

**Meeting Minutes
Executive Committee of the
South Carolina Education Lottery Board of Commissioners
April 15th and reconvened on April 28th, 2009**

A meeting of the Executive Committee of the South Carolina Education Lottery Board of Commissioners was held on Wednesday, April 15, 2009, at 10 a.m. in the Fourth-Floor Conference Room (#445), 1333 Main Street, Columbia, South Carolina, and reconvened on Tuesday, April 28, 2009, at 11:30 a.m. in the same location.

The following committee members participated:

April 15, 2009

Tim Madden, Chairman
Moffatt Burriss, Treasurer
Marvin Quattlebaum, Secretary
Dr. Edward Keith, At-Large*

April 28, 2009

Tim Madden, Chairman
Jimmy Bailey, Jr., Vice Chairman*
Moffatt Burriss, Treasurer*
Marvin Quattlebaum, Secretary*
Dr. Edward Keith, At-Large*

Vice Chairman Jimmy Bailey, Jr. was unable to participate on April 15, 2009, due to a scheduling conflict.

The Chairman called the meeting to order.

Fiscal Year 2010 Budget

Dusty Rhodes, Director of Finance, was recognized to present an overview of the Executive Director's budget recommendations for FY10, which was distributed prior to the meeting. The budget is predicated upon total projected revenue of \$945.9 million and net income of \$252.4 million. Mr. Rhodes explained that each department made a thorough review of its needs in developing the budget. Controllable operating expenses are reduced by approximately \$1.7 million from the FY09 budget. Advertising (media development and placement) is budgeted at \$8.9 million, the same as the current fiscal year's budget.

*These members participated via teleconference.

Operating expenses, not including retailer commissions, are budgeted at approximately 4.8 percent of total revenue. SCEL's expense ratio as a percentage of revenue remains among the lowest in the lottery industry.

Mr. Rhodes also highlighted several items regarding SCEL's sales performance during calendar year 2008. Based upon *La Fleur's* rankings, SCEL ranks 7th in per capita instant tickets sales worldwide, up from 8th in the preceding year. SCEL is one of a few lotteries to demonstrate an increase in instant sales from calendar year 2007 to calendar year 2008.

Chairman Madden thanked Mr. Rhodes and his staff for the format and level of detail in the budget documents submitted to the Committee. He then opened the floor to questions. Committee members asked staff various questions and sought explanations of aspects of the proposed budget. These areas of inquiry, and the information provided by staff, include the following:

- To what is the projected gross revenue increase of \$16.4 million in instant games attributed? The increase is based on maintaining current sales performance, smaller print runs, frequent game turn-over, and an enhanced product mix;
- Why has the prize expense increased by approximately \$16 million? The increase is due to a realignment of prize percentages – based upon the increase of instant ticket sales which have higher payout percentage than online products (69%-instant/50%-online). The instant ticket payout percentage is in the middle range for the industry;
- How were the Powerball® and MM6 sales projections derived? MM6 has not performed as well as anticipated. Staff is reviewing the game for possible enhancements and/or exploring the possibility of replacing it with another game. Powerball® is experiencing “jackpot fatigue” and staff is always very conservative when making revenue projections;
- What actions caused the salaries decrease of \$526,000? Savings were achieved by omitting merit increases and reassigning responsibilities rather than filling vacancies whenever possible. The intern program, which is in a different line item, has also been reduced to \$20,000 from \$120,000; and
- What accounted for the reduction of \$284,000 in Consultants' fees? The major reductions were from the following: Internal Operations, \$30,000, no need for a compensation study; Marketing and Product Development, \$125,000 not performing a tracking study; Information Technology, \$20,000, costs associated with the online conversion that is now completed; Sales and Retailer Relations, \$100,000, not performing a customer satisfaction study.

Commissioners Madden and Quattlebaum asked several questions regarding the \$1.1 million budget for retailer selling bonuses and incentives. The questions focused on: (1) the criteria for award, (2) the distribution among the retailer network (including the payout experience), (3) whether there was a contractual or other obligation to pay, and the correlation between incentives and sales. Mr. Tony Cooper, Chief Operating Officer and Mr. Rhodes provided the following information: The owner of a retail outlet where a winning ticket of \$10,000 or more is sold receives 1 percent of the value of the prize as a

selling bonus, which is capped at \$50,000. The bonus is paid only if the prize is claimed. The Mystery Shopper Program is geared toward providing financial incentives (in the form of a gift certificate of \$100.00) to store clerks to encourage them to properly display lottery products and promote new games or other product offerings such as Power Play. There is no contractual obligation to pay a selling bonus or other incentives. During FY08, more than 1,184 selling bonus were paid to 942 individual owners. The total payout for bonuses and incentives for FY08 was \$963,105 (\$603,105 in selling bonuses and \$360,000 in incentives), as compared to \$864,997 for FY07 (\$582,403 in selling bonuses and \$282,594 in incentives). While there is no empirical data, staff believes there is a correlation between sales and the selling bonuses and incentives. Bonuses are meaningful to store owners but a portion is often shared with the sales staff. Staff explained the importance of recognizing and rewarding the retailer network as SCEL has relied upon these outlets for the sales success over the past seven years. Staff acknowledged the retailer incentive program is a matter of policy established by the Board.

Mr. Cooper and Mr. Rhodes were then asked to respond to several questions regarding the proposed advertising budget of \$8.9 million. They provided an overview of the advertising contract and the media placement contract. Advertising (creative) services are provided based on the specific needs for a given project and are billed by the hour based on the skill-set involved. Media placement fees are a fixed percentage of the cost charged by the various media outlets. Due to the current economic climate, SCEL has been able to increase the number of spots purchased while not increasing expenses. Staff reiterated that the FY10 budget request of \$8.9 million was the same as FY09. Reducing the advertising budget would result in fewer spots being purchased at a higher price point. If the advertising budget was reduced, there would be a corresponding reduction in the media placement fees. Mr. Cooper was asked to explain the sports packaging with the colleges, universities, and professional franchises. SCEL receives added media value by “bundling” the exposure in the venues (football, basketball, and baseball) with radio and television showcasing the coaches. The number and frequency of exposure opportunities in (bundled) sports packages yield more media value than if purchased separately.

The Chairman expressed his thoughts on the appropriate role of the Board and staff in the budget formulation process with regard to setting and implementing policy, and thanked staff for the briefing and budget material provided. The Chairman and other members of the Committee noted that despite the conservative budget proposed by staff, the dire economic conditions of the state require extraordinary analysis with an eye for being financially prudent. The Chairman opined the prospect of suspending retailer selling bonuses for a year, along with a 10 percent reduction in the advertising budget (which should result in an overall savings of approximately \$1.4 million) was worthy of further discussion and analysis. Committee members agreed it was important to protect sales revenue, and to not take action which is likely to significantly adversely impact sales. Without objection, the Committee recessed the meeting to allow staff time to more fully consider and respond to the points raised, and to prepare alternative budget reductions for review and consideration by the Committee.

Recess and Reconvening

There being no further business, the Committee recessed, subject to the call of the Chairman.

Subsequent to recess of this meeting, the time for reconvening was set for April 28, 2009, at 11:30 a.m. Consistent with the requirement of Section 30-4-80, notification for reconvening was posted at SCEL headquarters, 1333 Main Street in Columbia, as would occur for an initial meeting. As provided in the Board bylaws, the meeting notice and agenda were also posted on the SCEL website (sceducationlottery.com) and sent via facsimile transmission pursuant to requests made by media outlets and other organizations. These notifications included the time, date, place and agenda of the reconvening of the meeting.

On April 28, 2009, at 11:30 a.m. in the same location, the Chairman reconvened the meeting.

Other Business

The Chairman asked to move directly to this portion of the agenda to allow the Committee to discuss the SAS 70 audit. Bethany Parler, Director of Audit Services, was recognized. In accordance with best practices, the State Auditor and SCEL's external financial statement auditors require SCEL to procure a SAS 70 audit of Intralot to cover operations specific to SCEL. This audit includes the effectiveness of Intralot's internal controls over processing lottery transactions as well as pertinent areas of its financial, administrative, and information systems' processes. Although this audit is exempt from the Source Selection and Contract Formation provisions of the State Procurement Code, SCEL issued an Invitation for Proposal (IFP) to provide a competitive, uniform, and fair process for awarding this contract, subject to approval of the State Auditor. Mrs. Parler briefly explained the selection process and responded to questions from the Committee. In order to meet the completion date recommended by the external auditor, this award may need to be finalized prior to the May 13, 2009, Board meeting. While this is not a Request for Proposal, staff is asking for approval because the award is expected to be in the range of \$55,000 to \$65,000. Pursuant to the Board bylaws, the Committee may act on behalf of Board.

Motion Adopted

Commissioner Bailey made a motion to authorize the Director of Audit Services, in conjunction with the State Auditor, to award a contract for the performance of a SAS 70 audit of Intralot within the price range presented. Commissioner Keith seconded the motion, which was unanimously approved.

Fiscal Year 2010 Budget

The Chairman thanked staff for the additional material requested by the Committee relating to retailer incentives, advertising, and a revised budget summary reflecting additional budget reductions of approximately a total \$1.3 million from the proposed budget discussed on April 15th. Mr. Madden reiterated both the Board's and staff's responsibility and obligation to the stakeholders of South Carolina to review all options, especially during the current economic environment in the public and private sectors.

Mr. Rhodes was recognized to review the documents presented to the Committee prior to the reconvening. He explained the type and reason for each of the reductions. He called attention to an error in the previous version of the budget presented to the Committee. The retailer incentive programs and selling bonuses were overstated by \$414,279.

Mr. Ernie Passailaigue, Executive Director was recognized, and first apologized for the calculation error and explained his views on the potentially negative impact on sales if the incentive programs and selling bonuses are not funded in FY10. He recommended against modifying this program. He discussed an opinion previously expressed by the Board of Economic Advisors (BEA) which assessed a previously proposed reduction in retailer commissions (from 7% to 6%). He explained the BEA determined such a decrease would adversely impact sales. Mr. Passailaigue noted the reduction in retailer incentives and selling bonuses is not the same as a reduction in the statutory commissions, but described why a modification in this program was comparable. He discussed the current relationship between the SCEL and retailers, and the importance of maintaining good relations with these sales outlets. He identified specific intangible areas which could be impacted if the incentive program is modified, any or all of which could adversely impact sales. He emphasized the goodwill developed over time with the retailer network and the need to maintain and preserve this asset of SCEL. He observed the potential for the loss of some retail outlets, which would adversely impact sales.

Mr. Passailaigue also recommended against modifying the advertising budget. He noted a BEA study from 2005 on the correlation of lottery sales and advertising spending which found a multiplier of \$9 in sales for each \$1 spent on advertising. He acknowledged that some players would play regardless of the advertising level and at some point additional advertising will have diminishing marginal returns, but he believes a reduction in advertising will have a definite negative impact on sales. To lessen the impact, the likely choice for staff is to eliminate all non-product specific advertising message, i.e., branding/beneficiary and "Play Responsibly" messaging. The primary spending in this area is the sports packaging with the colleges and universities. He explained how this spending creates value for the SCEL and how staff determined this spending is valuable. In discussing the potential adverse impact of reducing the advertising budget, he explained in detail the results he could forecast in various areas of operations and sales, all of which would be negative.

Committee members asked Mr. Passailaigue to comment on the revised budget cuts throughout the agency and whether it would achieve the desired results or ultimately have a negative impact on the bottom line. Mr. Passailaigue stated he felt the budget he originally proposed was a good budget, but believes the revised budget can be implemented if necessary. The budget is derived from a zero based budget approach, with a philosophy to be very prudent and conservative in each and every expenditure. Budget approval does not mean the expenditure will be made unless doing so is appropriate and necessary at the time. It is staff's objective to not only present a workable budget to achieve the expectation set forth by the BEA, but to also strive each fiscal year to achieve beyond expectations through cost-cutting and improvements in

productivity. Mr. Passailaigue assured the Committee that staff will implement either version of the budget to the best of their collective abilities but, based on the concerns raised, he believes a decline in sales is likely if the further reductions are approved. Mr. Passailaigue stressed to Committee members that each employee is mindful of the cuts being made by other state agencies and is appreciative of the opportunity to be a part of the collaborative effort to raise funds for education that ultimately benefit all South Carolinians. Staff also appreciates the role and responsibility each Board member has to the respective appointing authorities and the citizens of South Carolina.

Members of the Committee discussed their respective views on the potential benefits and risks associated with the specific areas of retailer incentives and advertising. Without agreeing as to the Executive Director's basis for his opinion, the consensus of the Committee was to defer to the expertise of staff and to avoid making changes which are not recommended by staff. Members again thanked staff for providing the additional information needed to thoroughly review the budgetary matters for which the Board is responsible.

Motion Adopted

Commissioner Keith made a motion to recommend that the Board adopt the budget presented by the Executive Director on April 15, 2009, less the \$414,279 adjustment in the retailer incentives which was inadvertently misstated (as discussed above), and to direct staff to print and circulate to all Commissioners the revised proposed budget. Commissioner Quattlebaum seconded the motion, which was unanimously approved.

There being no further business, the meeting was adjourned.

/s/
Timothy Madden, Chairman

Date

As required by Section 30-4-80, notification for this meeting was posted at SCEL headquarters, 1333 Main Street in Columbia. As provided in the Board bylaws, the meeting notice and agenda were also posted on the SCEL website, sceducationlottery.com, and sent via facsimile transmission pursuant to requests made by media outlets and other organizations. These notifications included the time, date, place and agenda of the meeting.