



M E M O R A N D U M

Date: June 29, 2011

To: California State Lottery Commission

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Subject: Item 9(c) – Fiscal Year 2011-2012 Budget

ISSUE

Should the California State Lottery Commission (Commission) approve the proposed budget that presents a sales goal of \$4.090 billion, the highest level of sales in California State Lottery (Lottery) history, and is expected to provide \$1.2 billion in contributions to public education for Fiscal Year 2011-12?

RECOMMENDATION

Staff recommends that the Commission approve the Lottery budget for Fiscal Year 2011-12 as presented in the attached document.

SUMMARY

The proposed Fiscal Year 2011-12 budget reflects the first full year of Lottery operations since the passage of Assembly Bill (AB) 142, the Lottery modernization legislation that provided the Commission with flexibility for setting prize payout levels. This budget also reflects the Lottery's second year of execution of the Lottery's 2010-13 Business Plan.

The results are a budget with sales goals of \$4.090 billion, the highest level of sales in California State Lottery history and nearly a 20 percent increase over the expected sales total for Fiscal Year 2010-11. This budget also forecasts \$1.2 billion in profits to California public education, an increase of \$100 million over the contribution level projected for Fiscal Year 2010-11.

DISCUSSION

Development of the Lottery's Fiscal Year 2011-12 budget began by generating base sales goals by product, determining prize funding levels for each product type, and calculating associated fixed costs. Sales goals were further refined by factoring in the projected impact of the Business Plan initiatives approved by the Commission in May 2011 as well as the advertising and marketing strategies for the upcoming fiscal year.

Base operating costs were also reevaluated to identify opportunities to reduce funding levels through efficiencies, budget reductions or suspension of business activities. This analysis was conducted in consideration of the potential impact on sales.

The result of this comprehensive assessment of both sales goals and the funding needed to deliver those goals is the budget being proposed for the upcoming fiscal year. A summary of the elements of this budget is presented below.

Revenues

Total sales for all Lottery products are projected to be \$4.090 billion for Fiscal Year 2011-12. This represents a \$667 million increase (20 percent) over estimated year-end sales levels for Fiscal Year 2010-11.

The chart below, as well as the comparisons in the following narrative, contrasts estimated Fiscal Year 2010-11 year-end sales with proposed sales goals in the Fiscal Year 2011-12 budget.

**COMPARISON OF
FY 2010-11 ESTIMATED YEAR-END SALES
AND PROPOSED FY 2011-12 SALES GOALS
(\$ In Thousands)**

SALES:	ESTIMATED YEAR-END FY 2010-11	CHANGE	PROPOSED BUDGET FY 2011-12
Scratchers®	\$1,995,000	\$705,000	\$2,700,000
SuperLotto Plus®	\$428,000	(\$25,000)	\$403,000
MEGA Millions®	\$540,000	(\$21,000)	\$519,000
Daily Games®	\$330,000	(\$2,000)	\$328,000
Hot Spot®	\$130,000	\$10,000	\$140,000
Total Sales	\$3,423,000	\$667,000	\$4,090,000

Scratchers

The largest increase in projected sales for Fiscal Year 2011-12 is in the Scratchers product line with a sales goal of \$2.700 billion. This represents a \$705 million (35 percent) increase over estimated sales of \$1.995 billion for Fiscal Year 2010-11. This will be the largest year-over-year increase in Scratchers ticket sales in the Lottery's history. This is especially significant since the expected \$1.995 billion in Scratchers ticket sales for Fiscal Year 2010-11 will establish an all-time high for the Lottery.

The anticipated growth in Scratchers ticket sales is fueled by a multitude of Business Plan initiatives. These initiatives include increased prize payouts on new \$5 games, increasing the number of \$5 games available to high sales volume retailers, increased advertising support, rollout of new Ex\$ell strategies, and introduction of the first \$10 Scratchers game in the Lottery's history.

SuperLOTTO Plus

Sales for SuperLOTTO Plus are projected to be \$403 million. SuperLOTTO Plus sales have been on a downward trend since the introduction of MEGA Millions to the Lottery's product portfolio in Fiscal Year 2005-06. The previous four fiscal years averaged a year-over-year decline of nearly 11 percent. However, a smaller decline (less than 8 percent) is expected in Fiscal Year 2010-11. One of the Business Plan initiatives for Fiscal Year 2011-12 is to establish a second chance draw promotion for SuperLOTTO Plus. This promotion is expected to lessen the downward sales trend for this product.

MEGA Millions

The sales goal for MEGA Millions is \$519 million. This reflects a \$21 million decline (4 percent) from estimated sales for Fiscal Year 2010-11. This decline is not reflective of any issues with the health of this game.

Sales for MEGA Millions (and SuperLOTTO Plus) are heavily influenced by jackpot levels. Fiscal Year 2010-11 sales for MEGA Millions were greatly boosted due to jackpot levels exceeding \$300 million on two occasions during the year. This was atypical as jackpots reached the \$300 million level only once in each of the previous four fiscal years. The exception was Fiscal Year 2008-09 when no jackpots reached the \$300 million level.

The \$519 million sales goal for MEGA Millions is somewhat conservative as it assumes zero jackpots reaching the \$300 million level during the fiscal year. This sales goal does include expectations that the advertising initiatives in the Business Plan will continue to provide year-over-year increases in sales at comparable jackpot levels as seen in Fiscal Year 2010-11.

Daily Games

The sales goal for Daily Games (Fantasy Five, Daily Derby, Daily 3 and Daily 4) is \$328 million. This level is slightly below projected year-end sales of \$330 million Fiscal Year 2010-11. There are currently no Business Plan initiatives targeted for Daily Games in the upcoming fiscal year. As such, sales goals for the Daily Games are based on sales trends for each product.

Hot Spot

A sales goal of \$140 million is proposed for Hot Spot for Fiscal Year 2011-12, an increase of \$10 million (8 percent) over estimated sales of \$130 million for Fiscal Year 2010-11. This is noteworthy because hitting \$130 million in sales in the current year will be the first time in five years that sales have increased over the prior year. This turnaround is attributable to higher prize payouts and periodic promotions for the game. Continued sales growth for Hot Spot in Fiscal Year 2011-12 is based on Business Plan initiatives to increase the top number of spots players may select (from the current 8 spots to 10 spots), corresponding increases to prize payouts, addition of a rolling top prize feature, and continued promotions for the game.

Expenses

Prize Expenses

The proposed sales goals in the Fiscal Year 2011-12 budget are supported by higher prize payouts, primarily for the Hot Spot game and the Scratchers product line that includes the introduction of the Lottery's first ever \$10 Scratchers game. Prize Expenses are budgeted at \$2.390 billion which is \$477 million (25 percent) above the expected prize level of \$1.913 billion for Fiscal Year 2010-11.

Continuation of the Lottery's strategy of utilizing higher prize payouts to increase sales is reflected in the aggregate change in prize payouts from 55.9 percent of sales in Fiscal Year 2010-11 to 58.4 percent of sales in Fiscal Year 2011-12. This increase in prize payouts is one of the key drivers for the projected sales growth in Fiscal Year 2011-12.

Administrative Expenses

AB 142 amended the Lottery Act to limit the Administrative Expense budget to no more than 13 percent of total annual revenues. The Administrative Expense budget is comprised of retailer compensation, game operating costs, the marketing plan, and general administration expenses.

Total budgeted Administrative Expenses are \$532 million, an increase of \$86 million (20 percent) over Fiscal Year 2010-11 expected year-end expenses. This

increase is directly proportional to the expected increase in sales for Fiscal Year 2011-12. However, it is important to note the lion's share of this increase results from the cost of selling Lottery products i.e. 1) retailer compensation costs and 2) game operating costs.

Retailer compensation costs of \$281 million account for 53 percent of the Administrative Expense budget for Fiscal Year 2011-12. This represents an increase of approximately \$48 million (20 percent) over expected Fiscal Year 2010-11 retailer compensation costs and is attributable to the higher sales goals for the upcoming fiscal year.

Game operating costs are budgeted at \$76 million. This budget category includes the cost of operating the gaming system, acquisition of gaming equipment, installation and maintenance of gaming equipment, and production and distribution of Scratchers tickets. The proposed budget for game operating costs is a 31 percent increase over estimated Fiscal Year 2010-11 year-end expense levels. The increase is directly related to the projected sales growth in Fiscal Year 2011-12 as well as costs associated with the acquisition of new gaming equipment in the upcoming fiscal year.

The remaining Administrative Expense budget which includes personnel costs, advertising/marketing costs, base operating costs and funding for Business Plan initiatives, is budgeted at \$175 million. This reflects an increase of only \$20 million (13 percent) over Fiscal Year 2010-11 estimated expense levels. The increase is primarily to fund additional advertising/marketing costs and other business plan strategies to drive the higher sales goals contained in this budget. In addition, base operating costs were reduced nearly \$500,000 as a result of identifying efficiencies, eliminating non-essential activities and reevaluating past business practices in light of the current fiscal environment.

This budget also continues the long-standing practice of providing an administrative spending reserve as a safeguard against future uncertainties. The proposed Administrative Reserve is set at \$16 million for Fiscal Year 2011-12. The Administrative Reserve is an element of the 13 percent of total revenues specified for Administrative Expenses. While the proposed reserve is significantly higher than the \$2 million approved in each of the Lottery's prior two fiscal years' budgets, it is only 3 percent of the entire Administrative Expense budget.

Consideration was given to utilizing a portion of the Administrative Reserve for additional sales generating initiatives. However, this proposed budget projects a nearly 20 percent growth in sales over the current year with much of that growth being contingent upon the projected impact of a multitude of Business Plan initiatives. The staff's recommendation is to retain \$16 million in reserve to allow

time to evaluate the results of those initiatives. This approach also provides the Commission and the Lottery the flexibility to take advantage of sales growing opportunities that may emerge over the course of the upcoming year. Any portion of the Administrative Reserve remaining at the end of the fiscal year will be transferred directly to public education.

Summary

The proposed Fiscal Year 2011-12 Budget contains sales goals of over \$4 billion, nearly a 20 percent increase over expected sales for Fiscal Year 2010-11 and the highest sales level in California State Lottery history. This will generate \$1.2 billion in contributions to California public schools, an increase of \$100 million over the contribution level projected for Fiscal Year 2010-11. This translates to a 10 percent increase over expectations for the current fiscal year and will mark the 12th consecutive year the Lottery will surpass a billion dollars in contributions to public education.

While the \$4 billion sales goal for Fiscal Year 2011-12 is at an unprecedented level, it is based on execution of a vast array of Business Plan initiatives designed to result in sustainable growth of future revenues. And for the first time in several years, the proposed budget includes a healthy reserve that provides the Commission with the flexibility to take advantage of sales growing opportunities while also serving as a safeguard against uncertainties in the upcoming fiscal year.

Attachment

**CALIFORNIA STATE LOTTERY
FISCAL YEAR 2011-12 BUDGET**

(Dollars in Millions)

	Year-End Estimate <u>FY 2010-11</u>	<u>Change</u>	<u>% of Change</u>	Proposed Budget <u>FY 2011-12</u>
SALES	\$3,423	\$667	19.5%	\$4,090
PRIZE EXPENSE	\$1,913	\$477	24.9%	\$2,390
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Net Revenue after Prizes	\$1,510	\$190	12.6%	\$1,700
ADMINISTRATIVE EXPENSES				
Retailer Compensation	\$233	\$48	20.5%	\$281
Game Operations	\$58	\$18	31.1%	\$76
Marketing Plan	\$56	\$10	18.0%	\$66
General Administration	\$87	\$6	7.5%	\$93
Administrative Reserve	\$12	\$4	35.5%	\$16
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Total Administrative Expenses	\$446	\$86	19.4%	\$532
EDUCATION REVENUE				
Contribution to Education	\$1,064	\$104	9.8%	\$1,168
Interest and Other Income	\$2	\$0	-	\$2
Unclaimed Prizes	\$25	-\$4	-	\$21
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Total Revenues for Education	\$1,091	\$100	9.1%	\$1,191