Pennsylvania Lottery Profit Report

As Required by Act 53 of 2008

June 1, 2009

ANALYSIS

The Pennsylvania Lottery remains the only state lottery that designates all its proceeds to programs that benefit older residents. Since its inception 37 years ago, the Pennsylvania Lottery has contributed more than $18.3 billion to programs that include property tax and rent rebates; free and reduced-fare transit; the low-cost prescription drug programs PACE and PACENET; long-term care services; and the 52 Area Agencies on Aging, including more than 600 full- and part-time senior centers throughout the state.

Act 53 of 2008, passed in July 2008, granted the Pennsylvania Lottery temporary relief from the mandated 30 percent minimum return that had been in place since the Lottery's inception. The Lottery has been given the latitude to return a minimum of 27 percent for each of the next three fiscal years.

This change was granted with the understanding that it will give the Lottery the capability to grow sales and net revenues for programs even though the return percentage may be lower.

PROGRESS THROUGH WEEK 47 of Fiscal Year 2008-2009

After 47 weeks of fiscal year 2008-09 sales, the Lottery projects to end the fiscal year on June 30 with game sales totaling a record $3.130 billion. This would represent an increase of $41.3 million or 1.34 percent over fiscal year 2007-08 sales. Lottery sales would; however, fall $28.4 million short of the $3.158 billion goal for fiscal year 2008-09. A strong Powerball jackpot run at the end of the fiscal year could change this and result in the Lottery exceeding its sales projection.

The Lottery estimates it will return $934.1 million to the Lottery Fund in proceeds in fiscal year 2008-09. This is a $6.0 million or 0.65 percent increase in net proceeds as compared to fiscal year 2007-08 net return of $928.0 million.

The final net return percentage for fiscal year 2008-09, before the expected deduction from the Lottery Fund interest, is projected to be 29.84 percent.

Last year, the Lottery Fund earned $14.5 million in interest. Because of the national recession and lower interest rates, to date, the Lottery Fund interest is a negative $26.2 million for fiscal year 2008-09. If the Lottery Fund's interest earnings would have remained the same as last year, the Lottery would be reporting a projected net return of $948.6 million, well over the net return goal of $942.9 million.

CONTRIBUTING FACTORS

Powerball sales are down.

Powerball sales typically account for 25 percent to 30 percent of all terminal-based sales and are largely dependent on the size of the Powerball jackpot. Jackpots were down an average of 8.6 percent over the first 47 weeks of fiscal year 2008-09 compared to fiscal year 2007-08. As a consequence, Powerball sales are down $50.5 million dollars after 47 weeks.

Increasingly, instant ticket sales, with lower profit margins, are accounting for a larger portion of total game sales.

As displayed in Table 1, the lottery industry has experienced explosive growth in instant sales over the last 10 years.

Lottery	FY-9899	FY-0708	10 year Growth
(01) NY(k)	911.5	3,594.0	294%
(02) MA (k)	2,161.2	3,341.5	55%
(03) FL	593.7	2,368.8	299%
(04) TX	1,403.8	2,783.8	98%
(05) GA (k)	710.8	2,157.6	204%
(06) PA	448.5	1,706.8	281%
(07) CA (k)	955.2	1,551.0	62%
(08) NJ	528.4	1,284.0	143%
(09) MI (k)	629.9	734.2	17%
(10) OH	1,128.7	1,364.8	21%
(11) IL	519.7	1,093.6	110%
(12) MD (k)	177.0	513.9	190%

Table 1: Instant growth of top 12 non-VLT lotteries
(k) indicates a lottery with keno sales

Because the percentage of sales coming from the lower-margin instant products is increasing, net return percentages are decreasing. Table 2 reveals that 10 of the top 12 non-VLT (Video Lottery Terminal) lotteries have seen their overall net return percentages reduced over the last 10 years. All 12 jurisdictions, however, have seen their net return dollars increased, most by more than 30 percent.

Lottery	FY-9899	FY-0708	Change in Return %	Change in Net Growth
(01) NY(k)	38.2%	38.3%	0.1%	80.9%
(02) MA (k)	24.1%	19.9%	-4.2%	15.6%
(03) FL	38.5%	30.7%	-7.8%	59.0%
(04) TX	33.0%	28.2%	-4.8%	22.1%
(05) GA (k)	33.3%	26.5%	-6.7%	33.9%
(06) PA	40.0%	30.0%	-10.0%	38.9%
(07) CA (k)	36.0%	35.1%	-0.9%	18.9%
(08) NJ	39.5%	34.7%	-4.7%	34.7%
(09) MI (k)	29.8%	31.8%	2.0%	43.7%
(10) OH	29.3%	28.9%	-0.3%	7.1%
(11) IL	35.7%	31.5%	-4.1%	23.3%
(12) MD (k)	36.3%	31.6%	-4.6%	35.2%

Table 2: Net return percentage versus net return

There is a growing player preference for the higher price point games with their bigger top prizes and higher payouts. Table 3 shows that when comparing calendar year 2008 to calendar year 2006, the vast majority of the top 12 lotteries, including Pennsylvania, have seen percentage of sales from the lower price points ($1 to $3) decrease while percentage from the higher price points ($5+) have increased. Within the last two years, several lotteries have introduced games with price points of $20 or greater.

Lottery	$1	$2	$3	$5/$7	$10	$20	$25+	Total
(01) NY (k)	-10%	3%		7%	26%	-23%	New	6%
(02) MA (k)	-21%	2%		-100%	-33%	New	New	1%
(03) FL	-17%	-8%		12%	-2%	10%		3%
(04) TX	-24%	-21%	40%	3%	-11%	15%	-2%	-4%
(05) GA (k)	-10%	1%	12%	4%	-16%	New		15%
(06) PA	-11%	-10%	4%	-3%	3%	6%	New	2%
(07) CA (k)	-23%	-14%	-11%	-36%				-17%
(08) NJ	-19%	10%	-7%	29%	18%	New		10%
(09) MI (k)	-12%	0%	-100%	2%	46%	24%		4%
(10) OH	-23%	-13%	-64%	17%	-18%	62%		-2%
(11) IL	-10%	-9%	1%	15%	32%	-62%	46%	11%
(12) MD (k)	6%	21%	44%	17%	52%	9%		23%
Average	**-15%**	**-3%**	**-9%**	**-3%**	**9%**	**5%**	**22%**	**4%**

Table 3: Change in percentage of sales from price point - calendar year 2008 over calendar year 2006.

PLANNING FISCAL YEAR 2009-10 AND BEYOND

To meet its fiscal commitment in fiscal year 2009-10 and beyond the Lottery will:

- **Maintain a strong presence in the higher margin terminal-based games**

Cash 5 - In fiscal year 2007-08, the Lottery recognized that sales of Cash 5, one of the Lottery's most popular and profitable games, were beginning to decline. With the knowledge that players chase larger jackpots, the Lottery decided to change the game in order to increase jackpot size and increase the rate of jackpot growth. By increasing the matrix size from 39 to 43 balls (and increasing the percent of sales that funds the jackpot prize), the average jackpot run length has increased, thereby increasing the average jackpot. As Table 4 indicates, Cash 5 sales have increased by an average of $1.4 million per month or 9.3 percent. The Lottery will continue to monitor Cash 5 and its other terminal-based games to ensure that sales and profits are maximized.

Cash 5 monthly sales ($mm)

Monthly avg. before	15.5
Monthly avg. after	16.9
Diff. per month $mm	1.4
Diff. %	9.4%

	JUL	AUG	SEP	OCT	NOV	DEC	JAN	FEB	MAR	APR	MAY	JUN
FY-0607	14.4	16.3	16.6	17.0	17.2	16.4	17.3	15.6	15.7	15.5	17.0	15.7
FY-0708	13.2	12.9	14.5	16.1	13.8	15.3	13.6	**15.6**	**17.7**	**23.0**	**15.3**	**15.2**
FY-0809	**17.1**	**14.8**	**14.6**	**15.3**	**18.2**	**19.5**	**17.0**	**12.6**	**14.0**			

Table 4: Cash 5 sales ($mm), before and after matrix change.

Quinto and the Numbers Games – In August 2008, the Pennsylvania Lottery launched Quinto (mid-day and evening), the first five-digit numbers game introduced in the United States. The goal was to add new life to the Lottery's family of numbers games, introducing new players to numbers play and providing current numbers players an opportunity to play their numbers for greater prizes. As of April 20, 2009, Quinto sales have added $26.3 million to the fiscal year 2008-09 year-to-date sales. The Lottery has tasked Marc USA, its marketing partner, with providing a marketing strategy that will invigorate the numbers games category which now includes Quinto mid-day and Quinto evening. Numbers games are slated as featured consumer and retailer promotions in August, January and May of fiscal year 2009-10.

Match 6 / Super 7 – Understanding that in-state lotto games tend to have a shorter shelf life than the numbers games, Powerball and Cash 5, the Lottery monitors sales trends and plans for replacement of these in-state lotto games accordingly. In the case of Match 6, not only were sales declining after a successful run, but sales were not supporting the starting jackpot of $500,000 and subsequent jackpot rolls. Match 6 was replaced by Super 7 in March of 2009. It is still too early to make an accurate prediction of sales. However, to date, the Super 7 jackpots are covering much sooner than its predecessor Match 6. Several Super 7 initiatives are planned for fiscal year 2009-10 including two months of consumer and retailer promotion.

Raffle – The Pennsylvania Lottery was the first U.S. Lottery to launch a terminal-based raffle game, Millionaire Raffle. The Lottery will roll out two more Millionaire Raffles in fiscal year 2009-10. At the same time the Lottery is continuing to explore new opportunities in the area of Raffle and will introduce new games in this category when research and planning determine that it is advantageous.

Mix & Match Replacement - Mix & Match, a $2 in-state lotto game, is scheduled to be replaced with a $1 in-state multi-hand easy-win-style game. Players of these smaller lotto games tend to have a preference for fresh and new games. The concept had a successful run with Match 6 and has tested well in research as a smaller game. The Lottery feels, and research has suggested, that the $1 price point is a better fit for players that are attracted to this type of game. The new game is expected to launch in November 2009.

Instant-Win Games from the New Terminals – New retailer terminals and companion thermal printers that are a part of the Lottery's new equipment roll-out, which will be fully operational in July 2009, allow for terminal-based tickets to have enhanced graphics. The Lottery plans to take advantage of these new capabilities by introducing a new instant-win category of terminal-based games. They will resemble scratch-off tickets in appearance and allow terminal-based players an opportunity to play games that offer the instant-win experience without the need to scratch a ticket. Focus testing has been completed. The first games are slated to be introduced in May 2010.

- **Continue Trend of Strong Growth in Instant Sales**

Instant Growth Opportunity - Efforts to maximize terminal-based sales will allow the Lottery to continue to grow its instant sales base, while still meeting the current minimum return percentage requirements.

Some of the initiatives that will aide growth in instant sales in fiscal year 2009-10 and beyond are:

- Media and new games - Delivery of new instant tickets to retailers will be timed more closely to match the launch of the television commercials that feature the new games.

- Emphasis on core games - There are marketing initiatives in place for fiscal year 2009-10 to boost the awareness of the instant games that have a continuous presence (i.e. Win for Life, Bingo, Crossword).
- Improved ticket callouts - The Lottery is working closely with Scientific Games, its instant ticket partner, to identify the optimal design of callouts on tickets in order to attract players.
- As part of the Lottery's continuing effort to make it more convenient and efficient to sell the instant ticket product, it soon will begin to roll out a ground-breaking ordering tool called Predictive Order**.** Predictive Order will process key instant game variables to calculate the best combination of instant games and quantities for each retailer. The Lottery's representatives will recommend the ideal instant ticket order(s) for each store to maximize its sales.

- **New and Improved Retailer Equipment**

- Instant ticket vending machine connectivity: By January 2010, the Lottery expects to have the ability to monitor sales by bin for each instant ticket vending machine in its retailer network. This will allow the Lottery to decrease the number of empty bins for the average machine.
  - The average machine currently sells $182,260 annually or $7,594 for each of its 24 bins.
  - If the Lottery can reduce bin outages by an average of one bin per machine for each of its 3,750 machines, it would realize an annual increase of $28.5 million in instant ticket vending machine sales alone.
- The Lottery's current 1,000 self-service, 16-bin player activated terminals are being replaced with 1,500 new self-service 24-bin terminals. At the current annual selling rate of $4,875 per terminal bin, the 20,000 additional bins could result in additional sales of $97.5 million.
- As of April 20, 2009, the new retail terminals, which replaced the 10-year-old retail terminals, are over 60 percent installed. The entire network is on schedule to be converted by July 1, 2009. The new terminals are faster and more user friendly and will aide the Lottery's retailers in providing better and faster customer support.
- Also new with the installation of the terminals are 17-inch-flat-panel monitors that display the current jackpots for each game as well as other information and messaging at the point of purchase.
- Thermal printers are another addition to the new equipment being provided to the retailer. The new printers are more reliable and eliminate the need to change ribbons. As mentioned earlier, instant win tickets are planned as a new offering largely because the thermal printers will print out more attractive and interesting tickets.
- For the first time, player accessible ticket checkers are also being installed with the new system. This will greatly enhance the player experience by cutting down on lines for ticket checking and should reduce the number of players walking away due to long lottery purchase lines.
- An important benefit from the new equipment conversion is the ability to attract new retailers. Sales and profit growth is tied directly to retailer network growth. The ease and speed of the new equipment will help the Lottery in its continuing efforts to grow the retailer base.
- The new system will allow cross promotion between instant and terminal-based products giving the Lottery more flexibility in designing promotions that encourage player trial of all Lottery offerings. The new system will also provide capability to cross promote lottery products with non-lottery retailer products allowing for even further creativity in designing promotions, and also allowing for a tighter partnership with lottery retailers.

- **Retailer Incentives**

    - A retailer incentive strategy that began in January 2009 will continue in fiscal year 2009-10. In fiscal year 2008-09 marketing strategy discussions last year, it was felt that retailers would be more aware of retailer promotions that focus on a single game each month rather than incentives based on overall sales. In addition, base-lining overall sales was complicated by potentially large swings in Powerball jackpots that temporarily inflate or deflate sales. A new strategy of tailoring incentive programs to specific games was designed and implemented beginning in January 2009. The new strategy has not only delivered needed focus on particular games, but has limited unnecessary incentive liability as well.

Other initiatives the Lottery is considering that will generate sales and revenues in fiscal year 2009-10 and beyond.

- **Chain Account Expansion** - The Lottery is currently considering a proposal from a third-party vendor that has the potential to greatly expand the number of chain stores that sell Lottery products. There is the potential to add entire retailer chains in Pennsylvania that include convenience stores, drug stores, big box and dollar stores. Together these chains have the potential to increase the Lottery's retailer network and therefore its profit potential by 12 to 22 percent (1,000 to 1,800 new stores).

- **Pennsylvania Liquor control Board (PLCB) -** The Lottery continues to work with the PLCB on a plan to place Lottery vending equipment in as many of the 600 plus PLCB outlets as the PLCB deems appropriate. Should the legislation proposed by the PLCB to allow for the sales of lottery tickets be adopted, a limited test in select store locations is planned for fiscal year 2009-10.

The Pennsylvania Lottery and the current economy.

The first page of this report stated that the Lottery will likely set a new fiscal year sales record in fiscal year 2008-09 while returning well over the 27 percent profit margin directed by Act 53. This will be accomplished in a year that ranks as one of the worst economic environments since the great depression. The Lottery recognizes that it will have to continue to adapt to economic obstacles and shifting and diverse consumer preferences in order to meet its fiscal obligations in fiscal year 2008-09 and into the future.

The Lottery conducted its own study on consumer behavior with regard to leisure spending in February 2009 and found that among the 406 adults surveyed:

- Concern over the economy and less money available are the key causes for a decrease in overall leisure spending.
- Of the 87 percent of the 406 people surveyed who said they purchase PA Lottery products, 26 percent say they are spending less on the PA Lottery.
- Approximately 5 percent of PA Lottery players are cognitively shifting money into other competing leisure activities, such as movies and dining out.
- The biggest impact to PA Lottery sales is players say they are selectively cutting back due to "less money available" (75 percent) and "concern over the economy" (73 percent).

Conclusion

Despite the national recession, the PA Lottery is on track to set yet another sales record. Relief from the 30 percent return requirement, as granted by Act 53 of 2008, has undoubtedly helped PA Lottery grow it sales and net revenues this fiscal year.

The aforementioned initiatives - including new and revised games, new equipment, promotions, retailer and consumer incentive programs, retailer growth - will allow the PA Lottery to continue its recent history of year-over-year sales records and maximized profit to support programs that benefit older Pennsylvanians.

These are no doubt challenging times for all retailers, not just the PA Lottery. The PA Lottery will continue to focus on maintaining and growing its business. Over the past six years, under the leadership of Governor Rendell, the Pennsylvania Lottery has been one of the fastest growing in the nation. We are now ranked the sixth largest lottery in the country in terms of sales and fifth in proceeds to programs.

Appendix: Pennsylvania Lottery ranked with other U.S. Lotteries in sales and net income.

FY-0708
($mm)

			A		B		C			D
Lottery (Traditional Portion Only)	Pop (mm)	Ticket Sales	Rank: Ticket Sales	Per capita sales	Rank: Per capita sales	Per capita net income	Rank: Per capita net income	Admin & operational expenses	Admin & operational expens as % of total revenues	Rank: Admin & operational expens as % of total revenues
Arizona	6.50	$472.94	23	$73	38	$22	36	35.78	7.6%	28
California	36.76	$3,049.62	7	$83	35	$31	27	167.22	5.5%	21
Colorado	4.94	$505.81	21	$102	27	$25	30	33.02	6.5%	24
Connecticut	3.50	$998.15	15	$285	7	$81	7	50.63	5.1%	18
Delaware	0.87	$125.35	36	$144	23	$43	21	13.84	11.0%	36
District of Columbia	0.59	$252.72	28	$427	2	$119	2	32.14	12.7%	40
Florida	18.33	$4,174.78	3	$228	11	$74	10	154.56	3.7%	7
Georgia	9.69	$3,272.05	5	$338	4	$91	6	137.33	4.2%	11
Idaho	1.52	$136.85	35	$90	28	$24	32	12.41	9.1%	35
Illinois	12.90	$2,057.27	11	$159	20	$50	16	108.99	5.3%	19
Indiana	6.38	$822.85	18	$129	24	$34	26	50.07	6.1%	23
Iowa	3.00	$249.22	29	$83	34	$19	38	31.68	12.7%	39
Kansas	2.80	n/a	n/a	$84	33	$24	31	24.48	n/a	n/a
Kentucky	4.27	$778.21	19	$182	15	$46	19	46.50	6.0%	22
Louisiana	4.41	$373.69	25	$85	32	$30	28	31.21	8.4%	31
Maine	1.32	$228.52	31	$174	17	$41	23	19.32	8.5%	32
Maryland	5.63	$1,673.04	12	$297	5	$97	5	58.85	3.5%	6
Massachusetts	6.50	$4,689.50	2	$722	1	$141	1	101.38	2.2%	3
Michigan	10.00	$2,330.20	9	$233	9	$76	8	110.40	4.7%	16
Minnesota	5.22	$461.52	24	$88	30	$22	35	39.49	8.6%	33
Missouri	5.91	$995.49	16	$168	18	$46	20	41.87	4.2%	12
Montana	0.97	$43.82	39	$45	42	$11	42	7.47	17.1%	43
Nebraska	1.78	$121.91	37	$68	39	$17	39	15.00	12.3%	38
New Hampshire	1.32	$260.69	27	$198	14	$57	14	17.33	6.6%	26
New Jersey	8.68	$2,539.06	8	$292	6	$103	4	78.05	3.1%	5
New Mexico	1.95	$147.20	34	$77	37	$23	33	17.23	11.7%	37
New York	19.49	$6,673.18	1	$342	3	$109	3	253.20	3.8%	8
North Carolina	9.22	$1,048.45	14	$114	25	$38	24	45.79	4.4%	14
North Dakota	0.64	$22.12	41	$34	43	$9	43	3.70	16.7%	42
Ohio	11.49	$2,325.14	10	$202	13	$62	11	110.28	4.7%	17
Oklahoma	3.64	$214.28	32	$59	40	$20	37	15.85	7.4%	27
Oregon	3.79	$338.68	26	$89	29	$17	40	27.53	8.1%	29
Pennsylvania	12.45	$3,089.19	6	$248	8	$75	9	81.84	2.6%	4
R. Island	1.05	$241.24	30	$230	10	$57	15	9.71	4.0%	10
South Carolina	4.48	$992.49	17	$222	12	$59	12	42.22	4.3%	13
S. Dakota	0.80	$42.43	40	$53	41	$14	41	5.58	13.1%	41
Tennessee	6.21	n/a	n/a	$159	21	$46	17	52.10	n/a	n/a
Texas	24.33	$3,671.48	4	$151	22	$46	18	167.50	4.6%	15
Vermont	0.62	$101.99	38	$164	19	$37	25	8.87	8.7%	34
Virginia	7.77	$1,386.41	13	$178	16	$59	13	73.68	5.3%	20
Washington	6.55	$521.10	20	$80	36	$23	34	43.52	8.4%	30
W. Virginia	1.81	$198.04	33	$109	26	$43	22	7.72	3.9%	9
Wisconsin	5.63	$494.73	22	$88	31	$26	29	32.81	6.6%	25

Table 5– FY0708 sales, return and operational data for the 44 US Lotteries.