

Executive Director: Art Macias

JLBC Analyst: Leatta McLaughlin

| | FY 2006 Actual | FY 2007 Estimate | FY 2008 Approved | FY 2009 Approved |
|---------------------------------------|-------------------|---------------------|--------------------------------|--------------------------------|
| OPERATING BUDGET | | | | |
| <i>Full Time Equivalent Positions</i> | 110.0 | 110.0 | 110.0 | 110.0 |
| Personal Services | 4,148,300 | 4,787,400 | 5,010,500 | 4,854,000 |
| Employee Related Expenditures | 1,366,500 | 1,616,700 | 1,748,300 | 1,635,900 |
| Professional and Outside Services | 272,900 | 366,800 | 383,400 | 366,800 |
| Travel - In State | 265,900 | 246,400 | 262,600 | 250,900 |
| Travel - Out of State | 18,000 | 16,700 | 16,700 | 28,400 |
| Other Operating Expenditures | 567,000 | 622,700 | 633,000 | 633,000 |
| Equipment | 346,400 | 102,700 | 265,700 | 69,100 |
| OPERATING SUBTOTAL | 6,985,000 | 7,759,400 | 8,320,200 | 7,838,100 |
| SPECIAL LINE ITEMS | | | | |
| Advertising ^{1/} | 10,777,700 | 11,000,000 | 11,000,000 ^{2/} | 11,000,000 ^{2/} |
| Instant Tickets ^{1/} | 7,697,700 | 9,403,500 | 9,565,000 ^{3/} | 9,645,700 ^{3/} |
| On-Line Vendor Fees ^{1/} | 9,849,000 | 8,399,000 | 8,562,700 ^{4/} | 8,771,600 ^{4/} |
| Retailer Commissions ^{1/} | 30,858,000 | 31,371,300 | 32,029,500 ^{5/} | 32,526,900 ^{5/} |
| Sales Incentive Program | 21,300 | 50,000 | 50,000 | 50,000 |
| Telecommunications | 2,705,500 | 2,814,400 | 654,400 | 654,400 |
| AGENCY TOTAL | 68,894,200 | 70,797,600 | 70,181,800^{6/} | 70,486,700^{6/} |

FUND SOURCES

Other Appropriated Funds

| | | | | |
|--------------------------------------|--------------------|--------------------|--------------------|--------------------|
| State Lottery Fund | 68,894,200 | 70,797,600 | 70,181,800 | 70,486,700 |
| SUBTOTAL - Other Appropriated Funds | 68,894,200 | 70,797,600 | 70,181,800 | 70,486,700 |
| SUBTOTAL - Appropriated Funds | 68,894,200 | 70,797,600 | 70,181,800 | 70,486,700 |
| Other Non-Appropriated Funds | 261,849,000 | 260,818,900 | 269,089,700 | 273,538,400 |
| TOTAL - ALL SOURCES | 330,743,200 | 331,616,500 | 339,271,500 | 344,025,100 |

AGENCY DESCRIPTION — The Arizona Lottery is responsible for administering sanctioned games of chance. Arizona-specific games include instant tickets, the Pick, Pick 3, and Fantasy 5 on-line games. Arizona also participates in the multi-state Powerball on-line game.

- ^{1/} Advertising, Instant Tickets, On-line Vendor Fees, and Retailer Commissions are appropriated as a percentage of sales. Therefore, the amounts shown for those line items are estimates only.
- ^{2/} An amount equal to 2.7% of gross lottery game sales, but no more than \$11,000,000, is appropriated for Advertising in accordance with A.R.S. § 5-505, which states that not more than 4% of the annual gross revenues shall be expended for Advertising. Based on projected sales, this amount is currently estimated to reach the \$11,000,000 cap in FY 2008 and FY 2009. (General Appropriation Act footnote)
- ^{3/} An amount equal to 3.6% of actual instant ticket sales is appropriated for the printing of instant tickets or for contractual obligations concerning instant ticket distribution. This amount is currently estimated to be \$9,565,000 in FY 2008 and \$9,645,700 in FY 2009. (General Appropriation Act footnote)
- ^{4/} An amount equal to a percentage of actual on-line game sales as determined by contract is appropriated for payment of on-line vendor fees. This amount is currently estimated to be \$8,072,200 in FY 2008 and \$8,269,100 in FY 2009 or 3.8012% of actual on-line ticket sales. (General Appropriation Act footnote) As of June 2007, this estimate is \$8,399,000 in FY 2007, \$8,562,700 in FY 2008, and \$8,771,600 in FY 2009 due to a provision in the on-line vendor contract which allowed the Lottery Commission to implement GamePoint options. Exercising this provision increased the rate to 4.0322% of on-line game sales beginning April 2007.
- ^{5/} An amount equal to 6.5% of gross lottery game sales is appropriated for payment of sales commissions to ticket retailers. In accordance with Laws 1997, Chapter 214, an additional amount of not to exceed 0.5% of gross lottery game sales is appropriated for payment of sales commissions to ticket retailers. The combined amount is currently estimated to be 6.7% of total ticket sales, or \$32,029,500 in FY 2008 and \$32,526,900 in FY 2009. (General Appropriation Act footnote)
- ^{6/} General Appropriation Act funds are appropriated as an Operating Lump Sum with Special Line Items by Agency.

| PERFORMANCE MEASURES | FY 2004 | FY 2005 | FY 2006 | FY08 - FY09 |
|---|---------|---------|---------|-------------|
| | Actual | Actual | Actual | Approved |
| <ul style="list-style-type: none"> Increase in on-line sales from prior year (\$ in millions) Comments: On-line sales are largely jackpot driven, impacting sales in any given year. | 20.3 | (5.4) | 41.0 | 5.3/5.2 |
| <ul style="list-style-type: none"> Increase in instant ticket sales from prior year (\$ in millions) | 24.0 | 36.4 | 30.1 | 4.5/2.2 |
| <ul style="list-style-type: none"> Customer satisfaction rating for retailers (Scale 1-8) | 7.0 | 7.6 | 7.8 | 7.5/7.5 |

Operating Budget

The budget provides \$8,320,200 and 110 FTE Positions from the State Lottery Fund for the operating budget in FY 2008 and \$7,838,100 and 110 FTE Positions in FY 2009. These amounts fund the following adjustments:

Statewide Adjustments

The budget provides an increase of \$261,200 from the State Lottery Fund in FY 2008 and a decrease of \$(24,300) in FY 2009 for statewide adjustments. *(Please see the Statewide Adjustments section at the end of this Appropriations Report for details. The annualization of these adjustments for FY 2009 will be addressed in the 2008 budget process.)*

Computer Replacement

The budget provides a one-time increase of \$150,000 from the State Lottery Fund in FY 2008 for the purchase of a computer system. The Lottery currently has 3 systems. One system is used as the main back-up for production processing, a second system is used as a secondary back-up for the main production system, and the third is used for software development and quality assurance testing. The first system was replaced in FY 2006, and the agency estimates the third system will need to be replaced in FY 2012. The Government Information Technology Agency approved the Lottery's Project Investment Justification for the computer upgrade of the second system in August 2006.

Replacing the second system will allow for business continuity, disaster recovery purposes, and a redundant system for Powerball drawings in the event of a system failure. A redundant back-up system configuration is a requirement for participation in the Powerball multi-state game. This system would be moved from Phoenix to Tucson to provide an off-site location for disaster recovery.

Additional Vehicle

The budget provides an increase of \$29,400 from the State Lottery Fund in FY 2008 and \$11,700 in FY 2009 to purchase an additional vehicle for the Security Division. Of the \$29,400 FY 2008 increase, \$17,700 would be a one-time expense to purchase the vehicle, while the remaining

\$11,700 would fund ongoing fleet management and in-state travel costs.

Currently 5 Investigators and 1 Supervisor share 3 vehicles in the Security Division, 1 of which is a spare vehicle. In FY 2006, the agency conducted 17% more investigations when compared to FY 2005. Investigators monitor retailer and age 21 compliance, perform background checks on license retailers, conduct criminal investigations regarding Lottery ticket theft, and investigate various retailer and public complaints.

Personnel Funding

The budget provides an increase of \$120,200 from the State Lottery Fund in FY 2008 and \$91,300 in FY 2009 to fund a Product Management Assistant and a Special Investigator. This would not require an increase in the number of appropriated FTE Positions as the funding would be used to fill existing vacancies.

The Product Management Assistant position would assist in managing the instant ticket product line. Instant ticket games include Powerball, The Pick, Fantasy 5, and Pick 3. Currently 1 person manages instant ticket games, which have grown by 48% from FY 2000 to FY 2006.

The Special Investigator position would provide enforcement and compliance of agency functions, such as retailer compliance checks, background checks to license retailers, and criminal investigations regarding Lottery ticket theft. The commission investigated 17% more theft cases in FY 2006 when compared to the prior fiscal year, and had a 71% increase of cases that were classified as criminal in FY 2006 compared to FY 2005.

Special Line Items

Advertising

The budget provides \$11,000,000 from the State Lottery Fund for Advertising in FY 2008 and FY 2009. This amount is unchanged from FY 2007.

Monies in this line item are used to promote and market Lottery games. The actual appropriation is for 2.7% of total ticket sales, but no more than \$11,000,000. Based on projected sales, this amount is estimated to reach the \$11,000,000 cap in FY 2008 and FY 2009.

Instant Tickets

The budget provides \$9,565,000 from the State Lottery Fund for Instant Tickets in FY 2008 and \$9,645,700 in FY 2009. These amounts fund the following adjustment:

Sales Increase

The budget provides an increase of \$161,500 from the State Lottery Fund in FY 2008 and an increase of \$242,200 in FY 2009 for Instant Tickets due to higher projected sales.

Monies in this line item are used to pay for instant ticket printing and distribution costs. The actual appropriation is for 3.6% of instant ticket sales. The amount displayed is derived by applying the approved spending percentage to the forecasted sales total.

On-Line Vendor Fees

The budget provides \$8,562,700 from the State Lottery Fund for On-Line Vendor Fees in FY 2008 and \$8,771,600 in FY 2009. These amounts fund the following adjustment:

New Vendor Contract

The budget provides an increase of \$163,700 from the State Lottery Fund in FY 2008 and \$372,600 in FY 2009 for On-Line Vendor Fees due to a new on-line vendor contract.

Monies in this line item are used to pay the vendor that operates the on-line game computer system. The actual appropriation is equal to a percentage of on-line ticket sales specified in the Lottery's contractual agreement with the vendor. The new contract, which took effect September 2006, specifies that the contractor will be paid 3.8012% of on-line ticket sales through March 2007 and 4.0322% of on-line ticket sales beginning April 2007. The prior contract was for 4.99% of on-line ticket sales. The new contractor will incorporate network-related telecommunication costs for the first time, which will result in a decreased appropriation for the Telecommunications Special Line Item (SLI). (*See the Telecommunications SLI for more information.*)

The displayed amount is derived by applying the approved percentage to the forecasted sales total. The old contract rate of 4.99% was applied to the first 2 months of FY 2007, the 3.8012% rate was applied to the next 7 months of 2007, and the new rate of 4.0322% was applied to the remaining 3 months of FY 2007 and all of FY 2008 and FY 2009.

Retailer Commissions

The budget provides \$32,029,500 from the State Lottery Fund for Retailer Commissions in FY 2008 and \$32,526,900 in FY 2009. These amounts fund the following adjustment:

Sales Increase

The budget provides an increase of \$658,200 from the State Lottery Fund in FY 2008 and \$1,155,600 in FY 2009 for Retailer Commissions due to higher projected sales.

Monies in this line item are used to compensate retailers for selling lottery tickets. The actual appropriation is equal to 6.5% of total ticket sales. Pursuant to statute, an additional 0.5% of total ticket sales may be paid to retailers based on their attainment of specified sales and marketing objectives. Since 40% of retailers are estimated to meet these objectives, this would result in an additional 0.2% in retailer commissions and a total retail commission rate of 6.7%. The displayed amount is derived by applying the approved percentage to the forecasted sales total.

Sales Incentive Program

The budget provides \$50,000 from the State Lottery Fund for the Sales Incentive Program in FY 2008 and FY 2009. This amount is unchanged from FY 2007. Monies in this line item are used to provide monetary incentives to employees in the Lottery's Marketing Division for working with retailers to increase sales.

Telecommunications

The budget provides \$654,400 from the State Lottery Fund for Telecommunications in FY 2008 and FY 2009. This amount funds the following adjustment:

New Vendor Contract

The budget provides a decrease of \$(2,160,000) from the State Lottery Fund in FY 2008 and FY 2009 for Telecommunications due to a new on-line vendor contract. A new on-line vendor contract took effect September 2006, and for the first time, the new contractor will incorporate network-related telecommunication costs. The Telecommunications SLI will still require an appropriation for non-network related telecom costs. (*See the On-Line Vendor Fees SLI for more information.*)

Monies in this line item are used to pay for all costs related to the Lottery's telecommunications network. The Lottery provides telecommunications services to retailers who sell on-line game tickets through a contract with private vendors.

Other Issues

Lottery Forecast

The following table displays the January 2007 JLBC Staff forecast of Lottery ticket sales and the corresponding profit distribution. The JLBC Staff forecasts a slight decrease in overall Lottery sales for FY 2007, followed by moderate increases in FY 2008 and FY 2009. Lottery sales are forecast to be \$468,200,000 in FY 2007, \$478,100,000 in FY 2008, and \$485,500,000 in FY 2009.

Table 1**Forecast of Lottery Revenue Distribution
(\$ in Millions)**

| | <u>FY 2006</u> | <u>FY 2007</u> | <u>FY 2008</u> | <u>FY 2009</u> |
|-------------------------------------|----------------|-----------------------|---------------------------|---------------------------|
| Sales: | | | | |
| Instant Sales | \$249.8 | \$261.2 | \$265.7 | \$267.9 |
| On-Line Sales | <u>218.9</u> | <u>207.0</u> | <u>212.4</u> | <u>217.5</u> |
| Total Sales | \$468.7 | \$468.2 ^{1/} | \$478.1 | \$485.5 |
| Less: | | | | |
| Operating Budget | \$ 68.9 | \$ 70.8 | \$ 69.3 | \$ 69.9 |
| Prizes ^{2/} | <u>261.8</u> | <u>260.8</u> | <u>269.1</u> | <u>273.5</u> |
| Net Profit ^{3/} | \$138.0 | \$136.6 | \$139.6 | \$142.0 |
| Profit Transfers: | | | | |
| LTAf | \$ 23.0 | \$ 23.0 | \$ 23.0 | \$ 23.0 |
| CAF | 7.7 | 7.7 | 7.7 | 7.7 |
| Heritage | 20.0 | 20.0 | 20.0 | 20.0 |
| Econ. Development | 4.0 | 4.1 | 4.2 | 4.2 |
| Mass Transit | 18.0 | 14.2 | 18.0 | 18.0 |
| Health & Welfare | | | | |
| Programs | 20.0 | 20.7 | 21.1 | 21.5 |
| General Fund | <u>45.3</u> | <u>47.0</u> | <u>45.7</u> ^{4/} | <u>47.6</u> ^{4/} |
| Total Transfer ^{5/} | \$138.0 | \$136.6 | \$139.6 | \$142.0 |

^{1/} Total sales were \$425,360,000 through May 2007.

^{2/} Prizes are estimated by subtracting net profit and operating budget expenditures from total Lottery sales.

^{3/} To derive the profit transfer amounts, the actual FY 2006 rate of return for each game was applied to the current forecast.

^{4/} FY 2008 and FY 2009 General Fund revenues will be reduced by up to \$1,000,000 due to the newly established Homeless Shelter Fund.

^{5/} Total Transfers might not add due to rounding.

The largest single contributor to the FY 2007 forecasted decrease is the multi-state Powerball game. In FY 2006, this game reached its highest historical sales level due to several large jackpots. Due to the uncertainty of predicting when large jackpots will accumulate, the forecast calls for a decrease in FY 2007, followed by modest growth in FY 2008 and FY 2009.

Sources and Uses of Lottery Profit Distributions

Table 1 shows the sources of forecasted Lottery profits by revenue stream and illustrates the actual distributions to fund beneficiaries for FY 2006 and the projected distributions through FY 2009. A brief description of each beneficiary and its Lottery-generated revenue sources follows.

Local Transportation Assistance Fund (LTAf)

LTAf receives shares of the proceeds from the Pick, Fantasy 5, and Instant Tickets games. The funds are distributed to counties, cities, and towns. The uses include road building, traffic signals, sidewalk and alley repair, general maintenance, and Dial-a-Ride operating expenses.

County Assistance Fund (CAF)

Shares of the proceeds from 3 games – The Pick, Fantasy 5, and Instant Tickets – are directed to CAF, which receives a maximum of \$7,650,000 each fiscal year. The monies are distributed to the General Funds of each of the counties to be used at their discretion.

Heritage Fund

The Heritage Fund receives a portion of the proceeds from the Pick, Pick 3, Fantasy 5, Instant Tickets, and Scratch Bingo games up to a maximum of \$20,000,000. Monies are divided equally between the Game and Fish Commission Heritage Fund and the State Parks Board Heritage Fund. The funds are used to promote wildlife habitat and education programs, rehabilitate historic buildings, acquire and develop parkland, and renovate trail systems, among other purposes.

Commerce and Economic Development (CEDC) Fund

Administered by the Arizona Department of Commerce, CEDC receives its funds from the sales of 2 Arizona Lottery Scratchers games. The funds are used to support the state's community and economic development goals, initiatives, and strategic plans as defined and developed by the CEDC.

Mass Transit Fund

The Mass Transit Fund (otherwise known as LTAf II) receives its monies from Powerball ticket sales after obligations to the General Fund are met. The funds are used by the counties to enhance existing public transportation systems.

Health and Welfare Programs

Once Healthy Arizona Funds reached the \$17,000,000 statutory limit in FY 2005, annual adjustments for inflation are to be made to the cap in each subsequent fiscal year. The amount is pro-rated and distributed among the following agencies:

- 29.4% to the Department of Economic Security for the Healthy Families program.
- 23.5% to the Board of Regents for the Arizona Health Education Center program.
- 17.6% to the Department of Health Services (DHS) for teenage pregnancy prevention.
- 11.8% to DHS for the Disease Control Research Center.
- 11.8% to DHS for the Health Start program.
- 5.9% to DHS for the Women, Infants and Children food program.

General Fund

The General Fund derives most of its Lottery proceeds from the sale of multi-state (Powerball) tickets. It also receives additional funds that are remaining after the statutory funding obligations have been met.

Additional Legislation

Homeless Shelter and Services Funding

The General Revenues Budget Reconciliation Bill (Laws 2007, Chapter 260) revises the Lottery distribution formula, and annually appropriates up to \$1,000,000 to the Department of Economic Security (DES). The department shall use the funding to distribute grants to nonprofit

organizations, including faith based organizations, for homeless emergency and transitional shelters and related support services. DES is required to submit an annual report by December 31 to the Governor, Speaker of the House of Representatives, President of the Senate, and the Joint Legislative Budget Committee on the amounts, recipients, purposes, and results of each grant. *(Please see the Department of Economic Security Aging and Community Services Cost Center for more information.)*

The fund would annually reduce General Fund revenues beginning in FY 2008 by up to \$1,000,000 since these monies would have otherwise been deposited into the General Fund.

