



## Legislative Fiscal Bureau

One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

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Joint Committee on Finance

Paper #665

### **Lottery Sales Projections (DOR -- Lottery Administration)**

[LFB 2005-07 Budget Summary: Page 435, #1 and Page 439, #6]

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#### **CURRENT LAW**

Annual lottery sales are estimated in each biennial budget process in order to establish sum sufficient appropriation estimates for lottery retailer compensation and lottery vendor fees and to estimate the lottery proceeds that will be available for property tax relief (the lottery and gaming credit and the farmland tax relief credit). Two procedures under current law, the annual lottery and gaming credit certification, and the annual lottery sales and prize payout report, affect the issues discussed in this paper:

*Annual Lottery and Gaming Credit Certification.* Under s. 79.10(11)(b) of the statutes, the Department of Administration (DOA) is required to provide the Joint Committee on Finance with an estimate prior to October 16 of each year of total funds available for distribution under the lottery and gaming credit for property taxes levied in that year. The Department of Revenue (DOR) must be notified of the total amount available for distribution under the lottery and gaming credit by November 1. This estimate provides DOR with the basis for calculating the fair market value (termed the credit base) necessary to distribute the lottery and gaming credit. The credits are calculated by multiplying the credit base by school tax rates. The Committee is authorized to revise the DOA estimate and may do so at a meeting that takes place before November 1. If the Committee chooses to accept the DOA estimate, no further Committee action is required.

*Annual Lottery Sales and Prize Payout Report.* Under s. 565.02(7) of the statutes, DOR is required to submit a lottery prize payout report to the Joint Committee on Finance, not later than March 1 of each year, that includes: (1) an estimate for that fiscal year and for the subsequent fiscal year of the gross revenues from the sale of lottery tickets; (2) the total amount paid as prizes and the prize payout ratio for each type of lottery game offered; and (3) an

evaluation of the effect of prize payout ratios of lottery games on lottery sales, lottery operating costs, and on maximizing the revenue available for the lottery and gaming tax credit.

The report is subject to a 14-day passive review by the Committee. If, within 14 working days of receiving the report, DOR is notified that a meeting has been scheduled to review the agency's proposed prize payouts, DOR may proceed with its plans for the prize payouts for the subsequent fiscal year only with Committee approval. If the Department is not notified within this period that a meeting has been scheduled, the agency's plan for prize payouts for the subsequent fiscal year are considered approved by the Committee.

## GOVERNOR

Estimate lottery sales at \$480.3 million in 2005-06 and \$490.3 million in 2006-07. The following table shows the projections under the bill, as well as 2003-04 actual lottery sales and the sales projected in October, 2004, for the purposes of certifying the amount available for the 2004(05) lottery and gaming property tax credit.

### DOR Lottery Sales Projections (\$ in Millions)

<u>Game Type</u>	<u>Actual 2003-04</u>	<u>2004-05</u>	<u>2005-06</u>	<u>Percent Change from 2004-05</u>	<u>2006-07</u>	<u>Percent Change from 2005-06</u>
Scratch	\$266.6	\$276.0	\$285.8	3.6%	\$295.8	3.5%
Pull-tab	3.7	3.3	3.7	12.1	3.7	0.0
On-line	<u>212.6</u>	<u>193.0</u>	<u>190.8</u>	<u>-1.1</u>	<u>190.8</u>	0.0
Total	\$482.9	\$472.3	\$480.3	1.7%	\$490.3	2.1%

## DISCUSSION POINTS

1. Lottery sales declined between 1994-95 and 2000-01, but now appear to have stabilized at a higher level. The following table shows the actual annual lottery sales from 1994-95 through 2003-04. The sales shown for 2004-05 reflect the estimates made under the October, 2004, lottery and gaming credit certification process. The estimates for 2005-06 and 2006-07 reflect the Governor's estimates in AB 100.

**Lottery Sales History  
(In Millions)**

<u>Fiscal Year</u>	<u>Game Type</u>			<u>Total Sales</u>
	<u>Scratch</u>	<u>Pull-Tab</u>	<u>On-Line</u>	
1994-95	\$310.3	\$10.0	\$198.6	\$518.9
1995-96	302.2	8.2	171.7	482.1
1996-97	266.2	7.2	157.7	431.1
1997-98	246.6	6.3	165.7	418.6
1998-99	224.9	5.9	197.4	428.2
1999-00	235.6	5.4	165.6	406.7
2000-01	233.2	4.8	163.2	401.2
2001-02	233.6	4.6	189.3	427.5
2002-03	245.1	4.3	185.6	435.0
2003-04	266.6	3.7	212.6	482.9
2004-05*	276.0	3.3	193.0	472.3
2005-06**	285.8	3.7	190.8	480.3
2006-07**	295.8	3.7	190.8	490.3

\* October, 2004 Estimate

\*\* Governor

2. The 2005-06 and 2006-07 projected sales under the bill are identical to the Department's sales estimates in its 2005-07 biennial budget request. These sales projections were developed early in 2004-05, based on sales models utilized by the Lottery Division in DOR.

3. The 2004-05 annual sales and prize payout report by DOR was originally submitted to the Committee on February 28, 2005, but was withdrawn by the Department on March 17, 2005. On March 23, 2005, a revised sales and prize payout report was submitted by DOR to the Committee to correct errors that were contained in the original report. On April 5, 2005, the Committee advised the Department that the matter would be addressed in conjunction with the Committee's deliberations on Lottery Division budget issues to review the agency's sales projections and proposed prize payouts.

4. The currently authorized prize payout ratios for lottery games are as follows: (a) 63.92% for instant scratch games; (b) 62.5% for instant pull-tab game tickets sold by for-profit retailers and 80% for instant pull-tab game tickets sold by nonprofit organizations; and (c) 51.62% for on-line games. In its report now before the Committee, the Department is requesting the approval of one modification to these payout ratios: an increase in the average payout ratios for instant scratch games to 63.98%. While the requested change requires the approval of the Committee, any modification to the prize payout ratio would not require an amendment to the biennial budget bill since the payout ratios are not established by statute.

5. The reason for the Department's requested increase in the payout ratio to 63.98% for instant scratch games is the planned introduction of two \$20 scratch ticket games that would have a

higher prize payout structure than current scratch games. This modification would be consistent with increases in prize payout ratios associated with the introduction of other higher priced games in the past (\$2, \$3, \$5 and \$10 tickets). Higher payouts, according to the report, are required to attract players to purchase higher-priced tickets. The new \$20 games would payout at approximately 74%.

6. With respect to sales, the Department's revised report reestimates 2004-05 sales at \$460.8 million. This figure is \$11.5 million less than the estimate of \$472.3 million made in October, 2004. The revised report estimates sales in 2005-06 at \$480.3 million, which is the same estimate as contained in AB 100. The statutes do not require the agency's report to provide an estimate of 2006-07 sales at this time (although the Department supports the 2006-07 sales estimate under the bill). The following two sections provide an analysis of the reestimated 2004-05 sales and the 2005-06 and 2006-07 lottery sales projections.

### **Reestimated 2004-05 Lottery Sales**

7. The DOR report reestimates 2004-05 total sales from \$472.3 million (the October, 2004 estimate) to \$460.8 million, a decline of \$11.5 million or 2.4%. The reestimate appears to be required because the October, 2004, estimate of 2004-05 total sales now appears unlikely to be met. This revised 2004-05 estimate would also represent a 4.6% decrease from the actual 2003-04 lottery sales total of \$482.9 million.

8. Several factors have affected 2004-05 total sales: (a) a conversion to a new statewide lottery computer system in September, 2004, resulted in fewer new scratch-game introductions in 2004-05 and some disruption in lottery operations; (b) no large Powerball jackpots have materialized to date in 2004-05 and, as a result, on-line sales have fallen behind projections; and (c) the success of a new pull-tab game appears to have partially mitigated the sales decline in 2004-05. Each of these factors will be briefly discussed.

9. The conversion of the lottery computer system involved replacing all lottery retailer on-line game terminals and the central computers in Madison that track ticket sales for all types of games and validate winning ticket numbers. According to lottery officials, the conversion of the system was necessary to replace equipment that was at the end of its life-cycle and to accommodate software that will allow enhanced functionality relating to the types of games offered. While the conversion prevented the lottery from introducing new scratch games for a period of four weeks (thereby adversely affecting scratch ticket sales in 2004-05), the new system is expected over time to enhance the Department's flexibility in offering games and should result in improved future sales. The DOR report before the Committee would reestimate scratch ticket sales in 2004-05 from \$276.0 million to about \$273.0 million.

10. On-line game sales also to appear to be lower in 2004-05 than estimated in October, 2004, primarily because large Powerball jackpots, which can increase sales dramatically, have not been generated in 2004-05 as often as they were in 2003-04. The Powerball game accounted for slightly more than 50% of all on-line game revenue in 2003-04. In 2003-04, there were four occasions when the Powerball jackpot grew high enough to attract weekly sales of more than \$5.0

million for at least a one-week period. In 2004-05, there has only been one week in which Powerball sales have exceeded \$5.0 million. Average weekly sales for Powerball tickets in 2003-04 exceeded \$2.0 million per week, but in 2004-05, average sales through March, 2005, have been about \$1.5 million per week. While a large Powerball jackpot may yet materialize in 2004-05, total Powerball sales this year are not likely to reach the estimate of sales made in October, 2004. The DOR report before the Committee would reestimate on-line ticket sales in 2004-05 from \$193.0 million to about \$180.4 million.

11. The sales of pull-tab tickets in 2004-05 have been enhanced by the introduction of a new type of pull-tab ticket being offered to for-profit retailers. The ticket incorporates barcode technology used on scratch tickets to assist the retailer in authenticating and validating the pull-tab ticket and prize. Traditional pull-tab tickets do not have barcode technology and are packaged loose in boxes. The new tickets are printed in sequence and can be displayed and distributed from dispensers similar to those used for scratch tickets, enhancing security, inventory control, and accountability. Barcode pull-tab tickets can also sell at higher price points than the \$0.50 price of the traditional pull-tab ticket. The new pull-tab ticket has proven to be more popular with retailers than the old-style pull-tab tickets and, as a result, DOR now estimates these sales in 2004-05 at \$7.4 million, more than double the \$3.3 million made in October, 2004.

12. In summary, 2004-05 sales have been negatively affected by the transition to a new lottery computer system and the lack of large Powerball jackpots. A small portion of the decline due to these factors has been offset by an increase in pull-tab sales relating to a new type of pull-tab ticket. Taking all of these factors into consideration, the reestimated 2004-05 sales made by DOR in its March 23, 2005, report before the Committee totals \$460.8 million.

13. The 2004-05 reestimate is required to establish more accurately the year-end condition of the lottery fund. The lottery and gaming credits that will be paid in 2004-05 were determined in October, 2004, and must be paid at the certified level. A reestimate of 2004-05 sales at a lower level will have the effect of reducing the lottery fund's reserve (set each year by statute at 2% of gross revenue) and will result in a lower opening balance in the lottery fund on July 1, 2005.

14. Under the bill, the opening balance of the lottery fund on July 1, 2005, would be \$9,447,600. Reestimating 2004-05 lottery sales to \$460.8 million would lower the 2005-06 opening balance to \$4,128,100, a reduction of \$5,319,500. The effect of this change is to lower the lottery and gaming credit available in 2005-06 by this same amount, from \$120,997,100 to \$115,677,600. There would be no effect on the lottery fund in 2006-07.

#### **Lottery Sales in 2005-06 and 2006-07**

15. As a result of reestimating total lottery sales in 2004-05 from \$472.3 million to \$460.8 million, based on actual year-to-date sales experience relating to all lottery game types, the 2005-06 and 2006-07 sales estimates contained in the bill should also be reexamined. As noted above, the projections of sales under the bill in the 2005-07 biennium are identical to those sales estimates developed early in 2004-05 and used in the Department's 2005-07 biennial budget request.

16. The scratch ticket sales estimated under the bill, total \$285.8 million in 2005-06 and \$295.8 million in 2006-07. These estimates represent annual increases of 3.6% in 2005-06 and a further 3.5% in 2006-07 above the 2004-05 sales estimate developed in October, 2004. If the 2004-05 scratch ticket sales estimate is lowered to \$273.0 million, as discussed above, then the scratch ticket sales estimates for 2005-06 and 2006-07 as contained in the bill would represent annual increases of 4.7% and 3.5%, respectively.

17. Scratch ticket sales in the last five years have averaged \$242.8 million annually, with highest sales achieved in 2003-04, when scratch ticket sales reached \$266.6 million. [The record year for scratch sales was 1994-95, with \$310.3 million in sales.] Given this recent history of scratch ticket sales, the proposed reestimate of such sales to \$273.0 million in 2004-05, followed by additional projected increases to \$285.8 million in 2005-06 and to \$295.8 million in 2006-07 are ambitious sales targets. However, given the general strengthening of scratch ticket sales in recent years and the completion of the new computer system supporting these sales, the estimates under the bill appear to be achievable.

18. These projected sales increases also depend to some extent on the Committee's approval of the pending lottery sales and prize payout report to increase the currently authorized prize payout ratios for scratch lottery games from an average of 63.92% to an average of 63.98%. As described previously, the requested increase is associated with the planned introduction of two \$20 scratch ticket games with a higher prize payout structure. Higher priced tickets are an important part of the Department's strategy to increase scratch ticket sales, as projected under the bill.

19. The Committee could approve the requested prize payout increase as part of its action relating to the 2005-07 lottery sales estimates. However, if the higher average payout ratio is not approved, the Department indicates that the \$20 scratch tickets would not be introduced. The agency projects that the resulting loss of scratch ticket sales would be approximately \$10.0 million annually in both 2005-06 and 2006-07. If the Committee chooses not to approve the prize payout ratio increase, scratch ticket sales estimates should be lowered accordingly to reflect this action.

20. On-line sales totaled \$212.6 million in 2003-04, a record high driven by very strong Powerball sales. On-line sales over the last five years have averaged \$183.3 million annually. In October, 2004, on-line sales were estimated at \$193.0 million in 2004-05, a 9.2% decline from 2003-04 sales. That estimate assumed strong Powerball sales in 2004-05, but not as strong as the sales experienced in 2003-04. The reestimate of 2004-05 on-line sales in the revised sales and prize payout report would further lower this sales estimate to \$180.4 million, a 15.1% decline from 2003-04 sales. This adjustment is based primarily on lower Powerball sales due to an extended period of lower jackpots.

21. The on-line estimates under the bill (\$190.8 million annually in 2005-06 and 2006-07) represent about a 1% decline from 2004-05 sales of \$193.0 million included in the October, 2004 estimate. Compared to the 2004-05 sales reestimate of \$180.4 million in the revised sales and prize payout report, the estimates contained in the bill would now represent a 5.8% on-line sales

increase. As with the scratch sales reestimate, the on-line sales estimates under the bill are aggressive, but appear achievable. The realization of these projected sales figures will depend on the generation of some significant Powerball jackpots during each fiscal year.

22. Pull-tab ticket sales have generally been in decline since 1992-93, with 2003-04 sales reaching an all-time low of \$3.7 million. In October, 2004, pull-tab sales were estimated to total \$3.3 million. The revised 2004-05 pull-tab sales estimate would total \$7.4 million, based on a new type of pull-tab ticket that has proven to be more popular.

23. The estimated pull-tab sales under the bill (which are supported by the Department), would total only \$3.7 million annually in 2005-06 and 2006-07. These estimates are the same as the estimates made in the Department's 2005-07 biennial budget request, and were made prior to the introduction of the new pull-tab ticket design that has successfully doubled 2004-05 pull-tab sales. In its sales and prize payout report, the Department argues that 2005-06 pull-tab sales were not reestimated to a higher level because there is not enough sales history with the new ticket type to make an accurate reestimate. DOR officials have also indicated that the new pull-tab tickets are expensive to print and this may limit, to some extent, their availability in the next biennium.

24. Given the increase in pull-tab sales in 2004-05 due to the new ticket type, higher pull-tab sales may again materialize in 2005-06 and 2006-07. However, the Department is correct that the sales history in this area is very limited. Any adjustment to pull-tab sales would only change overall lottery sales by less than 1%. Given the somewhat aggressive estimates for scratch and on-line ticket sales in the bill, maintaining the pull-tab sales estimate at \$3.7 million annually in 2005-06 and 2006-07 would be a conservative, but justifiable approach.

**ALTERNATIVES**

1. Approve the Governor's lottery sales estimates of \$480.3 million in 2005-06 and \$490.3 million 2006-07. Reestimate 2004-05 lottery sales to \$460.8 million to reflect year-to-date sales experience. [This reestimate and any others adopted by the Committee will be incorporated into a revised lottery fund condition statement as part of the substitute amendment to AB 100.] The sales estimates under this alternative are shown in the following table:

**Lottery Sales Projections (\$ in Million)**

<u>Game Type</u>	<u>2004-05</u>	<u>2005-06</u>	<u>2006-07</u>
Scratch	\$273.0	\$285.8	\$295.8
Pull-Tab	7.4	3.7	3.7
On-Line	<u>180.4</u>	<u>190.8</u>	<u>190.8</u>
Total	\$460.8	\$480.3	\$490.3

In addition, approve the Department's request under its March 23, 2005, lottery sales and prize payout report to increase the currently authorized prize payout ratios for scratch lottery games from an average of 63.92% to an average payout ratio of 63.98%.

2. Do not approve the Department's request under its March 23, 2005, lottery sales and prize payout report to increase the currently authorized prize payout ratios for scratch lottery games from an average of 63.92% to an average payout ratio of 63.98%. Reestimate the Governor's lottery sales estimates in 2005-06 and 2006-07 by lowering scratch ticket sales by \$10.0 million annually in 2005-06 and 2006-07. Reestimate 2004-05 lottery sales to reflect year-to-date sales experience. [This reestimate and any others adopted by the Committee will be incorporated into a revised lottery fund condition statement as part of the substitute amendment to AB 100.] The sales estimates under this alternative are shown in the following table:

**Lottery Sales Projections (\$ in Million)**

<u>Game Type</u>	<u>2004-05</u>	<u>2005-06</u>	<u>2006-07</u>
Scratch	\$273.0	\$275.8	\$285.8
Pull-Tab	7.4	3.7	3.7
On-Line	<u>180.4</u>	<u>190.8</u>	<u>190.8</u>
Total	\$460.8	\$470.3	\$480.3

Prepared by: Art Zimmerman