



M E M O R A N D U M

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**Date:** June 25, 2010

**To:** California State Lottery Commission

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Director

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**Subject:** Item 9(d) – Fiscal Year 2010-2011 Budget

**ISSUE**

Should the California State Lottery Commission (Commission) approve the proposed budget that projects a contribution of \$1.103 billion to public education for Fiscal Year 2010-11?

**RECOMMENDATION**

California State Lottery (Lottery) staff recommends that the Commission approve the budget for Fiscal Year 2010-11 as presented in the attached document.

**BACKGROUND**

The proposed Fiscal Year 2010-11 budget reflects the first full year of implementation of the Lottery's 2010-13 Business Plan and business strategies resulting from passage of Assembly Bill 142, the Lottery modernization legislation that provides the Commission flexibility for setting prize payout levels.

The proposed Fiscal Year 2010-11 budget projects sales of \$3.519 billion, a 16 percent increase above the Fiscal Year 2009-10 budget levels. The proposed budget is expected to result in over \$1.103 billion for California public schools marking the eleventh consecutive year the Lottery will surpass the one billion dollar mark in funding for public education.

## **DISCUSSION**

The development of the Lottery's budget traditionally begins by projecting sales performance and determining prize funding levels by product type. Sales performance is projected using sophisticated modeling as well as recent sales trend data.

The development of Fiscal Year 2010-11 sales goals was further refined by leveraging the Lottery's RENEW efforts. This included assessing each of the Business Plan initiatives for its effect on sales and returns to public education.

The proposed budget also factors in projected growth in sales as a result of passage of Assembly Bill (AB) 142. AB 142, signed by the Governor on April 9, 2010, recognized that the Lottery Act requirement that no less than 34 percent of sales must be transferred to public education was hindering the Lottery from maximizing contributions to education. AB 142 amended the Lottery Act by providing the Commission with the flexibility to determine the amount of annual revenues that are returned to the public in the form of prizes. The added flexibility will increase total revenues for public education by allowing California to implement best practices for setting prize payouts at levels that have proven successful in increasing sales for other state lotteries.

AB 142 has also had a significant effect on the proposed Fiscal Year 2010-11 budget in the area of expenses. Prior to AB 142, the Lottery Act required that no more than 16 percent of total annual revenues shall be allocated for payment of "expenses of the lottery". The term "expenses of the lottery" is typically referred to as "Administrative Expenses" and includes retailer compensation, game operation costs, communications, and general administration (e.g. personnel costs and other base operating costs).

AB 142 amended the Lottery Act to reduce the cap on "Administrative Expenses" to no more than 13 percent of total annual revenues. The proposed budget incorporates the 13 percent cap on "Administrative Expenses".

## **Revenues**

Total sales for all Lottery products are projected to be \$3.519 billion for Fiscal Year 2010-11. This is a \$492 million increase over budgeted sales levels for Fiscal Year 2009-10 that translates to a 16 percent increase in sales.

The chart below as well as the comparisons in the following narrative contrasts sales goals in the revised Fiscal Year 2009-10 budget (adopted by the Commission in April 2010) with proposed sales goals in the Fiscal Year 2010-11 budget.

**COMPARISON OF REVENUES  
 FY 2009-10 BUDGET AND FY 2010-11 BUDGET  
 (\$ In Thousands)**

| <b>SALES:</b>        | <b>REVISED<br/>BUDGET<br/>FY 2009-10*</b> | <b>CHANGE</b>    | <b>PROPOSED<br/>BUDGET<br/>FY 2010-11</b> |
|----------------------|---|------------------|---|
| Scratchers®          | \$1,718,000                               | \$482,000        | \$2,200,000                               |
| SuperLOTTO Plus®     | \$472,000                                 | (\$72,000)       | \$400,000                                 |
| MEGA Millions®       | \$409,000                                 | \$51,000         | \$460,000                                 |
| Daily Games®         | \$311,000                                 | \$13,000         | \$324,000                                 |
| Hot Spot®            | \$117,000                                 | \$18,000         | \$135,000                                 |
| Total Sales          | \$3,027,000                               | \$492,000        | \$3,519,000                               |
| Investment Proceeds  | \$45,000                                  | (\$45,000)       | 0   |
| <b>Total Revenue</b> | <b>\$3,072,000</b>                        | <b>\$447,000</b> | <b>\$3,519,000</b>                        |

\* Sales goals in the revised budget adopted by the Commission 4/14/10.

The largest increase in projected sales is in the Scratchers product line where sales are expected to grow \$482 million to a total of \$2.2 billion. This represents a 28 percent increase over the budgeted sales level in Fiscal Year 2009-10. The growth in sales is fueled by Business Plan initiatives specifically for Scratchers games as well as a Scratchers product plan that incorporates higher prize payouts.

Sales for SuperLOTTO Plus are projected to continue on a downward trend in Fiscal Year 2010-11. Addressing the health of this game is one of the key Business Plan initiatives in the upcoming fiscal year. The proposed budget does not include any assumptions regarding a proposed modification to or replacement for SuperLOTTO Plus.

Sales for MEGA Millions are projected to increase \$51 million in Fiscal Year 2010-11. The increase in sales is based on resumption of marketing efforts for this game based on the success of advertising efforts tested during the latter part of Fiscal Year 2009-10.

It is important to note that sales for both the SuperLOTTO Plus and MEGA Millions jackpot games are heavily influenced by jackpot levels. This is illustrated by comparing the first 50 weeks of this fiscal year and the first 50 weeks of the previous fiscal year. The chart below comparing SuperLOTTO Plus sales for Fiscal Years 2008-08 and 2009-10 illustrates this point.

**SuperLOTTO Plus**

|            |                                       |                          |
|------------|---------------------------------------|--------------------------|
| FY 2008-09 | 33 Jackpots in excess of \$30 million | \$536 million in Sales   |
| FY 2009-10 | 11 Jackpots in excess of \$30 million | \$443 million in Sales * |

*\* Actual Sales through 50 weeks of the fiscal year.*

The difference in jackpot levels between Fiscal Years 2008-09 and 2009-10 has contributed to a significant difference in year-to-year comparisons of sales for our large jackpot games, SuperLOTTO Plus and MEGA Millions. This information is presented to point out that forecasting sales for the large jackpot games is challenging because of many variables including the jackpot size.

For the remaining Lottery products, Daily Games and Hot Spot have sales goals that are slightly above the levels being forecasted for Fiscal Year 2009-10. For the Daily Games category, a sales goal of \$324 million is proposed. This represents an increase of \$13 million compared to the current year's sales goal.

A goal of \$135 million is proposed for Hot Spot, an \$18 million increase over the current year sales goal. This increase is based on the projected outcomes of both the Business Plan initiative for Hot Spot and increases in the prize payouts for this game from 51 percent to 56 percent.

The proposed Fiscal Year 2010-11 budget does not include additional resources from the restructuring of the Lottery's investment portfolio. The Lottery's goal to capitalize on the opportunity to reduce the Lottery's investment costs and generate additional funds for public education was achieved in Fiscal Year 2009-10 and no additional activity is planned in the coming fiscal year.

**Expenses**

The proposed sales goals in the Fiscal Year 2010-11 budget are supported by an increase in prize payouts in several Lottery products, most notably the Scratchers product line and the Hot Spot game. As a result, prize expenses are projected to increase from \$ 1.621 billion to \$ 1.982 billion.

To put this into context with respect to the Lottery's strategy to utilize higher prize payouts to increase sales, the increase reflects an aggregate change in prize payouts from 52.77 percent of sales in Fiscal Year 2009-10 to 56.33 percent of sales in Fiscal Year 2010-11. As discussed above, this increase in prize payouts is primarily targeted for the Scratchers product line and the Hot Spot game and is a key driver for the projected growth in sales for these two Lottery products.

The Administrative Expense budget is now limited to no more than 13 percent of total annual revenues as a result of the passage of AB 142. Administrative Expenses are comprised of retailer compensation, game operations costs, communications, general administrative expenses and a small administrative reserve.

Total budgeted Administrative Expenses are \$458 million. This represents a \$50 million increase (12 percent) above Fiscal Year 2009-10 budget levels.

Retailer compensation costs account for over half of the Administrative Expense budget. In the Fiscal Year 2009-10 budget, retailer compensation costs were budgeted at \$213 million which represents 52 percent of the Administrative Expense budget. This proposed budget includes the assumption the Commission will adopt amendments to the Lottery regulations being proposed at this June meeting that reduce retailer compensation and incentive bonuses. With those amendments, retailer compensation costs will increase \$26 million (12 percent) above Fiscal Year 2009-10 budget levels and will continue to represent 52 percent of the Administrative Expense budget.

The remaining Administrative Expense budget which includes personnel costs, advertising and marketing costs, base operating costs and funding for the Business Plan initiatives has increased \$23 million (12 percent) from 2009-10 budget levels to \$218 million. Nearly half of the increase has been allocated to fund marketing and advertising strategies in the proposed budget.

A total of 644 permanent positions are included in the proposed budget. This reflects an increase of four positions over Fiscal Year 2009-10 levels. Three of the positions are in the prize payment area to address the projected increase in claims from prize winners as a result of the higher prize payout strategies. The additional positions are needed for the Lottery to continue to meet the six-week processing period that is advertised on the Lottery claim forms. These three positions are requested to be approved effective October 2010 and will be three-year limited terms positions.

One additional position is being proposed for the Security/Law Enforcement Division. This position is necessary to support the security systems and manage security guard services for the Lottery's facilities. There is currently one permanent position allocated for these activities but workload has required additional support from a Retired Annuitant. The additional position will eliminate the need for reliance on a Retired Annuitant to adequately staff these activities. This position is requested to be approved effective July 2010.

Also included in the Administrative Expense budget is funding for Information Technology projects included in the Business Plan (e.g. Business Intelligence Project and Public Website Project), marketing initiatives contained in the Business Plan, exams and training to support the Workforce and Succession Planning Project, and preparations for moving into the new headquarters building.

This budget also continues the longstanding practice of providing an administrative spending reserve as a safeguard against future uncertainties. Given the conservative nature of the sales forecast, the administrative spending reserve is set at a very conservative \$2 million. This level of reserve provides protection against a sales shortfall and/or for unanticipated expenses.

## **SUMMARY**

With this budget, profits to California public schools are anticipated to be over \$1.103 billion in Fiscal Year 2010-11 marking the eleventh consecutive year that the Lottery has surpassed the billion dollar mark in contributions to public education. This represents a 3 percent increase over the budgeted contribution to public education for Fiscal Year 2009-10.

The proposed budget includes funds for the first full year of implementation of the Lottery's Fiscal Year 2010-13 Business Plan and the strategies resulting from passage of AB 142. This budget will fund actions that provide the foundation for sustainable growth in revenues and further enable the Lottery to carry out the commitment to enhancing education and supporting local communities.

**CALIFORNIA STATE LOTTERY  
FISCAL YEAR 2010-11 BUDGET**

(Dollars in Millions)

|                                      | <b>Revised<br/>Budget<br/><u>FY 2009-10</u></b> | <b><u>Change</u></b> | <b><u>% of<br/>Change</u></b> | <b>Proposed<br/>Budget<br/><u>FY 2010-11</u></b> |
|--------------------------------------|---|----------------------|-------------------------------|--|
| <b>SALES</b>                         |   |                      |                               |  |
| Estimated Sales                      | \$3,027   | \$492                | 16.3%                         | \$3,519  |
| Additional Resources                 | <u>\$45</u>                                     | <u>(\$45)</u>        | <u>-</u>                      | <u>\$0</u>                                       |
| <b>Total Revenue</b>                 | <b>\$3,072</b>                                  | <b>\$447</b>         | <b>14.6%</b>                  | <b>\$3,519</b>                                   |
| <b>PRIZES</b>                        |   |                      |                               |  |
| Prize Expense                        | <u>\$1,621</u>                                  | <u>\$361</u>         | <u>22.3%</u>                  | <u>\$1,982</u>                                   |
| <b>Total Prizes</b>                  | <b>\$1,621</b>                                  | <b>\$361</b>         | <b>22.3%</b>                  | <b>\$1,982</b>                                   |
| <b>Net Revenue after Prizes</b>      | <b>\$1,451</b>                                  | <b>\$86</b>          | <b>5.9%</b>                   | <b>\$1,537</b>                                   |
| <b>ADMINISTRATIVE EXPENSES</b>       |   |                      |                               |  |
| Retailer Compensation                | \$213   | \$27                 | 12.6%                         | \$240  |
| Game Operations                      | \$56  | \$10                 | 18.8%                         | \$66   |
| Communications                       | \$46  | \$10                 | 21.3%                         | \$56   |
| General Administration               | \$89  | \$5                  | 5.8%                          | \$94   |
| Administrative Reserve               | <u>\$4</u>                                      | <u>(\$2)</u>         | <u>-</u>                      | <u>\$2</u>                                       |
| <b>Total Administrative Expenses</b> | <b>\$408</b>                                    | <b>\$50</b>          | <b>12.3%</b>                  | <b>\$458</b>                                     |
| <b>EDUCATION REVENUE</b>             |   |                      |                               |  |
| Statutory Requirement to Education   | \$1,043   | \$36                 | 3.4%                          | \$1,079  |
| Interest and Other Income            | \$5   | -\$2                 | -                             | \$3  |
| Unclaimed Prizes                     | <u>\$21</u>                                     | <u>\$0</u>           | <u>-</u>                      | <u>\$21</u>                                      |
| <b>Total Revenues for Education</b>  | <b>\$1,069</b>                                  | <b>\$34</b>          | <b>3.2%</b>                   | <b>\$1,103</b>                                   |