

2012/2013
BUDGET BRIEFING
 HOUSE APPROPRIATIONS COMMITTEE (D)
 HOUSE APPROPRIATIONS COMMITTEE (D)



JOE MARKOSEK, DEMOCRATIC CHAIRMAN September 25, 2012

Lottery Fund Thrives; Impact of Privatization Unclear

The Lottery recently reported record sales and the highest profits in its 41-year history, providing record revenue to support programs that benefit older Pennsylvanians. The Lottery achieved this unprecedented growth while spending just over 2 percent of sales on operating costs. In fact, the Lottery's administrative costs actually decreased from 2.3 percent of total sales in 2010/11 to 2.1 percent last year.

This document outlines how revenue from the Lottery Fund is used in the enacted 2012/13 budget, the senior programs it supports and what is known about Gov. Corbett's current effort to pay a private company to run the Lottery.

Act 91 of 1971 created the Lottery Fund for the deposit of monies received from lottery operations. Net collections – the money generated from lottery ticket sales, less the commission retained by retailers as compensation for the sale of the tickets and the prizes paid directly by retailers – are deposited into the Lottery Fund. Other revenues deposited into the fund include transfers from the Gaming Fund (pursuant to Act 1 of Special Session No. 1 of 2006, known as the Taxpayer Relief Act) and investment earnings on securities and deposits. The Lottery receives no money from the state General Fund Budget.

The state law has two required spending provisions – one related to lottery prizes and one related to funding for programs. Act 91 requires at least 40 percent of gross ticket sales be paid out as prizes to players. Current law requires at least 27 percent of gross ticket sales be used for programs benefitting seniors.

Lottery Fund Expenditures

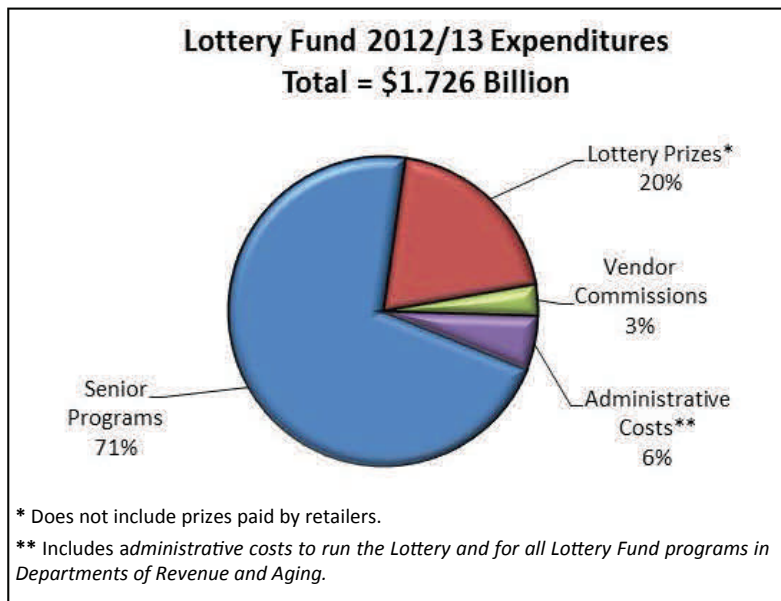
In any given fiscal year, Lottery Fund revenue available to spend includes net lottery collections, Gaming Fund transfers, investment earnings, and prior year ending balances. The available revenue is used to pay lottery prizes, cover operational expenses, and finance (through net profits) senior programs.

The 2012/13 Lottery Fund budget proposed by Gov. Corbett included

expenditures totaling \$1.667 billion, of which \$1.169 billion was for senior programs. Due to strong ticket sales in the final quarter of 2011/12, net lottery collections exceeded projections by \$65 million. The enacted budget spent \$59 million of the surplus collections, all of which was used for senior programs, increasing total Lottery Fund expenditures to \$1.726 billion for 2012/13.

The chart below shows the distribution of Lottery Fund expenditures in the enacted 2012/13 budget:

- **\$1.228 billion is for various programs that benefit Pennsylvania's senior population.** Detail on these programs is provided in the following section.



- **\$344 million is for payment of the following types of Lottery prizes:** online and instant game prizes that are more than \$2,500; prizes for which winning ticket holders choose to present their tickets at Lottery headquarters for payment; and online prizes not claimed within 180 days and are more than \$100. The amount budgeted for this executive authorization is based on ticket sale projections.
- **\$56 million is for vendor commissions.** This includes the commission paid to the contractor who operates/maintains the online game system – payments are calculated at 0.835 percent of the total sales of all lottery games. It also includes the payment of ticket testing and vendor commissions for the printing, warehousing and delivery of instant tickets to retailers – the commission is equal to 0.91 percent of actual sales of the instant games plus a bonus for increased profits.
- **\$97 million for administrative costs.** This includes funding for the operating costs in the

Department of Revenue to administer the lottery as well as the Property Tax/Rent Rebate Program, costs associated with advertising and promotional activities for the lottery, and the administrative/overhead costs in the Department of Aging that support senior programs.

Senior Programs

The enacted 2012/13 budget spends a total of \$1.23 billion on senior programs, nearly \$101 million more than 2011/12 and \$59 million more than Gov. Corbett’s initial 2012/13 budget proposal. The additional lottery revenue was directed to Medical Assistance Long-Term Care Program in the Department of Public Welfare, which received an overall increase of \$130 million.

The table on page 3 details the Lottery Fund expenditures budgeted for 2012/13 by agency and program. Expenditures for programs administered by the Department of Aging and the Department of Public Welfare are appropriated from the Lottery Fund as part of the General Appropriations Act (SB 1466 of 2012). Expenditures for programs administered by the Department of Revenue and the Department of Transportation are made through Executive Authorizations.

PENNCARE — This appropriation encompasses all of the lottery-funded community-based and in-home service activities of the Department of Aging. The department distributes grants to the 52 Area Agencies on Aging (AAAs) that serve all 67 counties. The AAAs use their funds to provide a broad array of services that meet the needs of older residents.

Aging Services provide a comprehensive and coordinated system of social services, including: congregate meals, home-delivered meals, personal care, home health, employment services, and recreation/socialization activities at senior community centers.

Attendant Care provides in-home personal care services to people with physical disabilities who “age out” from the attendant care program in the Department of Public Welfare which serves individuals under age 60.

What is the PA Lottery?

The Pennsylvania State Lottery was established by Act 91 of 1971 to generate revenue to fund programs for older Pennsylvanians. Initially, lottery proceeds were targeted at providing property tax relief for seniors in the form of property tax rebates. Over the years, lottery-supported programs have expanded to include other programs that benefit older Pennsylvanians including: rent rebates, transportation services, prescription drug assistance, home and community-based services, caregiver support, and long-term care.

The Department of Revenue is responsible for the administration and operation of the Pennsylvania State Lottery. This involves marketing and developing games, promoting sales, licensing agents to sell lottery tickets, and validating winners.

The Lottery offers two basic types of games: instant games and terminal-based games. Instant games, which consist of pre-printed “scratch and win” tickets, account for more than half of all sales. Terminal-based games are the numbers games such as The Daily Number and jackpot games such as Cash 5 as well as the two multi-state jackpot games (Powerball and Mega Millions) in which Pennsylvania participates. Lottery tickets are sold through a statewide network of more than 9,100 retailers. Winning ticket holders may redeem prizes up to \$2,500 at any lottery retailer; for higher amounts, winners receive a check from the Lottery.

Options In-Home provides customized supports and services that enable seniors to remain in their homes and avoid relocating to a nursing facility.

Other services include Medicare Managed Care Education (which provides information and counseling for health insurance and benefits), Elder Abuse Education and Prevention, and Ombudsman activities (that investigate and assist in resolving complaints made by older persons receiving long-term care).

Each AAA's annual grant amount is determined by a statutory formula that is based on the proportion of older people residing in the service area; however, a "hold harmless" provision prevents AAAs receiving less than the prior year's grant amount.

The 2012/13 appropriation provides nearly \$3.5 million in increased funding for Attendant Care, of which \$1.1 million is budgeted to serve 180 additional people age 60 and older with disabilities. All other funding for the AAAs decreases by approximately \$4.1 million compared to the 2011/12 allocations.

Pre-Admission Assessment — This appropriation pays for the assessments, performed by the local Area Agencies on Aging (AAA), of individuals applying for nursing facility care. Assessments are also performed to determine eligibility for Medicaid home- and community-based (waiver) programs as well as other alternatives to nursing facility care that are appropriate to the individual's needs and that will allow the individual to remain in their own home or community. The assessment screening process involves a thorough review of each applicant's medical and functional needs to determine their eligibility for services. The 2012/13 appropriation is expected to fund 105,725 pre-admission assessments and re-certifications.

Caregiver Support — This appropriation pays for the state Family Caregiver Supports Program in the Department of Aging. The program provides financial assistance to qualified families caring for

Lottery Fund Expenditures for Senior Programs		
<i>(\$ in Millions)</i>		
Agency / Program	FY 2012/13	Change from FY 2011/12
Department of Aging:		
PennCARE	\$248.164	-\$0.600
Pre-Admission Assessment	\$10.735	-
Caregiver Support	\$12.103	-
Pharmaceutical Assistance Fund Transfer	\$190.000	-\$35.000
Alzheimer's Outreach	\$0.250	-
Department of Public Welfare:		
Medical Assistance Long-Term Care	\$309.081	\$130.643
Department of Revenue:		
Property Tax and Rent Rebate	\$286.100	\$2.200
Department of Transportation:		
Shared Ride	\$80.975	\$1.975
Free Transit	\$91.268	\$1.658
TOTAL	\$1,228.676	\$100.876

frail older relatives. Eligible caregivers may be reimbursed up to \$200 per month for services and supplies and up to \$2,000 in one-time grants for home modifications and assistive devices. The enacted budget anticipates serving 7,120 families.

Pharmaceutical Assistance — Lottery Fund revenues are transferred to the Pharmaceutical Assistance Fund to support three pharmaceutical assistance programs – PACE, PACENET and PACE Plus – administered by the Department of Aging. Approximately 304,000 seniors, age 65 or older, receive assistance, of which about 248,000, or 82 percent, are enrolled in the PACE Plus program.

The PACE program is available to seniors whose annual income is \$14,500 or less for a single person and \$17,700 or less for a married couple. PACE participants pay no monthly fees or premiums. Their only costs are co-payments, which are \$6 for generic drugs and \$9 for brand-name drugs.

The PACENET program helps seniors whose annual income is between \$14,500 and \$23,500 for a single person and between \$17,700 and \$31,500 for a married couple. PACENET has no monthly premium, but participants pay a monthly deductible equal to the regional benchmark premium for Medicare Part D (which is \$34.32 for 2012). In addition, PACENET participants pay higher co-payments for prescriptions, \$8 for generic drugs and \$15 for brand-name drugs.

The PACE Plus Medicare program supplements PACE/PACENET drug coverage with the Medicare Part D drug benefit. Each year the department enrolls PACE and PACENET cardholders in Medicare Part D plans, where they continue to receive the same PACE/PACENET medications plus other prescriptions covered in the Part D plan.

PACE Plus is designed so that out-of-pocket costs for enrollees are the same, or lower, as PACE/PACENET. Enrollees pay the lower of the PACE/PACENET co-payments and the Part D plan co-payments; if the Part D plan has higher co-pays, PACE Plus pays the difference. PACE Plus also pays for drugs not covered by the Part D plan and drugs purchased during the “donut hole.” In addition, PACE Plus pays the monthly premium for PACE cardholders that enroll in a Part D plan that has signed an agreement with the department.

The amount of the annual Lottery Fund transfer to the Pharmaceutical Assistance Fund is based on estimated state expenditures for the three programs. The PACE and PACENET programs are paid entirely with state revenue, whereas PACE Plus is funded largely with federal Medicare funds – the state only pays for the “wrap around” coverage provided by PACE Plus (i.e., the monthly premiums for PACE cardholders, differences in co-pays, drugs not included in the Part D plans and claims for drugs purchased by individuals in the donut hole). Because the federal Medicare program pays for most of the prescription drug costs in PACE Plus, enrolling seniors in this program significantly reduces state expenditures and frees up Lottery Funds that can be used for other senior programs.

The 2012/13 budget transfers \$190 million of Lottery Fund revenue to the Pharmaceutical Assistance Fund, a decrease of \$35 million compared to 2011/12.

For the most part, the reduced Lottery Fund transfer reflects the availability of excess (or unused) transfers that were appropriated in the 2011/12 budget – specifically, \$25 million of the 2011/12 Lottery Fund transfer was not spent and is available to cover state expenditures incurred in 2012/13. Similarly, the availability of other excess monies in the Pharmaceutical Assistance Fund further reduced the required 2012/13 Lottery Fund transfer by another \$4 million. Part of the remaining \$6 million reduced transfer is due to Medicare Part

D provisions in the federal Affordable Care Act (federal health reform) which close the “donut hole” and thereby reduce 2012/13 state expenditures for the PACE Plus program.

Alzheimer’s Outreach — This appropriation funds programs that offer support, education, and community awareness services to address the needs of individuals and families affected by Alzheimer’s disease and related disorders. It also funds outreach activities to families, medical professionals, human service providers and the general public.

Medical Assistance Long-Term Care — This appropriation in the Department of Public Welfare uses Lottery Fund revenue to help pay for nursing home care provided to low-income individuals who qualify for Medical Assistance (the name of Pennsylvania’s federal Medicaid program). The lottery funds reduce the need to spend state General Fund revenue on nursing home expenditures in the Medical Assistance program.

Property Tax/Rent Rebate (PTRR) Program — The Department of Revenue administers the PTRR program which benefits senior citizens over age 65, widowed individuals over age 50, and permanently disabled individuals by providing rebates on property taxes or rent paid by eligible households.

Prior to 2006, the PTRR income eligibility limit was \$15,000 per household – this applied to both homeowners and renters – and eligible households could receive a maximum rebate of up to \$500. The Taxpayer Relief Act of 2006 expanded the PTRR program with respect to income eligibility and rebate amounts. Specifically, the income eligibility limit for homeowners increased to \$35,000; the income eligibility limit for renters remained at \$15,000.

The act increased the standard rebate for all recipients to a maximum of \$650 and created supplemental property tax rebates for qualifying homeowners. Depending upon their household income, eligible renters may receive a standard rebate of either \$500 or \$650 while eligible homeowners may receive a property tax rebate between \$250 and \$650.

The law provides an additional 50 percent in property tax relief (for a maximum rebate of \$975) to the following senior citizens who have household

income less than \$30,000:

- Senior citizens residing in Philadelphia, Pittsburgh and Scranton.
- Senior citizens residing elsewhere in the state who pay more than 15 percent of their income in property taxes.

Funding for the enhanced income limits and rebate amounts under the 2006 act are paid for through an annual transfer of gaming revenue from the Property Tax Relief Fund to the Lottery Fund.

The 2012/13 enacted budget includes \$286.1 million for the PTRR program, \$2.2 million more than in 2011/12. This increase is based on the projection that 606,000 households will participate in the rebate program in 2012/13, an increase of 1,000 households compared to the 2011/12 projection. More than half of the Lottery Fund revenue budgeted for PTRR is supported by gaming revenue transferred to the Lottery Fund to pay for rebates afforded to seniors under the program enhancements in the 2006 act – an estimated \$166.8 million of gaming revenue will be transferred in 2012/13.

Free and Reduced Fare Transit — The Department of Transportation administers two transit programs for Pennsylvanians over age 65.

The Free Transit program offers free rides on local bus routes and rapid-transit lines during all operating times. This program is funded with Lottery Fund revenues deposited into the Public Transportation Trust Fund and distributed by PennDOT to local transit systems as part of their

annual operating assistance grant. Lottery Fund revenue is allocated annually to the program based on the prior year expenditures, adjusted by the consumer price index.

The Shared Ride program offers door-to-door specialized transportation services (such as vans and mini buses) at a discounted fare. PennDOT contracts with service providers who operate on a non-fixed route basis. Senior citizens, or approved third-party sponsors (such as human services agencies), pay a discounted rate equal to 15 percent of the existing shared ride fare; the Lottery Fund pays the remaining 85 percent of the fare.

Record Lottery Revenue; Reduced Operating Costs

On July 31, the Department of Revenue reported that 2011/12 was the most successful year for the Pennsylvania Lottery, with record ticket sales of \$3.48 billion generating record net profits of more than \$1 billion for senior programs. Specifically, net profits totaled \$1.06 billion in 2011/12, which was an increase of \$100 million compared to 2010/11 and represented annual growth of 10.4 percent.

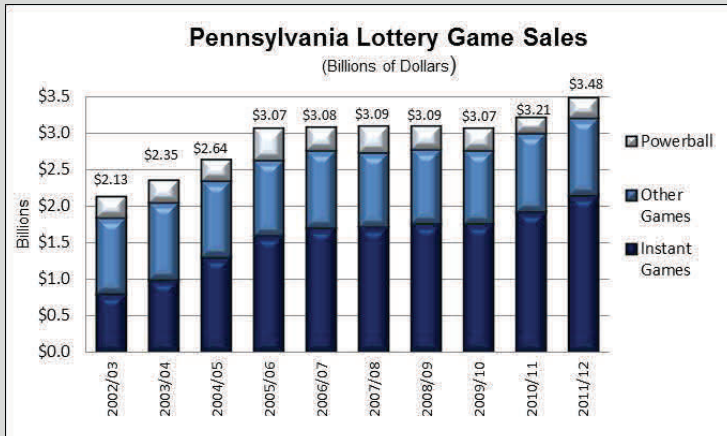
In the announcement of record sales, Corbett administration officials acknowledged how efficiently the Lottery is run. In fiscal year 2011-12, the Lottery's administrative costs actually decreased from 2.3 percent of total sales to 2.1 percent because of a new contract with the independent drawing auditor, reductions in printing costs and fleet management changes.

The table below shows a 10-year history of Lottery sales. For 2011/12, total Lottery sales were \$273 million (or 8.6 percent) above 2010/11, led by the growth in ticket sales for instant games and Powerball.

Instant game sales were nearly \$2.135 billion in 2011/12, an increase of \$212 million (or 11 percent) from the prior year.

Powerball sales were \$288 million in 2011/12, an increase of nearly \$64 million (or 30 percent) from the prior year.

Sales for all other games (Mega Millions and other terminal-based games) totaled \$1.068 billion, which is down \$3 million (or 0.3 percent) from 2011/12.



Exploring Privatization

The Corbett administration is currently considering the use of a private company to manage the Pennsylvania Lottery, with a decision expected later this fall on whether to move forward with his privatization initiative. On April 2, Gov. Corbett announced that his administration was looking at the concept of a private management agreement as a way to maximize lottery revenue and increase future funding for senior programs.

Under the governor's plan, a private manager would assist the Department of Revenue in managing the day-to-day operations of the Pennsylvania Lottery and its core functions, such as game development, supply of goods and services, marketing and advertising. In accordance with federal law, the commonwealth would continue to own and operate the Lottery, with the Department of Revenue retaining control over all significant business decisions and having the authority to direct and countermand the operating decisions of any private manager. The private manager would enter into a private management agreement (PMA) with the department, with the private company taking on the risk to grow Lottery revenues and enhance funding for senior programs. Part of the private manager's compensation would be correlated to its performance in increasing net revenue. The terms of the agreement would be structured to guarantee that Lottery revenues meet the targeted levels as defined in the contract – failure to meet designated targets would require the manager to provide “catch-up” payments to the Lottery to bridge the revenue gap.

The exploratory process for privatizing Lottery operations officially began April 2 when the commonwealth issued a Request for Qualifications (RFQ) to identify potential bidders. Firms interested in entering into a Lottery PMA were given 30 days to provide information relating to their technical capability, financial capability, and suitability for such a project. In particular, the RFQ required each firm to describe its technical experience in managing lotteries (that have annual revenue in excess of \$1 billion), including the results achieved in terms of growing revenues and cash flow. Firms also

had to demonstrate their ability to deliver the commonwealth one or more irrevocable letters of credit totaling at least \$100 million to secure the private manager's obligations under any PMA.

Based on information presented in the RFQ responses the Department of Revenue announced on June 12 that a pool of qualified bidders had been established and so the administration was moving forward with the Invitation for Bids (IFB) process. Qualified respondents, a list of which has not yet been made public by the Corbett Administration,

Privatization Effort Raises Questions

Before determining if privatization of the Pennsylvania Lottery may be in the best interest of senior citizens and taxpayers, the Corbett administration should provide more open and transparent information to questions such as:

- **Is legislative approval needed** to privatize Lottery operations?
- **How much is it costing** the commonwealth to explore privatization of the Lottery?
- Will the multi-million contracts with private consultants hired to help explore privatization be paid out of Lottery funds that would otherwise support programs for older Pennsylvanians?
- **How many companies have expressed an interest** in running the PA Lottery?
- When will the names of the companies interested be shared with the public?
- Since the cost of running the Lottery is currently just 2.1 percent, will a private management agreement hold vendors to that same operating margin?
- When will the commonwealth provide a fiscal analysis on the pros and cons of privatizing the Lottery?
- Is legislative approval needed for a private vendor to expand the **PA Lottery to include online gaming?**
- Why should Pennsylvania pay millions of dollars to a private company to explore ways to increase Lottery funds; can't we do that with existing staff and the private vendors already on contract with the Lottery?
- If Pennsylvania pays a private for-profit company, **doesn't that take money away from the senior programs the Lottery currently supports?**
- When will the commonwealth make a decision about whether to privatize operation of the Lottery?

will have the opportunity to bid on the PMA through an IFB process that involves three steps as explained below – at any stage of this process, the commonwealth may terminate procedures and abandon the PMA should it determine such action is in its best interest.

In the **first step** of the IFB process, the commonwealth’s evaluation team will conduct a “due diligence process” with each qualified bidder and develop a PMA. During this time, the commonwealth will engage in discussions with each qualified bidder to explore ideas for improving the lottery’s operation and to determine what a private management agreement would look like. The commonwealth will also examine the business plans of each qualified bidder, their character, fitness and suitability. Due diligence discussions are expected to take several months, with a decision made in the fall of 2012 whether to proceed with the PMA and move to step two of the IFB process.

In the **second step**, the commonwealth will present qualified bidders with the PMA developed during the due diligence process and invite priced bids for these lottery management services.

In the **final step**, the commonwealth will decide whether to award a contract to a qualified bidder or keep the Lottery under state management. If a decision is made to hire a private manager, selection of the winning bidder will be made by the commonwealth team in consultation with its legal and financial advisors — **Greenhill and Co.**, a financial advisory firm from Chicago; and **DLA Piper**, a Baltimore law firm.

The commonwealth’s team is comprised of representatives from various agencies including the Departments of Aging, Revenue, General Services, the Pennsylvania Lottery, the Governor’s Budget Office, the Governor’s Policy Office, and the Governor’s Office of General Counsel. The commonwealth contracted with Greenhill and Co., and DLA Piper to provide financial and legal expertise.

To ensure the commonwealth has sufficient background information to complete due diligence, the Corbett administration contracted with **Kroll Advisory Solutions** to conduct probity investigations on each bidder. If the commonwealth eventu-

ally seeks bids, Kroll will also conduct a full investigation into the winning company and its executives – examining criminal history, financial history, reputation, business practices and contractor integrity – before the PMA is finally executed.

At this time, the Corbett administration has not disclosed the names of the qualified bidders with whom the Department of Revenue is currently having due diligence discussions. According to the administration, the number of RFQ responses received and the identities of respondents will remain confidential until the PMA procurement process is completed or abandoned. The department asserts such confidentiality will preserve the integrity of the procurement process and maximize competition among the respondents.

By contrast, when the commonwealth sought expressions of interest from companies interested in a potential lease of the PA Turnpike in 2008, all submissions were made public.

It is not known how a private management agreement might affect the 230 employees at the Lottery. Specifics regarding what would be done differently at the Lottery and how operations would be improved under a PMA have yet to be determined. **The Corbett administration has not yet revealed how much the privatization exploration is costing Pennsylvania** — funds coming out of lottery profits which would otherwise fund programs for seniors.

When Gov. Corbett announced his initiative in April, he noted that the annual growth in Lottery net profits had averaged just 0.3 percent per year for the five years through 2010/11 and that net profits were projected to grow an average of about 1 percent per year through 2014/15. Because such minimal growth is unlikely to keep pace with demand for lottery-funded programs as the number of older Pennsylvanians increases, the administration wanted to explore whether a private operator could bring in more revenue.

As the Corbett administration continues to explore the feasibility of a private management agreement to improve Lottery operations and increase the bottom line, it noted that last year’s record sales and net profits raise the bar higher for any prospective bidders for such a Lottery PMA.

House Appropriations Committee (D)

Miriam A. Fox, Executive Director

Beth Balaban, Senior Budget Analyst

Barry Ciccocioppo, Communications Director