

**E75D
State Lottery Agency**

Operating Budget Data

(\$ in Thousands)

| | <u>FY 04 Actual</u> | <u>FY 05 Working</u> | <u>FY 06 Allowance</u> | <u>FY 05-06 Change</u> | <u>% Change Prior Year</u> |
|---|-------------------------|--------------------------|----------------------------|----------------------------|--------------------------------|
| Special Fund | \$50,689 | \$51,817 | \$55,473 | \$3,656 | 7.1% |
| Total Funds | \$50,689 | \$51,817 | \$55,473 | \$3,656 | 7.1% |
| Contingent & Back of Bill Reductions | | | -67 | -67 | |
| Adjusted Total | \$50,689 | \$51,817 | \$55,406 | \$3,589 | 6.9% |

- After adjusting for the contingent reductions, the fiscal 2006 budget allowance increases 6.9%, or \$3.6 million from \$51.8 million in fiscal 2005 to \$55.4 million in fiscal 2006.
- The increase in the allowance is largely due to a \$3.7 million increase in the advertising and promotions budget.

Personnel Data

| | <u>FY 04 Actual</u> | <u>FY 05 Working</u> | <u>FY 06 Allowance</u> | <u>FY 05-06 Change</u> |
|------------------------|-------------------------|--------------------------|----------------------------|----------------------------|
| Regular Positions | 170.00 | 168.00 | 174.00 | 6.00 |
| Contractual FTEs | 10.75 | 11.00 | 8.50 | -2.50 |
| Total Personnel | 180.75 | 179.00 | 182.50 | 3.50 |

Vacancy Data: Regular Positions

| | | |
|-----------------------------------|------|-------|
| Turnover, Excluding New Positions | 6.61 | 3.80% |
| Positions Vacant as of 12/31/04 | 7.00 | 4.17% |

- The fiscal 2006 allowance adds 6 regular positions which are offset by a reduction of 2.5 contractual positions. The 6 new positions include a public affairs specialist, a cost accountant, an accounts receivable supervisor, a procurement specialist, and 2 computer programmers. The reduction in contractual positions reflects actual usage in fiscal 2004.

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

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E75D – State Lottery Agency

- The State Lottery Agency's budgeted turnover rate of 3.8% requires that an average of 6.61 positions remain vacant throughout fiscal 2006 to achieve the \$409,633 in savings required. The agency's current number of vacant positions is 7, or 4.2% of the Lottery's workforce; 6 have been vacant for less than 6 months; and 1 has been vacant for longer than 12 months.

Analysis in Brief

Major Trends

Agency Earnings: Lottery agents are compensated with commissions and bonuses for selling and cashing lottery tickets. The expenditures for these commissions and bonuses has increased commensurate with the increase in lottery sales. As a percentage of total sales, these commissions and bonuses have remained at approximately 6.6%

Operating Budget to Sales Ratio: The lottery's operating budget is estimated to increase from \$51.8 million in fiscal 2005 to a proposed \$55.4 million in fiscal 2006. The increase is primarily due to a \$3.7 million increase in the advertising budget. As a percentage of sales, the agency's operating budget has increased from 3.6% in fiscal 2005 to a proposed 3.7% in fiscal 2006.

Prize Payouts Remain Stable: In order to keep game interest high, the Lottery changes its game offerings and at times the individual game matrix. Prize payouts have remained at approximately 56.8% of total sales.

Issues

Overview of Sales and Revenue Results and Forecasts: Fiscal 2004 sales reached \$1.4 billion, resulting in revenues of \$436.4 million to the general fund after distributing \$22.0 million to the Maryland Stadium Authority. Current revenue estimates total \$446.2 million to the general fund for fiscal 2005 and \$461.1 million for fiscal 2006. **The Department of Legislative Services (DLS) recommends that the Lottery brief the committees on the sales and revenue outlook for fiscal 2005 and 2006.**

Record Sales Growth Despite Reductions in Advertising Budget: The fiscal 2006 allowance provides the lottery with an advertising and promotions budget of \$17.5 million. This represents a 27% increase over the fiscal 2005 working appropriation. A review of the fiscal 2001 through 2005 sales, revenue, and advertising trends reveals that increased funding for advertising does not necessarily lead to increased sales and revenue. **DLS is recommending a \$3.7 million reduction in the advertising budget. This reduction provides the same level of funding as in fiscal 2005.**

E75D – State Lottery Agency

Recommended Actions

| | <u>Funds</u> | <u>Positions</u> |
|--|---------------------|------------------|
| 1. Reduce funds for Lottery marketing activities. | \$ 3,720,000 | |
| 2. Delete four new regular positions and associated benefits. | 182,556 | 4.0 |
| 3. Delete one new regular position and associated benefits, but leave funds to convert position to a contractual full-time equivalent. | 10,394 | 1.0 |
| Total Reductions | \$ 3,912,950 | 5.0 |

E75D – State Lottery Agency

E75D
State Lottery Agency

Operating Budget Analysis

Program Description

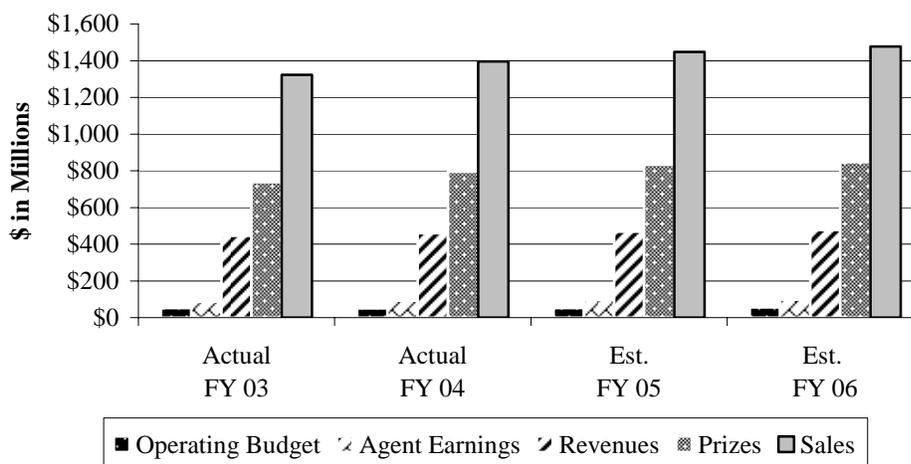
The Maryland State Lottery Agency administers and operates lottery games for the purpose of generating revenue for the State. The State Lottery Commission, consisting of five members appointed by the Governor, has oversight responsibility for the agency. The lottery, which has been in operation since 1973, consists of six divisions plus a security unit. The six divisions are Administration, Finance, and Operations (AFO); Information Technology; Marketing; Sales; Public Affairs; and Executive.

The lottery games are sold through lottery agents which are private businesses that receive fees in exchange for selling the games to the public. All operating expenses of the agency are paid out of the proceeds from the games. The lottery currently offers eight games: Pick 3, Pick 4, Lotto, Keno, Keno Bonus, Mega Millions, Bonus Match Five, and the Instant Games. In fiscal 2004, 56.9% of sales receipts paid for prizes, 6.5% paid for agent commissions and redemption fees, 3.6% paid the agency's operating costs, and the remaining 32.8% of the receipts was credited as revenue to the State.

Performance Analysis: Managing for Results

Exhibit 1 provides fiscal 2003 and 2004 actual and fiscal 2005 and 2006 estimated figures for lottery sales, agent earnings, operating budget expense, and prize amounts.

**Exhibit 1
Lottery Sales and Selected Expenditures**



Source: Maryland State Lottery

- Agent Earnings Keep Pace with Sales:** Lottery agents are compensated with a commission for selling and cashing lottery tickets. In addition, the lottery maintains an agent bonus and incentive program that is capped at one-half of 1% of gross sales. As shown in Exhibit 1, the total amount of agent earnings is expected to be \$97.5 million in fiscal 2006, or \$2.2 million more than what was paid to agents in fiscal 2005. However, as a percentage of sales these earnings have remained steady at approximately 6.58% of gross sales annually.
- Operating Budget to Sales Ratio:** One of the agency’s Managing for Results (MFR) goals is to achieve a ratio of operating costs to sales of 5% or less on an annual basis. As shown in Exhibit 1, the lottery has surpassed its objective in the last four fiscal years. Based on anticipated sales and operating costs in fiscal 2005 and 2006, the lottery will continue to maintain a cost to sales ratio below 4%. In fiscal 2006, the operating budget to sales ratio is expected to increase from 3.6% in fiscal 2005 to a proposed ratio of 3.7% of total sales. The increase is primarily due to a \$3.7 million increase in the advertising budget.
- Prize Payouts Remain Stable:** Prize payouts for the games operated by the lottery are expected to be \$847.2 million in fiscal 2006, which is up from the \$833.5 million paid out in prizes in fiscal 2005. The sales to prize ratio is expected to increase 1.3% from fiscal 2003 to 2006, primarily due to the growth in sales primarily being derived from Keno and Instant games which naturally have higher payout ratios.

Governor’s Proposed Budget

As shown in **Exhibit 2**, the Governor’s fiscal 2006 budget includes one contingent reduction:

- \$67,197 for matching employee deferred compensation contributions up to \$600 contingent upon enactment of a provision in the 2006 budget reconciliation legislation.

After adjusting for the contingent reduction, the Governor’s fiscal 2006 allowance for the Lottery increases \$3.6 million, or 6.9% over the fiscal 2005 working appropriation. The majority of the increase is the result of a \$3.7 million increase in the advertising and promotional budget. Exhibit 2 summarizes the major changes.

Exhibit 2
Governor’s Proposed Budget
State Lottery Agency
(\$ in Thousands)

| How Much It Grows: | <u>Special</u> <u>Fund</u> | <u>Total</u> |
|---|---------------------------------------|---------------------|
| 2005 Working Appropriation | \$51,817 | \$51,817 |
| 2006 Governor’s Allowance | 55,473 | 55,473 |
| Contingent & Back of Bill Reductions | <u>-67</u> | <u>-67</u> |
| Adjusted Allowance | 55,406 | 55,406 |
| Amount Change | \$3,589 | \$3,589 |
| Percent Change | 6.9% | 6.9% |

Where It Goes:

Personnel Expenses

| | |
|---|-------|
| Six new positions..... | \$279 |
| Increments and other compensation | 202 |
| Employee and retiree health insurance | -62 |
| Retirement..... | 83 |
| Turnover adjustments | -37 |
| Other fringe benefit adjustments..... | 123 |

Other Changes

| | |
|--|-----|
| Decrease of 2.5 contractual positions | -54 |
| Decreased travel | -24 |
| Decreased utilities..... | -30 |
| Increased motor vehicle to replace seven vans over 100,000 miles. | 65 |

E75D – State Lottery Agency

| | |
|--|----------------|
| Increased funding to support advertising and promotion of Lottery products..... | 3,720 |
| Instant ticket printing | 240 |
| Consultant fees..... | 77 |
| Telecommunications lines/modems..... | -67 |
| Increase in vendor fees – instant and on-line games..... | 500 |
| Reduced capital lease payment – instant ticket vending machine and quick check terminal leases paid off..... | -1,165 |
| Decrease in Department of Budget and Management (DBM) paid telecommunication charges | -179 |
| Rent expense..... | -34 |
| Miscellaneous | -48 |
| Total | \$3,589 |

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

Personnel Expenses

The fiscal 2006 allowance provides \$10.7 million for personnel expenses to support 174 regular employees. These expenses account for 19.0% of the agency's total budget and accounts for \$588,621 of the \$3.6 million of additional funds provided in the allowance. Personnel related changes include an increase of \$278,744 for the following six new positions:

- Public Affairs Officer I – To support the expansion of promotional activities at local events statewide.
- Two Computer Programmers – To create database applications for new product introductions and game promotions.
- Accountant Advanced – The Lottery Commission has requested the Lottery convert to a cost accounting system. Currently, the agency allocates its administrative expenses across games based on percentage of sales. Cost accounting would require the specific identification of costs as they relate to each game. The agency does not have a cost accountant to comply with this request.
- Accountant Lead – This position would be utilized as an accounts receivable supervisor responsible for providing assistance to lottery agents. The assistance primarily entails answering questions concerning the agent's weekly sweep and resolving financial and accounting issues. Currently, the Controller and Assistant Controller provide this assistance.

E75D – State Lottery Agency

- Procurement Specialist II – In fiscal 2006, the Lottery will need to issue several major request for proposals (RFP), which will include at least the following:
 - on-line games computer system;
 - research and related services;
 - printing of instant tickets and related services; and
 - televised drawings.

The State is over the Spending Affordability Committee position cap by 153 positions, and as a result the Department of Legislative is recommending the deletion of 4 new positions and the conversion of the Procurement Specialist II to a contractual position. The RFP's will result in multi-year contracts; therefore, a full-time position to procure the contracts is not a requirement.

Other personnel adjustments include an increase of \$202,005 for increments; a decrease of \$36,716 due to an increase in turnover from 3.5% in fiscal 2005 to 3.8% in fiscal 2006; a decrease of \$61,613 in health insurance; and an increase of \$83,139 in retirement benefits.

Non-personnel Expenses

The Lottery's total advertising and promotions budget for fiscal 2006 is \$17.5 million, which represents an increase of \$3.7 million over the fiscal 2005 working appropriation. Other significant adjustments include an increase of \$239,500 for instant ticket printing and an increase of \$500,000 for vendor fees. Vendor fees are estimated at 0.7% of projected sales and increase commensurate with an increase in lottery sales. The allowance includes a reduction of \$1.2 million due to the retirement of two equipment leases and a \$179,047 decrease in DBM paid telecommunication charges. DBM modified the statewide allocation formula decreasing the Lottery's share of the expense. The Lottery utilizes consultants to advise on state-of-the-art technology and to assist in the development of RFPs. In fiscal 2006 on-line gaming consultant fees increase \$77,200. Motor vehicle expense increases \$64,843 due to the replacement of seven vans: one compact van (\$10,287) and six full-size cargo vans (\$54,556) that are in excess of 100,000 miles.

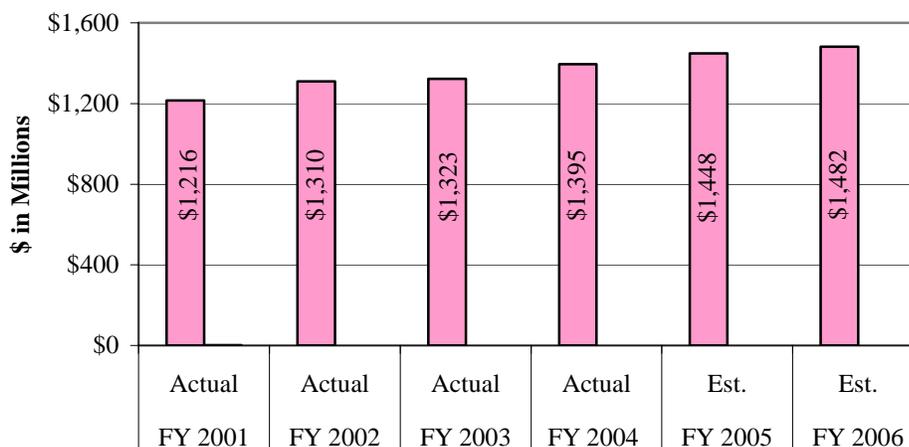
Issues

1. Overview of Sales and Revenue Results and Forecasts

Fiscal 2004 Results

The Lottery recorded total sales of \$1,395.4 billion during fiscal 2004. This represents a 5.5% increase over sales recorded for fiscal 2003. Instant ticket sales and Mega Millions, spurred by several large jackpots, provided between them \$59.5 million of the \$75.0 million increase in sales. In fiscal 2004, the lottery gave away \$2.2 million in free promotional tickets which are not included in the total fiscal 2004 sales figure. Fiscal 2004 sales resulted in net revenue of \$458.4 million, of which \$436.4 million was credited to the State’s general fund after distributing \$22.0 million to the Maryland Stadium Authority (MSA). As shown in **Exhibit 3**, the Lottery has achieved record sales growth in each of the last four years. The Board of Revenue Estimates (BRE) is expecting continued sales growth in fiscal 2005 and 2006.

Exhibit 3
Sales Growth
Fiscal 2001 through 2006



Source: Maryland State Lottery

Pick 3: Sales declined by \$5.9 million, or 2% continuing a long-term sales trend for the product. The lottery industry as a whole is seeing a decline in the Pick 3 game. The top prize of \$500 is no longer attractive to players, since many other on-line games offer higher prizes. During fiscal 2004, the lottery conducted two Pick 3 promotions, which gave players an opportunity to win additional

E75D – State Lottery Agency

prizes. These promotions helped stabilize the decline in Pick 3 sales. Revenues decreased by \$12.2 million, or 8.8%.

Pick 4: Sales increased by \$5.7 million, or 2.8% over fiscal 2003. Prize payouts were lower resulting in 12.6% increase in revenues.

Lotto: Sales increased by \$2.1 million, or 6.1% from fiscal 2003. Sales increased due to slightly better jackpots and Lotto promotions. Revenues increased by \$381,366, or 2.8%.

Keno and Keno Bonus: Sales grew by \$12.4 million, or 3.3% in fiscal 2004. It is believed that continued growth in Keno is due to the social environment in which the game is played, the instant winning experience (new games are drawn every minute), and the possibility of winning large prizes. Some of the growth in fiscal 2004 is due to new promotions such as the Doubler and Tripler that provide the purchaser the opportunity to double or triple his/her winnings. Sales of both Keno and Keno Bonus are continuing to grow, however, at a slower rate. One possible reason for the decline in sales growth is that the opportunity to place new monitors in additional venues is becoming increasingly difficult. Revenues increased by \$2.9 million, or 2.5%.

Mega Millions (multi-state lottery game): Sales increased by \$21.1 million, or 31.0%. The sales of Mega Millions are primarily driven by its ability to generate large jackpots. The addition of Texas in December 2003 allowed the jackpots to grow at a faster pace, thus increasing sales. Revenues increased by \$9.4 million, or 33.5%. Maryland only had one winner in fiscal 2004 which increased revenues, as opposed to two winners in fiscal 2003.

Bonus Match 5: Sales increased by \$1.6 million, or 7.5%, and revenues increased \$73,838, or 1.0%.

Instant Games: Sales increased by \$38.4 million, or 12.1%, and revenues increased \$3.6 million, or 5.6%. The increase in sales is a continuation of a long-term trend for this product. The increase is primarily attributed to the purchase of more \$5 and \$10 tickets that provide additional winning experiences. Increased sales are also attributed to adding instant games to Keno locations and placing more manual instant ticket dispensers in sales locations to encourage and simplify the sale of more games per location.

Instant Win: In fiscal 2003, Cash in Hand was discontinued and replaced with Instant Win. In its first year, Instant Win generated \$3.0 million in sales and \$610,668 in revenues.

The Lottery is currently researching several new products for possible rollout in fiscal 2006. These include:

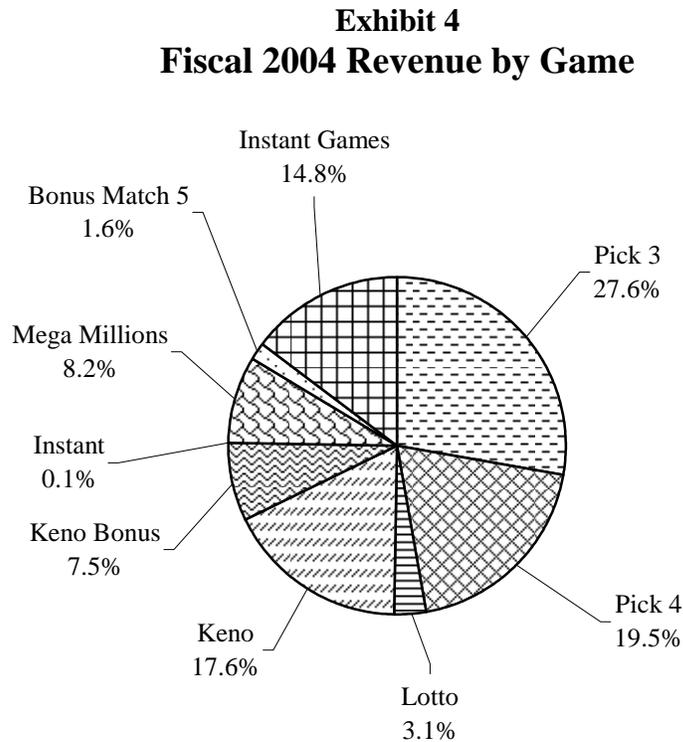
- a new product to replace the existing Lotto game;
- potential changes to the Mega Millions game to accommodate the possible addition of another large state (such as California);

E75D – State Lottery Agency

- an additional play option for the Keno games that allows the players to play Keno at home, receiving winning numbers from the Internet;
- new Instant Scratch game concepts such as “Ticket Families”;
- a new game to replace Bonus Match 5, which may have reached the end of its natural life; and
- new technology games that integrate fast action play with high quality video presentation.

DLS recommends that the Lottery discuss new games under consideration as well as any changes to existing games.

Exhibit 4 illustrates the percentage of total revenues each game contributes.



Source: Maryland State Lottery

Year-to-date Fiscal 2005 Sales and Revenue Performance

BRE set the sales target for fiscal 2005 at \$1,448.3 billion which would result in general fund revenues of \$446.2 million after disbursing \$21.4 million to MSA. This is a 2.2% increase over fiscal 2004 general fund revenues of \$436.4 million. A game by game comparison of year-to-date sales (through January 2005) in **Exhibit 5** shows that sales are up 8.3% for all lottery games.

Fiscal 2005 started strongly with sales from Pick 4, Mega Millions, Keno, and Instant games all growing over 8.0%. Pick 3 and Pick 4 are up substantially due to an increase in payouts which is attracting more players and a Pick 3 bonus promotion. Mega Millions is up over 23.0% due to large jackpots. On three occasions, the jackpot has exceeded \$100.0 million. One jackpot alone netted \$6.5 million in sales. Keno sales are up 11.0% due to the addition of approximately 40 locations and three sales promotions – two Keno Doubles (summer and pre-holiday) and one Keno Tripler in December 2004. Instant games are up 8.2% due to the introduction of specialty products such as the Golden Ticket and the hybrid pull tab games. Only two games have declining sales – Lotto and Bonus Match 5, both represent fewer than 3.7% of total sales. To date, about \$7.5 million in unclaimed prize fund balance has been used for a variety of promotions, particularly in the Pick 3 and Keno games. Use of the unclaimed fund increases sales, but its effect on revenue is not as clear since revenues are driven by the amount of prize payouts.

Exhibit 5 January 2005 Year-to-date Sales Versus January 2004

| <u>Game</u> | <u>Year-to-date January 2004</u> | <u>Year-to-date January 2005</u> | <u>Difference</u> | <u>% Change</u> |
|----------------------|--------------------------------------|--------------------------------------|---------------------|-----------------|
| Pick 3 | \$145,149,501 | \$149,204,781 | \$4,055,280 | 2.79% |
| Pick 4 | 103,034,859 | 112,886,853 | 9,851,994 | 9.56% |
| Lotto and Lotto Subs | 16,969,898 | 16,736,469 | -233,429 | -1.38% |
| Mega Millions | 37,867,263 | 46,790,547 | 8,923,284 | 23.56% |
| Keno | 131,727,218 | 142,840,056 | 11,112,838 | 8.44% |
| Keno Bonus | 58,439,599 | 68,747,484 | 10,307,885 | 17.64% |
| Bonus Match 5 | 12,379,584 | 10,481,203 | -1,898,381 | -15.33% |
| Instant | 171,976,500 | 186,062,241 | 14,085,741 | 8.19% |
| Total Sales | \$677,544,422 | \$733,749,634 | \$56,205,212 | 8.30% |

Note: Includes sales as of January 4, 2004, for fiscal 2004 and sales of January 2, 2005, for fiscal 2005.

Source: Maryland State Lottery

E75D – State Lottery Agency

Net revenues are up \$7.1 million, or 3.1% above year-to-date revenue attainment in January 2004, as shown in **Exhibit 6**. Mega Millions and Keno are contributing significantly to net revenue during the first half of fiscal 2005. Pick 4, Lotto, and Instant games are all experiencing high prize payouts and, as a result, revenues have declined. **DLS recommends that the Lottery brief the committees on the latest results and forecasts with respect to sales and revenues, and steps being taken to improve results.**

Exhibit 6
January 2005 Year-to-date Revenues Versus January 2004

| <u>Game</u> | <u>Year-to-date January 2004</u> | <u>Year-to-date January 2005</u> | <u>Difference</u> | <u>% Change</u> |
|----------------------|--------------------------------------|--------------------------------------|--------------------|-----------------|
| Pick 3 | \$64,303,917 | \$64,585,295 | \$281,378 | 0.44% |
| Pick 4 | 48,486,387 | 44,852,455 | -3,633,932 | -7.49% |
| Lotto & Lotto subs | 6,611,693 | 6,473,494 | -138,199 | -2.09% |
| Mega Millions | 16,209,985 | 19,559,691 | 3,349,706 | 20.66% |
| Keno | 38,034,972 | 42,949,862 | 4,914,890 | 12.92% |
| Keno Bonus | 16,003,917 | 20,026,320 | 4,022,403 | 25.13% |
| Bonus Match 5 | 3,343,142 | 3,357,850 | 14,708 | 0.44% |
| Instant- Stadium | 36,334,173 | 34,620,912 | -1,713,261 | -4.72% |
| Total Revenue | \$229,328,186 | \$236,425,879 | \$7,097,693 | 3.09% |

Note: Includes revenues as of January 4, 2004, for fiscal 2004 and sales of January 2, 2005, for fiscal 2005.

Source: Maryland State Lottery

Fiscal 2006 Forecast

As shown in **Exhibit 7**, fiscal 2006 general fund revenues are projected to be \$461.1 million, which is 3.3% higher, or \$14.9 million more than fiscal 2005 projected revenues. **DLS requests that the Lottery brief the committees on the feasibility of attaining the BRE estimate given the continuing decline in Pick 3 revenue, the growing market saturation of Keno, and the expected growth in sales to be primarily derived from Keno and Instants, which naturally have higher prize payout ratios.**

Exhibit 7
Actual and Projected Lottery Revenues
Fiscal 2002 through 2006
(\$ in Millions)

| | <u>FY 02</u> <u>Actual</u> | <u>FY 03</u> <u>Actual</u> | <u>FY 04</u> <u>Actual</u> | <u>FY 05</u> <u>BRE</u> | <u>FY 06</u> <u>BRE</u> |
|--------------------------------------|-------------------------------|-------------------------------|-------------------------------|----------------------------|----------------------------|
| Sales | \$1,306.6 | \$1,322.2 | \$1,395.4 | \$1,448.3 | \$1,482.3 |
| Net Revenue | 442.5 | 444.9 | 458.4 | 467.4 | 482.1 |
| Less Stadium Authority | 26.2 | 22.0 | 22.0 | 21.2 | 21.0 |
| Less Transfers to Horse Racing | 2.2 | 0.0 | 0.0 | 0.0 | 0.0 |
| Total Revenue to General Fund | 414.1 | 422.9 | 436.4 | 446.2 | 461.1 |
| | | | | | |
| Change from Prior Year | 29.1 | 8.8 | 13.5 | 9.8 | 14.9 |

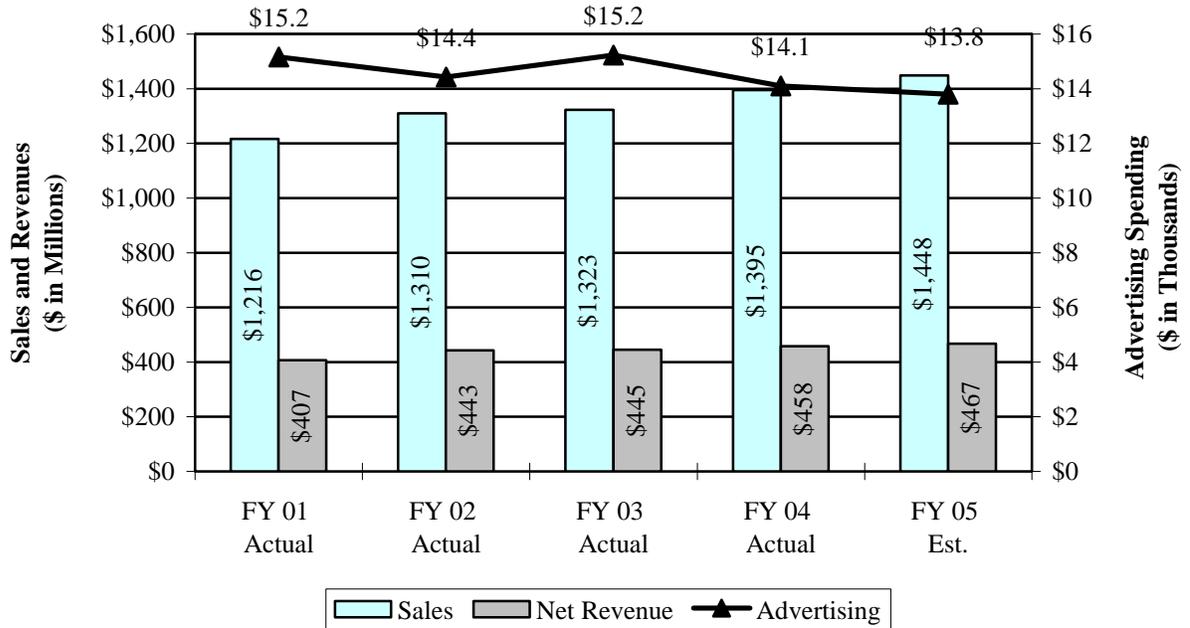
Source: Board of Revenue Estimates; Fiscal 2006 Governor’s Budget Book Volume I

2. Record Sales Growth Despite Reductions in Advertising Budget

The fiscal 2006 allowance provides the lottery with an advertising and promotions budget of \$17.5 million. This represents a 27% increase over the fiscal 2005 working appropriation. While the Lottery’s primary objective is to generate sales and produce general fund revenues for the State, **Exhibit 8** shows that reductions to the advertising budget have not significantly impacted sales or revenue growth over the past five fiscal years. In addition, while sales growth is important, revenue generation is highly dependent on the prize payout ratio which may vary from year to year.

A review of the fiscal 2001 through 2005 sales, revenue, and advertising trends reveal that increased funding for advertising does not necessarily lead to increased sales and revenue. In fiscal 2002, the advertising budget decreased 4.9%, however, the lottery achieved an increase in sales of 7.8%, and in fiscal 2003, the advertising budget increased 5.6%, yet sales increased only marginally, or 1%. Since fiscal 2003, the lottery’s advertising budget has decreased on average 4.8% per year; however, in fiscal 2003 and 2004, the lottery achieved record sales of \$1,323.0 billion and \$1,395.4 billion, respectively. In addition, in fiscal 2005, the BRE is estimating the Lottery will once again attain record sales of \$1,448.3 billion, or a 3.8% increase over fiscal 2004 despite a slightly reduced advertising budget. Year-to-date fiscal 2005 sales and revenues numbers indicate that the lottery is on target to meet the fiscal 2005 BRE estimate. **Given the fact that the lottery has been able to achieve strong sales growth in each of the last five fiscal years despite the decrease in the advertising budget, DLS is recommending a \$3.7 million reduction in the advertising budget. This reduction provides the same level of funding as in fiscal 2005.**

Exhibit 8
Sales and Revenue Trends Compared to Advertising Spending
Fiscal 2001 through 2005



Source: Maryland State Lottery

Recommended Actions

| | <u>Amount Reduction</u> | | <u>Position Reduction</u> |
|---|-----------------------------|----|-------------------------------|
| 1. Reduce funds for Lottery marketing activities. This reduction provides \$13,790,621 which is the same amount appropriated for these activities in fiscal 2005. | \$ 3,720,000 | SF | |
| 2. Delete four new regular positions and associated benefits. The State is over the Spending Affordability Committee position cap by 153 positions, and as a result, the Department of Legislative Services is recommending these functions be performed by current staff. | 182,556 | SF | 4.0 |
| Public Affairs Specialist | NEW001 \$41,907 | | |
| Computer Information | NEW002 \$41,907 | | |
| DP Programmer Analyst I | NEW003 \$49,371 | | |
| Fiscal Accounts Technician | NEW005 \$49,371 | | |
| 3. Delete one new regular position and associated benefits, but leave funds to convert one position to a contractual. In fiscal 2006, the Lottery is issuing four major requests for proposals. The new contracts when executed will result in multi-year, multi-million dollar contracts. However, once the contracts are executed, the Lottery will not require a full-time Procurement Specialist. | 10,394 | SF | 1.0 |
| Total Special Fund Reductions | \$ 3,912,950 | | 5.0 |

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 2004 | | | | | |
| Legislative Appropriation | \$0 | \$50,919 | \$0 | \$0 | \$50,919 |
| Deficiency Appropriation | 0 | 0 | 0 | 0 | 0 |
| Budget Amendments | 0 | 0 | 0 | 0 | 0 |
| Cost Containment | 0 | 0 | 0 | 0 | 0 |
| Reversions and Cancellations | 0 | -230 | 0 | 0 | -230 |
| Actual Expenditures | \$0 | \$50,689 | \$0 | \$0 | \$50,689 |
| Fiscal 2005 | | | | | |
| Legislative Appropriation | \$0 | \$51,817 | \$0 | \$0 | \$51,817 |
| Budget Amendments | 0 | 0 | 0 | 0 | 0 |
| Working Appropriation | \$0 | \$51,817 | \$0 | \$0 | \$51,817 |

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

Audit Findings

The December 2002 audit rated the Lottery’s fiscal accountability and compliance level as unsatisfactory and disclosed 24 findings. When an unsatisfactory rating is found, the Joint Audit Committee rules require a follow-up review. In August 2003, a follow-up review was performed on 18 of the 24 findings to determine if corrective action was taken to remedy those findings. The review found that the Lottery had either corrected or made significant progress in resolving 15 of the 18 findings. It was determined that the remaining 3 findings required additional time to fully implement the corrective action.

| | |
|------------------------------|------------------------------------|
| Audit Period for Last Audit: | February 1,2000 – January 31, 2002 |
| Issue Date: | December 2002 |
| Number of Findings: | 24 |
| Number of Repeat Findings: | 8 |
| % of Repeat Findings: | 33% |
| Rating: (if applicable) | Unsatisfactory |

Finding 1: Failure to segregate duties, as recommended in our two preceding audit reports, resulted in instant ticket books being improperly activated. The agency estimated that \$232,000 in instant ticket books were improperly activated and prizes for winning tickets of at least \$112,000 were cashed. This matter has been referred to the Office of the Attorney General – Criminal Investigations Division.

Finding 2: Considering the potentially fraudulent activities and questionable transactions, the Agency should reevaluate the extent to which the Agent Plus Program should be continued.

Finding 3: Procurement transactions totaling approximately \$1.4 million were executed without required approvals from the Board of Public Works.

Finding 4: The agency did not ensure that appropriate internal controls were in place over the automated gaming system operated by the contractor.

Finding 5: The on-line gaming contractor entered incorrect winning lottery numbers in the automated system on three occasions that resulted in payouts of \$86,000 for non-winning tickets. The agency was not routinely monitoring this process and had not adequately investigated these occurrences.

Finding 6: The value of promotional (free) tickets issued was not disclosed in the Agency’s annual budget requests submitted to the General Assembly. The agency had also not established adequate accountability over promotional tickets issued.

E75D – State Lottery Agency

- Finding 7:** The agency did not fully disclose all relevant concerns to the Legislative Policy Committee in seeking approval for a new lottery game (Let it Ride). The game was later terminated as a result of poor sales. The agency estimates that the total loss from the game was \$1.4 million.
- Finding 8:** The agency did not sufficiently monitor on-line lottery games to ensure game integrity.
- Finding 9:** **The agency did not take appropriate action in response to the Internal Revenue Service’s report that identified invalid taxpayer identification numbers.**
- Finding 10:** The agency did not clearly disclose in its promotional literature how Lotto prize payments are determined for winners who select the lump-sum cash payment option.
- Finding 11:** **The agency relied on the contractor to report when system outages occurred that could result in the assessment of non-performance penalties. Also, certain penalties were not computed in accordance with the contract and the agency did not document its reasons to waive other penalties.**
- Finding 12:** The agency’s advertising contract did not prohibit the contractor from awarding subcontracts, that were to be competitively procured, to affiliated entities. The advertising contractor used a subcontractor with whom it also entered into a joint business venture on another project.
- Finding 13:** **The agency did not adequately monitor the advertising contractor to ensure that the contractor complied with all significant contract provisions.**
- Finding 14:** The agency did not ensure that agents had established bank accounts as required by State law.
- Finding 15:** The agency’s practice for payment of lottery agency commissions resulted in the bypassing of the State’s intercept program for unpaid debts.
- Finding 16:** **Internal controls over the processing of purchasing and disbursement transactions were inadequate.**
- Finding 17:** **The working fund was not properly reconciled and an unresolved difference of approximately \$80,000 was not identified.**
- Finding 18:** **Adequate procedures and controls were not established over the records related to delinquent amounts due from lottery agents. Furthermore, the agency did not use remedies provided by State law and its own procedures to improve collections on delinquent accounts.**
- Finding 19:** Adjustments were made to cash reconciliations that could not be explained and adequate control was not established over subscription receipts.

E75D – State Lottery Agency

Finding 20: Prize payment checks were unnecessarily returned to the agency for distribution and access to these checks was not restricted. During the audit period 156,000 checks totaling \$201 million were returned to the agency.

Finding 21: Detail records of investments held by agency custodians were not maintained and reconciliations of the total value of investments held by custodians with the agency records were not reviewed by supervisory personnel.

Finding 22: Certain network security was not adequate.

Finding 23: System controls over file access, program changes, passwords, and user accounts were deficient.

Finding 24: The agency's information systems' contingency plan was incomplete and outdated.

*Bold denotes item repeated in full or part from preceding audit report.

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

| <u>Object/Fund</u> | <u>FY04 Actual</u> | <u>FY05 Working Appropriation</u> | <u>FY06 Allowance</u> | <u>FY05 - FY06 Amount Change</u> | <u>Percent Change</u> |
|--------------------------|------------------------|---|---------------------------|--------------------------------------|---------------------------|
| Positions | | | | | |
| 01 Regular | 170.00 | 168.00 | 174.00 | 6.00 | 3.6% |
| 02 Contractual | 10.75 | 11.00 | 8.50 | -2.50 | -22.7% |
| Total Positions | 180.75 | 179.00 | 182.50 | 3.50 | 2.0% |
| Objects | | | | | |
| 01 Salaries and Wages | \$ 10,035,639 | \$ 10,000,211 | \$ 10,656,029 | \$ 655,818 | 6.6% |
| 02 Technical & Spec Fees | 302,039 | 346,600 | 292,269 | -54,331 | -15.7% |
| 03 Communication | 752,602 | 539,881 | 363,334 | -176,547 | -32.7% |
| 04 Travel | 40,933 | 81,900 | 57,700 | -24,200 | -29.5% |
| 06 Fuel & Utilities | 70,136 | 118,826 | 89,100 | -29,726 | -25.0% |
| 07 Motor Vehicles | 317,346 | 210,382 | 284,222 | 73,840 | 35.1% |
| 08 Contractual Services | 36,451,375 | 37,539,336 | 41,960,711 | 4,421,375 | 11.8% |
| 09 Supplies & Materials | 186,282 | 183,543 | 175,500 | -8,043 | -4.4% |
| 10 Equip - Replacement | 121,339 | 86,236 | 81,336 | -4,900 | -5.7% |
| 11 Equip - Additional | 1,519,604 | 1,698,863 | 530,469 | -1,168,394 | -68.8% |
| 13 Fixed Charges | 944,547 | 1,011,166 | 982,653 | -28,513 | -2.8% |
| 14 Land & Structures | -53,000 | 0 | 0 | 0 | 0.0% |
| Total Objects | \$ 50,688,842 | \$ 51,816,944 | \$ 55,473,323 | \$ 3,656,379 | 7.1% |
| Funds | | | | | |
| 03 Special Fund | \$ 50,688,842 | \$ 51,816,944 | \$ 55,473,323 | \$ 3,656,379 | 7.1% |
| Total Funds | \$ 50,688,842 | \$ 51,816,944 | \$ 55,473,323 | \$ 3,656,379 | 7.1% |

Note: The fiscal 2005 appropriation does not include deficiencies, and the fiscal 2006 allowance does not reflect contingent reductions.

**Fiscal 2006 Cost Containment Actions
As Submitted by the Agency
Estimated Fiscal 2006 Savings
Compared to Fiscal 2005**

| <u>Cost Saving Action/Efficiency Measure</u> | <u>Program Code</u> | <u>Total Funds</u> | <u>General Funds</u> | <u>Special Funds</u> | <u>Positions Reduced</u> | <u>Impact of Action</u> |
|---|---------------------|--------------------|----------------------|----------------------|--------------------------|-------------------------|
| | E75 | \$1,551,936 | | 100% | | None |
| <u>Available Funds – Efficiency</u> | | | | | | |
| Overtime | | 10,000 | | | | |
| Contractual employees | | 36,300 | | | | |
| Legal services | | 2,500 | | | | |
| Other phone | | 15,400 | | | | |
| Travel | | 24,200 | | | | |
| Electric | | 29,700 | | | | |
| IT Telco costs | | 15,800 | | | | |
| Outside IT services | | 6,000 | | | | |
| General printing | | 6,000 | | | | |
| General maintenance | | 10,000 | | | | |
| Game and promotional printing | | 50,000 | | | | |
| Promotional rentals | | 6,000 | | | | |
| Audits | | 25,000 | | | | |
| ACH and credit reviews | | 4,900 | | | | |
| Instant ticket delivery | | 2,500 | | | | |
| On-line Telco network | | 51,600 | | | | |
| Forms and supplies | | 3,500 | | | | |
| Treasurer lease payments (paid off leases in fiscal 05) | | 1,165,136 | | | | |
| Office space | | 35,000 | | | | |
| Insurance | | 8,800 | | | | |
| Training and staff develop | | 15,500 | | | | |
| IT training | | 12,500 | | | | |
| IT consulting | | 5,000 | | | | |
| Computer PC software | | 4,500 | | | | |
| Office equipment | | 6,100 | | | | |
| Total | | \$1,551,936 | | | | |