

Arkansas Lottery Commission: Internal Audit

**Instant Ticket Lottery Game
Services Contract Modifications
& “Properties Plus”**

Special Report

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Instant Ticket Lottery Game Services Contract Modifications & “Properties Plus”

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Initial Contract

- Scientific Games’ (SGI) Official Proposal Price Sheet (Attachment A) for the Arkansas Lottery Commission Instant Ticket Lottery Game Services Request for Proposal (RFP) # ALC-090001 was submitted on July 29, 2009.

- Scientific Games’ Official Proposal Price Sheet offered two options: **(See Attachment A, PAGE 3 of 22)**
 - 1.75% of instant ticket sales

 - OR

 - 1.15% of instant ticket sales and the implementation of “Properties Plus” at the rate of 2.3078% of the prize fund for all tickets regardless of which vendor prints the tickets

- Properties Plus includes the following: **(Attachment B)**
 - Points for Prizes
 - Players Club
 - Play It Again
 - Licensed Properties
 - Easy Entry Validation
 - Player Registration Module

- The Scientific Games’ Official Proposal Price Sheet was provided to the Commission members for review during the August 5, 2009 Arkansas Lottery Commission meeting.

- The Arkansas Lottery Commission unanimously approved the Intent to Award the Instant Ticket Lottery Game Services Contract and the Contract Execution, pending review by the Legislative Lottery Oversight Committee. **(Attachment C, PAGES 4 - 6 of 12)**

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- The Instant Ticket Lottery Game Services Contract Evaluation Summary and Scientific Games’ Official Proposal Price Sheet was provided to the Arkansas Legislative Lottery Oversight Committee (LOC). The LOC reviewed the Instant Ticket Lottery Game Services Contract approved by the Arkansas Lottery Commission on August 13, 2009. (**Attachment D**)

- The Agreement for Contractual Services for Instant Ticket Lottery Games Services between the Arkansas Lottery Commission and Scientific Games was executed on August 18, 2009. (**Attachment E**).

The Agreement for Contractual Services for Instant Ticket Lottery Games Services - Agreements Section – Terms of Compensation (Item 3) states, in part, the following *“Instant ticket pricing for SGI’s comprehensive product solution is located in SGI’s Official Proposal Price Sheet. The attached pricing information was offered by SGI in response to Section 5.1.1 (Pricing Formula) and 5.1.2 (Determination of Net Sales) of the Instant Ticket Lottery Games Services Request for Proposal which commences with the execution of the Contract on the 18(th) day of August 2009.”*

The Instant Ticket Lottery Game Services Request for Proposal (RFP) Section 5. – Evaluation Criteria for Selection (Subsection 5.1 – Cost) under the Pricing Formula Section (5.1.1) states, in part, the following: **Bidders must include all pricing information on the Official Price Proposal Sheet**

- Arkansas Lottery Commission Chair, Ray Thornton, announced at the August 19, 2009 Arkansas Lottery Commission meeting that the Instant Ticket Contract has been executed.
- Lottery Management and Scientific Games appear to have agreed upon the election of the “Properties Plus” option (1.15% of instant ticket sales and 2.3078% of the prize fund).

The Order/Price Confirmation for one of the first four games printed for the Arkansas Scholarship Lottery (Game 4 - \$100,000 Cash Bonanza) dated August 19, 2009 and signed by Arkansas Scholarship Lottery Management (David Barden – former Vice President of Gaming) and Scientific Games on August 25, 2009 indicates that the final invoice will be based on a percentage of sales at a rate of 1.15%. (**Attachment F**)

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This is consistent with the original Official Proposal Price Sheet that was approved by the Arkansas Lottery Commission on August 5, 2009 and reviewed by the Arkansas Legislative Lottery Oversight Committee on August 13, 2009 (“Properties Plus” option).

Lottery Management’s Authority to Amend an Executed Contract

- Vendors are subject to all requirements of the Arkansas Lottery Commission Major Procurement Rules, whether such requirements are specifically set forth in this RFP or not (Page 3).
- Arkansas Lottery Commission Major Procurement Rules Section 5 – General Policies. (Subsection G. – Contract Amendment.) states, in part, the following:

“A contract amendment is a written document that changes, adds or deletes one or more terms or conditions of an existing contract. During the course of the performance of a contract, it may become necessary to change, add to, or delete from the terms and conditions of the contract.

 - i. *A contract amendment shall clearly detail the additions, deletions, and modifications to the subject contract.*
 - ii. *The Commission may enter into a contract amendment with respect to a major procurement contract if the Director determines any or all of the following: (A) the contract amendment is within the original scope of work and within the intent and purpose of the applicable major procurement contract, (B) the contract amendment is a logical extension to the original scope of work of the applicable major procurement contract, or (C) if entered into as a stand-alone contract, such contract would not constitute a major procurement contract.”*
- Arkansas Lottery Commission Major Procurement Rules Section 4 – Definitions. (Subsection B.) states the following: *“Commission” means the Arkansas Lottery Commission.”*

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- Arkansas Lottery Commission Major Procurement Rules Section 5 – General Policies. (Subsection L. – Purchase Order or Contract Required.) states the following:

“Any vendor or other person who manufactures or delivers a product or service without a written purchase order or contract or who delivers a product or service not specifically authorized by a purchase order or contract does so at the vendor’s (or other person’s) own risk. Under no conditions shall the Commission be liable for payment of any type for any product or service provided by a vendor or other person, even such provided in good faith, which is not specifically authorized by a purchase order or contract.”

- Arkansas Lottery Commission Major Procurement Rules Section 6. – General Provisions. (Subsection D. – Procedures Regarding Submissions.) states, in part, the following:

- ii. *“All bids, offers, quotes or proposals and the contracts resulting from solicitations are subject to the requirements of and must comply with the Act, regardless of whether or not specifically addressed in either the solicitations or the proposal. All potential vendors shall read and be familiar with the Act, a copy of which may be obtained through a link on the Commission’s web site.”*

Arkansas Lottery Commission Major Procurement Rules Section 4 – Definitions. (Subsection A.) states the following: “Act” means the Arkansas Scholarship Lottery Act.

- The Arkansas Scholarship Act (Subchapter 7 – Procurements – 23-115-701(e)(1)) states the following:

“Each proposed major procurement contract and each amendment or modification to a proposed or executed major procurement contract shall be filed with the Arkansas Lottery Commission Legislative Oversight Committee for review at least thirty (30) days before the execution date of the major procurement contract or the amendment or modification to a proposed or executed major procurement contract.”

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Recital of Selected Options (Contract Modification)

- The *Recital of Selected Options (Attachment G)* was created by Scientific Games on August 25, 2009 and signed by Lottery Management (Ernie Passailague – former Arkansas Scholarship Lottery Director) and Scientific Games on August 25, 2009. The document states the following: “*Revisions to Original Pricing Schedule (Dated July 29, 2009) between the Arkansas Lottery Commission and Scientific Games International Agreement for Additional Service Options and Fees.*”

The date the document is prepared and the date that the document is signed by Mr. Passailague are the same.

- The revisions in pricing and terms that are listed in the *Recital of Selected Options* document do not appear to be approved by the Arkansas Lottery Commission or reviewed by the Arkansas Lottery Commission Legislative Oversight Committee.

Internal Audit reviewed the minutes and listened to the audio of the Arkansas Lottery Commission meetings dated August 5, 2009, August 12, 2009, August 19, 2009, and August 26, 2009 and did not note any evidence that the modifications to the Instant Ticket Lottery Games Services Contract between the Arkansas Lottery Commission and Scientific Games was presented by Arkansas Scholarship Lottery Management to the Arkansas Lottery Commission.

The fiscal year 2010 Arkansas Lottery Commission Audit Report prepared by the Division of Legislative Audit noted the following in Finding 2010-2 “*The subsequent Recital of Selected Options and three licensing agreements were not approved by the Commission or reviewed by the LOC.*” (**Attachment H**)

- The following five (5) changes were made by the *Recital of Selected Options* document dated August 25, 2009 without the approval of the Arkansas Lottery Commission and the Arkansas Legislative Lottery Oversight Committee on August 5, 2009.

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Change #1 - Selected the invited option of Failsafe (keyless validation bar code)

- The purpose of *The Recital of Selected Options* dated August 25, 2009 was for Lottery management to select “invited options” included in the *Official Proposal Price Sheet* approved by the Arkansas Scholarship Lottery Commission on August 5, 2009 and reviewed by the Arkansas Lottery Commission Legislative Oversight Committee on August 13, 2009.

The *Instant Ticket Lottery Game Services Request for Proposal (RFP)* Section 1. – General Information (Subsection 1.26 – Cost) states, in part, “Vendors may expand items to identify all proposed services. A separate listing, which must include pricing, may be submitted with summary pricing.”

Failsafe was an “invited option” that included pricing (\$1.89 per 1000 tickets) in the Scientific Games’ *Official Proposal Price Sheet* approved by the Lottery Commission on August 5, 2009 and reviewed by the Arkansas Lottery Commission Legislative Oversight Committee on August 13, 2009 (**See Attachment A, PAGE 9 of 22**).

Change # 2 - Pricing Change

- The *Recital of Selected Options* document increases the billing percentage based on sales for the Instant Game contract from 1.15% to 1.92%, a .77% increase. Also, in lieu of electing the “Properties Plus” option offered in the *Official Proposal Price Sheet* at a rate of 2.3078% of the prize fund; a “Points for Prizes” option was added at a rate of 1.5% of the prize fund.

The options are broken out in the following manner:

- Instant Ticket Lottery Game Services – 1.69%
- Web Site Marketing Services (Player’s Club/Internet Marketing) - .09%
- Play It Again and Second Chance Drawing Management Services - .14%
- Points for Prizes Rewards/Merchandise Prizes and Fulfillment – 1.50% of the prize fund for all instant ticket games included in the program

The Web Site Marketing Services, Play It Again and Second Chance Drawing Management Services, and Points for Prizes are all part of the “Properties Plus” Program.

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- Lottery management issued a Post Executed Change (PEC) on October 2, 2009 (Game 4 - \$100,000 Cash Bonanza) to reflect the “Revisions to the contract pricing.” The documents were prepared by Scientific Games. (*Attachment I, Page 1 of 3*)

Note the change in the pricing percentage in net sales: Original Contract Price (1.15%) prepared prior to the Recital of Selected Options (August 19, 2009) (*Attachment F*) and Revised Contract Price (1.92%) prepared after the Recital of Selected Options (October 2, 2009) (*Attachment I, PAGE 3 of 3*). The Documents were prepared by Scientific Games and were signed by former Vice President of Gaming, David Barden. This resulted in a pricing increase of .77% of net sales.

Based on instant ticket game sales of \$973,974,109 from the inception of the lottery on September 28, 2009 through February 29, 2012, the Lottery has paid Scientific Games approximately 7.5 million dollars (\$973,974,109 X .77%) in additional fees based on net sales over the original agreement, the Official Proposal Price Sheet (“Properties Plus” Option), which was approved by the Arkansas Lottery Commission and reviewed by the Arkansas Legislative Oversight Committee. Internal Audit estimates that over the life of the contract (7 years) the additional cost based on the net sales percentage will exceed 21 million dollars.

- The “Properties Plus” option offered in the Official Proposal Price Sheet at a rate of 2.3078% of the prize fund was lowered in the Recital of Selected Options document to a “Points for Prizes” option at a rate of 1.5% of the prize fund.

Scientific Games’ response to the Instant Ticket Lottery Games Services Request for Proposal (RFP) Section 5 Evaluation Criteria for Selection (Subsection 5.4 – Program Options) (*Attachment J*) states, in part, the following:

“The ALC benefits from the “Properties Plus Program” because it gets to: Preserve its prize payout claim, since players receive bonus prizes equal to the amount of the fee paid by the Lottery from the prize fund.”

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Scientific Games and Lottery management have stated that the reduction in the amount applied to the “Properties Plus”/“Points for Prizes” portion of the prize fund (2.3078% to 1.5%) is reflected in the cash prize portion of the prize structure of an instant ticket game. Therefore, the amount allocated for the total prize fund for players is not affected. The cash prize portion of the prize fund for an instant ticket game is paid out of the Arkansas Scholarship Lottery proceeds.

- Internal Audit could not identify any additional services provided by Scientific Games in the Recital of Selected Options to justify the pricing modifications to the original negotiated contract price (Official Proposal Price Sheet) approved by the Arkansas Lottery Commission on August 5, 2009. However, based on conversation with Scientific Games and Lottery Management, Scientific Games’ position is that the Tel-Sell operations were not part of the original contract, therefore additional services were provided. See Change #3 – Tel-Sell Operations Provided by Scientific Games (See Page 9 of 16).

- The Recital of Selected Options document that changed the pricing formula was not approved by the Arkansas Lottery Commission as required by the Arkansas Lottery Commission Major Procurement Rules. Furthermore, the contract modification changing the pricing formula was not reviewed by the Arkansas Legislative Oversight Committee as required by the Arkansas Scholarship Lottery Act (23-115-701(e)(1)).

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Recommendation #1 – Pricing Change

Internal Audit recommends that Lottery management seek legal guidance as to the validity of the contract pricing changes made on the Recital of Selected Options document dated August 25, 2009 by Lottery Management and Scientific Games without Arkansas Lottery Commission approval or Arkansas Legislative Lottery Oversight Committee review. If the determination is made that the contract pricing and term modifications are not binding, Internal Audit recommends Lottery Management seek recovery of the additional cost in excess of the original Official Proposal Price Sheet submitted by the instant ticket game services vendor, Scientific Games. Furthermore, Arkansas Scholarship Lottery Management should ensure the correct amount is paid to the vendor for instant ticket lottery game services for the remainder of the contract term.

Change #3 - Tel-Sell operations provided by Scientific Games are included in the Instant Ticket Game Lottery Services percentage.

- The Tel-Sell operators are responsible for contacting Lottery retailers via telephone and securing orders for instant tickets utilizing the Arkansas Lottery Gaming System’s Back Office System (BOS).
- Tel-Sell is addressed as part of the Cooperative Services Program (CSP) in the Instant Ticket Game Lottery Game Services Request for Proposal (RFP) response submitted by Scientific Games in Section 4: Additional Vendor Requirements – Warehousing. (**Attachment K**)
- Tel-Sell was not an invited option included on the Scientific Games’ original Official Proposal Price Sheet approved by the Lottery Commission on August 5, 2009 and reviewed by the Arkansas Lottery Commission Legislative Oversight Committee on August 13, 2009.

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The Instant Ticket Game Lottery Game Services Request for Proposal (RFP) Section 1 – General Information (Subsection 1.26 – Cost) states the following:

1. *“The ALC will not be obligated to pay any costs not identified on the Official Proposal Price Sheet.”*
2. *“Any cost not identified by the Vendor but subsequently incurred in order to achieve successful operation will be borne by the Vendor.”*

The Instant Ticket Game Lottery Game Services Request for Proposal (RFP) Section 5 – Evaluation Criteria for Selection (Subsection 5.4 – Program Options) states, in part, the following:

“As part of the basic compensation that has been proposed by the Successful Vendor, all items represented in the Proposal must be provided for unless specifically identified as options. If programs, equipment or services represented in the Proposal are not clearly indicated as options, the ALC will rightfully assume that the cost is included in the percentage of sales quotation in the Proposal.”

Scientific Games’ response to the Instant Ticket Lottery Games Services Request for Proposal (RFP) Section 5 Evaluation Criteria for Selection (Subsection 5.4 – Program Options) (**Attachment L**) states, in part, the following:

“As part of the basic compensation proposed by Scientific Games, all items represented in our proposal will be provided for unless specifically identified as options. We understand and agree that if programs, equipment or services represented in our proposal are not clearly indicated as options, the ALC will rightfully assume that the cost is included in the percentage of sales quotation in the proposal.”

The Recital of Selected Options document that added Tel-Sell Operations was not approved by the Arkansas Lottery Commission as required by the Arkansas Lottery Commission Major Procurement Rules. Furthermore, the contract modification changing the pricing formula was not reviewed by the Arkansas Legislative Oversight Committee as required by the Arkansas Scholarship Lottery Act (23-115-701(e)(1)).

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Arkansas Lottery Commission Major Procurement Rules Section 5 – General Policies. (Subsection L. – Purchase Order or Contract Required.) states the following:

“Any vendor or other person who manufactures or delivers a product or service without a written purchase order or contract or who delivers a product or service not specifically authorized by a purchase order or contract does so at the vendor’s (or other person’s) own risk. Under no conditions shall the Commission be liable for payment of any type for any product or service provided by a vendor or other person, even such provided in good faith, which is not specifically authorized by a purchase order or contract.”

Recommendation #2 – Tel-Sell Operations

Internal Audit recommends that Lottery Management seek legal guidance as to whether the Lottery is obligated to pay additional cost for the Tel-Sell Operations provided by Scientific Games. In addition, **Internal Audit recommends** that Lottery management seek legal guidance as to the validity of adding the Tel-Sell Operations on the Recital of Selected Options document created on August 25, 2009 by Lottery Management and Scientific Games without Arkansas Lottery Commission approval or Arkansas Legislative Lottery Oversight Committee review.

Change # 4 - Offered an Option for delivery of POS materials to Lottery Regional Offices.

This option has not been utilized by the Arkansas Scholarship Lottery.

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Change # 5 – Exclusive Instant Ticket Provider

- The Instant Ticket Game Lottery Game Services Request for Proposal (RFP) Section 3. – Instant Ticket Operations (Subsection 3.7 – Distribution of Tickets from Other Vendors) states the following:

“The Successful Vendor may be required, up to seven (7) times a year, to package, warehouse, and distribute up to seven (7) instant ticket games per year purchased by the ALC from other Vendors, which will include as part of their bid price up to three (3) licensed properties of the ALC choice each year of the contract. If the ALC does not elect to use any or all of the licensed properties in any given year of the contract, usage will not roll over to subsequent years. These tickets will be distributed along with the Successful Vendor’s tickets, and the Successful Vendor will not be reimbursed for warehousing and distributing these tickets, nor will they be paid a percentage of sales, when the tickets are sold.”

- The Recital of Selected Options added the following to the agreement between the Arkansas Scholarship Lottery and Scientific Games:

“All prices are based upon Scientific Games being the exclusive instant ticket provider throughout the entire term of the contract.”

- The August 5, 2009 Arkansas Lottery Commission meeting minutes states the following:

“Mr. Passailaigue reminded the Commission that the RFP provided for a secondary Instant Ticket Vendor, noting that the Commission may select up to seven games annually from this source and therefore, it (is) likely the Arkansas Scholarship Lottery would actually be doing business with one of the two unsuccessful vendors.”
(Attachment C, PAGE 5 of 12)

- Scientific Games being the exclusive instant ticket provider throughout the entire term of the contract was not an invited option or noted in Scientific Games’ original Official Proposal Price Sheet approved by the Lottery Commission on August 5, 2009 or reviewed by the Arkansas Lottery Commission Legislative Oversight Committee on August 13, 2009.

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Internal Audit could not identify any benefit or financial gain for the Arkansas Scholarship Lottery to exclusively use Scientific Games as the instant ticket game provider. In fact, the move seems to limit the Arkansas Scholarship Lottery's options to utilize instant ticket games available from other vendors that might be successful in the State of Arkansas. In addition, if the Lottery was able to procure the printing of instant ticket games at a lower cost from another vendor a few times a year, dollars could be saved for scholarships.

The arrangement appears to greatly benefit Scientific Games. An exact dollar amount of financial gain for Scientific Games cannot be determined. However, it is safe to surmise that the change guarantees Scientific Games millions of dollars of additional revenues that could have been paid to another instant ticket game vendor per the Instant Ticket Game Lottery Game Services Request for Proposal (RFP).

Scientific Games factored in the possibility of not printing up to 49 games during the term of the contract in their bid price submitted on the Official Proposal Price Sheet.

Scientific Games' response to the Instant Ticket Lottery Games Services Request for Proposal (RFP) Section 3. – Instant Ticket Operations (Subsection 3.7 – Distribution of Tickets From Other Vendors) (**Attachment M**) states, in part, the following:

“Our proposal is based upon the sales performance model that the possible seven games from other vendors will represent no more than five percent of the annual overall instant ticket sales during the first two years of sales. The two years shall be measured starting from the time instant ticket sales begin in October 2009.

After the first two years of sales, our proposal is based upon the sales performance model that the possible seven games from other vendors will represent no more than 15% of the annual overall instant ticket sales.”

The Recital of Selected Options document that made Scientific Games the exclusive instant ticket provider throughout the entire term of the contract was not approved by the Arkansas Lottery Commission as required by the Arkansas Lottery Commission Major Procurement Rules. Furthermore, the contract modification was not reviewed by the Arkansas Legislative Oversight Committee as required by the Arkansas Scholarship Lottery Act (23-115-701(e)(1)).

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Recommendation #3 – Exclusive Instant Ticket Provider

Internal Audit recommends that Lottery Management seek legal guidance as to the validity of Scientific Games being the exclusive instant ticket provider throughout the entire term of the contract based on the Recital of Selected Options document created on August 25, 2009 by Lottery Management and Scientific Games without Arkansas Lottery Commission approval or Arkansas Legislative Lottery Oversight Committee review.

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“Properties Plus” Program License Fees and Merchandise

- The Arkansas Scholarship Lottery elected to implement Scientific Games’ “Properties Plus” program.
- Scientific Games’ (SGI) Official Proposal Price Sheet (Attachment A – Page 14 of 22) for the Arkansas Lottery Commission Instant Ticket Lottery Game Services Request for Proposal (RFP) states, in part, the following:

“As a Properties Plus customer, the Lottery pays no license or royalty fees and nothing for the merchandise involved in a game, other than experiential prizes such as trips or grand prizes such as vehicles and motorcycles. All of this is included in the Properties Plus fee.”

Scientific Games’ response to the Instant Ticket Lottery Games Services Request for Proposal (RFP) Section 5. Evaluation Criteria for Selection (Subsection 5.4 – Program Options) (Attachment J) states, in part, the following:

“The fee would be noted on each prize structure prepared by the ALC. In return for the annual fee, the Lottery would receive: Unlimited use of Scientific Games licensed game portfolio.”

“The ALC benefits from the “Properties Plus Program” because it gets to: Secure unlimited use of Scientific Games’ licensed game portfolio for no out-of-pocket costs.”

Internal Audit noted that from the inception of the lottery on September 29, 2009 through February 29, 2012 the Lottery has paid \$604,762 of fees associated with two license games. The amount does not include the cost of experiential trips. The amount that is considered license fees could not be determined.

Internal Audit also noted that the Lottery has purchased \$200,000 in merchandise associated with three instant ticket games.

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- Arkansas Lottery Commission Major Procurement Rules Section 5 – General Policies. (Subsection F. – Contract.) states, in part, the following: *The purpose of a written contract is to embody, in writing, the complete agreement between parties. No terms shall be left to an unwritten understanding.*

Recommendation #4 – “Properties Plus” Program License Fees and Merchandise

Internal Audit recommends that Lottery Management seek legal guidance as to whether the Lottery is obligated to pay for license fees and merchandise involved in instant ticket games. If the determination is made that the license fees and merchandise purchases that have been paid to Scientific Games were not due, **Internal Audit recommends** Lottery Management seek recovery of the license fees and merchandise purchases paid to-date. Furthermore, Arkansas Scholarship Lottery Management should ensure the correct amount is paid to the vendor for these items for the remainder of the contract term.