



MEMORANDUM

To: California State Lottery Commission **Date:** June 27, 2006

From: Joan M. Borucki
Acting Director

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Subject: Item 10(a) - Approval of the Business Plan and Budget for
Fiscal Year 2006/07

ISSUE

Should the California State Lottery Commission (Commission) approve the Annual Business Plan and Budget for Fiscal Year 2006/2007, for an annual education contribution of over \$1.27 billion from sales of \$3.6 billion?

RECOMMENDATION

Staff recommends that the Commission approve the Annual Business Plan and Budget for Fiscal Year 2006/2007.

BACKGROUND

The annual planning process began early in 2006 with a review of lottery industry trends and an analysis of California State Lottery (Lottery) games and programs of the past year. In March, the Lottery's senior management staff identified the priority issues for the 2006/2007 fiscal year and developed objectives to address those issues. After a review of potential programs by the planning group, action plans for proposed new programs were prepared by staff in April and May. Moving on a parallel path, Budget Office staff developed the baseline operating expenses and equipment budget with input from each Lottery division, and identified the funds available for new programs.

At the May 16, 2006 meeting, the Commission was presented with a broad overview of the Business Plan including the objectives proposed for the upcoming year as well as sales trends and industry data that helped to shape next year's business plan. During late May and early June, the Lottery's senior management staff reviewed all action plans for resource requirements and judged them based on the criteria of alignment with objectives, advancement of objectives, short- and long-term return on investment, and likelihood of success. A final budget, incorporating both the baseline costs and all approved action plans, was then prepared.

DISCUSSION

In the 2006/2007 fiscal year, the Lottery will be following another record breaking year that saw the biggest jackpot in California history as well as the highest sales and the largest annual contribution to education in California Lottery history. The 2005/06 fiscal year will be the sixth consecutive year that the Lottery has been able to produce over \$1 billion in proceeds for education, and for this year, it's a record of over \$1.26 billion.

For the 2006/2007 fiscal year, a key element in the Lottery's Business Plan is to produce \$3.6 billion in sales and to provide public education with \$1.27 billion. This would be the seventh consecutive year that over \$1 billion has been provided for public education. Prior to the first year in the current streak (2000/2001 fiscal year), the \$1 billion mark had only been reached once.

Four objectives were developed as the foundation of the 2006/2007 Business Plan:

- Maximize sales from the games with the greatest profit potential—those having prize payouts in the 50 to 55 percent range.
- Increase the availability and visibility of Lottery products by efficiently expanding the number and types of retail locations where the tickets are sold and by additional merchandising efforts.
- Build stronger connections with Californians.
- Bolster the Lottery's infrastructure over the next several years.

The 2006/2007 Business Plan sales goal of \$3.6 billion is about \$40 million higher than the anticipated actual sales for the year.

For the Lotto games, a combined sales goal of \$1.245 billion is being recommended. This represents an increase of \$65 million over the current year's performance –or more than a 5 percent growth rate. All of the sales gains are anticipated to come from the MEGA Millions game. As this game has been available for just one year, it is natural for a new product to take some time to realize its full potential. The public

is becoming increasingly aware and more familiar with the game, and sales have had definite positive trends. This is anticipated to continue into next fiscal year.

For the Scratchers product line, the sales gains experienced over the past few years cannot be sustained in the Fiscal Year 2006/2007 budget. While consumer demand for the \$5 game is still strong, there is not enough administrative dollars available to support the introduction of more than one of these high payout products. As such, the Scratchers sales goal is recommended at \$1.88 billion, which is \$30 million lower than sales during this current fiscal year. While sales from the \$5 product line will be substantially lower in Fiscal Year 2006/2007, programs to boost sales of the \$1 and \$2 games are planned.

For Hot Spot, the sales goal for next fiscal year will be \$160 million. This figure is slightly lower than the estimated sales for the current year and \$15 million below the current year budget. This is a reasonable goal that is consistent with the long term erosion of the sales for this product. The pace of this erosion is expected to be lessened as a result of continued prize payout promotions that are planned for next year.

For the Daily Games, a \$315 million target is planned for the upcoming fiscal year. This figure is \$15 million more than current year budget, and \$9 million higher than the estimated sales for the current year. All of the games included here performed better than originally budgeted and this improvement is expected to continue into next year

Fiscal Year 2006/2007 SALES & EDUCATION CONTRIBUTION TARGETS

	FY 05/06 Estimate	FY 06/07 Target	Change
Scratchers	\$1,910,000,000	\$1,880,000,000	-2%
Lotto Games	1,180,000,000	1,245,000,000	+5%
Hot Spot	164,000,000	160,000,000	-2%
Daily Games	306,000,000	315,000,000	+3%
Total Sales	\$3,560,000,000	\$3,600,000,000	+1%
Education	\$1,260,000,000	\$1,270,000,000	+1%

Fiscal Year 2006/2007 BUDGET HIGHLIGHTS

The Fiscal Year 2006/2007 Annual Business Plan is estimated to produce \$3.6 billion in sales with a budget that is estimated at 12.09 percent of sales. The main categories within the budget are retailer compensation, game operations, communications, general administrative expenses, and the administrative reserve. The total administrative budget proposed for next year is about \$435 million.

Retailer Compensation:

Retailer compensation costs include sales commissions, special handling fees, incentives, and cashing bonuses. There are no proposed changes to the specific features of the currently authorized retailer compensation program. At the projected sales level of \$3.6 billion, retailer compensation will be \$255 million, the largest item in the budget at 7.1 percent of total revenue.

Game Operations:

Game operations costs include all costs directly associated with the Lottery's gaming system—the gaming contracts, Scratchers ticket printing and delivery costs, and Instant Ticket Vending Machine maintenance costs.

The GTECH gaming contract is budgeted at a straightforward 1.36 percent of sales. The budget proposes to continue an administrative charge of \$12 per week for each retailer location and a \$3 per week charge to retailers with monitors currently used for the Hot Spot game. The Lottery plans to continue to recruit new retailers during Fiscal Year 2006/2007 in an effort to increase sales. In order to meet our recruiting goals, this category includes costs of additional gaming system equipment, i.e., additional Altura terminals, self service terminals, GamePoint terminals, and check-a-ticket devices. Also included in this category are the GTECH programming costs for additional software support services for the gaming system.

At the first of the calendar year, the Lottery entered into new contracts for the printing of Scratchers tickets. These contracts will result in a significantly reduced cost for printing Scratchers tickets as a percent of sales. It is estimated that these contracts will result in an approximate one-third reduction in ticket printing costs. At the budgeted sales level, this amounts to about a \$6.5 million budget savings. Also, the budget anticipates small increases for both the cost of ticket delivery in anticipation of a new courier contract and in Instant Ticket Vending Machine maintenance because of new machines being installed at new retailer locations.

Total game operations costs are about \$60 million or 1.7 percent of total revenue. This represents a significant decrease from just three years ago when this category was 2.9 percent of total revenue.

Communications:

Communications costs include advertising, broadcast programs, point-of-sale materials, and consumer and retailer promotions. In total, over \$36 million has been budgeted for communications support of the programs contained in the Business Plan. This amount is roughly the same amount that was budgeted in the current year. In addition to a base budget allocation of \$33 million, funding for a number of

Action Plans has been added, the largest one is for \$1.6 million for new merchandising and retailer play centers for both new and existing retailers. Total communications support amounts to about 1.0 percent of total revenue.

General Administrative Expenses:

The remaining portion of the budget is for general administration expenses. This includes employee salaries and benefits, operating expenses, such as telephones, supplies and facilities costs, contractual and consultant services, State Controller's Office charges, and equipment and building depreciation charges.

As discussed at the March 15, 2006 Commission meeting, permanent position staffing is being reduced by 30 position to a total of 620 authorized positions. Since last year's budget anticipated the position reduction by reducing funding for 30 positions, overall, ongoing personnel cost estimates are essentially unchanged from last year. Funding for a 5.5 percent general salary increase has been added to the proposed budget. This is a placeholder in anticipation of actions that will be finalized during the first weeks of the fiscal year. Any salary increase granted would need to be agreed between the administration and the union, then ratified by the unions and approved by the legislature. The budget maintains salary savings estimates at 5 percent of salaries, and the budget estimates for the state funding for retirement costs and staff benefits have been further refined to reflect current estimate, including an adjustment to worker's compensation costs.

In general, this area of the budget represents a continuation of the spending levels approved in last year's budget, and is essentially unchanged from the previous year. The nature of the costs included here are mostly recurring housekeeping type costs and significant adjustments are not being proposed. Operating expenses are about the same as last year's budget with increases in such areas as vehicle fuel costs being offset with reductions in other expense categories. Contractual services are up slightly from last year due to new contracts like the biennial security audit required by the Lottery Act, and the anticipated cost of living increases in some recurring contracts. Payments for the State Controller's Office support are nearly unchanged at just under \$1.5 million. The depreciation expenses included in this expense category primarily represent the 2006/2007 fiscal year cost of capitalized purchases made in prior years plus any new purchases to be made this fiscal year. This area of the budget totals \$76 million and represents 2.1 percent of the budget.

Administrative Reserve:

This budget continues the long-standing budget policy of providing an administrative spending reserve as a safeguard against future uncertainties. Staff recommend that the spending reserve be set at \$8 million. This level of a reserve provides for protection against a sales shortfall and/or for unanticipated expenses. If sales performance is near or above the projected levels, the spending reserve provides a

source of funding for new program needs. As always, staff will closely monitor sales and expenditure performance and come back to the Commission during the year if actual performance deviates significantly from the anticipated.

**CALIFORNIA LOTTERY
 FY 2006-2007 BUDGET**
 (Dollars in Millions)

	<u>Dollars</u>	<u>% of Sales</u>
SALES		
• Estimated Sales	\$3,600	100.0%
PRIZES		
• Prize Expense	1,800	50.0%
Promotional Prizes	<u>141</u>	<u>3.9%</u>
Total Prizes	\$1,941	53.9%
ADMINISTRATIVE EXPENSES		
• Retailer Compensation	\$255	7.1%
• Game Operations	60	1.7%
• Communications	36	1.0%
• General Administration	76	2.1%
• Administrative Reserve	<u>8</u>	<u>0.2%</u>
Total Administrative Expenses	\$435	12.1%
EDUCATION REVENUE		
• Statutory Requirement	\$1,224	34.0%
• Interest and other income	16	0.5%
• Unclaimed prizes	<u>30</u>	<u>0.8%</u>
Total Revenues for Education	\$1,270	35.3%