



MEMORANDUM

To: California State Lottery Commission **Date:** February 28, 2007

From: Joan M. Borucki
Director

Prepared by: Patricia Eberhart, Director
Finance and Administration Division

Subject: Item 9(c) – Sales Update and Approval of Adjustments to the 2006-07 Fiscal Year Budget

ISSUE

Should the California State Lottery Commission (Commission) approve the proposed mid-year adjustments to the 2006-07 fiscal year budget?

RECOMMENDATION

I recommend that the Commission approve the mid-year adjustments to the 2006-07 fiscal year budget and to authorize staff to notify the Department of Finance and education community of the revised estimates. These adjustments revise the projected revenue to \$3.2 billion, and make needed changes to the prize fund allocations and the administrative budget. The revised budget projects education revenues at \$1.134 billion, compared to the original projection of \$1.27 billion. While this is a reduction of \$136 million from the original projection of \$1.27 billion, it still will represent the third highest education earnings in the California State Lottery's (Lottery) 22-year history. Current projections indicate the Lottery will not meet its sales goals and estimated transfer to education.

DISCUSSION

On June 27, 2006, the Commission adopted the Annual Business Plan and Budget for the 2006-07 fiscal year. This plan was based on the achievement of \$3.6 billion in sales and the resultant generation of \$1.27 billion in revenue for public education.

This goal was very close to the final \$3.585 billion overall sales for the 2005-06 fiscal year.

These projections were predicated on a combined increase in the sales of MEGA Millions® and SuperLOTTO Plus® from \$1.18 billion to \$1.245 billion. All the growth was expected to come from the MEGA Millions game because it was believed that this game had yet to reach its full potential. Unfortunately, there has been an absence of large jackpots in both MEGA Millions and SuperLOTTO Plus. Based on the first two quarters of this fiscal year, our trend analyses and simulations show that we will not meet the \$1.245 billion goal for these games.

MEGA Millions sales are now projected at \$355 million, down \$205 million from the budgeted sales goal of \$560 million, or about 37 percent. SuperLOTTO Plus sales are projected at \$605 million, down \$80 million from the budgeted sales goal of \$685 million, or about 12 percent. These projections are based on in-house simulations of possible sales performance and assumes average jackpot levels for the remainder of the year.

Looking at nationwide trends, all twelve MEGA Millions states are facing the same problem. Overall, the twelve MEGA Millions states are experiencing an average decline of over 30 percent in sales compared to the same period last year. California is experiencing a decline of about 28 percent. (*See attached chart.*) The primary difference between this year and last year is the number of large jackpots. It is well established that MEGA Millions is a jackpot driven game, meaning higher jackpots drive higher sales. Unfortunately, jackpot levels are out of our control and have been low this fiscal year.

Customer driven demand in the lottery business is changing across the nation. Lotteries across the country are facing declines in lotto game sales. Some have speculated that consumers have less discretionary spending while competition for discretionary dollars has increased.

Unlike other lotteries, our lottery is uniquely constrained by the way we must fund prize levels in our Scratchers® games. We are the only lottery in the country that must fund Scratchers games through draw game sales and administrative savings. As a result, when draw game sales decline, we are not allowed to make up the deficit through increased Scratchers sales. States that are not constrained by this limitation have been able to increase the sale of scratcher tickets, which remain a strong and growing product. Instead, we must artificially curtail the sales of Scratchers tickets because we cannot afford to fund Scratchers prize levels. Our current shortfall in draw game sales, requires us to limit Scratchers sales, which has only compounded the problem.

For the Scratchers product line, the \$1.88 billion sales level projected in the original budget cannot be sustained this fiscal year. Due to the factors discussed above, a

revised sales goal of \$1.76 billion is being recommended, which is only six percent below the original target. Should some of the sales and funding assumptions being recommended not materialize, a further reduction to the Scratchers sales may need to be implemented. Options to accomplish that include postponing the introduction of high payout games until next fiscal year and/or the possible termination of distribution of the product late in the fiscal year.

Education will still receive the mandated 34% (in fact, it is projected to be 35%), but it will be a smaller dollar amount than the prior year. If this cycle continues and draw game sales continue to decline, as they are across the nation, education will continue to receive smaller and smaller amounts from the Lottery.

Despite these constraints, we have taken similar steps to introduce new and innovative games such as the Million Dollar Raffle and are developing additional games for the future, but more needs to be done to reverse long term trends. We are exploring fundamental and critical changes such as selling products where consumers prefer to shop today instead of where they shopped 20 years ago. These options are being evaluated and will be presented to the Commission after they are fully assessed.

We have taken steps to mitigate the decline in sales including cuts in administrative spending and other reductions. We have cut \$3 million for over a dozen projects planned for this fiscal year. The original budget contained an administrative spending reserve of nearly \$8 million as a safeguard against future uncertainties. With these sales and budget adjustments, the administrative spending reserve has been reduced to under \$1 million. This level of a reserve provides very little protection for uncertainties and it becomes very important that these new budget projections are accurate. Staff will continue to monitor sales and expense performance very closely and return to the Commission with updates as needed. However, these cuts will not be enough to make up the sales deficits.

Related adjustments to the prize fund category and the administrative spending category are also needed to bring the budget in balance and help assure that Education receives the statutorily required 34 percent of Lottery sales revenues. The adjustments are detailed on the attached table.

Sales to date and the projected trends for the remainder of the year point to a revised sales goal of \$3.2 billion for this fiscal year. The net impact of these budget revisions is a change in the projected education revenues to \$1.134 billion.

CALIFORNIA STATE LOTTERY
ADJUSTMENTS TO FY 2006-07 BUDGET
(Dollars in Millions)

	Original Budget <u>FY 2006-07</u>	% of <u>Sales</u>	<u>Change</u>	Adjusted Budget <u>FY 2006-07</u>	% of <u>Sales</u>
SALES					
o Estimated Sales	\$3,600	100.0%	(\$400)	\$3,200	100.0%
PRIZES					
o Prize Expense	\$1,800	50.0%	(\$200)	\$1,600	50.0%
Promotional Prizes	\$141	3.9%	(\$31)	\$110	3.4%
Total Prizes	\$1,941	53.9%	(\$231)	\$1,710	53.4%
ADMINISTRATIVE EXPENSES					
o Retailer Compensation	\$255	7.1%	(\$27)	\$228	7.1%
o Game Operations	\$60	1.7%	(\$2)	\$58	1.8%
o Communications	\$36	1.0%	\$3	\$39	1.2%
o General Administration	\$76	2.1%	\$0	\$76	2.4%
o Administrative Reserve	\$8	0.2%	(\$7)	\$1	0.0%
Total Administrative Expenses	\$435	12.1%	(\$33)	\$402	12.6%
EDUCATION REVENUE					
o Statutory Requirement	\$1,224	34.0%	(\$136)	\$1,088	34.0%
o Interest and Other Income	\$16	0.4%	\$0	\$16	0.5%
o Unclaimed Prizes	\$30	0.8%	\$0	\$30	0.9%
Total Revenues for Education	\$1,270	35.3%	(\$136)	\$1,134	35.4%