

To: California State Lottery Commission **Date:** May 20, 2008

From: Joan M. Borucki

Director

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Subject: Item 9(b) – Revised FY 2007-08 Sales Goal and Revised FY

2007-08 Budget

ISSUE

Should the California State Lottery Commission (Commission) approve the proposed revisions to the FY 2007-08 sales goal and the related adjustments to the FY 2007-08 budget.

RECOMENDATION

California State Lottery (Lottery) staff recommends that the Commission approve the proposed revisions to the FY 2007-08 sales goal and the related adjustments to the FY 2007-08 budget.

BACKGROUND

Over the last year, we implemented innovative and groundbreaking strategies as outlined in our Business Plan. Indeed, we have achieved some very significant milestones. In the last year, we have recruited over 1000 new retailers surpassing the 20,000 mark for total retailers. Our new marketing campaign has stabilized and even reversed the downward trend in our lotto games with Super Lotto Plus and Mega Millions seeing lifts of 7% and 13% at lower jackpot levels, respectively. We have improved our consumer protection efforts to industry leading levels. Our communications program has made great strides in generating media coverage of lower jackpots levels as well as local winner stories.

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These accomplishments signal a major change in the way we now do business. More importantly, for the first time in the Lottery's twenty-two year history we have established a strong foundation for long term sustainable growth. As promised in June of 2007, we are no longer operating on a year to year basis. The Lottery is following through on the multi-year strategy adopted by the Commission.

Despite the fact that we are seeing a positive sales response to our multi-year strategy, we are projecting that we will fall short of our sales goals. The reasons behind the decline are complex, multifaceted and not always discernable. We are aware our poor brand image, and low prize payouts have and will continue to contribute to declining playership levels. Some states have attributed their declines to the poor economy and rising gas prices. For example, the Florida Lottery, which was often heralded for its recent growth, is currently experiencing instant ticket (Scratchers) sales 9% lower than this same time last year. Other lotteries have been similarly effected, with nineteen of forty-two state lotteries reporting flat or declining sales in the fourth quarter of 2007. Sales declines are not limited to the lottery industry. As reported in *Advertising Age*, consumer spending is definitely worse than expected with the nation's retailers reporting the weakest sales for March 2008 since 1995.

Sales are lagging behind the pace necessary to achieve the \$3.350 billion sales goal and \$1.180 billion contribution for education. Sales to date and the anticipated trends for the remainder of the year point to a revised sales goal of \$3.075 billion and \$1.091 billion in revenue for education. The Lottery has taken steps to make the related adjustments to the prize fund category and the administrative spending category to bring the budget in balance and assure that education receives its 34% of Lottery sales.

DISCUSSION

On June 27, 2007, the California Lottery Commission adopted the 2007-10 Business Plan and Annual Budget for the 2007-08 Fiscal Year. This budget was based on a sales goal of \$3.350 billion, generating \$1.185 billion in revenue for education. The budget as adopted included a \$192 million expenditure for administration, a \$1.780 billion expenditure for prizes and a \$239 million expenditure for retailer compensation.

The lotto games, including Super Lotto Plus and Mega Millions, were budgeted at a combined total of \$1.050 billion. Scratchers games were budgeted at \$1.800 billion. Prize payouts were reduced 1% from the previous fiscal year in order to afford two \$5 price point games for launch during the fiscal year. Hot Spot and Daily games were budgeted at \$460 million. Two raffle games were planned and budgeted at \$40 million combined.

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For the lotto games, a revised combined sales goal of \$1.020 billion is forecasted. This represents a modest \$30 million or 2.9% decrease from the budget. The positive news is that this will be equal to the combined sales from 2006-07 fiscal year, marking a stabilization or reversal of the negative trend line for our lotto games. The adopted Business Plan set out a goal of shifting the jackpot paradigm away from the emphasis on very large jackpots and encouraging play at smaller jackpot levels. Since launching the marketing campaign, targeted to shift this paradigm in January 2008, the Lottery has seen a 7% and 13% rise in sales at the lower jackpot levels for Super Lotto Plus and Mega Millions, respectively. Individually, we are forecasting Super Lotto Plus sales to be \$605 million, down 3.2% from budget and Mega Millions sales at \$415 million, down 2.4% from budget. Sales for these games in the previous fiscal year were off projections by 7% and 44%, respectively. Progress is being made in the draw games.

For Hot Spot, a revised sales goal of \$135 million is forecasted. This represents a \$15 million or 10% decrease from the original budget. Despite numerous promotions, this game continues to struggle.

For the Daily games, a revised sales goal of \$321 million is forecasted. This represents an \$11 million or 3.5% increase versus the original combined sales goal of \$310 million. While Daily 3 and Fantasy 5 are expected to increase a mere 1% to 2%, Daily Derby is expected to generate a 45% increase in sales. The Daily Derby increase is directly attributable to an unusually large jackpot earlier this year that fueled sales.

For the Scratchers product line, the \$1.800 billion sales level projected in the original budget will not be realized, and is now forecasted at \$1.590 billion or an 11.7% decrease. The overall level of Scratchers sales that can be supported is influenced by the aggregate payout for the Scratchers product, other prize funding available to be used for Scratchers prizes, and the administrative savings that can be diverted to Scratchers prizes. When the Fiscal Year 2007-08 budget was developed, it included the release of three \$5 price point Scratchers. To afford these higher payout games, the overall prize payout for Scratchers was reduced from 58.5% to 57.5%.

The largest decline in Scratchers sales is in the \$2 game category. Here, sales were down over 19%, and the declines for the \$1 and \$3 game categories were 14% and 12%, respectively. The \$3 games dropped from 60.6% prize payout to 59.4%; \$2 games decreased from 56.7% prize payout to 55.6%; and the \$1 games remained the same at 53.6%. Enthusiasm for Scratchers declines with players experiencing fewer wins of significant prizes.

Over the course of the first six months of this fiscal year, sales of the \$5 games were up nearly \$30 million compared to the prior year. This is the first time in several years that we have had a continued presence of a \$5 game. When combined with

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the decline of sales of \$3, \$2, and \$1 games, the average prize payout is forcasted to be 58.1% at year end, rather than the budgeted 57.5%. Steps have already been taken to postpone the introduction of any more \$5 games.

The original budget included a forecast of \$40 million from two potential Raffle games. Only one Raffle game was launched, resulting in sales of \$9 million or a decrease of 77.5%. Our tracking study showed that awareness of the prior Raffle games was relatively low, and that we had insufficient administrative funds for the investment in advertising, necessary for the success of another Raffle game. Currently, our plans are not to offer any further Raffle games, until the low awareness levels can be addressed through an investment in advertising, or through an improved brand image, facilitating sales.

The net impact of these sales forecasts is a change in revenue to education from \$1.185 billion to \$1.091 billion, a decrease of \$94 million. Staff will continue to monitor sales and expenditure performance very closely and keep the Commission informed as we progress.

It is important to note that these revised projections do not take into account the new "State of Winning" marketing campaign or the upcoming Daily 4 game launch. The number of retailer locations have surpassed 20,000 with the addition of over a thousand new retailers in the last year. These and the many other efforts the Lottery is undertaking should minimize or even reverse the downward trend.

The Business and Marketing Plans continue the long term strategy to improve our brand image and reverse the downward trend in sales, and are already showing signs of progress. More importantly, the plans reflect an even more exciting and innovative year to come.

Attachment (1)

CALIFORNIA STATE LOTTERY ADJUSTMENTS TO FY 2007-08 BUDGET

(Dollars in Millions)

		Original Budget FY 2007-08	% of Sales	<u>Change</u>	Adjusted Budget FY 2007-08	% of Sales
SALES						
0	Estimated Sales	\$3,350	100.0%	(\$275)	\$3,075	100.0%
PRIZES						
0	Prize Expense	\$1,675	50.0%	(\$137)	\$1,538	50.0%
	Promotional Prizes	\$105	3.1%	(\$5)	\$100	3.3%
	Total Prizes	\$1,780	53.1%	(\$142)	\$1,638	53.3%
ADMINISTRATIVE EXPENSES						
0	Retailer Compensation	\$239	7.1%	(\$20)	\$219	7.1%
0	Game Operations	\$60	1.8%	(\$4)	\$56	1.8%
0	Communications	\$40	1.2%	\$0	\$40	1.3%
0	General Administration	\$77	2.3%	\$0	\$77	2.5%
0	Administrative Reserve	\$15	0.4%	(\$15)	\$0	0.0%
	Total Administrative Expenses	\$431	12.9%	(\$39)	\$392	12.7%
EDUCATION REVENUE						
0	Statutory Requirement	\$1,139	34.0%	(\$94)	\$1,045	34.0%
0	Interest and Other Income	\$20	0.6%	\$0	\$20	0.7%
0	Unclaimed Prizes	\$26	0.8%	\$0	\$26	0.8%
	Total Revenues for Education	\$1,185	35.4%	(\$94)	\$1,091	35.5%