

CALIFORNIA STATE LOTTERY COMMISSION

Minutes – January 17, 2007

Sacramento, California

1. Call to Order

Chairperson John Mass called the public meeting of the California State Lottery Commission to order at 10:05 a.m. at the California State Lottery Headquarters, 600 North 10th Street, Sacramento, California 95814.

2. Pledge of Allegiance

John Mass led the Pledge of Allegiance.

Mass publicly thanked the Governor for his reappointment to the Commission and thanked Loretta Doon for her dedication to the California State Lottery and wished her well on her future endeavors.

3. Roll Call

Mass asked Elisa Topete to call the roll.

Commission Members Present:

Commissioner Rachel Montes

Commissioner Manuel Ortega

Chairman John Mass

CSL Staff and presenters:

Linh Nguyen, Executive Division

Don Currier, Executive Division

Heather Lambert, Executive Division

Susan Kossack, Executive Division

Gordon Jones, Executive Division

Bill Hertoghe, Security/Law Enforcement Division

Jim Hasegawa, Marketing Division

Tricia Metzger, Sales Division

Elisa Topete, Assistant to the Commission

Amber Henry, Recording Secretary

4. Consider Approval of the Agenda

Mass asked if any of the Commissioners wanted to make changes to the January 17, 2007 agenda as proposed. Ortega moved to approve the agenda. Seconded by Montes. The motion passed unanimously (3-0).

5. Approval of Minutes

Mass asked if there were any additions or corrections to the November 1, 2006 minutes. Montes moved to approve the minutes. Seconded by Ortega. The motion passed unanimously (3-0).

6. Commission Liaison Reports

Commissioner Montes :

Montes attended The Big Spin tapings in Burbank on November 5, December 3, and January 7. Montes attended the Lottery Retailer of the Year Event on November 9. The Retailer of the Year honor went to Doughnut Galore from the City of El Monte.

Commissioner Ortega:

As Security Liaison, Ortega was briefed by Security Director Bill Hertoghe on several issues including the OGT (Oberthur Gaming Technology) ticket issue and the GTECH Lottomatica disclosure update. The Security/Law Enforcement Division Strategic Plan was also discussed as well as the civilianization within Special Investigations and the Gaming unit. Ortega was also briefed on the participation in the Terrorism Liaison Officer Program with California Homeland Security. Internal Audits advised Ortega that a draft copy of the Security Evaluation was received and the Division did very well.

Chairman Mass:

On December 21, Mass attended a hearing in Sacramento of the Senate Governmental Organization Committee regarding the GTECH/Lottomatica merger. Mass was given a year-to-date update on Lottery sales. As Procurement Liaison, Mass was provided information on the request for approval of wiring and services purchase order with Trius Technologies and Telecommunications and Network Services, and the Moving and Transportation Services purchase order to increase funding by \$45,000. As Marketing Liaison, Jim Hasegawa and Susan Kossack provided Mass with an update on the American Idol promotion and the Jackpot Captains project.

Mass asked if anyone from the audience had any questions on the Liaison Reports. No one came forward so he proceeded to the next item on the agenda.

7. Director's Report

a. 2006 Annual Report to the Public

Linh Nguyen, Director of Business Planning, advised the 2006 Annual Report to the Public was completed and it provides a summary of financial results for the 2005-06 fiscal year. It details the Lottery's contributions to education by school, highlights noteworthy Lottery winners and noteworthy retailers of the past year. Copies of the Report to the Public will be distributed in the coming weeks to members of the Legislature, the education community and stakeholders, and will be available on the Lottery's website.

b. 2006 Comprehensive Annual Financial Report (CAFR)

The 2006 Comprehensive Annual Financial Report contains the Lottery's audited financial reports for the 2005-06 fiscal year. The Government Finance Officers Association of the United States and Canada, awarded the Lottery a Certificate of Achievement for excellence in financial reporting for the 2004-05 fiscal year and it was the third consecutive year that the Lottery has achieved this prestigious award.

c. Presentation of the September 30, 2006 Financial Statements

The September 30, 2006 Financial Statements is a quarterly report on the Lottery's operations that is completed pursuant to Government Code section 8880.22. It is prepared in accordance with the generally accepted accounting principles and is distributed to the Governor, Attorney General, State Controller, State Treasurer and the California State Legislature. In accordance with Government Code section 8880.65, the Lottery requested the transfer of \$289,909,112 to education on November 20, 2006.

d. Business Plan Overview

Nguyen gave the Commission a draft of the Mission, Vision and Goals that is in preparation for the 2006-07 fiscal year. Staff is beginning the Business Plan development in order to have a guide and foundation of the Lottery's budget development for the 2006-07 fiscal year and to establish strategic direction and the initiatives that the Lottery will be presenting to the Commission as part of the budget. Nguyen asked the Commission to review and comment on the Mission, Vision and Goals and stated that it will be on the next Commission Meeting's agenda.

e. Hot Spot® Update

Nguyen provided the Commission an update on the revised prize structured Hot Spot® Game, which was successfully launched on November 27. Sales are down about 16-17% over the first six weeks, which is expected given that it is a new game and players need an opportunity to adjust. The Lottery implemented the first promotion of the game and over five days, staff has already seen a 14% jump in sales. The Lottery is about three percent short of reaching its normal sales, however the promotion will run for a total of two weeks and that should increase sales significantly. Nguyen also reported that on February 5, the Lottery is moving from five minute draws to four minute draws, approved by the Commission at the last meeting.

f. Sales Update

Sales from July to December 2006 were down about 8.5% from this same period last year. At the current sales pace, the Lottery will end the year with \$3.2 billion in sales, which is going to be \$400 million short of the \$3.6 billion budgeted goal. Most of the short fall is occurring in the SuperLOTTO Plus® and MEGA Millions® games, where sales are down about 17% from this same period last year. The decline is mainly due to significantly lower jackpot levels for MEGA Millions® compared to last year and is being experienced by all 12 states in the consortium. Scratchers® sales are also down about five percent compared to this same period last year.

g. Legislative Update

Heather Lambert, Director of Legislative Affairs and Outreach, briefed the Commission on the information hearing with Senator Dean Florez, Chair of the Senate Governmental Organization Committee, on December 21. The Acting Director, General Counsel and the Commission Chair were questioned specifically on the Due Diligence that the Lottery performed on the Lottomatica/GTECH merger. The Lottery feels it was a positive step towards developing a better relationship with the Senator and his staff and to keep an open dialogue.

Lambert reported that the California Legislature is experiencing the largest freshman class in history, mostly due to term limits. There are a record 34 new Senate and Assembly Members, with a majority of them coming from local government, city council, supervisors, school board members and water board members. The Lottery has requested meet and greets between the freshmen members of both the Senate and Assembly and the Acting Director. The meetings are to provide an understanding of the Lottery and thus far, members have expressed a desire to help if legislative changes are deemed necessary to better achieve the Lottery's goal of providing supplemental funding to education.

Staff has reached out to every legislative office to create a point of contact, which has not existed in the last year or so, and has been met with positive feedback. The offices did not have too many questions, but welcomed the idea of having a contact at the Lottery.

For Educational Outreach, Lambert focused on the educational organizations at the statewide level. Lambert and Borucki have met with most of the groups and have opened up a dialogue that had not existed in previous years. The meetings have been fairly positive and organizations have expressed frustration with the lack of communication and apprehension about the "Lottery effect," and hope for a better relationship with the Lottery. Staff is working on developing an ongoing communication strategy, and are keeping the educational organizations abreast of items of interest and hope to use the strategy to reach some of the smaller, grassroots education organizations.

h. Oberthur Gaming Technologies Misprinted Crossword Scratchers®

Hertoghe reported that Games 468 and 492 in the \$3 Bonus Crossword format were printed by Oberthur Gaming Technologies (OGT) and 38,400,000 tickets for each game were set for distribution to multiple retailers statewide. In mid-December 2006, a ticket was submitted to a Lottery District Office as a \$20,000 winner; however the ticket did not validate and was determined to be a non-winner. The ticket was reconstructed by OGT and a printing error was revealed. Outstanding tickets were quarantined by the retailers at the request of the Lottery and ultimately recovered and placed in a Security-Hold status. The printing dynamics of the games require a dual pass printing process. During the process, the playing area is printed on the initial press run. The tickets are then subjected to a second press run, whereas the latex overprint is produced on the ticket. An acceptable ticket would

contain a play area that matches the overprint. With the aberrant tickets, the play area was printed with a crossword puzzle as configured; however, the latex overprint was printed with an alternate crossword puzzle. Before the aberration was detected and tickets quarantined, 1865 tickets had been sold (Hertoghe gave the Commissioners samples of the tickets). Hertoghe advised the Commission that staff is meeting with OGT and will have an inspection of the plant. OGT advised the Lottery of the changes that are immediately going to take place and the Lottery will not be printing any games in the future with OGT until the changes are complete.

i. Creative Games International, Inc. Acquisition

The Security/Law Enforcement Division (S/LED) began a disclosure investigation on October 18, 2006 after GTECH Printing Company (GPC), a subsidiary of GTECH Corporation, entered into an agreement to purchase Creative Games International, Inc. (CGI). CGI is a secondary instant game ticket producer for the Lottery and the corporate officers were subjected to a disclosure investigation in 2005. Disclosure documents submitted by GPC confirmed that two new officers had joined the corporate structure of GPC. As a result, a background investigation was completed on the new officers. No adverse or disqualifying information was discovered that would hinder GPC's ability to contract with the Lottery. S/LED has requested a financial Due Diligence review internally from the Lottery's Finance and Administration Division. Staff is also doing a business plan review of CGI and its association with GTECH to ensure that the business plan is correct and that CGI will be able to provide the Lottery the service that is needed.

j. Scientific Games International, Inc. Restructure

Scientific Games International, Inc. (SGI) was awarded an instant games contract in July 2005, following a disclosure investigation by S/LED. In November 2006, SGI reported its intent to restructure the organization and create a new wholly-owned subsidiary. Because the printing of instant game tickets will be performed by the new subsidiary, Scientific Games Products, Inc. (SGP), SGI entered into an inter-company agreement with SGP. The officers of SGP will be drawn from SGI staff, all of whom have already been subjected to disclosure investigations. S/LED has requested an updated Contractor Disclosure (CSL 0829) and a corporate structure report to confirm the accuracy of what has been reported.

k. Honeywell International, Inc. Restructure

In October 2004, the Lottery approved Honeywell International, Inc. as the contract vendor for the Lottery's electronic security. Within the term of the contract, SecurityCo, Inc. purchased Honeywell International, Inc. becoming Honeywell Security Management and later HSM Electronic Protective Services, Inc. The ownership change was subject to a disclosure investigation and no disqualifying factors were discovered. The name change was not subject to review. On December 18, 2006, HSM personnel notified S/LED staff that HSM would be acquired by Stanley Works in early 2007. S/LED has requested disclosure documents from the corporate staff of Stanley Works.

I. HMI & Associates, Inc. Merger Update

HMI and Associates, Inc (HMI) was subjected to a disclosure investigation in June 2006 as a potential contract provider of security guard services for the Lottery. The disclosure investigation proved to be relatively complex, due to multiple mergers and acquisitions that occurred during or immediately previous to the investigation. Ultimately, HMI was acquired by Andrews International; however, HMI remained the service vendor. Because of the acquisition, the corporate officers for Andrews International were subjected to a background investigation. No disqualifying information was discovered. In January 2007, HMI notified S/LED that Andrews International would be more involved as a corporate partner to HMI, although no name change has been proposed. As a result of this latest disclosure by Andrews International/HMI, S/LED has initiated an updated background investigation. Since the corporate officers have already been the subject of a background, the focus of the instant investigation is the corporate structure of Andrews International and the relationship of HMI to the parent company.

m. Distribution / Inventory Logistics Study

Gordon Jones advised the Commission of an in-house evaluation that is currently being conducted on the Lottery's materials distribution practices. The evaluation covers ticket inventory and point-of-sale materials and how staff handles those materials from manufacturing to delivery to our internal warehouses, down to the retailers. The reason for the study is because the Lottery's material handling practices have been unchanged for approximately ten years and there have been significant advances in the industry. Advances have been made in warehouse automation, interim inventory storage practices and materials tracking. The Lottery is hiring Studley Inc., a firm with specialized expertise in materials handling and distribution, to evaluate existing Lottery practices and make recommendations for efficiency and service improvements. The consultant's draft report is expected in mid-February 2007.

n. Gift Packs / Kiosks Update

Tricia Metzger reported on the Holiday Gift Packs, which were a new initiative for the Lottery this year. Each gift pack holds 50 - \$1 Scratchers® tickets, ten SuperLOTTO Plus® QuickPick coupons and five holiday gift envelopes, a value of 60 Lottery tickets for \$50. There were 19,200 gift packs ordered and the packs were sold at the Raleys/Bel Air/Nob Hill and The Customer Service Experts chain locations as well as the Lottery's top 200 independent retailers. To date, retailers have activated and settled 51.15% of the game or 9,822 packs. The number of activated packs is significant because packs do not settle until 80% of the low tier tickets are redeemed. Players were excited about the availability and packaging of the tickets for gift giving. The awareness of the gift pack was low due to the limited distribution and limited point of sale. The sales were encouraging and the retailer and player acceptance was very high.

The Lottery was able to negotiate with Westfield Malls to rent space for five kiosk locations in Santa Ana, San Francisco, Topanga, La Jolla and Escondido. Retailers

began ticket sales the week of December 4 and equipment was removed by January 5. Staff negotiated and contracted the space and existing Lottery retailers staffed the kiosks and sold tickets. Sales were somewhat disappointing for the retailers because of labor costs and with the extended mall hours. Sales did not cover costs. Even though sales may have been lighter than expected at the malls, staff feels it received exposure similar to advertising that the Lottery wouldn't have received had it not initiated such a program.

o. Jackpot Captains Update

Jim Hasegawa provided the Commission an update on the Jackpot Captains. To date, 6,700 have signed up to be Jackpot Captains. The first 4,500 sign-ups came in the initial month of November. As a result, the pace of the sign-ups has slightly decreased so staff is looking at doing additional efforts to promote the Jackpot Captains through radio advertorials and possibly some in-store retail point of sale materials. About 82% of the captains have opted to receive emails from the Lottery to receive information about products to key players. Nearly half of the groups are playing SuperLOTTO® Plus on a weekly or twice a week basis, irrespective of the jackpot amount, and the numbers are slightly lower for MEGA Millions®. The groups overall, are fairly sizeable with nearly a third of the groups containing ten or more players. In terms of geography, over 3,000 Jackpot Captains are from the Los Angeles Metro area. There are about 700 sign-ups from the Bay Area and approximately 450 in the San Diego County area. Hasegawa discussed the marketing tactics that will be employed with the Jackpot Captains over the next year such as e-mail blasts that will be used to provide jackpot notifications, promotional announcements and other information.

p. American Idol Promotion

Hasegawa presented the various strategies and tactics being used to promote the American Idol Scratchers® game and its unique prizes. A limited budget will provide support via on-line banner ads and radio advertorials. In addition to the Lottery's website, there will be advertising on entertainment oriented pages such as yahoo.com, aol.com, and citysearch.com as well as Spanish language websites. The Lottery has some event marketing through its basketball sponsorships at the Los Angeles Clippers and Golden State Warrior games. Two adult fans will be picked to sing 15 seconds of the same song and the crowd determines who the winner is. During the radio promotions, there will be on-air American Idol trivia contests, singing contests as well as call-in discussions regarding favorite former American Idol finalists. Listeners could win not only American Idol Scratchers® tickets, but also passes to attend the Lottery's private viewing party in Hollywood on the night of the American Idol finale. Staff is also working with Ford dealers throughout California on possibly winning tickets for a test drive or entering a second chance drawing at Ford dealerships for tickets to the finale night Lottery party. The Lottery is trying a new promotional effort with viral marketing, which will go live on January 24, 2007. It allows the customer to create and star in an American Idol video by using digital photos of themselves (video demonstration played) and when completed, allowing the customer to email it to friends and family.

9. Consent Calendar

There were no items on the Consent Calendar.

10. Action Items

- a. Approval of Scratchers® Game Profiles for Games 509, 510, 511, 512, 513, 514, 515, 516, and 517 and Amendments to Previously Approved Game 507 and 508 Profiles

Susan Kossack presented the Commission the May and June games. Game 509 is a \$1 game with a Key Number Match playstyle call "Solid Gold." The top prize for the game is \$2,000 and overall odds are 1 in 5.22. Game 510 is developed as a \$2 Tic-Tac-Toe game with three games for the price of two. The top prize is \$10,000 and odds are 1 in 4.61. Scratchers Game 511 will be "Bingo Doubler" and the Lottery has launched several game features to freshen the appeal of the product category such as additional bonus numbers, extra "free" play spots, and "wild" symbols. The top prize will be \$20,000 and overall odds of winning any prize are 1 in 3.82. The last game for May is Game 512 and will showcase a top prize of \$100,000. The \$5 game will have a Match 3 with a specific variant playstyle and offer 16 chances to win on each ticket. The Lottery will be delivering over \$51 million in cash prizes on the game and the overall odds of winning are 1 in 3.89.

The June games will feature Game 513, a \$1 game with a Match 3 playstyle and top prize of \$1,000 with overall odds of winning at 1 in 4.98. Game 514 is a \$2 game with a Key Number Match with specific variant playstyle and the ability to win up to ten times on each ticket. The top prize is \$10,000 with overall odds of 1 in 4.70. Game 515 is called "Red, White & Blue 7's" and is a \$3 game that provides the ideal opportunity to focus on popular summer holidays: Memorial Day, Independence Day, and Labor Day. The game will have a Key Number Match playstyle and ability to win up to 12 times on a ticket through the use of four winning numbers. The top prize for this game is \$47,777 and overall odds of winning are 1 in 4.36.

Staff is bringing forward for the Commissions approval, the Lottery's first \$10 Scratchers® game. The popularity of higher-priced games is seen throughout the lottery industry, with the top 16 per capita states all offering a \$10 price point. Game 516 will offer a Key Number Match playstyle. The game will offer over \$100 million in cash prizes (the highest amount of prizes awarded in any California Lottery Scratchers® game) including the opportunity to win one of 15- \$1 million cash prizes instantly. Players will also have a chance to win a \$1 million prize by entering a non-winning tickets into a second chance drawing. Overall odds of winning a prize are 1 in 3.32. Game 517 is another \$10 game that may launch if available funding levels are met during the fiscal year. Staff is recommending the game offer over \$100 million in prizes, with 30 - \$500,000 top

prizes. The game will have a Key Number Match playstyle and overall odds of winning a prize are 1 in 3.32.

Staff made some minor adjustments and was able to obtain more competitive merchandise prize packs for Games 507 and 508, Major League Baseball. The overall odds of winning did not change from 1 in 4.17.

Discussion by Commissioners.

Mass asked if anyone from the audience had any questions on Action Item 10(a). No one came forward so he proceeded to the motion of approval.

Montes made the motion to approve Action Item 10(a). Seconded by Ortega. The motion passed unanimously (3-0).

b. Approval to Award Contract for African American Advertising Services

Before the presentation of Action Item 10(b), Chairman Mass brought up a concern he had with a possible conflict of interest with the contract for African American Advertising Services. A friend contacted Mass during the process of selecting an agency, and advised Mass that he had a relationship with one of the bidders for the contract. Mass advised his friend that he would have to refrain from any discussion about his friend's involvement with the company as Mass felt there was a proposed conflict of interest. Mass advised the Lottery's Chief Counsel and Acting Director of his situation and recused himself from any further discussion on the contract. As Procurement Liaison, Mass would have been updated on a regular basis on the competitive bidding process, but was not part of the process at all. Two bidders went through the final Due Diligence and investigation of bidding process, however, neither company was the company associated to Mass' friend. Mass feels comfortable returning to the process and being part of the approval of Action Item 10(b).

Jim Hasegawa presented the Commission the recommendation to award a three-year contract to Muse Communication for African American Advertising Services. The contract would have a total contract expenditure authority of \$5 million. Staff posted a draft Request for Proposal (RFP) on the Lottery's website on June 20 2006 and a letter of notification was sent to all interested vendors in the Lottery's Contract and Procurement Services database. A mandatory agency conference was held in July 2006 at Lottery Headquarters with seven advertising agencies in attendance. The final RFP was released on July 20, 2006. Four agencies submitted proposals in response to the RFP by the deadline of August 10, 2006. The Evaluation Team recommended Muse Communications as having the overall best value for the Lottery and the Acting Director designated Muse Communications as the apparent successful bidder. No protests to the announcement were received by the Lottery. Staff recommends awarding the three-year contract with up to three, one-year extension options and a total

expenditure of \$5 million to Muse Communications. The new contract with Muse is anticipated to commence on February 1, 2007.

Discussion by Commissioners.

Mass asked if anyone from the audience had any questions on the Action Item 10(b). No one came forward so he proceeded to the motion of approval.

Ortega made the motion to approve Action Item 10(b). Seconded by Montes. The motion passed unanimously (3-0).

c. Approval of New Retail Model Regulations

Linh Nguyen, presented to the Commission a proposal to amend the Retailer Compensation and Incentive Bonus Regulations to give the Director the authority and flexibility to enter into alternative compensation agreements with retail partners for the purpose of pilot testing new retail business models. The current business model requires a large commitment and workload on the part of retailers. Staff would like to begin testing new mutually beneficial business models with interested retailers. Under the proposal, the Director would be required to notify the Commission Chair of any proposed pilot. If the pilot proves successful, staff would return to the Commission for approval of permanent regulatory changes to any compensation structure. The proposed amendment would be added to the end of the retailer compensation and incentive bonus regulations.

Mass asked if anyone from the audience had any questions on the Action Item 10(c). No one came forward so he proceeded to the motion of approval.

Discussion by Commissioners.

Ortega made the motion to table Action Item 10(c) to the February 28 Commission Meeting. Seconded by Montes. The motion passed unanimously (3-0).

10. Commissioner General Discussion

11. Scheduling Next Meetings

The next Commission meetings are tentatively scheduled for February 28, May 16, June 27, August 15 and November 7, 2007 at the Lottery Headquarters in Sacramento. The times for the meetings will be determined.

12. Public Discussion

Phil Green, Senior Vice President of Sales and Marketing for Creative Games, clarified the impact on the lottery industry of CGI's acquisition by GTECH Corporation.

The following individuals all spoke in regards to the issues between the Glendale Hilton and union supporters:

Joan Lee – deferred time to Bill Camp.
Bill Camp – Represented FLCIO
Marjorie Boehm – deferred time to Sandra Bass
Sandra Bass – Oakland Marriott Hotel employee (banquet server)
Valencia Henley – Sacramento State University student
Howard Lawrence – PICO California Project co-chair
Olga Trevizo – Sacramento Chapter of LULAC
Nelson Hernandez – Sacramento Hilton Hotel employee
Liana Molina – East Bay Alliance
Agar Jaicks – San Francisco citizen, retired television director for ABC
Melinda Rivasplata – Peace in the Precincts
Greg Larkins – Chairman of the Democratic Party for Sacramento County
Bob Fossgreen – retired educator
Ellen Schwartz – Sacramento Valley Branch of the Women’s International League for Peace and Freedom co-chair
Gale Ryall – Secretary of the California Capitol Chapter of the Coalition of Labor Union Women
Marion Betz – retired
Sarah Michaelson – East Bay Alliance
Earl Streeter – San Francisco Fairmont Hotel employee

13. Closed Session

The Commission convened in a closed session at 12:30 p.m. to confer with and receive advice from counsel regarding pending litigation: California Coalition Against Gambling Expansion, et al. v. California State Lottery Commission; Carpenters Local 46 v. DGS; California State Lottery, et al.; City of Huntington Beach v. California State Lottery, et al.; Lee v. California State Lottery Commission; Gustafson v. California State Lottery; McFoy v. Director, California Lottery Commission, et al.; Potential Litigation Involving Instant Ticket Vendor.

14. Adjournment

Meeting adjourned at 1:07 p.m.