### CALIFORNIA STATE LOTTERY COMMISSION

Minutes – December 9, 2010 Sacramento, California

#### 1. Call to Order

Chairperson John Mass called the public meeting of the California State Lottery Commission to order at 9:30 a.m. at the California State Lottery Headquarters, 600 North 10<sup>th</sup> Street, Sacramento, CA 95811

### 2. Pledge of Allegiance

John Mass led the Pledge of Allegiance.

# 3. Roll Call

Mass asked Elisa Topete to call the roll.

#### **Commission Members Present:**

Commissioner Yuri Vanetik Commissioner John Menchaca Chairman John Mass

#### CSL Staff and presenters:

Joan Borucki, Director
Linh Nguyen, Chief Deputy Director
Lisa Hightower, Chief Legal Counsel
Michael Ota, Deputy Director of Finance
Michael Brennan, Deputy Director of Sales and Marketing
Jim Hasegawa, Deputy Director of Business Planning
Elisa Topete, Assistant to the Commission
Mary Montelongo, Recording Secretary

# 4. Consider Approval of the Agenda

Mass asked if any of the Commissioners wanted to make changes to the December 9, 2010 agenda as proposed. Joan Borucki, Director, stated that there would not be a closed session. Menchaca moved to approve the amended agenda. Seconded by Vanetik. The motion passed unanimously (3-0).

## 5. Approval of Minutes

Mass asked if there were any additions or corrections to the October 28, 2010 minutes. Menchaca moved to approve the October 28, 2010 minutes. Seconded by Vanetik. The motion passed unanimously (3-0).

### 6. Commission Liaison Reports

#### **Commissioner Menchaca:**

Menchaca provided the Audit Liaison Report. Beginning with the State Controller's Office (SCO), field work began on the Fourth Quarter Transfer Report Analysis for Fiscal Year 2010 in May 2010 and has been completed. An exit conference is pending and as of today, six preliminary findings were noted. Initial field work began on the 3 Ball Production Contract in February 2010 and was completed in June 2010. On July 22, 2010, SCO expanded their audit scope. Additional field work has been completed and an exit conference is pending. As of today, six preliminary findings were notes. Field work began on the Alcone Marketing Group Contract in September 2010 and is expected to last through the end of December 2010. As of today, no preliminary findings were noted. Field work began on the Otto Construction Contract in October 2010 and is expected to last through the end of February 2011. As of today, no preliminary findings were noted. Field work began on the LPA Sacramento Inc. Contract in October 2010 and is expected to last through the end of January 2011. As of today, no preliminary findings were noted.

On the KPMG Audits, field work began on the Financial Statement Audit as of June 30, 2010. The final report was issued on October 20, 2010 and no findings were noted. KPMG continues to observe and report on the Lottery's daily draws. There are no significant findings to report. For the Lottery's Internal Audits, field work began on the Contract and Procurement Services Audit in January, 2010 and is on hold. As of today, no preliminary findings were noted. Field work began on the Camelot Contract in August 2010 and is expected to last through the end of December 2010. As of today, no preliminary findings were noted. Field work began on the Asset Management Audit in August 2010. The audit scope expanded in November to include the inventory of Scratchers® tickets. Field work is expected to last through the end of February 2011 and as of today, no preliminary findings were noted. Lastly, the Audit Committee will have an informal meeting following today's Commission Meeting.

### **Chairman Mass:**

As Marketing Liaison, Mass was updated on the Holiday Scratchers Advertising which is supporting the Holiday Scratchers products with a statewide advertising campaign. The advertising strengthens the key message, "Scratchers now have over \$50 million more in prizes every month." The ads encourage consumers to purchase Scratchers as a great gift for family and friends. The campaign starts on November 29 and runs four weeks until December 26. The advertising elements include TV, radio, outdoor, gas screens, grocery screens, online banners, and instore point-of-sale. The TV commercial features a talking reindeer and a very tired Santa. This year, Scratchers are now merrier with over \$50 million in prizes every month. Scratchers equal big gifts in small packages. The Lottery is offering four new Holiday Scratchers: \$5 Winter Green, \$3 Season's Gold, \$2 Holiday Cash, and \$1 Happy Holidays. The air dates are 11/29-12/26.

The 25<sup>th</sup> Anniversary \$25,000 bonus draw is doing well. The winner of the bonus draw of \$25,000 for this promotion will be posted by December 10, 2010. The jackpot alerts update is that MEGA Millions® specific messages support jackpots of \$50 million or more in Los Angeles and \$70 million in San Francisco, are continuing. The Lottery is also continuing the NFL Second-Chance Program. The final drawings from the NFL promotions were held last week and there were almost 640,000 tickets entered during the promotion period. The leader was the Raiders with 270,000 entries; second is the 49ers with 195,000 entries; and third is the Chargers with 173,000 entries.

As Procurement Liaison, Mass was briefed by staff and requested approval of the following: A contract with Surewest Broadband to provide data center co-location services for the Lottery's Disaster Recovery Site, and a Solicitation Brief for Office Moving Services for the Lottery's new headquarters building. Staff will issue an Invitation to Bid to invite responses from qualified Bidders to provide moving services for the upcoming move of the headquarters staff into the new building.

### 7. Director's Report

Borucki congratulated Corporate Social Responsibility (CSR) Deputy Director Susan Kossack who finished the preparation and printing of the Lottery's first CSR plan. The Lottery will now forward its application to the World Lottery Association, who is responsible for the Responsible Gaming Certification. Borucki gave the Commissioners a copy of the plan as well as a video clip that celebrates the Lottery's 25<sup>th</sup> Anniversary.

#### a. Lottery Report Card

Linh Nguyen, Chief Deputy Director, updated the Commissioners with the Lottery Report Card and sales. For sales, the Lottery is about \$225 million short of the original projections for the first 22 weeks of the year and is catching up. In early September, the Lottery was about 85 percent of its sales goal and is now at 94 percent and still gaining. The Lottery will be on target for its sales goals in the jackpot games, the Daily Games, and Hot Spot®. Scratchers sales are now 24.4 percent higher than a year ago. Total Lottery sales through November 27 were just over \$1.1 billion, which is 8 percent higher than sales would have been without prize payout relief and the initiatives from the RENEW Project. However, sales for the first time in five months are running at 85 percent of the goal to date, or a little more than \$215 million short of projected sales for this time period.

The jackpot games are running on pace with the sales goal, although year-to-date sales for MEGA Millions are just 91 percent of the goal; there have been very modest jackpots so far this year. By comparison, the largest jackpot this year has only been \$140 million. By this time last fiscal year, MEGA Millions had already seen a \$336 million jackpot. The jackpot games are measured by comparing similar sized jackpots and sales at those jackpot levels. When that comparison is done, staff sees that sales for MEGA Millions are 23 percent higher than sales for prior

draws at comparable jackpot levels. Staff contributes this to the advertising campaign.

SuperLOTTO Plus® continues to have slightly declining sales, however relative to comparable jackpots, current year sales are down about 6 percent. The Daily Games continue to perform as originally anticipated and are on pace to meet their sales goals for this fiscal year. Hot Spot sales are over \$49 million so far this fiscal year. While it is slightly short of the pace needed to meet the goal, staff anticipates that annual sales should be reached as the start of the higher prize payout strategies for Hot Spot are only beginning to be implemented.

Scratchers sales are \$680 million through November 27 and while sales are about 14 percent above what would have been expected without prize payout relief in the RENEW Project, it is currently tracking at just 77 percent as of November 27. Sales from the \$5 Scratchers game has been growing over this fiscal year as more of these games are being introduced and carried by retailers. In the past three months, the average number of games sold at retail has gone up from 1.3 games faced, to 3.3. games faced, which is an increase from 11 percent of sales in Scratchers to 24 percent of all sales. The gap in Scratchers sales relative to its goals should continue to be reduced over the next couple of months with the Holiday advertising campaign underway and the retail strategies being implemented statewide.

Scratchers sales spikes are typical and consistently occur at the beginning of each month which may or may not be the result of new game launches, or people simply getting paid at the beginning of each month. Sales beginning for the fiscal year almost match exactly from the prior year however for the week ending September 11 sales start to break away rather dramatically. Staff believe the breakout is due to several factors, most notably the higher price point tickets as a result of AB 142. The Lottery also started the statewide Scratchers advertising campaign, which began on September 13. In addition, several of the RENEW efforts including the sales force's effort to communicate to retailers was also underway. For week ending November 20, sales are 23.1 percent ahead of last year's sales and are continuing to grow. The most recent data for the week ending December 4 shows that sales are 24.4 percent higher than the same week last year. Staff is predicting that in the next weekly report, sales will be at least 26 percent higher than last year.

Nguyen provided some project updates including the Ex\$ell Program, which will roll out the best practices statewide. The teams have visited and trained all nine Lottery district offices. The Sales Advisory Board conducted its first meeting, which was reported very successful. The Marketing Communications project is beginning with "As is" mapping of all of the current processes and will then move into the recommendations phase of the project. The Jackpot Games project is changing its focus away from multi-state games and is focusing on possible changes to SuperLOTTO Plus to stem the downward trend.

#### b. 1009-10 Financial Statements

Borucki stated that pursuant to Government Code, the Lottery engages in an independent firm of Certified Public Accountants to conduct an annual audit of all the Lottery's accounts and transactions. KPMG conducted the 2009-10 annual audit for the Lottery. KPMG has prepared them in accordance with generally accepted accounting principles and are distributed to the Governor, the State Controller, the State Treasurer, the Attorney General, and the California State Legislature per statute. The June 30, 2010 financial statements are included in the Lottery Commission public meeting booklet. The financial statements reflect approximately \$45 million that were realized from the Lottery's investment portfolio restructuring. At year end, the Lottery requested the State Controller's Office to transfer \$266 million to the Lottery Education Fund for the final quarter of the fiscal year, bringing the total amount transferred to \$1.089 billion. The Lottery accrued \$6.75 million for legal contingencies for various litigations, including the legality of furloughs for State employees. Discussion by Commissioners.

### 8. Consent Calendar

a. Ratification of Contract Amendment to Change the Name of Contractor and Payee from HSM to Stanley Convergent Security Solutions, Inc.

Vanetik made the motion to approve Consent Calendar Item 8(a). Seconded by Menchaca. The motion passed unanimously (3-0).

## 9. Action Items

a. Lottery Investment Policy and Strategy

Michael Ota, Deputy Director of Finance, stated that the Lottery's investment policy requires that the investment strategy and policy be reviewed annually and approved by the Commission. Prior to January 2009, the investment policy was to purchase U.S. Treasury bonds to provide the cash flow to pay the Lottery's annuity prize winners. During fiscal year 2008-09, the Lottery saw an opportunity to leverage its investment portfolio of over \$1 billion of U.S. Treasure bonds to generate additional resources for public education.

The proposal for investment restructuring was first introduced in January of 2009, when staff requested and received Commission approval to broaden the allowable investments from U.S. Treasury bonds to include agency and municipal bonds. The strategy was to sell the U.S. Treasury bonds and purchase higher-yielding, high-credit quality agency and municipal bonds to generate net proceeds. And those net proceeds would then be reinvested into the business to generate a greater contribution to education.

The Lottery's investment restructuring activities spanned two fiscal years. In 2008-09, the Lottery generated \$16 million of additional proceeds for its use. In 2009-10, the Lottery generated an additional \$45 million in net proceeds and 34 percent of those dollars went to education, and the remainder was

utilized to increase prize payouts, to fund marketing efforts, and to fund some of the Lottery's RENEW efforts. The end result was that the proceeds allowed the Lottery to generate greater contributions to education.

The investment restructuring strategy was always a short-term plan. It focused on taking advantage of the financial market conditions at the time. The restructuring efforts were performed under guiding principles for prudent investment of funds by public entities and are documented in a comprehensive investment policy that the Commission approved December 2009.

A major focus of the investment policy is mitigation of risk which is accomplished by requiring a minimum credit rating of the Lottery's investments, requiring a diversified mix of investments, and also managing a small reserve fund. Requirement of the investment policy is that the Commission approves the Lottery's strategy annually, and also the investment policy. For the investment strategy, which was the short-term plan, staff accomplished its goals by the end of last fiscal year. For 2010-11, staff is recommending that the investment strategy be limited maintenance activities, which include business-as-usual purchasing of U.S. Treasury bonds for all of the new annuity prize winners, and also any monitoring and managing of the investment portfolios to mitigate risk.

For the investment policy, staff reviewed what was accomplished through the Lottery's investment restructuring efforts, more importantly the manner in which it was accomplished. Staff has reviewed the investments and internal controls and has concluded that no substantive revisions are required for the investment policy. However, staff is requesting one minor revision to the policy. The current policy states that the Commission will approve the investment strategy and policy by resolution. Staff is requesting that the policy be revised to remove reference to "Commission approval by resolution," and be replaced by "Commission approval by vote." In conclusion, staff is requesting the Commission to approve the Lottery's investment strategy and the revised investment policy. Discussion by Commissioners. Borucki thanked State Treasurer Bill Lockyer for his staff's assistance in accomplishing the restructuring and also sponsoring a piece of legislation that enabled the Lottery to purchase State of California bonds.

Mass asked if anyone from the audience had any questions on Action Item 9(a). No one came forward so he proceeded to the motion of approval.

Menchaca made the motion to approve Action Item 9(a). Seconded by Vanetik. The motion passed unanimously (3-0).

#### b. Amendment to Business Planning Contract

Nguyen stated that in June 2009, the Commission approved a consulting contract with Camelot for assistance in developing and implementing the Lottery's business plan, with a total expenditure authority of \$13.5 million to cover a four-year contract period from July 2009 through July 2013. The proposed contract amendment will allow the Lottery to continue the use of Camelot services.

The following amendments to the contract are proposed: Removal of the 400 contract day limit, with replacement to an annual invoicing limit that is aligned to a resourcing plan set out in the issue memo, including a tolerance of up to 20 percent. Second, the staff day cap for Phase 2, which is implementation support for the RENEW Project, will be increased from 1,000 days to 3,913 days. The expenditure cap for Phase 2 will be increased from \$900,000 to \$3,521,000. The staff day cap for Phase 3, which is project management support, will be increased from 744 days to 949 days. And the expenditure cap for Phase 3 will be increased from \$1.2 million, to \$1.684 million. The maximum possible performance fee to be earned by Camelot will be reduced from \$10 million to \$6.895 million, which is a reduction of \$3.105 million.

The following contract terms will not change: The total contract amount will remain at \$13.5 million. The rate for implementation support will remain at \$900 a day and the rate for project management support will remain at \$1,613 a day. The performance fee rebate at \$5 million will also remain the same.

Mass stated that he was happy with what Camelot has done for the Lottery and Lottery staff feels comfortable working alongside the staff from Camelot. By asking for an increase in the amount of staff and hours, it is increasing their fees significantly from \$900,000 to \$3.5 million in Phase 2 as well as increasing the amount of days Camelot will be on site at the Lottery. However, it is making Lottery staff very reliant on an outside firm as opposed to Lottery staff managing and operating the Lottery. The way the contract was originally structured was to be back-end weighted or balanced where Camelot can make money, but also had the incentive by the Lottery's success. If the Lottery and Camelot succeeded together, then there was an opportunity for Camelot to have a performance bonus. Because the current proposal reduces the performance bonus and increases the front-end pay, it is a concern. Mass asked if staff analyzed the increase in days and staff to see if some of the work could be performed by Lottery staff to reduce the fees paid to Camelot.

Borucki stated that Camelot is in an advise-and-consult role with the Lottery therefore Camelot is not actually dong the work, Lottery staff is and are doing wonderfully. The Lottery is basically learning a new way to approach the

business but unfortunately when the original contract was produced, it was before the completed As-is assessment and the business plan. The scope was a lot larger than staff had anticipated when the contract days were figured in. It has expanded well beyond just the Sales force; to the Marketing, to the way research is performed, to the involvement and insights from Lottery players and the information about the product, and finally how the Lottery is packaging it all to be able to make better business decisions.

Michael Brennan, Deputy Director of Sales and Marketing, spoke of the Marketing efforts to implement a number of changes when it comes to how the Lottery goes to market the retail. Initially, staff was gong to implement a number of changes statewide. After the As-is assessment, there was approximately 20 elements that were being looked at so it was decided to begin a pilot program in one area, San Francisco. Lottery and Camelot staff then rolled out the program in San Diego for the final visit and instruction, which went very well. Staff implemented only four of the elements in Phase 1 and will roll those out state-wide as the Phase 2 pilot begins again in San Francisco. The Lottery will return with an introduction of Phase 2 in late Spring, and incorporate any other elements, including visitation schedules and other elements of an ideal retail visit at that time. Even without the entire implementation of the scope of the project, staff is seeing success with the pilot in that retailers statewide are now displaying three \$5 Scratchers as apposed to only one. Clearing out old tickets so that new tickets can be displayed at the beginning of the month is also contributing to higher sales.

Borucki stated that Lottery staff may utilize the Camelot staff in the beginning of the mentioned projects to provide guidance and advice, but Lottery staff is beginning to take the lead of the various projects. The transfer of knowledge is taking place and staff is excitedly embracing the changes. However, staff is continuing to find issues that Camelot can assist them with, therefore needing more days from Camelot. Another issue is the Lottery's contract obligation regarding payment of staff days versus the performance fees. Nguyen stated that the Lottery is obligated to pay \$13.5 million however, Phase 2 is being increased from \$900,000 to \$3.521 million and reducing the performance fee cap by essentially equally that amount.

Mass stated that in the past, the contract was more performance-oriented as opposed to being paid on more of a daily rate. Mass understands the Lottery keeps uncovering new opportunities, but does not like the fact that staff is using Camelot as a crutch to operate the business. Brennan stated that Lottery staff has asked to cut some of the proposed days because they feel confident with certain projects, but do need advice on certain elements. Mass requested information on the rebate component of the contract to see if there was still an opportunity to structure the rebate because California was

Camelot's first Lottery in the U.S. market. Borucki stated that there was still a rebate at \$500,000.

Mass asked if it was possible to see if the 22 percent increase was due to the contribution of RENEW versus Assembly Bill (AB) 142? Jim Hasegawa, Deputy Director of Business Planning, stated that staff compared sales from the "Do-nothing" projection scenarios, to what is anticipated for this fiscal year. Staff segregated certain actions, whether it was directly attributable to the kind of prize payout change or the RENEW Projects. With respect to AB 142, it is estimated that about \$400 million in additional sales will come about this year with prize payout changes, with a little more than \$380 million coming from the Scratchers. The additional sales increase comes from the Lottery offering additional \$5 game products and by the retailers facing the new games so that players see all of the \$5 games. Another area that contributes to the additional \$400 million are the RENEW efforts going towards Hot Spot and the prize payout promotions.

Hasegawa stated that the jackpot games are not benefiting from the prize payout change, but their increase in sales are due to the Marketing workstream done by the RENEW team. Because of the marketing strategies done for the jackpot games as well as better positioning of the products, the games are going to deliver \$30 million more in sales this year versus the "Donothing" projections. There is an additional \$150 million that is due to a combination between the prize payout changes and the RENEW effort. A conservative assumption would be that a third of the \$150 million impact would be related to RENEW, where two-thirds would be related to the prize payout change. With this assumption, the grand total of the sales related to RENEW would be approximately \$120 million and for the prize payout issues, it would be about \$500 million. RENEW provides an additional \$36 to \$37 million to the bottom line to education, which far exceeds the dollars that are being associated with the Camelot contract. Hasegawa took the percentages that are being provided to education this year, which is about 30 to 31 percent and applied it against the \$120 million. It will also generate \$15 million in extra dollars to the administrative budget, which is far exceeding what the contract costs are.

Mass believes that Lottery staff has valued from Camelot, however he is uncomfortable with the structuring of the contract amendment. Borucki requested that Action Item 9(b) be tabled for the next Commission Meeting.

# 10. Commissioner General Discussion

# 11. Scheduling Next Meetings

The next Commission Meetings are tentatively scheduled for February 4, April 7, May 19, June 23, September 8, October 27, and December 8, 2011 in Sacramento.

# 12. Public Discussion

Mass asked if anyone from the public had anything to discuss. No one had signed up prior to the meeting and no one came forward, so he proceeded to the next item on the agenda.

# 13. Adjournment

Meeting adjourned at 10:25 a.m.