



## M E M O R A N D U M

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**Date:** June 25, 2020

**To:** California State Lottery Commission

**From:** Alva V. Johnson, Director 

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**Subject:** Item 9(a) – Fiscal Year 2020-21 Budget

### **ISSUE**

Pursuant to California State Lottery (Lottery) policy, the Lottery is required to present the California State Lottery Commission (Commission) with a proposed annual budget each June. The Fiscal Year (FY) 2020-21 budget presents a sales goal of approximately \$7.1 billion and is estimated to provide nearly \$1.6 billion to public education.

### **BACKGROUND**

The FY 2020-21 budget development process occurred amid the unprecedented challenges that came with the COVID-19 pandemic. In adapting to the pandemic, Lottery teams worked to control the spread of the disease via the Governor's executive orders. First and foremost, the Lottery set into motion changes in operations to ensure the health and safety of employees, retailers, and players. The pandemic also caused the Lottery to examine its approach to offering products and services to its retail partners.

This year's budget development process incorporated zero based budgeting (ZBB) for the first time since the Lottery's inception. Each Lottery Division devised a ZBB plan by considering resource needs for each area of the organization through analyzing and justifying, funding for inclusion in the budget. This new process replaces the concept of a "base budget," since now the same level of scrutiny is applied to all operational costs (recurring and newly-proposed). Zero basing enables the allocation of resources to be utilized where they are most effective and best aligned with strategic priorities, all while providing greater transparency in the use of Lottery resources.

The proposed FY 2020-21 budget sets up the Lottery with the best chance of rebounding sales while providing the ability to transition operational and marketing efforts to better align with California's changing economic conditions and consumer preferences in this unprecedented time. Attachment I to this memo presents the Lottery's proposed FY 2020-21 budget, which reflects a sales goal of \$7.1 billion and is estimated to result in approximately \$1.6 billion in contributions to California public education.

## **DISCUSSION**

The Lottery's approved FY 2020-21 Business Plan revolves around six key objectives that combine strategies to drive sales and contributions to education in the coming year and to deliver growth in subsequent years. The six key objectives are:

- Modify Operations to Ensure Health and Safety and Recover from Depressed Sales
- Revisit Retail Strategies Adapting to New Consumer Preferences
- Grow Draw Game Sales Particularly Jackpot Games and Hot Spot®
- Defuse the Barriers to Play by Changing Perceptions
- Inform the Public and Stakeholders about the Lottery
- Shift the Corporate Culture in the Lottery Organization

Development of the Lottery's FY 2020-21 budget began by identifying barriers to sales caused by the pandemic and finding solutions to get Lottery products to market while maintaining focus on investment in tactics that are estimated to yield the highest contribution to education. Using preliminary sales projections, the budget (built on ZBB principles), was developed to determine the availability of resources to fund such tactics and to address operational improvements and recovery of Lottery sales to drive and sustain sales and contributions to public education. These funding requests were evaluated based on the availability of Lottery resources and the expected benefits the associated tactics would deliver.

This process, combined with the FY 2020-21 Business Plan that was approved by the Commission last month, results in the FY 2020-21 budget that is presented now for approval. A summary of the proposed funding requests by Business Plan objective, as well as the recommended resources to address operational growth and other improvements are included in this issue memo as Attachment II. Funding for the cost of the initiatives and additional revisions reflected on Attachment II is included in the proposed FY 2020-21 budget.

This comprehensive assessment of contribution to education, sales goals, and the funding needed to deliver those goals culminates in the upcoming fiscal year budget proposal. A summary of the elements of the proposed FY 2020-21 budget is presented below:

**Sales**

Total sales for all Lottery products are projected to be \$7.1 billion for FY 2020-21. These projected sales represent a \$512 million, or 7.7 percent increase over estimated year-end sales levels for FY 2019-20.

The table below compares the FY 2019-20 year-end estimate with proposed sales goals for the FY 2020-21 budget. Following the table is background information for the sales goals for each product type.

**Fiscal Years Comparison Chart**

<b>Comparison of Revenues FY 2019-20 Estimated Year-End Sales and Proposed FY 2020-21 Budget (Dollars in Thousands)</b>			
<b>Sales:</b>	<b>Year-End Estimate FY 2019-20</b>	<b>Proposed Budget FY 2020-21</b>	<b>Difference</b>
<b>Scratchers®</b>	\$5,018,465	\$5,400,000	\$381,535
<b>Multi-State Jackpot Games</b>	659,696	776,000	116,304
<b>SuperLotto Plus®</b>	231,336	234,000	2,664
<b>Hot Spot</b>	309,000	323,000	14,000
<b>Daily Games</b>	388,700	387,000	(1,700)
<b>Total Sales</b>	<b>\$6,607,197</b>	<b>\$7,120,000</b>	<b>\$512,803</b>

**Scratchers**

The most substantial year-over-year dollar increase in projected sales is in the Scratchers product line, with sales expected to grow \$381.5 million to a total of \$5.4 billion. This sales goal represents a 7.6 percent increase over the estimated FY 2019-20 year-end sales. The largest impact of the health pandemic on Scratchers sales was associated with the Lottery's ability to safely get the tickets shipped to the Lottery's vast retailer network. Observance of social distancing protocols essentially halved output at the Lottery's two distribution centers, resulting in a decline in Scratchers sales in the last four months of FY 2019-20. The projection for FY 2020-21 assumes these ticket distribution issues will

be resolved by the second quarter of the fiscal year. Tactics to support this growth in Scratchers include an increased number of game launches as compared to FY 2019-20 and increased email communications to registered players, as well as a focus on re-growing the Lottery's retailer network to pre-pandemic levels and beyond.

### **Multi-State Jackpot Games**

The \$776 million sales goal proposed for the Multi-State Jackpot games represents an increase of 17.6 percent or \$116.3 million over estimated year-end sales for FY 2019-20. Even if the pandemic never occurred, sales in these games were on track to be significantly lower in FY 2019-20 due to the lack of significantly large jackpots driving more sales. The projection for FY 2020-21 assumes sales recovery from the pandemic and a more typical number of large jackpots.

### **SuperLotto Plus**

Sales for SuperLotto Plus are projected to be \$234 million for FY 2019-20, which is \$2.7 million or 1.2 percent more than the projected year-end sales estimate of \$231 million. Like the Multi-State Jackpot games, the SuperLotto Plus jackpot was hit at relatively low levels throughout FY 2019-20. The year-over-year growth assumes sales recovery from the pandemic and a more typical number of higher jackpots.

### **Hot Spot**

A sales goal of \$323 million is proposed for Hot Spot, an increase of \$14 million or 4.5 percent above estimated year-end sales for FY 2019-20. The projected increase in sales is primarily based on assumptions for pre-pandemic sales momentum.

### **Daily Games**

The proposed sales goal for Daily Games (Fantasy 5, Daily 3, Daily 4, and Daily Derby) is \$387 million, which is a \$1.7 million (0.4 percent) decrease from the projected year-end sales level for FY 2019-20. The proposed decreased sales goal is due to projecting fewer very high top prizes in Fantasy 5 based on historical averages. This decrease is partially offset by modest projected increases in each of the other Daily Games.

## **Expenses**

The following section describes costs associated with the FY 2020-21 budget.

### **Administrative Expenses**

Administrative expenses include retailer compensation, gaming costs, and operating costs. The Lottery Act caps administrative expenses at 13 percent of total annual revenues.

Excluding the reserve for insurable risk and administrative spending reserve, total administrative expenses for FY 2020-21 are estimated to be \$866.1 million, an increase of \$65.5 million (8.2 percent) over expected FY 2019-20 expenses. Approximately \$45 million of this increase is in retailer compensation and gaming costs, and is driven by the projected year-over-year increase in sales. The remaining \$20.5 million increase is primarily due to investments in modernizing Lottery financial, gaming, and information technology systems. The Lottery has identified opportunities to deploy more cloud-centric and telework enabling assets. In conjunction with the expectation of expected growth in sales for FY 2020-21, investments in Business Plan initiatives are designed to increase the Lottery's contribution to education.

Retailer compensation costs are estimated to total \$491.5 million for FY 2020-21. This amount represents an increase of \$35.1 million (7.7 percent) over the projected amount for FY 2019-20 and is primarily attributable to the higher sales goals for the upcoming year, as retailers earn more for selling and cashing more Lottery tickets.

Gaming costs are budgeted at \$131.4 million for FY 2020-21. This is an increase of \$9.8 million (8.1 percent) over the projected amount for FY 2019-20 and is primarily attributable to the higher sales goals for the upcoming year. This budget category includes the cost of operating the gaming system, gaming equipment installation and maintenance, and production and distribution of Scratchers tickets.

Excluding the reserves, retailer compensation, and gaming costs account for 71.9 percent of the Lottery's proposed administrative expenses for FY 2020-21. The remaining elements of administrative expenses are grouped as operating costs, which are comprised of personnel costs, advertising/marketing costs, and other overhead expenses. As mentioned previously, all of these costs were developed from the ground up for FY 2020-21 in the ZBB process.

Operating costs also include the funding and resources required to execute the FY 2020-21 Business Plan initiatives as well as funding for operational improvements. As shown on Attachment II, the proposed budget includes the establishment of 25 new positions (four of which are the conversion of limited-term positions to permanent) and a modest

increase of \$7.3 million to meet the Lottery's Business Plan and program expansion needs.

Expenses include an insurable risk reserve and an administrative reserve. The insurable risk reserve is set at \$5 million to cover potential fiscal exposures for the areas of the organization that are self-insured. The administrative spending reserve is \$54.5 million; this reserve serves as a safeguard against future uncertainties and protects the Lottery's financial position during the period of a recession caused by the pandemic. The administrative spending reserve also provides the Lottery with the flexibility to take advantage of business growth opportunities that may emerge over the year. The administrative spending reserve is an element of the 13 percent of total revenues specified for administrative expenses, and the entire unspent amount within both the administrative spending reserve and the reserve for insurable risk is transferred directly to public education.

## **SUMMARY**

The proposed FY 2020-21 budget contains sales goals of \$7.1 billion, a 7.8 percent increase over expected sales for FY 2019-20. This level of sales, combined with the other elements in the budget, is estimated to generate approximately \$1.6 billion in contributions to California public schools, assuming both reserves remain unspent. The projected FY 2020-21 sales and contribution to education are both impacted by the pandemic; however, the Lottery takes pride in being able to sustain annual funding to education exceeding the \$1.5 billion mark (for five consecutive years beginning with FY 2015-16) in what will be the Lottery's 36th year in operation.

The \$7.1 billion sales goal and the nearly \$1.6 billion estimated contribution to education for FY 2020-21 are based on the execution of an array of Business Plan initiatives designed to result in the sustainable growth of future revenues. The proposed budget is designed to safely maximize supplemental funding for California's public education for FY 2020-21 and to sustainably grow the annual net revenues for public education for the long term.

## **RECOMMENDATION**

Lottery staff recommends that the Commission approve the Lottery's budget for FY 2020-21 as reflected in the attached documents.

Attachments