

Senate Finance Committee Lottery Growth Initiatives Testimony
Dan Meuser, Secretary
PA Department of Revenue
January 29, 2014

Chairman Brubaker, Chairman Blake and members of the committee, thank you for giving me the opportunity to submit comments on behalf of the Department of Revenue and Pennsylvania Lottery for today's hearing to discuss lottery growth. Joining me today are Sil Lutkewitte, Executive Director for the Pennsylvania Lottery, and Drew Svitko, Deputy Executive Director for Marketing and Product Development for the Pennsylvania Lottery.

The Pennsylvania Lottery is one of the best-run lotteries in the nation, consistently ranking highly in industry polls for sales and profits. The Pennsylvania Lottery is on-pace to meet or exceed budget estimates for fiscal year 2013-14 as it works to responsibly grow Lottery sales through a number of strategies I will address during today's hearing.

But as our population of older Pennsylvanians grows and demand for Lottery-funded programs increases, the Lottery must grow profits to satisfy that demand. The Lottery believes a key element in its ability to incrementally grow profit is long-term or permanent legislative reprieve from the 30 percent profit mandate. As the Pennsylvania Lottery continues to focus on the future, with the ultimate goal of providing the funding necessary to programs benefiting older Pennsylvanians, it again faces the possible sunset of legislative relief from the 30 percent profit mandate required by Pennsylvania Lottery law. The 27 percent profit mandate that has existed under special legislative authority since 2008 expires at the end of fiscal year 2014-15.

The reasons for requesting relief from the statutory 30 percent profit margin remain as valid today as they were when relief was granted in 2008 and again in 2011: profit can be maximized when artificial sales barriers are removed.

Over the last five years consumer demand has continued to shift further from terminal-based lottery games to instant lottery games. Instant game sales accounted for 24 percent of total revenues in 1998, 55.3 percent in 2008, 59.9 percent in 2011 and 62.3 percent today. This trend is consistent with the lottery industry nationwide, and the Pennsylvania Lottery anticipates consumer demand will continue to shift from terminal-based to instant games in future years, despite strategic efforts to broaden the player base and re-energize the portfolio of terminal-based games.

As sales shift from terminal-based to instant games, the Pennsylvania Lottery has seen most of its sales growth from instant products, specifically higher-price-point instant games. These games demand a much higher payout percentage, and therefore, deliver a lower profit margin for the Lottery.

Without legislative action to extend or make the profit margin reduction permanent, the Pennsylvania Lottery will have to make adjustments to its marketing plan, including diminished payouts, which will likely reduce total sales over the first five years by an estimated \$1.7 billion and profits by an estimated \$830 million. There is evidence to suggest that a more aggressive range of profit margin could yield even higher profits.

After operating for years with the ability to react to consumer demand for lower-margin, higher-price-point instant games, without legislative action on this issue the Pennsylvania Lottery will have to craft its 2015-16 marketing plan based on a 31 percent rate of return, with the additional percent to provide a buffer against unforeseen market conditions. This revamped marketing plan will require reduced payouts for certain instant games, limit numbers of higher-price-point games, and restrict the number of tickets that can be sold for certain games.

These efforts could have a disastrous impact on sales and profits, as evidenced by the only example of a U.S. Lottery reducing prize payouts. In the late 1990s, the Texas legislature required the Texas Lottery to reduce the payout percentage for instant product, directly plummeting instant game sales from \$2.36 billion to \$1.40 billion over two years. More importantly, instant game profits dropped from \$626.9 million to \$474.2 million. Even after the Texas legislature repealed the law, it took the Texas Lottery an additional five years to return to previous sales levels. In that seven-year period, the Texas Lottery's sales fell a cumulative \$3.54 billion, and profits fell by nearly \$1.1 billion. It appears that players left the Texas Lottery, and it took the Lottery five years to win them back.

The Texas example clearly illustrates that mandating higher margins negatively impacts the profitability of the business. From the Pennsylvania Lottery's perspective, growing the overall dollar amount going toward senior programs in profit is far more important than an arbitrary and restrictive profit margin mandate. The Lottery can deliver more dollars for senior programs at a lower profit margin, because the lower profit margin allows the Lottery to respond to consumer demand for instant games as well as perhaps new terminal-based games, and grow sales, thereby increasing profits.

Independent, private-sector evidence supports the Pennsylvania Lottery's position as well. The November 2012 bid on the Pennsylvania Lottery private management agreement received from Camelot, an international leader in the Lottery industry, assured significantly higher annual profit commitments at a 27 percent margin as opposed to a 30 percent margin. In fact, over the 20-year term of the proposed contract, Camelot's bid illustrated that the commonwealth could stand to sacrifice more than \$800 million in lost profit, should it return to a 30 percent profit mandate.

The department is in favor of permanent or long-term margin relief, which will enable the Pennsylvania Lottery to grow sales and profits without struggling against an artificial market barrier. Continued sales growth from lower-margin instant products will naturally drive the profit margin to or below 27 percent by fiscal year 2018-19, if not sooner, and sales of those instant products will have to be artificially capped in order to maintain a margin rate of 27 percent or above.

Margin relief will allow the Lottery to react to consumer demand by expanding the higher-price-point instant games, adding new games and providing extended play value consumers seek. Ultimately, it will allow the Pennsylvania Lottery to plan for increased profitability. Last year, the Lottery generated \$1.1 billion in profit at a 27 percent margin; planning for a 30 percent margin would have sacrificed nearly \$200 million in profit.

In addition to long-term profit margin relief, Keno is also among the options to inject new revenues into services benefitting our seniors. Keno – a terminal-based game very similar to the Lottery’s Match 6 lotto game, simply drawn more frequently – would present the Lottery a chance to grow its retailer and player bases simultaneously with a game embraced by more than a dozen other lotteries across the U.S. Further, through the PMA process industry bidders unanimously demonstrated that incorporating new games like Keno into the Lottery’s portfolio would be an effective way to responsibly grow revenues to benefit older Pennsylvanians.

The department estimates Keno could be introduced to the marketplace within six months from execution of a vendor contract to support the game, and that timeframe would include fulfilling regulatory obligations like publishing a game notice in the Pennsylvania Bulletin.

The Lottery believes Keno proposes significant opportunity to attract new, non-traditional retailers like restaurants and bars into the Lottery network, but how taverns and players may embrace Keno has yet to be determined, as does the competitive impact tavern small games of chance may have on Keno’s appeal to retailers and players. Given that caveat, the Lottery believes Keno could generate somewhere between \$40 and \$180 million in additional profit each year, as it is phased in over a number of years.

Finally, I would like to briefly discuss the valuable lessons the Corbett Administration and the Pennsylvania Lottery learned from the process of exploring a private management agreement for the Lottery.

The sole motivation behind exploring a private management agreement for the Pennsylvania Lottery was to protect and predictably grow future Lottery funding for a dramatically growing population of older Pennsylvanians that rely on the prescriptions, property tax rebates, free rides, long-term living services and myriad other social, recreational and educational services funded by the Lottery. The PMA process itself will pay off for Pennsylvania seniors, because we have benefitted from the ideas, practices, analysis and feedback we were exposed to by engaging three world-class lottery industry leaders in the procurement process. The Pennsylvania Lottery will continue exploring a number of new ideas discussed throughout the PMA process, including growing the retailer base through new sales channels, reviewing product development and marketing strategies in order to broaden the player base and exploring how e-commerce and the Internet may position the Pennsylvania Lottery for future growth. Specifically, we learned that there are opportunities to improve a player’s experience at retail, recruit large retail chains more aggressively and efficiently, invest in research to learn about both players and non-players and expand efforts in social responsibility.

The goal of the PMA process was to learn from the industry how best to prudently increase Pennsylvania Lottery revenues, and bidders all agreed Keno is a growth opportunity. But perhaps more importantly than the short-term revenue gain Keno could provide, the process reaffirmed the Lottery’s position that long-term relief from the 30 percent margin mandate has great potential to grow Lottery profit for many years to come.

In closing, I would like to recognize the Pennsylvania Lottery, which is a \$3.7-billion-a-year retail sales and marketing operation that remains the only state lottery that designates all its proceeds to programs that benefit older residents. Since its inception 42 years ago, the Pennsylvania Lottery has contributed more than \$23.7 billion to senior programs. The Pennsylvania Lottery benefits older Pennsylvanians, every day, by protecting their independence, preserving their health and help improving the quality of their lives.