



M E M O R A N D U M

Date: September 27, 2012

To: California State Lottery Commission

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Director

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Subject: Item 8(a) – Fiscal Year 2012-13 Budget Amendment

ISSUE

Should the California State Lottery Commission (Commission) approve amendments to the California State Lottery's (Lottery's) Fiscal Year 2012-13 Budget to include (1) implementation of a \$2 Powerball game, (2) an increase in Scratchers sales generated from business strategies focusing on the CVS store chain, (3) elimination of Retired Annuitant and Student Assistant positions and establishment of 35 additional permanent positions, and (4) other required adjustments?

These amendments to the Fiscal Year 2012-13 Budget, adopted by the Commission on June 21, 2012, are projected to produce an additional \$11.4 million in profits thereby increasing the contribution to education to \$1.326 billion this fiscal year.

RECOMMENDATION

Staff recommends the Commission approve the proposed amendments to the Lottery's Fiscal Year 2012-13 Budget.

BACKGROUND

On June 21, 2012, the Commission adopted the Lottery's Fiscal Year 2012-13 Budget. This budget was based on a sales goal of \$4.830 billion, generating \$1.314 billion in profits to California public education. In direct support of these goals, the approved budget included funding for 663 permanent and 29 Retired Annuitant and Student Assistant positions.

The Fiscal Year 2012-13 Budget included funding to assess the addition of the multi-state Powerball game in California. Our research concluded that adding

the Powerball game to the Lottery's draw games portfolio would significantly increase profits to public education. That research along with analysis of the Lottery's product strategies also indicated the optimum time to launch Powerball in California would be the spring of Fiscal Year 2012-13.

The Fiscal Year 2012-13 Budget also included a Retailer Recruitment Business Plan initiative. One of the areas of focus in this initiative is widening the Lottery's game selling platform of our existing "chain" retailers. We have achieved success in strengthening our partnership with the CVS store chain for Fiscal Year 2012-13.

Additionally, in the latter part of Fiscal Year 2011-12, the Lottery initiated efforts to reduce reliance on Retired Annuitants and Student Assistants among the workforce. The Lottery has developed a plan to phase out the remaining Student Assistant and non-mission critical Retired Annuitant positions by the end of the Fiscal Year 2012-13.

The proposed amended Fiscal Year 2012-13 Budget reflects the expected increase in sales and the impact on expenses of the items described above. The amended budget is projected to produce an additional \$11.4 million in profits thereby increasing the contribution to public education to \$1.326 billion for Fiscal Year 2012-13.

DISCUSSION

As stated previously, the Commission approved the Fiscal Year 2012-13 Budget based on a sales goal of \$4.830 billion with a net of \$1.314 billion generated in profits for public education. This was based on effective implementation of the Business Plan Initiatives and other operational improvements that would set the foundation for increased growth in contributions to public education, now and in the future.

The proposed amendments to the approved budget include funding for an April 2013 launch of the Powerball game in California and the direct cost associated with the expected increase in sales, Scratchers sales increases, changes in the make-up of the Lottery workforce, and other required adjustments to operating expenses. A summary of the proposed elements for the amendments to the Fiscal Year 2012-13 Budget is presented below.

Introduction of Powerball in California

As the Fiscal Year 2012-13 Budget was being presented for Commission approval, the Lottery was assessing adding the multi-state Powerball game to the Lottery's draw games portfolio. The Fiscal Year 2012-13 Budget already includes \$2.9 million for Powerball related costs, including funding for research to aid in the decision on whether or not to bring Powerball to California. The

budget also includes funding for start-up costs as a contingency in case the decision was made to launch Powerball early in Fiscal Year 2013-14.

Our research on the impacts of introducing Powerball in California has been completed. Analysis of the research and impact studies indicates the 40+ states that began selling both MEGA Millions and Powerball experienced a net increase in sales. The analysis also suggests that California would net a projected \$90 million to \$120 million in sales in the first full year of adding and supporting Powerball. Actual Powerball sales are projected to be greater than \$120 million, however, sales of SuperLotto Plus and MEGA Millions products can be negatively impacted as a result of some existing players redirecting limited disposable income to the new Powerball game.

The Lottery is recommending introducing Powerball in California. As previously mentioned, the Fiscal Year 2012-13 Budget includes funding for start-up costs in case the decision is made to launch Powerball in California during the first quarter of Fiscal Year 2013-14.

However, the Lottery consulted with industry experts and the Multi-State Lottery Association (MUSL) that hosts Powerball and received advice against launching Powerball during the summer months. Lotteries across the United States, including California, historically experience lower sales during the summer months. Therefore, the Lottery began reevaluating an optimal launch date for Powerball.

Staff reviewed the Scratchers product plan for next fiscal year and concluded postponing introduction of Powerball until the fall of Fiscal Year 2013-14 (to avoid the summer months) would result in the Powerball launch competing with the introduction of the Lottery's first \$20 Scratchers game planned for that time period.

Consequently, the Lottery is proposing introducing Powerball in California this Fiscal Year with launch targeted for April 2013. The chart below shows the expected increase in sales for three months of Powerball combined with MEGA Millions sales (+\$58 million) and the projected impact on SuperLotto Plus sales (-\$28 million) for a net increase in sales of \$30 million in Fiscal Year 2012-13.

Comparison of Revenues Approved FY 2012-13 Budget and Proposed Amended FY 2012-13 Budget (Dollars in Thousands)			
SALES:	Approved Budget FY 2012-13	Change	Proposed Budget FY 2012-13
SuperLotto Plus	\$423,000	(\$28,000)	\$395,000
Fantasy 5	\$166,000	\$0	\$166,000
Daily 3	\$137,500	\$0	\$137,500
Hotspot	\$160,000	\$0	\$160,000
Daily Derby	\$12,000	\$0	\$12,000
Daily 4	\$29,500	\$0	\$29,500
MEGA Millions/Powerball	\$592,000	\$58,000	\$650,000
Scratchers	\$3,310,000	\$10,000	\$3,320,000
TOTAL, ESTIMATED SALES	\$4,830,000	\$40,000	\$4,870,000

The Lottery's strategy to grow our draw games portfolio is to differentiate new games from existing games to ensure new games sales do not come at the expense of established draw games sales. To successfully launch a new draw game, players and retailers need to clearly understand key game attributes and benefits that each game in the portfolio offers.

This distinction will differentiate our draw games and enable the Lottery to be less reliant on a single game's large jackpot to drive sales. In order to achieve this distinction, additional funding in the amount of \$724,000 is requested to offer various promotions both to our customers and retailers. These promotions will include mall tours, participation at various festivities and events, and "ask-for-the-sale" promotions. This amount will augment the \$2.9 million already included in the Fiscal Year 2012-13 Budget for total start-up funds of \$3.6 million for Powerball.

Other expenses related to the implementation of Powerball include Prize Expense, Retailer Compensation, Game Costs and Personal Services*. These costs are included in the display of the revised budget (Attachment 1). This investment in Powerball in Fiscal Year 2012-13 will set the foundation for growth in draw game sales for future years.

* The Lottery Act requires that Lottery staff are to be on site during all draws in which the Lottery participates. Funding is needed for two part-time employees to audit Powerball draws conducted in Florida.

Increase in Scratchers Sales from CVS Stores

One of the Fiscal Year 2012-13 Business Plan Initiatives is to develop and execute a Retailer Recruitment Plan. Already this fiscal year, we have been successful in strengthening our partnership with the CVS store chain.

Currently CVS has 939 stores in California with plans to expand. 590 of these stores sell Lottery products. And 362 of these stores function under the Route Service Model.

The Route Service Model involves the placement of Scratchers ticket vending machines within the CVS stores. These vending machines are fully serviced by the Lottery's Route Service Representatives (RSRs). Under this model, there is less work required of the retailer and the Lottery has the benefit of ensuring the vending machines are stocked with the ideal product mix for customers.

Sales under the Route Service Model average \$2,886 per week, per CVS store compared to average sales of \$1,281 per week for non-Route Service Model CVS stores. Our goal is to convert 205 existing CVS retailers to the new Route Service Model and add 314 new CVS stores functioning under this model. The conversion and addition of CVS retailers selling Lottery products under the Route Service Model is expected to generate an additional \$10 million in sales for Scratchers products this fiscal year.

To support the increase in CVS stores operating under the Route Service Model, we are requesting approval to add 15 Lottery Route Sales Representative (RSR) positions to the sales force. The proposed amended budget also includes funding of \$61,839 for a corresponding number of vehicles for the 15 RSRs and the essential equipment (e.g. Ultrabooks and BlackBerry devices) required to support these new positions.

Expansion of the Route Service Model for existing and new CVS stores is expected to generate an additional \$10 million in Scratchers sales in the latter part of this fiscal year. Prize Expense, Retailer Compensation, and Game Costs associated with this increase in Scratchers ticket sales are included in the display of the revised budget (Attachment 1).

Elimination of Temporary Positions/Establishment of New Positions

In June 2012, a provision in the Governor's 2012 "May Revise" of the State Budget, as well as a side letter labor agreement with the Service Employees International Union (SEIU) and other unions, required elimination of Student Assistant positions and non-mission critical Retired Annuitants by September 1, 2012. State departments were instructed to review the utilization of these "temporary" employees to ensure only employees deemed critical to the department's core mission were retained.

The Lottery had already initiated the phase out of “temporary” employees in Fiscal Year 2011-12. During the prior fiscal year, 24 Student Assistant and Retired Annuitant positions were eliminated.

In support of the statewide mandate, Lottery management continued evaluation of current staffing and developed a plan to phase out the remaining “temporary” employees. As a result of this in-depth review, all non-mission critical Retired Annuitants and civil service Student Assistants were dismissed as of September 1, 2012.

Mission critical Retired Annuitants were identified and approved by the Lottery Director to be phased out over the remainder of the fiscal year. By June 30, 2013, an additional 29 “temporary” positions will be eliminated for a total of 53 “temporary” positions eliminated over the two fiscal years.

The elimination of “temporary” staff had an immediate workload impact on the Lottery. During the phase out of “temporary” staff, the Lottery attempted to address the elimination of Student Assistants and Retired Annuitants by redirecting permanent staff in order to continue to provide basic products and services. It became apparent the loss of the support provided by the 53 “temporary” positions was negatively impacting operations.

The Lottery is requesting approval of 20 additional permanent positions to address workload needs primarily as a result of the phase out of “temporary” positions. Each of the 20 positions were vetted by senior management to ensure they are 1) necessary to ensure successful execution and support of the Lottery’s Business Plan initiatives or 2) are essential for critical operational activities or delivery of project-related support. The list of positions and the corresponding justifications were reviewed and approved by the Lottery Director with the understanding that final approval would be made through the Commission.

A total of 35 additional positions are requested (including 15 RSR positions to service CVS stores) which would bring the Lottery’s authorized permanent positions to 698 (from 663). Of the 35 additional positions, 22 positions are directly related to efforts to recruit and service additional retailers. The remaining 13 positions are needed to ensure fundamental operational needs are met as a result of staff reductions stemming from the statewide mandate to eliminate “temporary” employees.

The budget impact of the reduction in “temporary” positions and the addition of permanent positions is a net increase of \$674,697 in the Personal Services Budget category.

Other Required Budget Adjustments

Since approval of the Fiscal Year 2012-13 Budget in June 2012, efforts have been underway to accomplish the aggressive goals proposed by the Lottery and approved by the Commission. While these initial endeavors are proving successful, they have also revealed opportunities for business process improvements to ensure sustained success. These opportunities as well as other required adjustments are summarized below within the Personal Services, Contractual Services and Operating Expense budget line-items.

Personal Services

- a) The Fiscal Year 2012-13 Budget was developed prior to implementation of the State-mandated Personal Leave Program (one-day of leave without pay each month), effective July 1, 2012. As such, the approved budget included a full salary allocation for all permanent positions. The amended budget will now reflect a reduction of \$1.0 million to the Personal Services line item to reflect "savings" from the State-mandated Personal Leave Program.
- b) The Fiscal Year 2012-13 Budget included \$5 million for Other Postemployment Benefits (OPEB). OPEB benefits consist of health insurance and other benefits provided to eligible retirees and their beneficiaries. In accordance with Generally Accepted Accounting Principles (GAAP), accrual accounting and reporting rules must be applied to OPEB obligations; thereby requiring the cost to be posted in the financial statements.

The State Controller's Office (SCO) provides prior year OPEB obligations to all state agencies in late August of each year. For the past few years, OPEB obligations have ranged from approximately \$4 million to \$5 million. However, SCO has indicated that OPEB contributions for Fiscal Year 2011-12 have been calculated at \$6.4 million, and are expected to increase due to the growing number of employees planning to retire. Therefore, the amended budget has been adjusted to include \$7 million for OPEB obligations, an increase of \$2 million from the Fiscal Year 2012-13 approved budget.

- c) The approved Fiscal Year 2012-13 Budget included 11 new positions to support the Retailer Recruitment Plan initiative. The funding in the budget assumed the positions would be filled by April 2013. The Lottery has accelerated action on strategies in the Recruitment Plan. The amended budget reflects a request to provide funding (\$292,974) to advance the filling of these new positions to September 2012.

- d) A core function of the Security/Law Enforcement Division (SLED) is to ensure integrity in the sale of Lottery products. The approved Fiscal Year 2012-13 Budget included overtime funds for SLED based on projected needs at the time of budget development. However, a significant increase in cases related to stolen tickets and questionable claims and a renewed focus on retailer probation monitoring has resulted in growing backlogs. The amended budget reflects a request to augment overtime funds (\$75,000) to allow SLED investigators to manage the increased workload.

Attachment 2 summarizes the recommended changes to the Personal Services category of the budget that results in a net increase of \$2.027 million and a total of 698 permanent Lottery positions.

Contractual Services

The Fiscal Year 2012-13 approved budget included allocations for contractual services required to achieve the Lottery's Business Plan Initiative objectives. Recent changes in business priorities and requirements have resulted in a modification of planned contractual services. Attachment 2 displays the itemized changes that have resulted in a net reduction of \$231,836 to the Contractual Services budget category.

Operating Expenses

- a) Lottery awareness is a key element to increasing sales and the contribution to education. In addition to paid or earned media to convey consistent branding of the Lottery image to its consumers and retailers, Lottery management has identified an untapped, yet vital component to increasing Lottery brand cognition – through its field representatives who serve as walking ambassadors of the Lottery.

Supplying Lottery employees, who service the retailer network on a daily basis, with clothing emblazoned with the Lottery logo conveys a professionally coordinated, consistent, and easily identifiable image of the Lottery. Therefore, it is requested that funding in the amount of \$51,000 be made available for the purchase of Lottery apparel for designated field representatives.

- b) Available staff resources were reallocated to the Investigator classification within SLED and various field representative positions within the Sales and Marketing Division. Thus, to accommodate the reclassification of positions and the daily operational functions, an additional 7 vehicles in the amount of \$14,000 is requested.

- c) The Lottery has contracted to build a parking lot on the site of the old Headquarters for utilization by visitors, staff, and those taking light rail. A lighted walkway will also be built to accommodate access to the new light rail station on Richards Boulevard. It is anticipated that outside foot and vehicle traffic will increase dramatically once the parking lots and path to light rail are fully operational. Historical data and research studies indicate 80% of crimes in offices, malls and other retail outlets take place in the parking lot. This translates to approximately one-third of security liability lawsuits filed. Additionally, settlements average \$1 million to \$2 million, depending on the severity of the crime.

Consequently, after careful consideration, the Lottery requests a one-time investment of \$37,473 to purchase and install surveillance cameras as a means to monitor and deter criminal activity. Funding to purchase the surveillance equipment is being requested at this time as the project to build the parking lot was not formulated until after the approval of the Fiscal Year 2012-13 Budget. Attachment 2 displays the breakdown of this total as \$27,664 in Contractual Services to install the surveillance equipment; and \$9,809 for the purchase of the surveillance cameras.

- d) The Lottery Headquarters building is currently "self-insured". Based on this status, the Lottery recognized that this could place the Lottery in a position of significant loss due to unforeseen or uncontrollable circumstances. Therefore, a \$40,000 placeholder in the budget is being requested until research is completed to identify building insurance premium costs.

Attachment 2 summarizes the recommended changes to the Contractual Services and Operating Expense budget categories. These changes result in a total decrease of \$52,000 from the approved Fiscal Year 2012-13 Budget.

Budget Summary

The proposed amendments to the Fiscal year 2012-13 Budget contain sales goals of \$4.870 billion reflecting a \$40 million increase above the approved Fiscal Year 2012-13 Budget. The net effect of the proposed changes in the amended budget is an increase of \$11.4 million in contributions to public education for a total of \$1.326 billion this fiscal year.

It is also important to emphasize that the amendments contained in this proposed budget continue the strategy for the Fiscal Year 2012-13 Budget to

reflect a balanced approach between actions that will increase sales over record-setting levels of Fiscal Year 2011-12 as well as prudent investments that will provide greater contributions to public education in years to come.

Attachments