



INTEROFFICE MEMO

Gary Grief, Executive Director

Alfonso D. Royal III, Charitable Bingo Operations Director

To: J. Winston Krause, Chairman
Carmen Arrieta-Candelaria, Commissioner
Peggy A. Heeg, Commissioner
Doug Lowe, Commissioner
Robert Rivera, Commissioner

From: Kathy Pyka, Controller *KP*

Date: January 24, 2017

Re: Budget Recommendations, 85th Legislature

The Legislative Budget Board (LBB) released their budget recommendation for the 85th Legislature. Unlike previous legislative sessions, the LBB budget recommendation for the introduced budget bills for the Senate and House reflect different amounts. A comparison of each budget recommendation to the Commission's FY 2018-19 Legislative Appropriations (LAR) is included below.

Texas Lottery Commission (TLC)	Lottery Account	General Revenue	Total
FY 2016-17 Budgeted	\$465,786,305	\$30,909,677	\$496,695,982
FY 2018-19 Baseline Budget Request	\$431,247,372	\$29,673,290	\$460,920,662
FY 2018-19 Exceptional Request	\$18,631,452	\$-	\$18,631,452
FY 2018-19 Total TLC Request	\$449,878,824	\$29,673,290	\$479,552,114
Senate Bill 1			
FY 2018-19 Senate Bill 1 LBB Introduced Bill	\$445,034,822	\$30,684,130	\$475,718,952
Difference TLC Request over/(under) SB 1	\$ (4,844,002)	\$ 1,010,840	\$ (3,833,162)
House Bill 1			
FY 2018-19 House Bill 1 LBB Introduced Bill	\$457,147,926	\$30,684,130	\$487,832,056
Difference TLC Request over/(under) HB 1	\$ 7,269,102	\$ 1,010,840	\$ 8,279,942

Items not funded in the LBB Recommendation

Based on a detailed review of the LBB Recommendation, the introduced budgets do not reflect the Commission's Rider request for modified funding of scratch ticket printing services or restoration of the advertising budget at the amount initially requested within the Commission's exceptional item request. Details of the advertising reduction are outlined below. In addition, the LBB further reduced the Commission's budget by \$3,448,348 on additional line items as described below.

- **Scratch Ticket Production and Services Contract Rider**
The Commission requested a new Rider to address the funding mechanism of Strategy A.1.7, Scratch Ticket Production and Services Contract(s) (Strategy A.1.7) using an estimated funding structure based on a percentage of scratch ticket sales. The introduced version of the bills did not include the modified funding model via the new Rider, but instead further restricted Strategy A.1.7 as a "Nontransferable" strategy and added Rider 15 to the budget which states funds may not be transferred from Strategy A.1.7.
Impact: The Commission's ability to procure scratch ticket products from its three contracted vendors will not be sustained at a level that can support the growth in sales of this product, thus impacting the amount of revenue that can be generated.
- **Advertising reduction – Strategy A.1.8**
Senate Bill 1 – The budget reflects an advertising budget of \$49,266,896 for the biennium which results in a reduction of \$14,733,104, or 23%, from the Commission's budget request of \$64 million.
House Bill 1 – The budget reflects an advertising budget of \$61,380,000 for the biennium which results in a reduction of \$2,620,000, or 4%, from the Commission's budget request of \$64 million.
Impact: A reduction to the amount of advertising services procured by the Commission will further limit communication about lottery products and the markets where advertising is placed. Research performed by the Texas A&M Mays Business School suggests that lowering advertising expenditures could lead to a significant decrease in lottery sales. More specifically, the results suggest that a 10 percent decrease in advertising expenditures would result in a 17 percent decrease in lottery sales. This would result in an accompanying \$106.5 million of reduced revenue under the Senate version of the budget and reduced revenue of \$18.9 million under the House version of the budget introduced.
- **Lottery Operations reduction – Strategy A.1.1**
Both introduced budgets reflect a decrease of \$339,196. This consists of reductions to the Commission's Facilities budget for leasehold improvements and a lease related to uninterruptable power supply (UPS).
Impact: The Commission's ability to respond to future leasehold improvement requirements may be impacted by the reduction. Regarding the UPS lease reduction, a cost benefit analysis was performed on the lease in 2016 and an UPS unit was purchased. Due to the useful life of current UPS units; an outright purchase of the unit was favorable over the continued lease. There is not an impact to the budget from the UPS lease reduction.

- **Marketing and Promotions reduction – Strategy A.1.3**
A decrease of \$933,849 is reflected in the introduced bills. The reductions relate to printing in the graphics area, postage for promotional mailers, promotional events and market research support.
Impact: The Commission's ability to market and promote lottery products will be impacted by a reduction to this strategy. Funds within the strategy are used for mailing promotional coupons as well as the sponsorship of promotional events. These contracted promotional events allow for the promotion and sale of scratch and draw game products resulting in revenue of \$1.2 million. Also impacted within this strategy are the support services for the market research contracts.
- **Security reduction – Strategy A.1.4**
A reduction of \$60,000 was included in the introduced budget. This funding was dedicated within the budget for additional security services for the Commission.
Impact: It will not be feasible for the Commission to have a Department of Public Safety officer present at Commission headquarters on a routine basis with a reduction to this strategy. An officer will continue to be available for meetings open to the public such as Commission meetings.
- **Administration reduction – Strategy A.1.5**
The introduced budgets reflect a decrease of \$1,353,503. Included in this amount are reductions to the Commission's budget for computer equipment, programming services and advertising related to our HUB program.
Impact: The Commission will be required to substantially reduce procurement of computer equipment used in support of agency staff with this reduction. Also reduced are programming services that will impact the Commission's ability to further promote efficiency within the Commission via the use of automation tools. Finally, the Commission's ability to place advertisements in HUB publications promoting HUB events and our program will be eliminated.
- **Market Research Contracts reduction – Strategy A.1.10**
Both introduced budgets reflect a decrease of \$761,800. While funding for the statutorily required demographic study was included in the introduced version of the budgets, the balance of the market research budget was reduced.
Impact: The Commission's ability to pursue research projects to gather insightful and reliable information about player demographics, player interests and purchase behavior and retailer attitudes will be impacted by the reduction. This market research data is critical when developing the state lottery's product mix and game portfolio management program. The data allows the Commission to support the goal of offering lottery players the best entertainment experience available through the responsible management and sale of products to generate revenue.

Excluding the two line items of the budget (Strategy A.1.6 – Lottery Operator Contract and Strategy A.1.12 – Retailer Commissions) that are funded based on a percentage of sales, the biennial amount of items not funded in the Lottery Dedicated Account and outlined above is:

Senate Bill 1: \$18,181,452 reduction, or 8.6% of Lottery Dedicated Account budget
House Bill 1: \$6,068,348 reduction, or 2.9% of Lottery Dedicated Account budget

Items not funded in the LBB Recommendation – Restoration requested

In preparation for budget hearings before Senate Finance and House Appropriations, the LBB requested a review of the items not funded in the introduced versions of the bills and feedback regarding which unfunded items the Commission would like to pursue as exceptional item requests. Documentation has been routed to the LBB indicating that the agency is requesting the Scratch Ticket Production and Services Contract Rider and is seeking restoration of all budgetary reductions that impact revenue generation of the Commission. A summary follows:

LBB Recommendation - Senate Bill 1 – requesting restoration of \$16.1 million

The Commission's exceptional item request for Senate Bill 1 amounts to \$16.1 million to seek partial restoration of the \$18.1 million budget reduction to the Lottery Dedicated Account. The Exceptional Item is prioritized to allow for continued revenue generating functions and for restoration of lottery revenue to the Foundation School Fund.

The exceptional item includes the following programs:

Mass Media Advertising Services – Strategy A.1.8 - \$14.7 million
Marketing and Promotion - Products and Promotional Events – Strategy A.1.3 - \$0.63 million
Market Research Services – Strategy A.1.10 - \$0.76 million

While the proposed budget reduction for these programs amounts to \$16.1 million, it translates to an exponentially greater impact on revenue to the State's beneficiaries and retailers. The following economic impacts are estimated from the proposed budget reduction:

- Sales reduction of \$399 million
- Revenue reduction to the Foundation School Fund of \$108 million
- Retailer compensation reduction of \$20 million

LBB Recommendation - House Bill 1 - requesting restoration of \$4.0 million

For the House version of the budget, the Commission is submitting an exceptional item request amounting to \$4.0 million to seek partial restoration of the \$6.1 million budget reduction to the Lottery Dedicated Account. The Exceptional Item request was also prioritized to allow for continued revenue generating functions and for restoration of lottery revenue to the Foundation School Fund.

Restoration is requested for the following programs:

Mass Media Advertising Services – Strategy A.1.8 - \$2.6 million
Marketing and Promotion - Products and Promotional Events – Strategy A.1.3 - \$0.63 million
Market Research Services – Strategy A.1.10 - \$0.76 million

While the proposed budget reduction for these programs amounts to \$4.0 million, it also translates to an exponentially greater impact on revenue to the State's beneficiaries and retailers. The economic impacts estimated from the proposed budget reduction include:

- Sales reduction of \$74.6 million
- Revenue reduction to the Foundation School Fund of \$20.1 million
- Retailer compensation reduction of \$3.7 million

Items funded in the LBB Recommendation

The introduced budgets also reflect adjustments to those strategies that are funded using a percentage of sales methodology. The budget recommendation reflects an increase to two strategies based on the projected lottery sales value developed by the LBB using the Comptroller's Biennial Revenue Estimate (BRE) issued in January 2017. The LBB also included an adjustment within the introduced budgets for restoration of the 4% reduction to the Bingo Prize Fee appropriation. Additional information follows:

- Lottery Operator Contract increase – Strategy A.1.6
The introduced budgets reflect an increase of \$10,876,575. This budget is funded based on a 2.2099 percent of lottery sales.
- Retailer Commissions increase – Strategy A.1.10
The introduced budgets reflect an increase of \$2,460,875. Funding for this budget is computed as 0.005 percent of lottery sales.
- Local Bingo Prize Fees increase – Rider 8
The introduced budgets reflect an increase of \$1,010,840. While this budget was subject to the 4% budget reduction required by leadership, the budget was restored to FY 2016-17 baseline levels by the LBB.

Rider Revisions and Article IX revisions

The Legislative Budget Board included revisions to several Riders and added new Riders within the introduced versions. Senate Bill 1 also includes an across the board funding provision in Article IX that will impact Bingo. Further description of the Riders and the Article IX provision is noted below.

- Rider 6 – Appropriations Limited to Revenue Collections
This Rider requires the Commission cover the cost of appropriations for Bingo as well as "other direct and indirect costs" from the collection of fees, fines, and other miscellaneous revenues authorized by the operation of charity bingo. The introduced budgets increase the value of "other direct and indirect costs" that the Commission will be required to cover via revenue collections by over \$300 thousand per year. The increased budgetary amount will require further review to determine if any Bingo fees require modification.

- Rider 11 – Appropriation of Increased Revenue

This Rider allows the Commission to increase appropriation for the purpose of fulfilling contractual obligations and other administrative costs in administration of the Lottery when lottery sales reach a certain threshold. Several points regarding the Rider revisions include:

- The lottery sales threshold within the Rider was not adjusted for the reduction to budgetary line items that impact revenue generation.
- The Rider now requires notification of the LBB prior to using the funds appropriated by the Rider.
- Following the use of funds appropriated by the Rider, a report must be filed with the LBB by December 1st regarding expenditure or lapse of the funds.

- Rider 15 – Limitation on Transfers.

This new Rider does not allow for the transfer of funds from the Scratch Ticket Production and Services Contract (Strategy A.1.7) without prior written approval of the LBB. In addition to this Rider, the introduced budget bills have placed a “nontransferable” provision on Strategy A.1.7.

The Commission’s LAR requested that Strategy A.1.7 be modified to an estimated and nontransferable strategy not subject to Article IX transfer authority. The “nontransferable” provision was submitted by the agency to ensure the greatest amount of transparency under the new Rider funding model requested in our LAR.

As noted above, the introduced versions of the budget bill did not include funding of Strategy A.1.7 via the new Rider, but instead further restricted Strategy A.1.7 as a “nontransferable” strategy and added Rider 15 which states funds may not be transferred from Strategy A.1.7.

Modifying Strategy A.1.7 as a nontransferable strategy without the new Rider funding will not only limit the transfer of funds from Strategy A.1.7, but will also limit the transfer of funds to Strategy A.1.7. Should the budget get adopted as presented, this essentially removes the use of Rider 11 and Article IX, Section 14.01 as funding models to fund excess scratch ticket printing as presently utilized by the Commission. In summary, the current version of the bill will limit Strategy A.1.7 to \$30.15M a year which will severely limit the Commission’s ability to respond to the market’s scratch ticket growth and, in turn, to print scratch tickets and generate revenue for the Foundation School Fund and the Fund for Veterans’ Assistance.

- Rider 16 – Notification Requirement (House Bill 1 only)

This new Rider requires the agency notify the LBB at least 30 calendar days before any amendment or change order is executed on the Lottery Operator Contract.

- Article IX, Section 15.05 Budget Reduction (Senate Bill 1 only)

This new provision includes an across the board reduction of 1.5% to General Revenue funds. The reduction equates to a biennial reduction of \$81,197 to the administrative portion of the Bingo budget and \$379,065 to Bingo Prize Fees.

Performance Measures

The introduced budgets do not adjust the Outcome Measure related to “State Revenue Received per Advertising Dollar Expended” for the impact to sales and revenue from the reduced advertising budgets. The bills as presented do not assume there will be a sales or revenue reduction from the advertising budget decreases.

An analysis that compares the LBB’s budget recommendations to the Commission’s budget request detailing the recommendation by strategy, method of finance and object of expense is attached.

Please feel free to contact me at 512-344-5410 if you need additional information or have any questions.

cc: Gary Grief
Alfonso Royal

**Legislative Budget Board Recommendation - Senate Bill 1
FY 2018 - 2019 Legislative Appropriations Request**

1/17/2017

	Texas Lottery FY 2016-17 Total Budgeted	Texas Lottery FY 2018-19 Total Requested	Senate Bill 1 FY 2018-19 LBB Recommendation	FY 2018-19 Difference between Request & Recommendation	% change
Goal A: Operate Lottery					
1.1.1. Lottery Operations	\$ 14,930,931	\$ 15,210,922	\$ 14,871,726	\$ (339,196)	-2.23% **
1.1.2. Lottery Field Operations	5,691,777	5,865,219	5,865,219	-	0.00%
1.1.3. Marketing and Promotion	13,944,438	13,811,405	12,877,556	(933,849)	-6.76% **
1.1.4. Security	11,276,958	11,382,403	11,322,403	(60,000)	-0.53% **
1.1.5. Central Administration	25,259,097	25,540,477	24,186,974	(1,353,503)	-5.30% **
1.1.6. Lottery Operator Contract(s)	207,695,833	194,896,562	205,773,137	10,876,575	5.58% *BRE adj.
1.1.7. Scratch Ticket Production Contract(s)	60,300,000	60,300,000	60,300,000	-	0.00%
1.1.8. Mass Media Advertising Contract(s)	65,500,000	64,000,000	49,266,896	(14,733,104)	-23.02% **
1.1.9. Drawing & Broadcast Contract(s)	5,269,711	5,270,356	5,270,356	-	0.00%
1.1.10. Market Research Contract(s)	1,017,935	1,105,240	343,440	(761,800)	-68.93% **
1.1.11. Retailer Bonus	8,145,175	8,400,000	8,400,000	-	0.00%
1.1.12. Retailer Commissions	46,754,450	44,096,240	46,557,115	2,460,875	5.58% *BRE adj.
Total, Operate Lottery	<u>465,786,305</u>	<u>449,878,824</u>	<u>445,034,822</u>	<u>(4,844,002)</u>	-1.08%
Goal B: Enforce Bingo Laws					
2.1.1. Bingo Licensing	\$ 1,610,977	\$ 1,418,914	\$ 1,418,914	\$ -	0.00%
2.1.2. Bingo Education & Development	296,354	285,408	285,408	-	0.00%
2.1.3. Bingo Law Compliance	3,153,621	3,075,120	3,075,120	-	0.00%
2.1.4. Bingo Prize Fee Collections & Acct.	577,725	633,688	633,688	-	
Rider 8, Local Bingo Prize Fees	<u>25,271,000</u>	<u>24,260,160</u>	<u>25,271,000</u>	<u>1,010,840</u>	4.17%
Total, Enforce Bingo Laws	<u>30,909,677</u>	<u>29,673,290</u>	<u>30,684,130</u>	<u>1,010,840</u>	3.41%
Total, Commission	<u>\$ 496,695,982</u>	<u>\$ 479,552,114</u>	<u>\$ 475,718,952</u>	<u>\$ (3,833,162)</u>	-0.80%
Method of Financing					
Lottery Account - 5025	\$ 465,786,305	\$ 449,878,824	\$ 445,034,822	\$ (4,844,002)	-1.08%
General Revenue Fund - 0001	<u>30,909,677</u>	<u>29,673,290</u>	<u>30,684,130</u>	<u>1,010,840</u>	3.41%
Total, Method of Financing	<u>\$ 496,695,982</u>	<u>\$ 479,552,114</u>	<u>\$ 475,718,952</u>	<u>\$ (3,833,162)</u>	-0.80%
FTE's	326.5	324.5	323.5	-1.0	
Object of Expense Informational Listing					
Salaries and Wages	\$ 44,507,663	\$ 45,153,008	\$ 44,996,250	\$ (156,758)	-0.35%
Other Personnel Costs	1,155,711	1,150,802	1,150,802	-	0.00%
Professional Fees and Services	12,393,439	12,138,022	10,359,319	(1,778,703)	-14.65%
Fuels and Lubricants	10,500	10,000	10,000	-	0.00%
Consumable Supplies	426,140	482,640	482,640	-	0.00%
Utilities	697,773	695,912	695,912	-	0.00%
Travel	1,067,161	1,054,446	1,054,446	-	0.00%
Rent - Building	8,600,178	8,777,220	8,777,220	-	0.00%
Rent - Machine & Other	1,974,584	2,055,190	1,860,994	(194,196)	-9.45%
Other Operating Expense	400,311,663	383,474,714	380,760,369	(2,714,345)	-0.71%
Grants	25,271,000	24,260,160	25,271,000	1,010,840	4.17%
Capital Expenditure	<u>280,170</u>	<u>300,000</u>	<u>300,000</u>	<u>-</u>	0.00%
Total, Object of Expense Info. Listing	<u>\$ 496,695,982</u>	<u>\$ 479,552,114</u>	<u>\$ 475,718,952</u>	<u>\$ (3,833,162)</u>	-0.80%

*Strategies A.1.6 and A.1.12 are funded on a % of lottery sales. The budget recommendation reflects increases for these line items based on the projected sales value developed by the LBB using the Comptroller's Biennial Revenue Estimate (BRE) issued in January 2017. The sales estimate does not factor a decrease in sales and revenue anticipated from budgetary decreases.

**The budget decrease to the Lottery Dedicated Account excluding the two strategies funded as a % of lottery sales is (\$18,181,452) or (8.6%).

Legislative Budget Board Recommendation - House Bill 1
FY 2018 - 2019 Legislative Appropriations Request

1/17/2017

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Total, Commission	<u>\$ 496,695,982</u>	<u>\$ 479,552,114</u>	<u>\$ 487,832,056</u>	<u>\$ 8,279,942</u>	1.73%
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*Strategies A.1.6 and A.1.12 are funded on a % of lottery sales. The budget recommendation reflects increases for these line items based on the projected sales value developed by the LBB using the Comptroller's Biennial Revenue Estimate (BRE) issued in January 2017. The sales estimate does not factor a decrease in sales and revenue anticipated from budgetary decreases.

**The budget decrease to the Lottery Dedicated Account excluding the two strategies funded as a % of lottery sales is (\$6,068,348) or (2.9%).