

E75D
State Lottery Agency

Operating Budget Data

(\$ in Thousands)

	<u>FY 07</u> <u>Actual</u>	<u>FY 08</u> <u>Working</u>	<u>FY 09</u> <u>Allowance</u>	<u>FY 08-09</u> <u>Change</u>	<u>% Change</u> <u>Prior Year</u>
Special Fund	\$51,808	\$57,804	\$60,049	\$2,244	3.9%
Total Funds	\$51,808	\$57,804	\$60,049	\$2,244	3.9%

- The fiscal 2009 allowance increases by \$2.2 million, or 3.9% over the fiscal 2008 working appropriation. However, this increase is overstated due to one-time health insurance savings in fiscal 2008 and budgeting for the long-term retiree health insurance liability. The underlying growth, absent health insurance, is close to \$1.5 million, or 2.6%.
- Underlying growth in the allowance is largely attributable to an increase in the contract for on-line gaming and to an increase in advertising expenses.

Personnel Data

	<u>FY 07</u> <u>Actual</u>	<u>FY 08</u> <u>Working</u>	<u>FY 09</u> <u>Allowance</u>	<u>FY 08-09</u> <u>Change</u>
Regular Positions	171.00	172.00	171.00	-1.00
Contractual FTEs	<u>11.50</u>	<u>9.50</u>	<u>9.50</u>	<u>0.00</u>
Total Personnel	183.50	181.50	180.50	-1.00

Vacancy Data: Regular Positions

Turnover, Excluding New Positions	6.41	3.75%
Positions Vacant as of 12/31/07	3.00	1.74%

- The allowance reflects the loss of 1 regular position, an administrative aide, as a result of cost containment efforts.
- The agency reports 3 vacant positions at the start of calendar 2008, below the 6.41 vacancies needed to meet the turnover rate in the fiscal 2009 allowance.

Note: Numbers may not sum to total due to rounding.

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Analysis in Brief

Major Trends

Sales Falter in 2007, Rebound Expected in 2008: The Lottery recorded sales of \$1.58 billion in fiscal 2007, falling short of the Board of Revenue Estimates projections by \$27.3 million. However, a rebound is expected in 2008 based on a significant increase in sales in the first five months.

Prizes and Agent Earnings Continue to Increase Share of Expenditures: Fiscal 2007 marked the first year of an increase in sales agent commissions. Also, the rise in popularity of games with high payout ratios increases prizes' share of expenditures.

Player Base Fails to Meet Expectations: The percentage of Marylanders who report playing at least one lottery game per year has fallen since 2002.

Issues

Instant Games Remain as Favorite Individual Game: The Lottery reports Instant game sales of \$425.1 million in fiscal 2007, an increase of 2.4% from fiscal 2006. This represents 28% of total sales in fiscal 2007. Instant games are followed in popularity by Pick 3, Keno, and Pick 4, representing 19%, 17%, and 15% of sales, respectively. **The Department of Legislative Services (DLS) recommends that the Lottery comment on its plans for sustaining long-term growth in future sales, especially in light of potential competition from video lottery terminals. The discussion should include plans for specific games including games under development.**

Change in Game Popularity Impacts General Fund Revenue: Games with high payout ratios are attractive to players. As high payout games rise in popularity as compared with other games, general fund revenues are affected. **DLS recommends that the Lottery comment on the current mix of games and payout ratios and the long-term impact on general fund revenues.**

Substitution Effect of Multiple Monitor Games: The popularity of Keno and Keno Bonus has led to the development of other monitor games. However, in the first year of the new Race Trax monitor game, there is evidence of a possible substitution effect on sales. A third monitor game was introduced in fall 2007. **DLS recommends that budget bill language be added that prohibits funds being spent on the expansion of monitor games until the agency reports to the budget committees on the impact of additional monitor games.**

Recommended Actions

	<u>Funds</u>
1. Add language requiring the Lottery to report to the budget committees on the impact of additional monitor games before it expends funds on the expansion of such games.	
2. Delete the net increase in advertising.	\$ 589,500
Total Reductions	\$ 589,500

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Operating Budget Analysis

Program Description

Since 1973, the Maryland State Lottery Agency has administered and operated lottery games to generate revenue for the State. The Lottery currently offers 9 games: Pick 3, Pick 4, Keno and Keno Bonus, Mega Millions, Bonus Match Five, Instant Games, Multi-Match (which replaced Lotto in February 2006), Race Trax, and a new game called Maryland Hold'Em.

All games, except Instant Games, are on-line, meaning players pick their numbers or use computer generated numbers, receive a ticket, and then wait for a drawing to see if they have won. With Instant Games, players scratch off a latex covering on a ticket play area to reveal preprinted combinations. Games are sold through lottery agents, which are private businesses that receive commissions and fees in exchange for selling the games to the public.

Proceeds from the games pay for prizes, agent earnings, and all operating expenses of the agency. In fiscal 2007, 58.3% of sales paid for prizes, 7.1% paid for agent commissions and redemption fees, 3.3% paid for agency operations, and the remaining 30.0% was credited as revenue to the State.

The State Lottery Commission, consisting of five members appointed by the Governor, has oversight responsibility for the agency. The agency's six divisions include Administration, Finance, and Operations; Information Technology; Marketing; Sales; Public Affairs; and Executive. The Lottery also has a security unit.

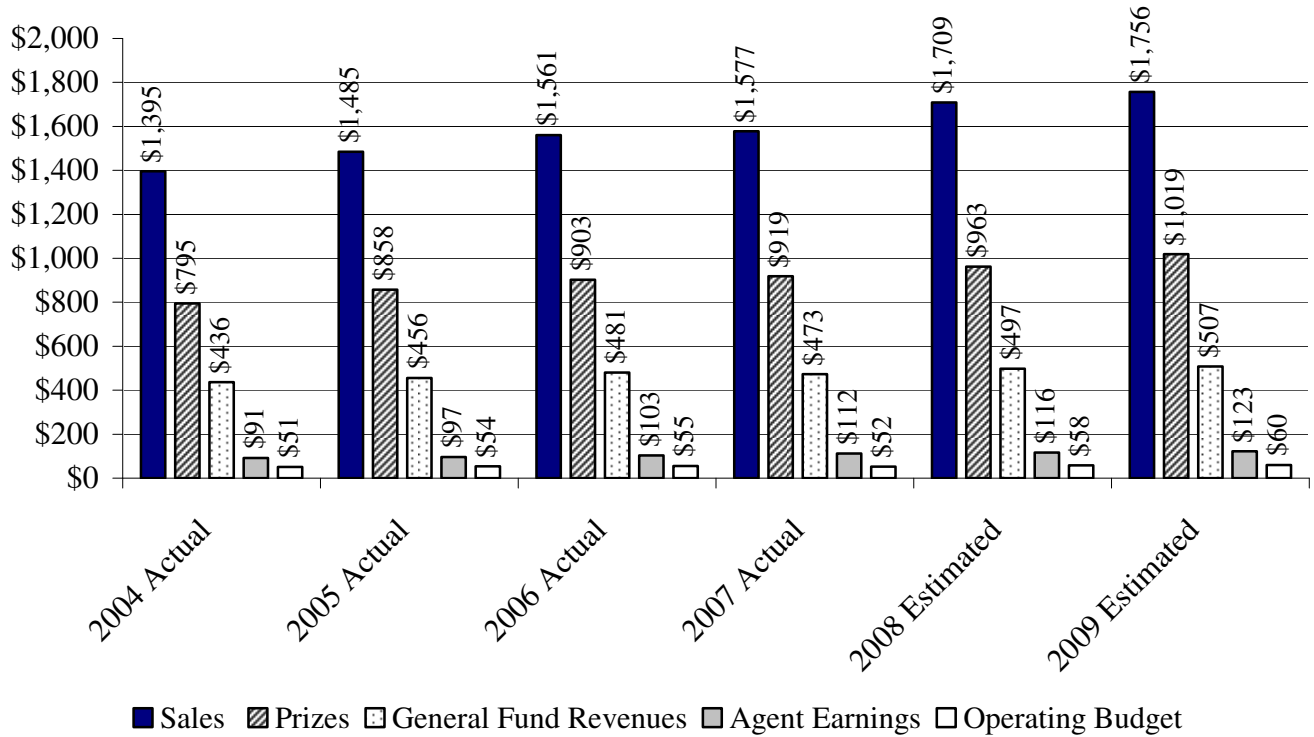
Performance Analysis: Managing for Results

Sales Falter in 2007; Rebound Expected in 2008

The Lottery recorded sales of \$1.58 billion in fiscal 2007, falling short of the Board of Revenue Estimates projections by \$27.3 million. The actual fiscal 2007 sales represent a small increase of \$16.0 million, or 1.0%, over fiscal 2006. This increase can be attributed in large part to the introduction of the Race Trax game which accounted for close to \$50.0 million in sales. However, this game may have had a dampening effect on the sales of similar games. For example, fiscal 2007 sales of Keno and Keno Bonus fell 5.4% from fiscal 2006. This impact, combined with mixed sales results of the remaining games, contributed to the smallest annual increase in sales since fiscal 2001. See Issue 1 for a discussion of sales and revenue trends by game and **Appendix 2** for sales by jurisdiction.

Exhibit 1 shows the financial components of the State Lottery Agency. As the exhibit shows, the impact of the small increase in sales, combined with higher prize payouts, resulted in a decline in actual general fund revenues for the State in fiscal 2007.

Exhibit 1
Lottery Sales and Expenditures
Fiscal 2004-2009
(\$ in Millions)



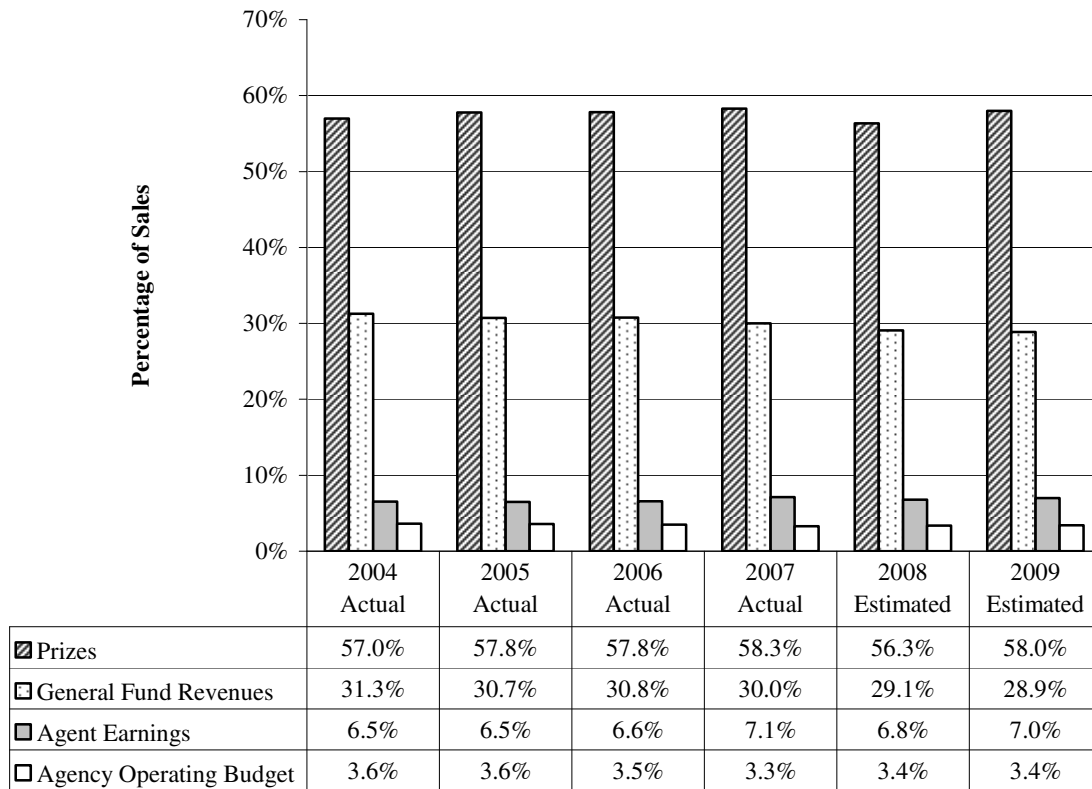
Source: Governor’s Budget Books, Fiscal 2005-2009

However, based on sales to date, sales for fiscal 2008 are expected to increase. Sales are up 12.1% for the first five months. This is largely driven by significant increases in Mega Millions and Instant tickets compared to flat sales during the same time period last year. The Instant ticket sales increase may be due in part, to the agency’s new inventory management system, which facilitates orders. Specifically, the vendor supplies personnel who call all agents on a weekly basis and take orders for Instant tickets. The amount of tickets ordered by each agent is packaged in the Lottery warehouse and shipped. Previously, agents received orders once a week based on a pre-established quota. Furthermore, when the Lottery introduces a new game, tickets may be sent to all retailers on the same designated shipping date. Previously, it took at least two weeks for shipments of new games to reach all retailers. This new method should also be able to improve estimates of Instant ticket printing needs.

Prizes and Agent Earnings Continue to Increase Share of Expenditures

As shown in **Exhibit 2**, prizes make up the largest proportion of Lottery expenditures, followed by general fund revenues, agent earnings, and the agency operating budget.

Exhibit 2
Lottery Expenditures as a Proportion of Sales
Fiscal 2004-2009



Source: Governor’s Budget Books, Fiscal 2005-2009

- In fiscal 2007, both agent earnings and prize payouts reached a recent high in terms of their share of overall expenditures. This year marked the first year in which agent sales commissions were increased to 5.5% of sales from 5.0%. Included in agent earnings are a cashing commission of 3.0% and an agent bonus and incentive program that is capped at one-half of 1.0% of gross sales. As a result, agent earnings reached 7.1% of total expenditures, up from 6.6% as shown in the exhibit.
- Prizes increased its share of expenditures to 58.3% in fiscal 2007, up from 57.8% in fiscal 2006. This increase is due to the fact that monitor games (Keno, Keno Bonus, and Race Trax) and Instant tickets have increased their share of sales. Such games have higher payout ratios

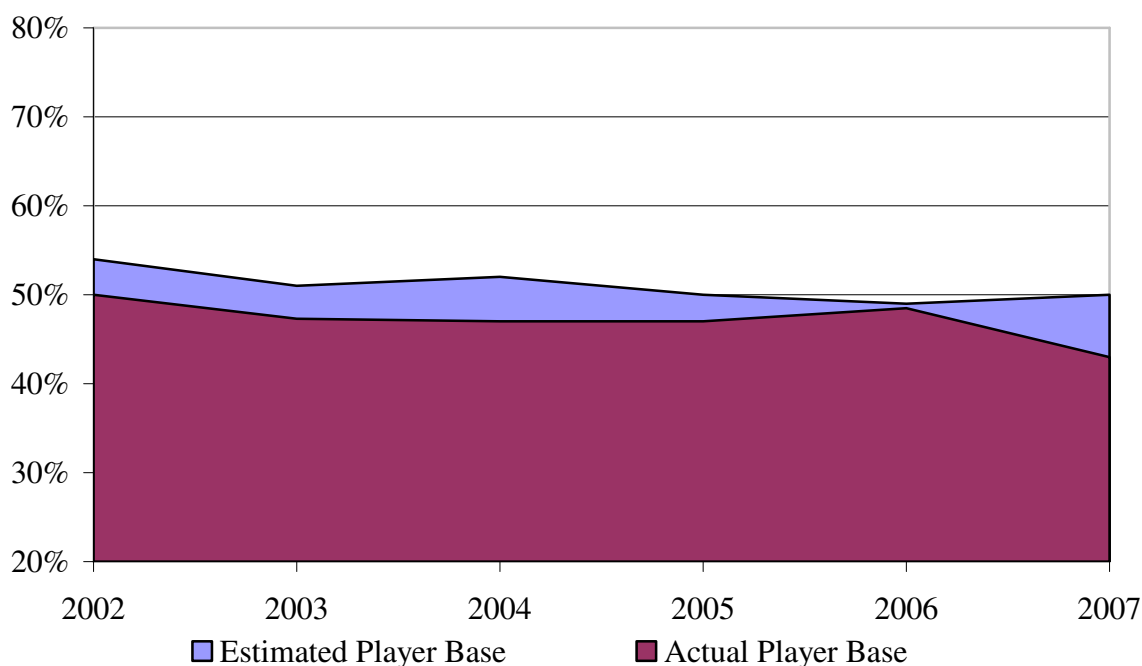
than the agency’s other games. However, as sales from other games are expected to rebound significantly in fiscal 2008, the higher prize payout trend should moderate.

- General fund revenues continue to grow, but its share of expenditures is expected to fall slightly in fiscal 2008 and 2009. This is due, in part, to the expected increase in the agency’s budget and an increase in the revenues distributed to the Maryland Stadium Authority. However, the agency’s budget proportion remains well within its stated performance goal of an administrative cost-to-sales ratio of less than 4%.

Player Base Fails to Meet Expectations

Exhibit 3 shows the percentage of Maryland adults who have played a lottery game at least once in a fiscal year. In fiscal 2002, 50% of Marylanders indicated that they have purchased a lottery game. In fiscal 2007, that number fell to 43%, a 14% decline. The agency has revised downward its expectations for its player base. However, the estimates have consistently been higher than the actual figures.

Exhibit 3
State Lottery Agency Player Base
Fiscal 2002-2007



Source: Governor’s Budget Books, Fiscal 2005-2009

To the extent that video lottery terminals are approved by the voters through a constitutional amendment, lottery participation estimates may have to be revised further downward.

The Lottery should comment on the outlook for its player base and the impact that video lottery terminals will have on the base, and consequently on sales and general fund revenue.

Fiscal 2008 Actions

Impact of Cost Containment

In fiscal 2008, the agency reduced special funds by \$351,500 in the cost containment effort. These funds were available due to a slight overbudgeting of the new on-line gaming contract due to a revised sales estimate.

Governor's Proposed Budget

The fiscal 2009 allowance increases by over \$2.2 million, or 3.9% over the fiscal 2008 working appropriation as shown in **Exhibit 4**. However, this increase is overstated due to one-time health insurance savings in fiscal 2008. The underlying growth, absent health insurance, is close to \$1.5 million, or 2.6%.

Impact of Cost Containment

The agency relinquished one position in the fiscal 2009 cost containment effort. This results in savings of approximately \$56,500 in special funds.

Personnel

Personnel expenditures increased by \$867,973, or 7.2% in fiscal 2009. However, as mentioned above, budgeting for employee and retiree health insurance, combined with funds for long-term insurance liability for future retirees, distorts the year-to-year comparison. Absent those costs, personnel expenditures increase by \$113,231, or 0.9%. This increase can be primarily attributed to salary increments.

Contractual Services

The core of the agency's budget is for contractual services. In total, the expenditures for such services increase by over \$1.5 million.

Among the increases, the on-line system contract rises from approximately \$15.8 million in fiscal 2008 to \$16.7 million in 2009. The costs of the on-line system are tied to sales volume. The system connects all agents with the Lottery agency so that sales and other data can be shared. The new system installed in July 2006 provides new touch screen terminals and communications based on satellite connections.

Exhibit 4
Governor’s Proposed Budget
State Lottery Agency
(\$ in Thousands)

How Much It Grows:	<u>Special</u> <u>Fund</u>	<u>Total</u>
2008 Working Appropriation	\$57,804	\$57,804
2009 Governor’s Allowance	<u>60,049</u>	<u>60,049</u>
Amount Change	\$2,244	\$2,244
Percent Change	3.9%	3.9%
 Where It Goes:		
Personnel Expenses		
Abolished/transferred positions		-\$56
Increments and other compensation.....		148
Employee and retiree health insurance		194
Health insurance – long-term Other Post Employment Benefits liability.....		572
Workers’ compensation premium assessment		46
Turnover adjustments.....		5
Other fringe benefit adjustments.....		-41
Other Changes		
Increase in contract for on-line gaming system based on sales.....		885
Net increase in advertising – notably outdoor, radio, and agency fees.....		590
Increase in contract for vending machine maintenance		152
Increase in drawing commitment contract.....		107
Increase in Instant ticket delivery contract.....		62
Increase in legal services fees		25
Decline in Instant ticket printing expenses due to overbudgeting in fiscal 2008.....		-300
Decline in motor vehicle and related purchases.....		-138
Decline in equipment purchases		-8
Other miscellaneous changes		1
Total		\$2,244

Note: Numbers may not sum to total due to rounding.

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Total advertising spending for the Lottery in the fiscal 2009 allowance is \$20.5 million, up from \$19.8 million in fiscal 2008. Expenses for various forms of advertising increase by a net of \$589,500. This is exclusive of the costs for the drawing commitment which increases by \$107,500. Specifically, outdoor advertising represents the largest increase within the broader category, growing over 153%, or \$922,750 over the fiscal 2008 working appropriation. Radio and television advertising also show significant increases (\$952,250). After a temporary loss of its advertising firm, the agency has contracted with a new firm. As a result of the new contract, agency fees increase by \$550,000. Some advertising and promotion expenses are expected to decrease. Print and Internet advertising experience a \$957,500 decline in fiscal 2009. Similarly, expenses for the production of advertising materials decline by \$700,000.

In fiscal 2009, the Lottery will be renewing a contract for Instant ticket vending machine maintenance. It expects this contract will require approximately \$152,000 in additional funds in fiscal 2009. In addition to inflationary increases, the agency expects that living wage requirements will further add to the cost of the contract.

Other Expenditures

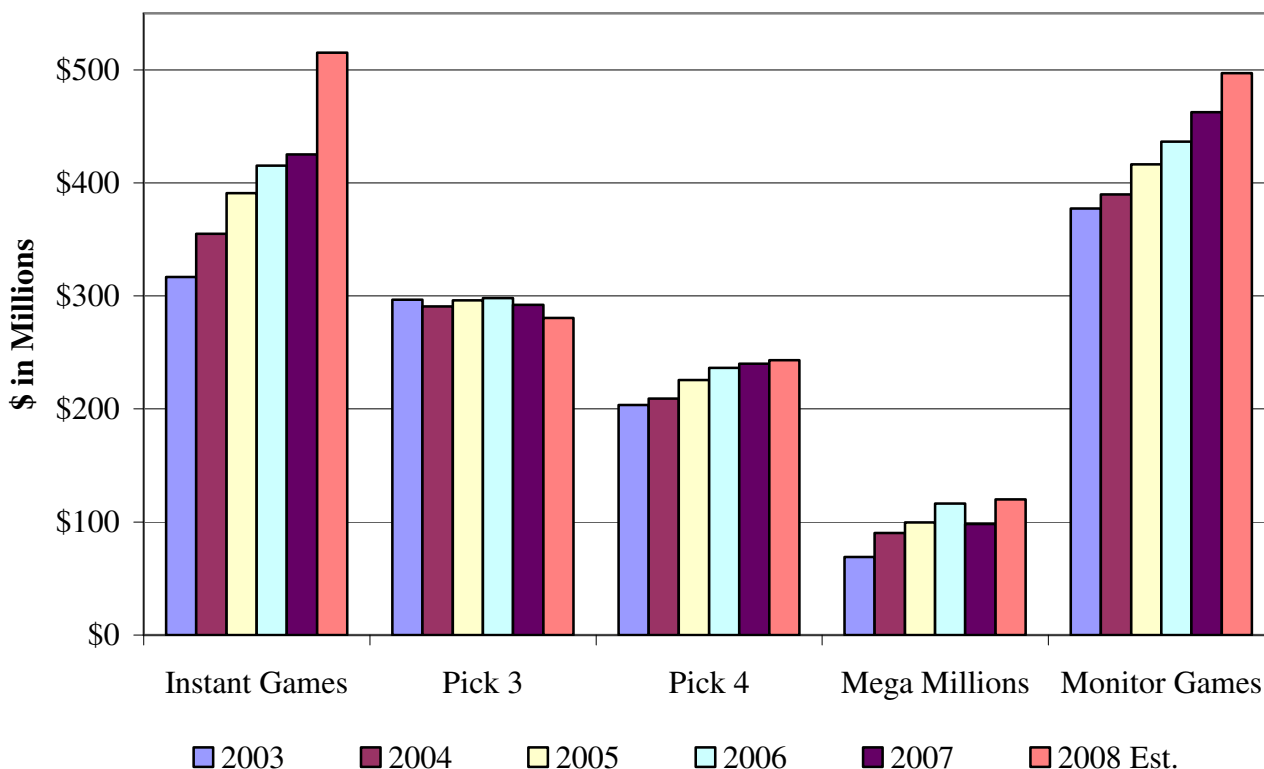
Legal fees increase in fiscal 2009 by \$25,000 in order to resolve an intellectual property dispute. Most other administrative expenses fall in the fiscal 2009 allowance including funds for motor vehicle purchases and equipment.

Issues

1. Instant Games Remain as Favorite Individual Game

The Lottery reports Instant game sales of \$425.1 million in fiscal 2007, an increase of 2.4% from fiscal 2006. Instant games are followed in popularity by Pick 3, Keno, and Pick 4. **Exhibit 5** shows the sales of the more popular games for fiscal 2003 through an estimate for fiscal 2008.

Exhibit 5
Sales – Selected Games
Fiscal 2003-2008



Source: State Lottery Agency; Board of Revenue Estimates

Exhibit 5 clearly shows the relative popularity of the games. Much of the focus of new game development is on monitor games. When considered together (Keno and Keno Bonus and Race Trax) monitor games match, and in some years exceed, the sales of Instant ticket games.

Pick 3 and Pick 4 sales have remained fairly flat. However, it does appear that Pick 3 sales are continuing a slow downward trend, losing sales of 2.0% from fiscal 2006 to fiscal 2007. Conversely, Pick 4 is experiencing a slow resurgence of sales going from \$236.5 million in fiscal 2006 to \$240.1 million in fiscal 2007. Mega Millions' sales tend to fluctuate more than other types of games. News of large jackpots and large prize payouts will drive up sales of Mega Millions. Long stretches of time between large jackpots dampens demand. This is evidenced in the decline of sales in fiscal 2007.

Not shown in the exhibit are Match 5 and Lotto/Multi-Match, which are relatively small sellers representing 1% and 2% of total sales respectively. Lotto/Multi-Match continue a long-term trend of declining sales; however, Match 5 sales are expected to increase marginally in fiscal 2008 and beyond.

The Department of Legislative Services (DLS) recommends that the Lottery comment on its plans for sustaining long-term growth in future sales especially in light of potential competition from video lottery terminals. The discussion should include plans for specific games including games under development.

2. Change in Game Popularity Impacts General Fund Revenues

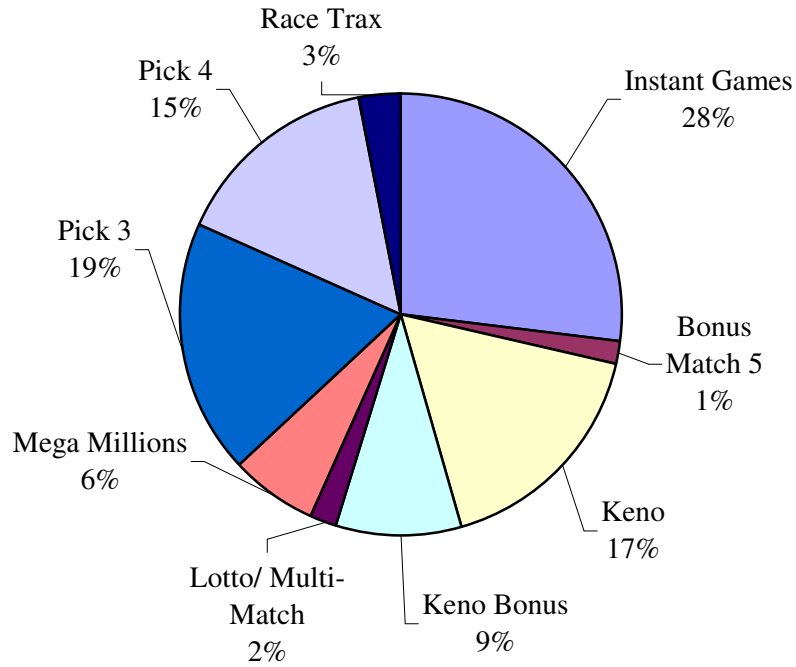
Different games have different payout ratios. To the extent that a high payout game increases in sales at a greater rate than a low payout game, general fund revenues are affected.

As shown in **Exhibit 6**, Instant games, followed by monitor games, (Keno and Keno Bonus and Race Trax) make up over half of all sales in fiscal 2007. Instant games, by far, have the highest payout ratio. As such, even though Instant games comprise 28% of sales, it only represents 16% of general funds revenue. Conversely, the lowest payout game is Pick 3. Pick 3 was responsible for 19% of sales and 26% of general fund revenue in fiscal 2007.

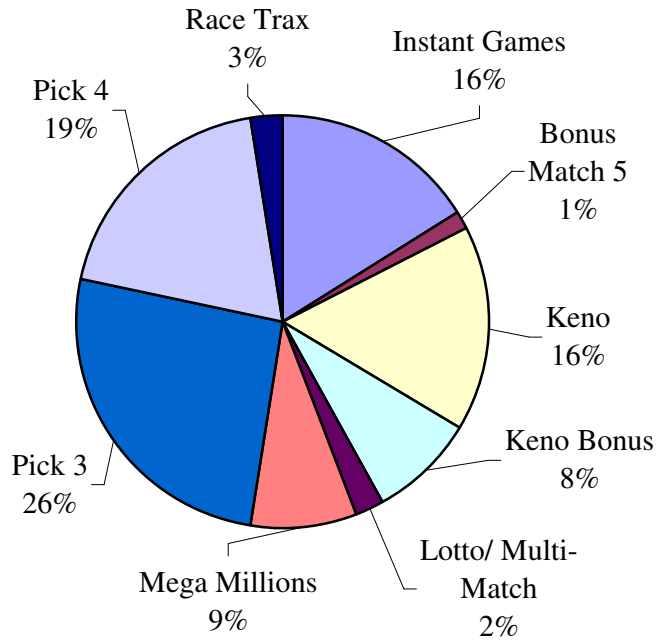
Instant games and monitor games have shown the most promise for future growth. Conversely, Pick 3 has steadily fallen in popularity. At this rate, general fund revenue growth will not keep pace with sales growth.

DLS recommends that the Lottery comment on the current mix of games and payout ratios and the long-term impact on general fund revenues.

**Exhibit 6
Sales – Fiscal 2007**



Revenue – Fiscal 2007

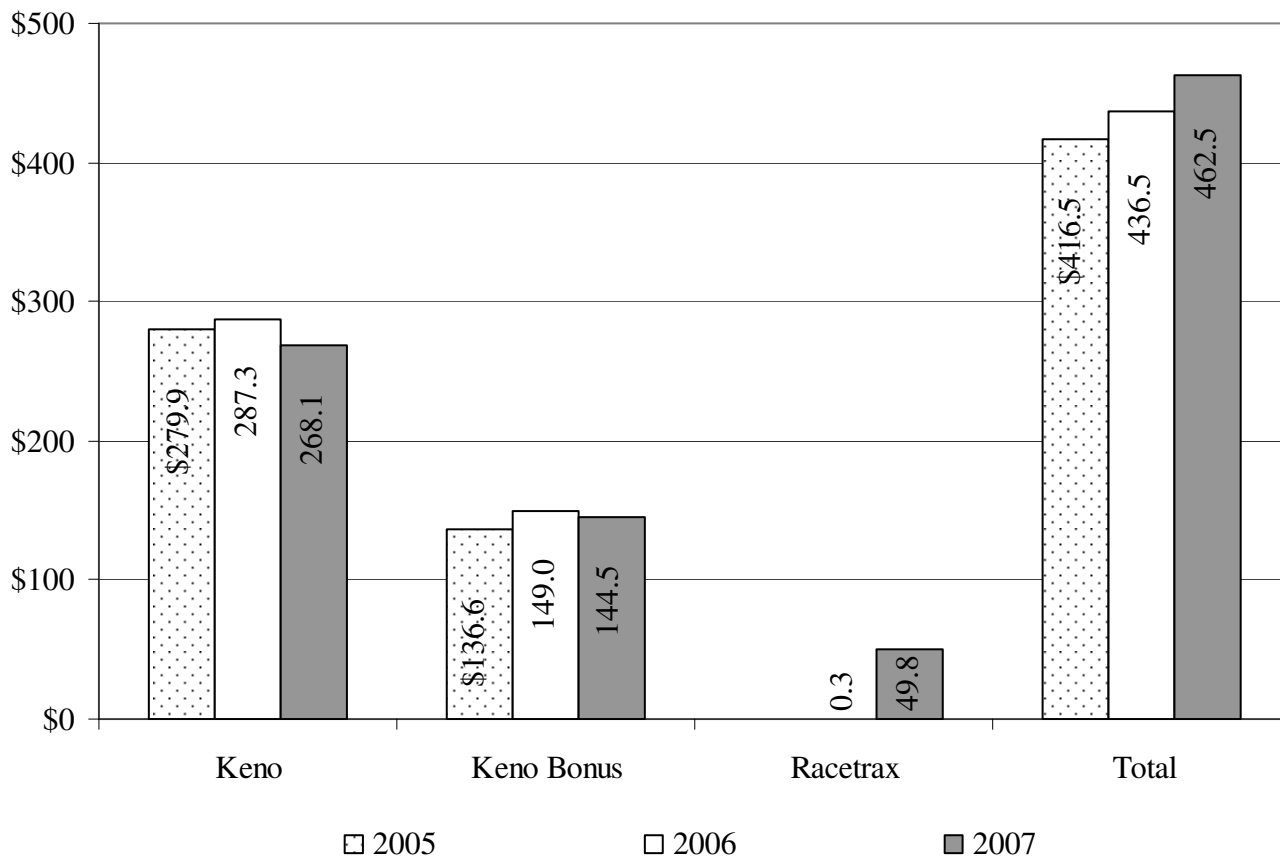


Source: State Lottery Agency

3. Substitution Effect of Multiple Monitor Games

The Lottery believes that monitor games like Keno are the most promising games under development. Keno and Keno Bonus have increased in popularity over the last 10 years. Accordingly, the agency introduced Race Trax in fiscal 2007. Race Trax is a game where simulated horse races appear on a monitor, and players may place bets on the winning horse. Race Trax is currently in 1,200 locations compared to Keno, which is in about 2,100 locations. **Exhibit 7** shows sales associated with each monitor game.

Exhibit 7
Sales
Monitor Games
Fiscal 2005-2007
(\$ in Millions)



Source: State Lottery Agency

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It is likely that the introduction of Race Trax drove a substitution effect. In fiscal 2007, sales fell for Keno and Keno Bonus. In fiscal 2006, sales for Keno and Keno Bonus reached \$436.3 million. There were no sales for Race Trax in fiscal 2006. The following fiscal year, sales for Keno and Keno Bonus were \$412.6, a decline of \$23.6 million. Race Trax sales were \$49.8 million, leading to an increase in monitor games as a whole. However, it is unclear what the total increase would have been absent the new game and absent the substitution effect.

A third monitor game, Maryland Hold'Em, was released in fall 2008. Maryland Hold'Em is a virtual card game similar to poker. It is currently in 144 locations across the State. Fiscal 2008 sales estimates do not include any sales forecasts associated with the new game. It is, therefore, difficult to predict the impact that the new game will have on sales of Keno, Keno Bonus, or Race Trax.

It is also unclear what the long-term impact of Race Trax will be. Keno was introduced 15 years ago. However, the agency released Maryland Hold 'Em just one year after the introduction of Race Trax. It is possible that this release schedule will lead to an over saturation of monitor games.

DLS recommends that budget bill language be added that prohibits funds being spent on the expansion of monitor games until the agency reports to the budget committees on the impact of additional monitor games and specific strategies for avoiding over saturation of monitor games.

Recommended Actions

1. Add the following language to the special fund appropriation:

. provided that no funds may be expended on or committed to the expansion of monitor games in the State until the agency reports to the budget committees on the impact of additional monitor games and specific strategies for preventing over saturation of monitor games. The budget committees shall have 45 days to review and comment on any proposed expansion.

Explanation: Despite consistent increases in sales over the last decade, Keno and Keno Bonus sales fell in fiscal 2007 after the introduction of a second monitor game. It is unclear if a third monitor game, introduced in fiscal 2008, will further negatively impact current monitor game sales. Before the expansion of additional monitor games, the agency should have a clear defined strategy for monitor games that addresses potential substitution effects and inefficiencies that could result from an over saturation of monitor games.

	<u>Amount Reduction</u>	
2. Delete the net increase in advertising expenses. This action would return funding for advertising to fiscal 2008 appropriation levels.	\$ 589,500	SF
Total Special Fund Reductions	\$ 589,500	

Current and Prior Year Budgets

Current and Prior Year Budgets State Lottery Agency (\$ in Thousands)

	<u>General Fund</u>	<u>Special Fund</u>	<u>Federal Fund</u>	<u>Reimb. Fund</u>	<u>Total</u>
Fiscal 2007					
Legislative Appropriation	\$0	\$58,278	\$0	\$0	\$58,278
Deficiency Appropriation	0	0	0	0	0
Budget Amendments	0	171	0	0	171
Reversions and Cancellations	0	-6,641	0	0	-6,641
Actual Expenditures	\$0	\$51,808	\$0	\$0	\$51,808
Fiscal 2008					
Legislative Appropriation	\$0	\$57,956	\$0	\$0	\$57,956
Cost Containment	0	-352	0	0	-352
Budget Amendments	0	0	0	0	0
Working Appropriation	\$0	\$57,604	\$0	\$0	\$57,604

Note: Numbers may not sum to total due to rounding.

Fiscal 2007

The original fiscal 2007 special fund appropriation of \$58.3 million was increased by \$171,133 for a State employee cost-of-living adjustment. However, the agency canceled approximately \$6.6 million in special funds, leaving the agency's budget well below what was originally appropriated. In fiscal 2007, the agency contracted with a new vendor for its on-line and Instant ticket games. The budget was compiled using the parameters of the previous contract. As such, contract funds were overbudgeted. Similarly, the agency overbudgeted approximately \$1.0 million for costs associated with the start-up of its new satellite communication system.

Fiscal 2008

A fiscal 2008 budget amendment on cost containment resulted in the decrease of \$351,500 in special funds due to overbudgeting for the on-line gaming system contract due to a revised sales estimate.

**Sales and Commission by Jurisdiction
Fiscal 2007**

<u>Jurisdiction</u>	<u>Total Sales</u>	<u>% of Sales</u>	<u>Number of Sales Agents</u>	<u>Commissions Earned</u>
Allegany	\$10,651,701	0.7%	52	\$585,844
Anne Arundel	165,042,541	10.5%	360	9,077,340
Baltimore	241,454,889	15.4%	586	13,280,019
Calvert	22,269,698	1.4%	52	1,224,833
Caroline	7,004,769	0.5%	26	385,262
Carroll	30,297,106	1.9%	114	1,666,341
Cecil	15,964,184	1.0%	81	878,030
Charles	54,912,943	3.5%	114	3,020,212
Dorchester	7,898,762	0.5%	32	434,432
Frederick	32,932,708	2.1%	131	1,811,299
Garrett	2,836,047	0.2%	22	155,983
Harford	53,116,230	3.4%	154	2,921,393
Howard	36,702,763	2.3%	127	2,018,652
Kent	4,085,382	0.3%	16	224,696
Montgomery	143,179,132	9.1%	340	7,874,852
Prince George's	319,962,689	20.4%	516	17,597,948
Queen Anne's	9,354,775	0.6%	38	514,513
St. Mary's	36,884,503	2.4%	87	2,028,648
Somerset	5,781,763	0.4%	19	317,997
Talbot	7,511,477	0.5%	29	413,131
Washington	25,061,762	1.6%	104	1,378,397
Wicomico	19,832,008	1.3%	70	1,090,760
Worcester	26,834,885	1.7%	83	1,475,919
Baltimore City	293,026,683	18.6%	614	16,116,468
Total	\$1,572,599,400	100.00%	3,767	\$86,492,967

**Object/Fund Difference Report
State Lottery Agency**

<u>Object/Fund</u>	<u>FY07 Actual</u>	<u>FY08 Working Appropriation</u>	<u>FY09 Allowance</u>	<u>FY08 - FY09 Amount Change</u>	<u>Percent Change</u>
Positions					
01 Regular	172.00	172.00	171.00	-1.00	-0.6%
02 Contractual	11.50	9.50	9.50	0	0%
Total Positions	183.50	181.50	180.50	-1.00	-0.6%
Objects					
01 Salaries and Wages	\$ 11,793,939	\$ 12,073,997	\$ 12,941,970	\$ 867,973	7.2%
02 Technical and Special Fees	456,173	310,953	354,548	43,595	14.0%
03 Communication	247,700	475,434	432,547	-42,887	-9.0%
04 Travel	53,151	68,200	68,000	-200	-0.3%
06 Fuel and Utilities	150,088	160,682	150,088	-10,594	-6.6%
07 Motor Vehicles	374,872	439,816	301,692	-138,124	-31.4%
08 Contractual Services	37,094,932	42,455,994	43,988,447	1,532,453	3.6%
09 Supplies and Materials	146,211	189,000	192,500	3,500	1.9%
10 Equipment - Replacement	53,476	70,525	65,525	-5,000	-7.1%
11 Equipment - Additional	505,207	576,139	571,636	-4,503	-0.8%
13 Fixed Charges	932,305	983,650	981,566	-2,084	-0.2%
Total Objects	\$ 51,808,054	\$ 57,804,390	\$ 60,048,519	\$ 2,244,129	3.9%
Funds					
03 Special Fund	\$ 51,808,054	\$ 57,804,390	\$ 60,048,519	\$ 2,244,129	3.9%
Total Funds	\$ 51,808,054	\$ 57,804,390	\$ 60,048,519	\$ 2,244,129	3.9%

Note: The fiscal 2008 appropriation does not include deficiencies.