

# **CALIFORNIA LOTTERY**

Report of Analysis

## **IMPACT OF AB 142 ON FURTHERING THE PURPOSE OF THE LOTTERY ACT**



**BETTY T. YEE**  
California State Controller

March 2016



**BETTY T. YEE**  
California State Controller

March 30, 2016

Members of the California State Legislature  
State Capitol Building  
Sacramento, CA 95814

Dear Senators and Assembly Members:

I am pleased to provide you with the analysis of the impact of Assembly Bill (AB) 142 (Stats. 2010, c. 13) on furthering the purpose of the California State Lottery Act of 1984. This analysis was prepared in accordance with Government Code section 8880.4.5 by a review group consisting of the State Controller, the Superintendent of Public Instruction, and the Chairperson of the California State Lottery Commission.

The review group has concluded that AB 142 has furthered the purpose of the Lottery Act to maximize Lottery revenues available to supplement funding for public education. Specifically, by augmenting the share of sales revenues allocated to prizes, Lottery ticket sales have risen resulting in a substantial increase in the total net revenues available to supplement funding for California's public schools.

Sincerely,

BETTY T. YEE

cc: Tom Torlakson, State Superintendent of Public Instruction  
Nathaniel Kirtman III, Chairperson  
California State Lottery Commission  
Gregory Ahern, Commissioner  
California State Lottery Commission  
Rowena Libang-Bobila, Commissioner  
California State Lottery Commission

Connie M. Perez, Commissioner  
California State Lottery Commission  
John Smolin, Commissioner  
California State Lottery Commission  
Hugo López, Director  
California Lottery  
Paula D. LaBrie, Chief Deputy Director  
California Lottery  
Nicholas Buchen, Deputy Director, Finance Division  
California Lottery  
Roberto Zavala, Chief Internal Auditor  
California Lottery

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# Report of Analysis

## Introduction

Following the first five full fiscal years after the enactment of Assembly Bill (AB) 142 (Stats. 2012, c. 13), Government Code section 8880.4.5 requires the State Controller's Office (SCO) to convene a review group consisting of the Controller, the Superintendent of Public Instruction, and the Chairperson of the California State Lottery Commission. The review group is required to report to the Legislature by March 31, 2016 on whether the amendments made by AB 142 have furthered the purposes of the California State Lottery Act of 1984 (Lottery Act).

## Background

In 1984, California voters passed an initiative that amended the State Constitution to authorize a state-operated lottery. The initiative enacted the Lottery Act, the purpose of which is to provide supplemental monies to benefit public education without the imposition of additional or increased taxes. The California State Lottery (Lottery) is administered by a five-member Commission appointed by the Governor.

The Lottery Act requires that net revenues be deposited in a special fund, known as the California State Lottery Education Fund, from which quarterly transfers are made by the SCO to the public education community. The SCO allocates these revenues on a per capita basis, using prior year certified Average Daily Attendance data, to specified educational institutions including K-12 education, Community Colleges, the California State University, and the University of California.

The Lottery Act initially required that 50 percent of total annual revenues be returned to the public in the form of prizes and that at least 34 percent of total revenues be allocated to the benefit of public education. No more than 16 percent of total revenues were to be used for administrative costs. In April of 2010, AB 142 changed the Lottery Act to allow the Lottery flexibility to pay out more money in prizes. Specifically, AB 142 required the Lottery to return at least 87 percent of total revenues to the public in the form of prizes and net revenues to benefit public education, and reduced allowable administrative costs to 13 percent of total revenues.

In enacting AB 142, the Legislature made a finding that the experience of other state lotteries demonstrates that augmenting the share of sales revenues allocated to prizes increases ticket sales and results in an increase in the total net revenues available to the lottery beneficiaries. As this report will demonstrate the California Lottery's beneficiaries have enjoyed a significant increase in funding as a result of the flexibility offered by AB 142.

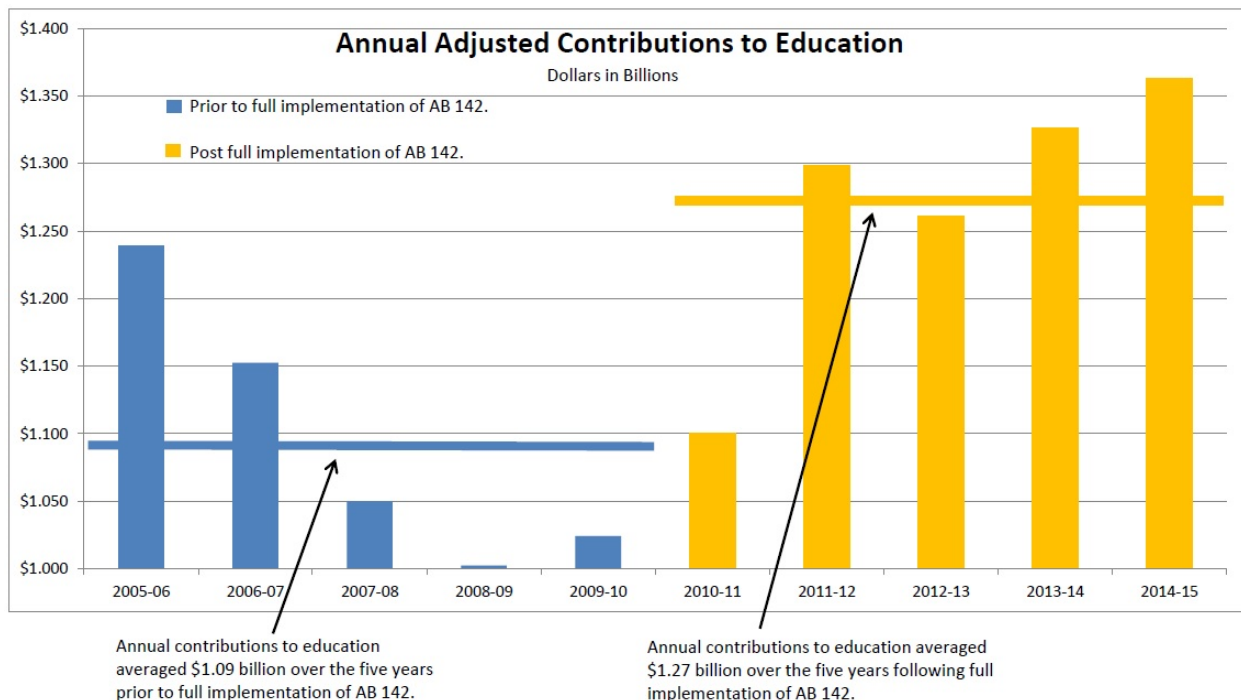
## Analysis

### Goals of AB 142

The Legislature declared that the purpose of AB 142 was twofold – “to increase lottery net revenues available to supplement funding for public education, and to maximize the amount of the increase in total net revenues generated by the lottery that are made available to public education.” This report will analyze each of these goals separately.

#### I. Increase in Lottery Net Revenues Available to Supplement Funding for Public Education

One way to determine if AB 142 was successful in increasing Lottery net revenues available to supplement funding for public education is to compare the Lottery’s annual contributions to education before and after implementation of AB 142. As shown in the chart below, the Lottery’s contribution to education has averaged \$1.27 billion over the five fiscal years in which AB 142 has been fully implemented. This compares to an average contribution to education of \$1.09 billion over the five fiscal years prior to the full implementation of AB 142. Thus, AB 142 clearly has resulted in increased net revenues available to supplement funding for public education.



AB 142 was enacted on April 8, 2010, during the fourth quarter of fiscal year (FY) 2009-10. Although the Lottery began implementing the new law as quickly as possible by launching a high payout Scratchers game in June of 2010 that created more instant millionaires than any other game in Lottery history at that time, there was minimal impact on the Lottery’s sales and

contribution to education for FY 2009-10 because the changes took place so late in the fiscal year. For this reason, including FY 2009-10 in the five-year comparison prior to full implementation of AB 142 does not skew the five-year average.

The contribution levels in each year shown in the chart above were calculated using the same methodology employed in the “Results Under AB 142” reports published by the SCO for each of the five years following full implementation of AB 142. As such, they do not include interest earnings, proceeds from investments, other income, or unclaimed prizes.

## **II. Maximizing the Amount of Funding Generated for Education Each Year**

Demonstrating that funding has been “maximized” can be difficult because there are many variables that influence the Lottery’s business from year to year. Some of these influences are unpredictable and out of the Lottery’s control, for example, the health of the economy and the mood of consumers. However, the Lottery has endeavored to ensure that all aspects of its business that can be controlled or predicted are directed toward maximizing funding to education.

### **A. Draw Games**

By their nature, draw games are unpredictable. For example, sales of Mega Millions and Powerball tickets typically increase as the advertised jackpot level increases. In forecasting sales revenues for these games in a given fiscal year, the Lottery assumes that the advertised jackpot levels will reach certain dollar thresholds a certain number of times in the course of the year based on historical averages. However, if the jackpot level does not meet the estimated dollar thresholds as frequently as forecast in a given fiscal year, there will be decreased contributions to education, all else being equal. Conversely, if the jackpot level meets the estimated dollar thresholds more frequently than forecast in a given fiscal year, there will be increased contributions to education, all else being equal. So generally, for draw games, the size of the Lottery’s contribution to education depends on the “luck of the draw.”

However, where possible, the Lottery has taken steps to increase contributions from draw games. For example, making use of the flexibility offered by AB 142, the Lottery was able to reverse a downward trend in Hot Spot sales by increasing prize amounts. Hot Spot sales had dropped from a peak of \$163.5 million in FY 2005-06 to a low of \$117.9 million in FY 2009-10. The annual decline in Hot Spot sales averaged 7.5 percent over this five year period. By returning a greater proportion of Hot Spot revenues to players in the form of prizes (from an average of 51.9 percent over the five years prior to full implementation of AB 142 to an average of 60.1 percent over the five years since AB 142 was fully implemented), the Lottery has completely reversed Hot Spot’s declining sales trend. Hot Spot sales steadily increased from a low of \$130.5 million in FY 2010-11 to a high of \$206.4 million in FY 2014-15. Hot Spot sales growth averaged 12.1 percent over this five year period, a swing of nearly 20 percentage points from the trend prior to AB 142.

## **B. Scratchers Games**

Scratchers ticket sales account for the majority of Lottery revenue. And while Scratchers are a much more stable revenue source than draw games, they are the Lottery's least profitable product line because of their higher prize payout. As a result, Scratchers generally net proportionally less to education than other lottery products. To illustrate this, Scratchers tickets sales accounted for 70.9 percent of total Lottery revenues but roughly 54 percent of the Lottery's \$1.363 billion contribution to education in FY 2014-15.

Prior to AB 142, the most expensive Scratchers ticket sold by the Lottery cost \$5. The Lottery has since added \$10, \$20, and \$30 Scratchers games to its portfolio. To encourage players to spend more money on tickets, the Lottery increases its prize expense as tickets move up in cost to provide more opportunities for players to win. This strategy has worked, contributing to an increase of more than \$1.9 billion, or nearly 96 percent, in Scratchers sales over the five years since full implementation of AB 142. This dramatic increase in revenue is a direct result of increased prize amounts.

### **Lottery Contributions to Education Compared with Proposition 98 Contributions**

In enacting AB 142, the Legislature observed that Lottery revenues available to supplement funding for public education had grown at a much lower rate than state spending on education during the preceding 10 years. A comparison of these growth rates in the years following full implementation of AB 142 further attests to the success of AB 142.

Although there are many ways to measure state spending on education, this report considers the constitutional guarantee of funding for K-14 schools (Proposition 98 funding). In the five years prior to full implementation of AB 142, Proposition 98 funding increased an average of 1.5 percent per fiscal year. This compares to an annual *decrease* in the Lottery's contribution to education that averaged 1.9 percent over this same timeframe. Following full implementation of AB 142, the annual average growth in Lottery revenues available to supplement funding for public education has outpaced the annual average growth in Proposition 98 funding. Specifically, the Lottery's contribution to education has increased an average of 6.1 percent per fiscal year, while Proposition 98 funding increased an average of 5.6 percent per fiscal year over this same timeframe.

### **Expectations Going Forward**

Beginning with the sixth fiscal year following full implementation of AB 142, to ensure continued growth in Lottery net revenues allocated to public education, Government Code section 8880.4.5 requires net revenues allocated to public schools to (1) be at least as much as were allocated on average in the prior five fiscal years and (2) increase in proportion to any



upward increase in sales revenues. This report will again analyze each of these requirements separately.

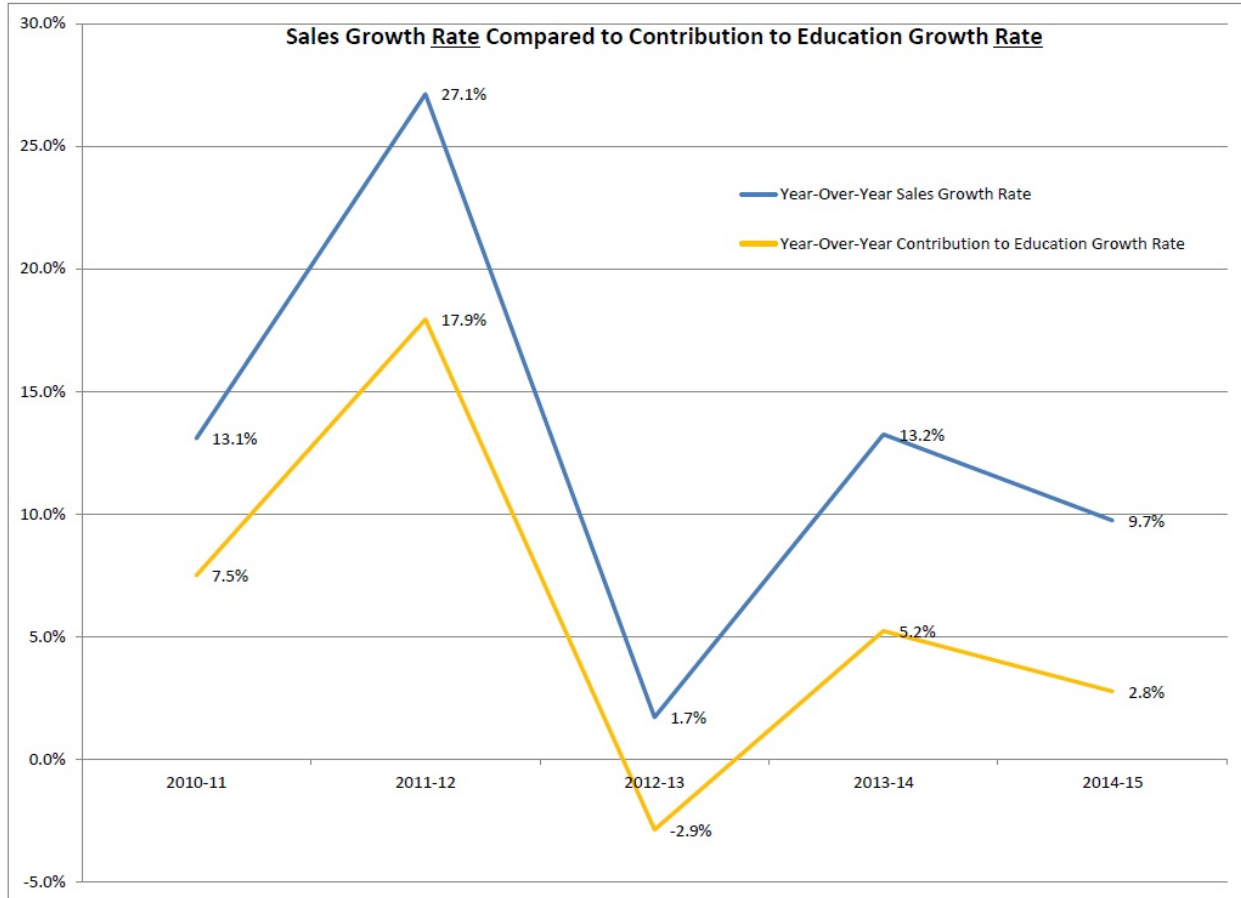
**I. Net Revenues Allocated to Public Schools are at least as Much as Were Allocated on Average in the Prior Five Fiscal Years**

The Lottery's contribution to education averaged \$1.27 billion from FY 2010-11 through FY 2014-15. This means the Lottery's contribution to education for FY 2015-16 must exceed this amount. The Lottery Commission-approved budget for FY 2015-16 reflected a contribution to education of \$1.435 billion and, with approximately three months remaining in the fiscal year, the Lottery estimates it will exceed this budgeted contribution level. Thus, the Lottery is clearly on pace to meet this requirement in FY 2015-16.

**II. Net Revenues Allocated to Public Schools Must Increase in Proportion to Any Upward Increase in Sales Revenues**

Despite the requirement that, going forward, growth in annual contributions to education be proportional to growth in sales revenues, it is a known consequence of increasing the share of sales revenues allocated to prizes (which AB 142 made possible) that the *percentage* of net revenues allocated to education will be lower than it was prior to the enactment of AB 142. Indeed, the point of AB 142 was to allow the Lottery to increase the share of sales revenues allocated to prizes, so that the *dollar amount* of net revenues allocated to education would increase. However, of necessity, this disrupts the proportionality between the growth in sales revenues and the growth in contribution to education. In other words, in enacting AB 142 there was an expectation that education would receive a smaller percentage of a larger "pie" which would translate into more dollars for education.

The following chart compares the year-over-year growth rates for Lottery sales to the year-over-year growth rates for the Lottery net revenues allocated to public education in each of the five years following full implementation of AB 142.



Although the trend lines in the chart clearly have a similar slope, year-over-year growth in sales, as expected, has outpaced the year-over-year growth in the contribution to education in each of the five years. The chart also shows that there is considerable variance between the two growth rates from year to year. The variances between the two growth rates are explained in large part by two factors – the difference in profit margins of the Lottery games and the unpredictability of the large jackpot games (Mega Millions, Powerball, and, to a lesser extent, SuperLotto Plus).

These two factors help to explain how sales were able to increase by 1.7 percent from FY 2011-12 to FY 2012-13 while the Lottery’s contribution to education decreased by 2.9 percent over this same timeframe. The significant increase in the growth rate for both sales and contribution to education in FY 2011-12 was primarily the result of the Mega Millions jackpot reaching a historical level of \$656 million in March of 2012. By contrast, the Mega Millions jackpot reached a high of only \$93 million in FY 2012-13. As a result, the Lottery’s sales of Mega Millions tickets decreased by 47.7 percent from FY 2011-12 to FY 2012-13. The Lottery was able to increase Scratchers sales in FY 2012-13 by 9.3 percent from FY 2011-12, which drove the overall year-over-year increase in sales. However, because Mega Millions is one of the most profitable games in the Lottery’s portfolio and Scratchers is one of the least profitable, there

was a year-over-year decline in the Lottery’s contribution to education. The following table illustrates the profitability of the various Lottery products.

Product	Prize Payout	Admin	Estimated Profit	Sales Needed for \$1M in Profits
Powerball / Mega Millions	50%	13%	37%	\$2,702,703
Daily Games	50%	13%	37%	\$2,702,703
SuperLotto Plus (FY 2014-15)	54%	13%	33%	\$3,030,303
Hot Spot	63%	13%	24%	\$4,166,667
Scratchers (FY 14-15 overall)	68.2%	13%	18.8%	\$5,319,149
\$1 Scratchers	57%	13%	30%	\$3,333,333
\$2 Scratchers	62%	13%	25%	\$4,000,000
\$5 Scratchers	68%	13%	19%	\$5,263,158
\$10 Scratchers	73%	13%	14%	\$7,142,857
\$20 Scratchers	76%	13%	11%	\$9,090,909
\$30 Scratchers	80%	13%	7%	\$14,285,714

The table above indicates why the Lottery’s growth in sales and growth in profits do not directly correlate. For each game/product line in the Lottery’s portfolio, the second column of this chart shows the percentage of sales revenue that goes toward paying prizes. For simplicity, the third column assumes that the administrative cost for each game is 13 percent of sales. The final columns show the resulting profit margin and the amount of sales revenue required of each game/product line to generate an incremental \$1 million contribution to education. Although the large jackpot games such as Powerball and Mega Millions are clearly the most profitable games in the Lottery’s portfolio, as mentioned previously, the Lottery has less direct influence on sales for these games and they account for a smaller percentage of overall sales. On the other hand, Scratchers are predictable and account for nearly 71 percent of the Lottery’s sales, but are the least profitable product in the Lottery’s portfolio.

**Conclusion**

This report has demonstrated that AB 142 undoubtedly has furthered the purpose of the Lottery Act to maximize Lottery revenues available to supplement funding for public education. By augmenting the share of sales revenues allocated to prizes, Lottery ticket sales have increased resulting in an increase in net revenues available to supplement public education. Although the Lottery has experienced tremendous growth in both sales and its contribution to education during the five years since AB 142 was fully implemented, it is not realistic to assume that this same level of growth will continue indefinitely. As these growth rates plateau in the future, it will be incumbent on the Lottery to continue to strike a responsible balance between prize payouts and contributions to education and to continually look for ways to maximize profitability.

*Original signed by*

BETTY T. YEE, Controller