors, CBNI does not provide on-line gaming systems for lotteries the size of California's, and AI was in the process of being purchased by Autotote Lottery Corporation. While ITS had lotteries in operation in Asia, Australia, and the West Indies and expressed early interest in California's RFP, it did not submit a proposal, and High Integrity Systems, Inc. (HISI) initially expressed interest in responding to the lottery's RFP.

Based on our comparison of the experience requirements in the RFP for California's on-line gaming system with the other lotteries in our survey and our research into potential bidders who met those requirements, California's less restrictive experience requirements appear reasonable and did not appear to unnecessarily restrict competition. Further, we found no indication that the requirements were not in the best interests of the State.

Design and Technical Specifications Appear Reasonable

In the RFP for its on-line gaming system, the lottery included certain design and technical specifications it wanted in its conversion to a new on-line gaming system. Specifically, the RFP required that the new on-line gaming system have a specific configuration for its central data system, including a backup site. In addition, the new system also had to be capable of taking over five on-line lottery games without

interruption and be capable of connecting to other computer systems that provide the lottery with management information and connecting to lottery terminals supplied by other vendors. Our survey of conversions of on-line gaming systems at eight other lotteries revealed that no other lottery required all of these specifications.

Most notably, the California lottery required the vendor to replace the dual-duplex configuration of its old central data system with a triplex configuration for the new central data system. The dual-duplex configuration of the lottery's old central data system consisted of two central data processing sites, one in Sacramento and the other in Whittier, near Los Angeles. The Sacramento site processed all transactions for Northern California; the Whittier site processed all transactions for Southern California. Each site had two computers hence, the name dual-duplex. Both computers processed all transactions for that location to ensure that if one computer failed, there would be no loss of data at that site. Backup for the entire State did not exist if either site failed.

A triplex configuration consists of two processing computers at a primary central site in Sacramento. Both computers process all transactions to ensure no loss of data if one fails. A third computer is available to automatically replace either one of the active processing computers if one fails. If the entire primary site for data processing fails, transaction processing can be switched to a backup site in Manteca. The backup site has two additional processing computers, both of which are capable of processing all incoming transactions. Only one other lottery required its vendor to convert its on-line gaming system from a duplex configuration to a triplex. See the Appendix for a graphic depiction of dual-duplex and triplex configurations.

In addition to a triplex configuration, the lottery specified that the new on-line gaming system take over operation of five on-line lottery games without interruption. One of the five games was Keno, a lottery game with draws every five minutes. The frequency of the draws in Keno allowed little tolerance for interruption during conversion of the on-line gaming system. Other lottery games are not drawn as frequently as Keno. Super Lotto is drawn twice weekly, Fantasy Five is drawn three times weekly, and Decco and Daily 3 are drawn daily. Although vendors for two of the eight other lotteries we surveyed also converted at least five on-line lottery games, no vendor for any of the eight lotteries converted an on-line gaming system that included Keno. In addition to converting five on-line games, the RFP required a vendor to establish connections from the central data systems to the following:

- Three existing lottery computer systems;
- One other vendor's scratcher cross-validation system; and
- Lottery terminals supplied by as many as three other vendors.

All eight lotteries in our survey required vendors to establish connections from their lotteries' central systems to other computer systems; six lotteries required connections to one computer system; and two lotteries required connections to two computer systems. Further, three of the eight other lotteries required their vendors to connect with a scratcher cross-validation system. Finally, although none of the eight lotteries in our survey required their vendors to connect with terminals supplied by another vendor, GTECH established a connection with another vendor's terminals during its operation of the lottery's old on-line gaming system. Therefore, we observed nothing unusual in our comparison of certain RFP requirements to the requirements imposed by the other eight lotteries in our survey or to the California lottery's old on-line gaming system.

During our review of the RFP, we did not observe any unnecessary design and technical specifications for the on-line gaming system. Further, the lottery did not appear to limit competition by including overly-restrictive design and technical specifications in the RFP. Based on our comparison of certain design and technical specifications identified in the RFP to the specifications of on-line gaming systems in other states, we concluded that California's specifications appear reasonable. Finally, we found no evidence that the design and technical specifications were against the best interests of the State.

**Other RFP
Elements
Compared With
RFP Elements
for Other
Lotteries**

In addition to comparing certain design and technical specifications of the lottery's RFP with conversions conducted at other lotteries in the United States, we compared other elements of the RFP. Specifically, we compared the initial term of the contracts and any options for extending the contracts, the amount of liquidated damages the lottery could assess, and the type of contract.

The lottery's initial contract term of five years is consistent with the initial contract terms of the eight lotteries we surveyed. Of the eight lotteries in our survey, seven had an initial five-year term, and one lottery had a six-year term. The lottery's contract also allowed for five one-year extensions. Two of the lotteries in our survey did not include extension provisions in their initial contracts. However, four lotteries allowed from 2 to 5 one-year extensions, and two contained provisions for a single five-year extension. Therefore, based on our review of the

contract terms used by the other eight lotteries in our survey, the initial five-year term of California's contract and its 5 one-year extensions appeared reasonable.

All eight lotteries we surveyed included provisions in their contracts to assess a vendor liquidated damages for not having the on-line gaming systems operational by the required due date. The amount of liquidated damages ranged from \$100,000 per day to \$250,000 per day. Four lotteries in our survey allowed liquidated damages of \$100,000 per day, two allowed liquidated damages of \$150,000 per day, and one contract allowed liquidated damages of \$250,000 per day. While the California lottery's liquidated damages of \$250,000 per day is at the high end of the range found in our survey, it was not outside the range and, therefore, did not appear unreasonable.

Finally, we compared the structure of the lottery's contract to the structure of the contracts for the other eight lotteries. The lottery structured its old on-line gaming system contract as a service contract, in which it purchased the hardware and software for the on-line gaming system but hired a vendor to operate it. Under the new contract, the lottery hired a vendor to provide and operate the on-line gaming system. This is known as a vendor turnkey system. At the end of the contract term, the lottery will not own the hardware or software. This vendor turnkey structure of the lottery's new on-line gaming system is consistent with seven of the eight lotteries we surveyed, which also use vendor turnkey structures.

**Evaluation of
the Proposals
Appears Adequate**

As described in the RFP for the on-line gaming system, the lottery established a process for evaluating the proposals it would receive in response to the RFP. The lottery also created an evaluation committee to review the proposals. The evaluation process consisted of reviewing critical portions of the proposals submitted by vendors. For example, the evaluation committee reviewed the proposals for compliance with all mandatory requirements. Mandatory requirements included the vendor's attendance at a lottery-held conference and submission of a proposal in four separately sealed sections. In addition, the evaluation process included reviewing and scoring the technical portion of the proposals and verifying that the vendor could provide the technical solution proposed. Also, the evaluation committee reviewed and scored the proposals for the vendor's participation in the State's Minority-, Women- and Disabled Veteran-Owned Business Enterprises (M/W/DVBE) program. Finally, the evaluation committee chairperson and the lottery's contracts administrator reviewed and scored the price proposals.

The lottery director selected eight of the lottery's staff to serve on the evaluation committee. In addition, six advisors, including three Battelle consultants, were selected to advise the committee. Other lottery staff served as a resource team to research issues for the evaluation committee members. Neither the advisors nor the resource team scored the proposals.

The RFP allowed vendors to submit two proposals. On February 17, 1993, the lottery received two proposals from GTECH, the only vendor to submit proposals. The lottery's evaluation committee verified GTECH's compliance with all mandatory RFP requirements. In addition, the evaluation committee evaluated, reviewed, and scored the technical portion of the proposals, GTECH's participation in the M/W/DVBE program, and the proposal prices. Finally, the lottery verified its understanding of the technical merits of GTECH's proposals by conducting site visits to Texas, a state with a similarly configured GTECH on-line gaming system, and to Rhode Island, the location of GTECH's headquarters. The total possible score was 400 points, weighted 65 percent for technical score, 10 percent for M/W/DVBE score, and 25 percent for price score. The evaluation resulted in a total score of 377.39 for GTECH's primary proposal and 319.25 for its alternate proposal. The most significant difference that the evaluation committee noted between the primary and the alternate proposals was that the alternate proposal offered 2,000 additional terminals and included support for advertising, promotions, and public relations.

The evaluation committee recommended that the lottery enter into a contract with GTECH to provide the on-line gaming system described in its primary proposal. Because GTECH was the only vendor that submitted proposals, the evaluation committee was limited to recommending that the lottery award a contract to GTECH. We reviewed the evaluation committee's recommendation and the lottery's evaluation procedures and score sheets. Based on our review, we concluded that, despite having received proposals from only one vendor, the lottery's procedures for evaluating the proposals appeared to have been adequate.

**Contract
Negotiation
Procedures
Appear
Reasonable**

The lottery's RFP for its on-line gaming system did not result in competing proposals. Only GTECH responded and, in its winning proposal, GTECH offered more than the lottery mandated in the RFP. The RFP allowed vendors to submit proposals that exceeded the minimum requirements identified in the final RFP. However, because there were no competing proposals, the lottery could not compare prices and optional features and services from other vendors. The

lottery decided that after it had selected the winning vendor, it would enter into negotiations to determine the specific optional items it wanted and to determine the final contract price. Because the lottery received proposals from only one vendor, in our view it is reasonable to expect that, before it entered into price negotiations with the vendor, the lottery would take certain actions to prepare for the negotiations. For example, it is reasonable to expect the lottery to have estimated the amount of on-line gaming sales and the contractor's costs over the five-year contract term. The lottery should also have developed a list that prioritized the optional items proposed by the winning vendor and determined what it needed and what it could afford. From this information, the lottery should have developed an estimate of the final negotiated price. Finally, after it arrived at a negotiated price with GTECH, the lottery should have evaluated the reasonableness of the negotiated price.

As part of its preparations for negotiations, the chief of the lottery's finance department estimated what would be a reasonable cost to the lottery for this contract. In mid-March, the chief of the lottery's finance department prepared a hypothetical price expected from GTECH. According to an analysis we reviewed, the chief developed the hypothetical price to provide the lottery with a "ball park" idea of what might be expected. He intended the hypothetical price to provide the lottery with a basis for determining whether the price in GTECH's proposal was reasonable or unreasonable since the lottery did not receive proposals from other vendors. For his analysis of the hypothetical price from GTECH, the chief used an estimate of \$7 billion for on-line sales over the five-year term of the contract and an estimated five-year cost to the contractor of \$288.9 million. He then derived an estimated price of 4.13 percent of sales from on-line games. The chief acknowledged that his analysis was not intended to be a sophisticated or in-depth analysis of various cost elements that would constitute the price.

According to former director Sharp, her negotiating team discussed strategy before meeting with GTECH. She stated that her goal was to get the price down to 3 percent or less of sales from on-line games. On March 30, 1993, the lottery entered into price negotiations with GTECH. The negotiations continued on March 31. According to the manager of the lottery's Special Projects Office, other discussions were conducted over the telephone during the nearly three weeks that followed these original contract negotiating sessions. A final session occurred on April 20, 1993, in Sacramento.

The former chief deputy director stated that former director Sharp was the primary negotiator. According to the manager of the Special

Projects Office, the lottery's former chief counsel and the chief of the lottery's finance department participated in the negotiations at times. GTECH representatives included the company's executive vice president and legal counsel.

The former lottery director stated that lottery staff developed a list of priority items. According to the manager of the lottery's Special Projects Office, the list was prepared for contract discussions with GTECH and included the optional requirements proposed by GTECH. A representative of the lottery's consultant, Battelle, and the chief of the lottery's finance department assigned price estimates to each item.

Negotiations concluded with a final negotiated price of 2.895 percent of on-line gaming sales. To achieve this final price, GTECH agreed to reduce its original bid price of 4.792 percent by one percentage point in exchange for the lottery continuing to assume all costs of telecommunications (the price in GTECH's winning proposal included its assumption of the cost of telecommunications). Other negotiated contract changes further reduced the price by an additional 0.897 percentage points.

On April 21, 1993, the chief of the lottery's finance department responded to former director Sharp's request for a review of the reasonableness of the price contained in GTECH's proposal, as well as an assessment of the recent negotiations to reduce that price. His assessment compared his projection of approximately 4.0 percent of sales for vendor-supplied terminals and 1 percent of sales for nonvendor terminals to GTECH's basic bid price of 4.792 percent. His assessment also included an analysis of the costs of other states' on-line games. In that analysis, he estimated a winning proposal that included a price ranging from 4.0 to 4.2 percent of on-line gaming sales. The chief also determined what the original 1985 GTECH contract would have cost the lottery in 1993 under comparable terms and conditions and assuming on-line gaming sales totaling \$7 billion over five years (\$1.4 billion per year). He compared the results of these analyses to the negotiated price of 2.895 percent and concluded that the price was fair. We found, based on our review of the lottery's actions, that the lottery used reasonable procedures to negotiate its on-line gaming system contract.

In an attempt to determine the reasonableness of the lottery's negotiated price for the contract, we compared the California lottery's final negotiated price to the prices other lotteries paid for their contracts and to an estimated cost the lottery would have paid for continuing its prior contract. All eight lotteries in our survey based their contract price on a percentage of sales from on-line games. This is consistent

with the California lottery's on-line gaming contract. The lottery's price of 2.895 percent of on-line gaming sales is within the range from 1.525 percent to 6.0 percent paid by the eight lotteries in our survey. However, we could not conclude whether the price was reasonable or unreasonable. Because the requirements of the California lottery's RFP were sufficiently different from other lotteries in our survey, we concluded that the most acceptable test of the reasonableness of the final negotiated price would have been comparing competing bids for the RFP.

In addition to comparing the California lottery's final negotiated price to the price other lotteries paid for their contracts, we also compared it to an estimated cost the lottery would have paid for continuing its prior contract. We estimated the amount the lottery would have paid over the five-year term following the expiration of the old contract if the lottery had retained its old on-line gaming system. We based the costs on fiscal year 1992-93 data, adjusted for inflation. We also assumed \$7 billion in on-line gaming sales over the period. If the lottery had retained its old on-line gaming system, we estimate the lottery would have paid GTECH \$227.6 million in operating costs, or 3.26 percent of the sales from on-line games.

We found that the final negotiated price of the new contract, 2.895 percent of on-line gaming sales, was not the entire cost of the new contract. Specifically, because the lottery transferred title to the old equipment to GTECH, it had to amortize the equipment's remaining \$8 million value over the five-year life of the new contract. Consequently, we included this amortized cost when we calculated the actual cost of the new on-line gaming system. We estimated that the actual cost of the new on-line gaming system contract would be \$212.1 million over the contract's five-year term, or 3.03 percent of on-line game sales. This cost is less than the cost of the old contract (\$227.6 million, or 3.26 percent of on-line game sales). However, as sales from on-line games increase so will the lottery's costs. Based on our estimate of an average of \$1.4 billion per year in sales from on-line games, we conclude that the lottery will pay less for its new on-line gaming system contract than it would have if it retained the old system.

Finally, because of the differences in system configurations and number of terminals operated by the other lotteries, we computed the cost-per-terminal as another basis for comparison. For example, the California lottery operated 13,000 terminals while the number of terminals in other states ranged from 900 to 7,800. We compared the California lottery's \$3,100 cost-per-terminal under this contract, assuming annual sales of \$1.4 billion, with the other lotteries' average cost-per terminal of \$4,200 for fiscal year 1992-93. The lottery at the

high end of our survey had a cost-per-terminal of \$6,476 while the lottery at the low end had a cost-per-terminal of \$2,104. For our comparison with the other eight lotteries in our survey, we expected to find the California lottery's cost-per-terminal at the low end of the range because the lottery's costs to operate the on-line gaming system are divided by a larger number of terminals. In fact, the California lottery's cost-per-terminal of \$3,100 was third lowest when compared with other lotteries.

**The Lottery
Complied With
Applicable
Approval
Requirements**

Its own procedures require the lottery to obtain commission approval for an RFP before the RFP is released to vendors. Further, the lottery act states that the lottery director awards contracts. On January 27, 1993, former director Sharp recommended and the commission approved the release of the RFP for the on-line gaming system. On April 21, 1993, the commission approved the negotiated contract with GTECH, and former director Sharp awarded the contract. Therefore, the lottery complied with these requirements for RFP and contract approval.

**Lottery Procedures
for Monitoring
Contract
Implementation**

The lottery's new contract for its on-line gaming system required the winning vendor, GTECH, to implement certain contract requirements by October 14, 1993, or the lottery could assess liquidated damages. We reviewed the lottery's records and interviewed the manager of the lottery's on-line management section to evaluate whether the lottery was adequately monitoring the contract's implementation. Based on our work, we noted that the lottery's procedures for monitoring contract implementation included the following:

- Requiring the manager of the on-line management section to monitor final disposition of all deliverables;
- Assigning the responsibility to determine the acceptability of each deliverable to the appropriate lottery staff;
- Periodic tracking of deliverable reports to update and determine the status of deliverables;
- Assessing liquidated damages for deliverables not provided in accordance with the contract; and
- Accepting the on-line gaming system upon full implementation.

Since the actual value of damages related to late implementation would be difficult, costly, and time-consuming to calculate, the contract stated that the lottery could assess liquidated damages on a per-day or

per-occurrence basis. The contract allowed the lottery to assess liquidated damages of up to \$250,000 per day for each day that GTECH did not meet a contractual requirement that directly affected the operation of the on-line gaming system and up to \$500 per day for each day that GTECH did not meet a contractual requirement that did not directly affect the system's operation. The contract also stated that the lottery could assess these damages until GTECH provided or performed the contractual requirement. Further, the contract stated that all assessments of liquidated damages were within the discretion of the lottery, and if the lottery determined that it, in part, caused a delay, it could reduce the amount of liquidated damages proportionately.

From October 15, 1993, through May 25, 1994, the lottery assessed GTECH liquidated damages totaling \$81,500 for system downtime and certain late reports. However, as of May 25, 1994, the lottery had not assessed GTECH any liquidated damages for late deliverables, even though GTECH had not provided all required deliverables by their due dates. To determine the status of late deliverables, we reviewed the lottery's status report dated May 25, 1994, for the 522 deliverables that GTECH was required to provide over the contract's life. From the lottery's records, we determined that GTECH was to provide 467 of the 522 deliverables by October 13, 1993. As noted in Chapter 1, based on our review of the status of the deliverables, we found that the lottery had not accepted 89 of the 467 deliverables as of May 25, 1994.⁵ Of these 89 deliverables the lottery had not accepted, the manager of the lottery's on-line management section, who is responsible for monitoring GTECH's performance, informed us that GTECH did not provide eight deliverables in full by October 13, 1993. She also stated that none of the undelivered items was critical to gaming operations, the items' absence did not jeopardize gaming operations, nor did their absence prevent the lottery from using the new system to sell lottery tickets.

Under the terms of the contract, the lottery could have assessed GTECH liquidated damages of up to \$500 per day for each day for each of the eight items that GTECH did not deliver on time. However, the manager of the on-line management section stated that the lottery knew of and agreed to GTECH's late delivery of the items. Furthermore, in some cases, the lottery accepted interim solutions to RFP requirements or allowed some modifications. She also indicated that, if it became necessary for the lottery to demand the items and

⁵ After GTECH provides a deliverable, the lottery must test the deliverable to determine whether it meets requirements. If the lottery does not accept the deliverable, GTECH must correct any problems with the deliverable and resubmit it to the lottery.

GTECH did not comply, the lottery would exercise its right to assess GTECH liquidated damages.

Conclusion We reviewed several components of the lottery's process for procuring its new on-line gaming system. We found that the RFP requirements appeared to have been reasonable and did not appear to limit competition. Furthermore, we found no evidence that the requirements were against the State's best interests. Moreover, the procedures the lottery used to evaluate GTECH's proposals appear to have been adequate. We also found that the lottery's procedures for negotiating the contract for the on-line gaming system appear to have been reasonable and that the lottery complied with applicable approval requirements.

We conducted this review under the authority vested in the state auditor by Section 8543 et seq. of the California Government code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope of this report.

Respectfully submitted,

KURT R. SJOBERG

State Auditor

Date:

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Dale A. Carlson

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