



M E M O R A N D U M

Date: June 20, 2019

To: California State Lottery Commission

From: Nicole Soluri, Chief Deputy Director *NS* [Initials on file]

Prepared By: Nicholas Buchen, Deputy Director, Finance Division

Subject: Item 8(i) - Fiscal Year 2019-20 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 budget prepared for Fiscal Year (FY) 2019-20 presents a sales goal of \$7.295 billion and is estimated to provide \$1.66 billion to public education.

BACKGROUND

Attachment I to this memo presents the Lottery's proposed FY 2019-20 budget, which reflects a sales goal of \$7.295 billion and is estimated to result in \$1.66 billion in profits to California public education. This proposed budget includes resources necessary to implement the FY 2019-20 Business Plan. These business initiatives, in conjunction with proposed operational growth resources, provide balanced tactics in driving sales and profits in the short-term as well as providing investments for continued growth in contributions to public education in future years.

DISCUSSION

The proposed Business Plan for FY 2019-20 continues to revolve around four key objectives that combine strategies and initiatives to drive the growth of sales and profits. The four key objectives are:

- Grow sales of all jackpot games and Hot Spot®

- Continue moderate growth of Scratchers® sales
- Improve the customer experience for players, retailers, and internal customers
- Elevate perceptions about the Lottery to grow the future player base

The Lottery's proposed FY 2019-20 budget invests in each of the four key objectives. Specifically, staff proposed broad strategies, many of which are continuation of previously-approved multi-year efforts, consistent with the four key objectives and developed tactics to implement these proposed strategies. Senior management evaluated these proposals and prioritized them based on the availability of Lottery resources and the expected benefits those strategies and tactics would deliver.

The proposed FY 2019-20 budget also includes funding for operational improvements to enable increased sales and contributions to public education into the future. Additionally, certain components of the proposed budget were developed from the ground up (also known as "zero-based budgeting") so that each individual element was vetted and justified prior to inclusion in the proposed budget. Under a zero-based budget, recurring costs are reviewed with the same level of scrutiny as newly proposed costs thereby enabling resources to be concentrated where they are most effective and best align with strategic priorities. The Lottery used this approach to construct the Marketing Budget Plan, which is the second largest expenditure category within the Lottery's operating costs, and certain components of the broader Sales and Marketing Division budget (the Lottery will be expanding the zero-based budgeting effort to the remainder of the Sales and Marketing Division budget as well as the budgets for all other Lottery divisions in the FY 2020-21 budget).

The net effect is the proposed FY 2019-20 budget that is being presented for approval. A summary of the funding requested for the various proposals aligned with each Business Plan objective, as well as the proposed resources to address operational growth and other improvements, is included in this issue memo as Attachment II. Funding for the cost of the initiatives and other revisions reflected on Attachment II is included in the proposed FY 2019-20 budget. A summary of the major components of the proposed FY 2019-20 budget is presented below:

Sales

Total sales for all Lottery products are projected to be \$7.295 billion for FY 2019-20. This represents an \$83 million, or 1.1 percent decrease from estimated year-end sales levels for FY 2018-19. This year-over-year decrease is primarily attributable to the unprecedented level of sales the Lottery achieved in the current fiscal year from the historic \$1.6 billion advertised Mega Millions® jackpot in October of 2018; the proposed FY 2019-20 budget instead reflects anticipated Mega Millions sales from more traditional jackpot levels. This year-over-year decrease in the multi-state jackpot games is partially

offset by modest projected year-over-year increases in the games for which the Lottery generally has more control over the sales, such as Scratchers and Hot Spot.

The chart on the following page compares the FY 2018-19 year-end estimate with proposed sales goals for the FY 2019-20 budget. Following the chart is background information for the sales goals for each product type.

Fiscal Year's Comparison Chart

Comparison of Revenues			
FY 2018-19 Estimated Year-End Sales and Proposed FY 2019-20 Budget			
(Dollars in Thousands)			
Sales:	Year-End Estimate FY 2018-19	Proposed Budget FY 2019-20	Difference
Scratchers	\$5,160,000	\$5,375,000	\$215,000
Multi-State Jackpot Games	1,260,000	925,000	(335,000)
SuperLotto Plus[®]	269,000	275,000	6,000
Hot Spot	314,000	335,000	21,000
Daily Games	375,000	385,000	10,000
Total Sales	\$7,378,000	\$7,295,000	(\$83,000)

Scratchers

The largest year-over-year increase in projected sales is in the Scratchers product line with sales expected to grow \$215 million to a total of \$5.375 billion. This sales goal represents a 4.2 percent increase over estimated FY 2018-19 year-end sales. Tactics to support this growth in Scratchers, along with specific emphasis to improve the profitability of Scratchers games, include: more focus on the lower price point games, assumed growth in the Lottery's retailer network, more customized email communications to registered players, and a concentrated effort using advanced analytics to identify retail activities having the largest impact on Scratchers sales.

Multi-State Jackpot Games

The \$925 million sales goal proposed for the multi-state jackpot games represents a decrease of \$335 million or 26.6 percent from estimated year-end sales for FY 2018-19. As explained on the previous page, the decreased sales in FY 2019-20 reflect a more conservative jackpot forecast for Mega Millions compared to what was experienced in the current fiscal year. This year-over-year decrease is partially offset by an assumed lift in both Powerball[®] and Mega Millions sales resulting from more frequent marketing support of jackpots ranging from \$250 million to \$700 million. This will help boost interest and sales at these jackpot levels, thereby compensating for a reduction in earned media due to the press becoming desensitized to moderate to large jackpots.

SuperLotto Plus

Sales for SuperLotto Plus are projected to be \$275 million for FY 2019-20 which is \$6 million or 2.2 percent more than the year-end sales estimate. Growth in SuperLotto Plus is due to building on the current fiscal year's "May the Best Dream Win" campaign as well as dedicated promotions for retailers and consumers.

Hot Spot

A sales goal of \$335 million is proposed for Hot Spot in FY 2019-20, an increase of \$21 million or 6.7 percent over estimated year-end sales for FY 2018-19. The projected increase in sales is primarily based on assumed growth in the retailer network and increased exposure for Hot Spot on the Lottery's new and improved public website coming later this summer.

Daily Games

The proposed sales goal for Daily Games (Fantasy 5, Daily 3, Daily 4, and Daily Derby) is \$385 million in FY 2019-20. This is a \$10 million or 2.7 percent increase from the projected year-end sales level for FY 2018-19. This is primarily due to projected growth in the Lottery's retailer network, increasing the number of jackpot signs at retail, and an initiative to more accurately estimate the advertised top prize for Fantasy 5.

Expenses

The following section describes costs associated with the FY 2019-20 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 2019-20 are estimated to be \$910.5 million, an increase of \$33.3 million (3.8 percent) over expected FY 2018-19 expenses. This increase is primarily due to the investment in Business Plan initiatives that are designed to increase the Lottery's contribution to education.

Retailer compensation costs are estimated to total \$500.9 million for FY 2019-20. This amount represents a decrease of \$2.6 million (0.5 percent) from expected FY 2018-19 retailer compensation costs and is mainly due to the decreased year-over-year sales projection.

Gaming costs are budgeted at \$130.4 million for FY 2019-20, which is an increase of \$1.6 million or 1.3 percent over the projected FY 2018-19 level. The increase in this budget category, which includes the cost of operating the gaming system, gaming equipment installation and maintenance, and production and distribution of Scratchers tickets, is primarily attributable to projected increased licensing and distribution costs for Scratchers tickets.

The remaining elements of administrative expense are grouped as operating costs, which are comprised of personnel costs, advertising/marketing costs, and other overhead

expenses. Operating costs also include the funding and resources required to execute the FY 2019-20 Business Plan initiatives, including the zero-based Marketing Budget Plan, as well as funding for operational improvements. As shown on Attachment II, the proposed budget includes establishment of 17.0 new positions and an additional \$104.2 million allocated to meet these needs.

Also included within administrative expenses for FY 2019-20 is a \$5 million reserve for insurable risk to cover fiscal exposures for the areas of the organization for which the Lottery elects to self-insure, as well as a \$32.8 million administrative spending reserve to act as a safeguard against future uncertainties. The administrative spending reserve also provides the Commission and the Lottery with flexibility to take advantage of profit growth opportunities that may emerge over the course of the upcoming 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 will be transferred directly to public education.

Summary

The proposed FY 2019-20 budget contains sales goals of \$7.295 billion and, combined with the other elements in the budget, is estimated to generate \$1.66 billion in contributions to California public schools. The \$7.295 billion sales goal and the \$1.66 billion estimated contribution to education for FY 2019-20 are based on execution of a vast array of Business Plan initiatives designed to result in sustainable growth of future revenues. The proposed budget includes a balanced approach between actions to drive short-term increases in sales and profits as well as prudent investments that will enable the Lottery to sustain growth in sales and contributions to public education in years to come.

RECOMMENDATION

Staff recommends the Commission approve the Lottery's budget for FY 2019-20 as reflected in the attached documents.

Attachments



FISCAL YEAR 2019-20 PROPOSED BUDGET

(Dollars in Thousands)

Attachment I

	<u>FY 2018-19 Year-End Budget</u>	<u>% of Sales</u>	<u>FY 2019-20 Proposed Budget</u>	<u>% of Sales</u>	<u>Difference</u>
SALES:					
Scratchers	\$5,160,000	69.9 %	\$5,375,000	73.7 %	\$215,000
Powerball	522,000	7.1 %	460,000	6.3 %	(62,000)
Mega Millions	738,000	10.0 %	465,000	6.4 %	(273,000)
SuperLotto Plus	269,000	3.6 %	275,000	3.8 %	6,000
Hot Spot	314,000	4.3 %	335,000	4.6 %	21,000
Other Daily Games	375,000	5.1 %	385,000	5.3 %	10,000
TOTAL, ESTIMATED SALES	<u>\$7,378,000</u>		<u>\$7,295,000</u>		<u>(\$83,000)</u>
			<u>Prize Payout</u>	<u>Prize Payout</u>	
PRIZE EXPENSE:					
Scratchers	\$3,637,800	70.5 %	\$3,810,875	70.9 %	\$173,075
Powerball	271,000	51.9 %	230,000	50.0 %	(41,000)
Mega Millions	370,000	50.1 %	232,500	50.0 %	(137,500)
SuperLotto Plus	122,400	45.5 %	137,500	50.0 %	15,100
Hot Spot	200,960	64.0 %	214,400	64.0 %	13,440
Fantasy 5	80,500	50.0 %	89,000	50.0 %	8,500
Other Daily Draw Games	106,570	49.8 %	103,086	49.8 %	(3,484)
2nd Chance - Scratchers	5,200		5,200		0
2nd Chance - Draw Games	3,900		3,900		0
Prize Expense Savings	(56,300)		(55,000)		1,300
TOTAL, PRIZE EXPENSE	<u>\$4,742,030</u>	64.3 %	<u>\$4,771,461</u>	65.4 %	<u>\$29,431</u>
NET SALES AFTER PRIZE EXPENSE	<u>\$2,635,970</u>		<u>\$2,523,539</u>		<u>(\$112,431)</u>
			<u>% of Sales</u>	<u>% of Sales</u>	
ADMINISTRATIVE EXPENSES:					
Retailer Compensation:					
Commission	\$428,506	5.8 %	\$426,758	5.9 %	(\$1,749)
Cashing Bonus	42,475	0.6 %	41,894	0.6 %	(580)
Special Handling	28,701	0.4 %	28,523	0.4 %	(178)
Incentives	3,750	0.1 %	3,699	0.1 %	(51)
Gaming Costs:					
Gaming Contract (IGT)	111,953	1.5 %	109,395	1.5 %	(2,558)
Administrative Retailer Fees	(21,155)		(21,712)		(557)
Gaming Monitor Fees	(580)		(594)		(14)
Scratchers Ticket Costs	30,945	0.4 %	35,000	0.5 %	4,055
Scratchers Delivery and Support Costs	7,612	0.1 %	8,299	0.1 %	687
Subtotal, Retailer & Gaming Costs	<u>\$632,207</u>	8.6 %	<u>\$631,263</u>	8.7 %	<u>(\$945)</u>
Operating Costs:					
Personal Services	\$112,700	1.5 %	\$117,923	1.6 %	\$5,223
Marketing Budget Plan	80,000	1.1 %	98,400	1.3 %	18,400
Contractual Services	18,000	0.2 %	21,394	0.3 %	3,394
Depreciation	18,840	0.3 %	21,574	0.3 %	2,734
Operating Expense	15,500	0.2 %	19,985	0.3 %	4,485
Reserve for Insurable Risk	0	0.0%	5,000	0.1 %	5,000
Administrative Spending Reserve	0	0.0%	32,811	0.4 %	32,811
Subtotal, Operating Costs	<u>\$245,040</u>	3.3 %	<u>\$317,087</u>	4.3 %	<u>\$72,047</u>
TOTAL, ADMINISTRATIVE EXPENSES	<u>\$877,247</u>	11.9 %	<u>\$948,350</u>	13.0 %	<u>\$71,103</u>
CONTRIBUTION TO EDUCATION					
Unclaimed Prizes	\$1,758,723		\$1,575,189		(\$183,534)
Interest Income	37,000		35,000		(2,000)
	14,000		12,000		(2,000)
TOTAL AVAILABLE FOR EDUCATION	<u>\$1,809,723</u>		<u>\$1,622,189</u>		<u>(\$187,534)</u>
TOTAL CONTRIBUTION TO ED WITH RESERVES	<u>\$1,809,723</u>		<u>\$1,660,000</u>		<u>(\$149,723)</u>

FISCAL YEAR 2019-20
SUMMARY OF FUNDING NEEDS BY OBJECTIVE
(Dollars in Thousands)

Objective	Positions	Cost
Grow sales of all jackpot games and Hot Spot	n/a	\$ 37,855
Continue moderate growth of Scratchers sales	6	\$ 52,534
Improve the customer experience for players, retailers, and internal customers	1	\$ 6,371
Elevate perceptions about the Lottery to grow the future player base	n/a	\$ 6,026
Additional personal services, operating expenses, and capitalized items	10	\$ 1,367
Total FY 2019-20 Initiatives and Other Revisions	17	\$ 104,153