
Pennsylvania Lottery Profit Report

As Required by Act 53 of 2008

2013

END OF FISCAL YEAR 2012-13 ANALYSIS

The Pennsylvania Lottery set a new sales record for fiscal year 2012-13 of \$3.700 billion, surpassing the \$3.481 billion record set in fiscal year 2011-12 by \$219 million or 6.3 percent. This is the third year in a row that the Lottery has set a record in total sales.

The Lottery also achieved record profits of \$1.067 billion for fiscal year 2012-13 which represents a \$6.5 million or 0.6 percent increase over fiscal year 2011-12 total profits of \$1.061 billion. This is the fourth year in a row that the Lottery has seen an increase in total profits.

The Pennsylvania Lottery remains the only state lottery that designates all its proceeds to programs that benefit older residents. Since its inception in 1971, the Pennsylvania Lottery has contributed more than \$23.7 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 living services; and the 52 Area Agencies on Aging, including full- and part-time senior centers throughout the state.

As demand for Lottery funding increases, the Lottery must grow profits to satisfy that demand. Key ways to grow sales and profits include growing the Lottery retail network into additional points of distribution and broadening the player base, both concepts discussed herein. Profit can also be maximized when artificial sales barriers are removed, which is the foundation of this profit report and the legislative reprieve from Lottery's 30 percent profit mandate.

Act 53 of 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 was given the latitude to return a minimum of 27 percent through fiscal year 2010-11. Act 23 of 2011 extended the 27 percent minimum return through fiscal year 2014-15.

Using this reduction of the minimum rate of return from 30 percent to 27 percent, the Lottery was once again able to execute a marketing plan that is expected to generate record sales and net revenues for these important programs. The lottery ended fiscal year 2012-13 with a net profit percentage of 28.85 percent.

The Pennsylvania Lottery remains one of the best performing lotteries of the 43 U.S. Lotteries, ranking sixth in population and fifth in profits in fiscal year 2011-12.

State of the Lottery Game Portfolio

The Lottery maintains a diverse product portfolio, providing lottery games that meet diverse consumer preferences. Although some categories of the portfolio are in decline due to shifting consumer preferences, both terminal-based games (3.6 percent increase in sales) and instant games (8.0 percent increase in sales) saw substantial growth in fiscal year 2012-13.

The table that follows summarizes the Lottery's 2012-13 fiscal year sales by category and by game, sales compared to fiscal year 2011-12 and the percentage of total sales that each category and game represents.

| FYTD | FY12-13 | FY12-13 est. | FY11-12 | versus Est. | versus Est. | versus FY11-12 | versus FY11-12 | % of Sales |
|-------------------|---------------|---------------|---------------|----------------|----------------|-------------------|-------------------|---------------|
| Total | 3,699,665,694 | 3,590,728,000 | 3,480,900,688 | 108,937,694 | 3.0% | 218,765,006 | 6.3% | 100.0% |
| Instant | 2,305,099,594 | 2,284,935,000 | 2,134,578,653 | 20,164,594 | 0.9% | 170,520,941 | 8.0% | 62.3% |
| Terminal-based | 1,394,566,100 | 1,305,793,000 | 1,346,322,035 | 88,773,100 | 6.8% | 48,244,065 | 3.6% | 37.7% |
| Numbers Games | 631,230,495 | 625,834,000 | 646,275,177 | 5,396,495 | 0.9% | (15,044,683) | -2.3% | 17.1% |
| TDN Nite | 235,824,461 | 236,675,000 | 247,264,451 | (850,539) | -0.4% | (11,439,990) | -4.6% | 6.4% |
| TDN Noon | 109,322,153 | 109,184,000 | 112,659,964 | 138,153 | 0.1% | (3,337,811) | -3.0% | 3.0% |
| Big 4 Nite | 164,224,943 | 162,731,000 | 167,492,852 | 1,493,943 | 0.9% | (3,267,909) | -2.0% | 4.4% |
| Big 4 Noon | 78,669,478 | 76,746,000 | 78,107,969 | 1,923,478 | 2.5% | 561,509 | 0.7% | 2.1% |
| Quinto Nite | 27,117,611 | 25,624,000 | 25,744,576 | 1,493,611 | 5.8% | 1,373,035 | 5.3% | 0.7% |
| Quinto Noon | 16,071,850 | 14,874,000 | 15,005,366 | 1,197,850 | 8.1% | 1,066,484 | 7.1% | 0.4% |
| InState Lotto | 258,285,559 | 239,752,000 | 250,174,989 | 18,533,559 | 7.7% | 8,110,570 | 3.2% | 7.0% |
| Cash 5 | 167,505,246 | 148,596,000 | 159,853,249 | 18,909,246 | 12.7% | 7,651,997 | 4.8% | 4.5% |
| Treasure Hunt | 25,654,457 | 24,087,000 | 24,313,690 | 1,567,457 | 6.5% | 1,340,767 | 5.5% | 0.7% |
| Match 6 | 65,125,856 | 67,069,000 | 66,008,050 | (1,943,144) | -2.9% | (882,194) | -1.3% | 1.8% |
| Multi-State Lotto | 484,650,886 | 420,207,000 | 428,925,549 | 64,443,886 | 15.3% | 55,725,337 | 13.0% | 13.1% |
| Powerball | 368,089,655 | 238,548,000 | 244,345,588 | 129,541,655 | 54.3% | 123,744,066 | 50.6% | 9.9% |
| Power Play | 32,766,469 | 34,476,000 | 33,346,262 | (1,709,531) | -5.0% | (579,792) | -1.7% | 0.9% |
| Mega Millions | 71,273,445 | 128,038,000 | 131,589,844 | (56,764,556) | -44.3% | (60,316,400) | -45.8% | 1.9% |
| Megaplier | 12,521,318 | 19,145,000 | 19,643,855 | (6,623,683) | -34.6% | (7,122,538) | -36.3% | 0.3% |
| Raffle | 20,399,160 | 20,000,000 | 20,946,320 | 399,160 | 2.0% | (547,160) | -2.6% | 0.6% |

Product Mix

Consumer demand drives Lottery sales. Lottery sales for fiscal year 2012-13 continue to reflect the industry trend of increased consumer demand for instant products. Since the Lottery's instant products return approximately half the profit per sales dollar as the terminal-based portion of the product portfolio, increased consumer demand for the instant product reinforces the necessity of the relief from the 30 percent mandate to grow sales.

Instant sales as a percentage of total traditional sales

| | FY 07-08 | FY 08-09 | FY 09-10 | FY 10-11 | FY 11-12 | FY 12-13 |
|----------------------|----------|----------|----------|----------|----------|----------|
| Pennsylvania | 55.4% | 55.3% | 56.9% | 59.9% | 61.3% | 62.3% |
| Other U.S. Lottery's | 56.8% | 57.3% | 57.2% | 58.7% | 58.5% | n/a |

Instant Games

For the third year in a row, the Lottery set a new instant product sales record for fiscal year 2012-13. Instant sales of \$2.30 billion easily surpassed the record of \$2.13 billion set in fiscal year 2011-12. The growth in instant sales amounted to an increase of \$170 million or 8.0 percent. An impressive 20 of the top 30 instant game sales weeks in the entire 41 year history of the Lottery occurred in fiscal year 2012-13. The category accounted for 62.3 percent of sales.

As with most lotteries, the sales mix is shifting toward the higher price point instant tickets. The table above shows the growth for instant games by price points over the same period last fiscal year.

| Instant Price Points | FY-1213 | vs. FY-1112 | % of Inst Sales |
|----------------------|-----------|-------------|-----------------|
| \$20 | \$651.87M | 22.2% | 28.3% |
| \$10 | \$445.32M | 11.4% | 19.3% |
| \$05 | \$705.24M | 2.6% | 30.6% |
| \$03 | \$161.21M | 13.3% | 7.0% |
| \$02 | \$227.24M | -8.4% | 9.9% |
| \$01 | \$116.39M | -9.2% | 5.0% |

Multi-State Lotto: Powerball and Mega Millions

The multi-state lotto category ended up with a 13.0 percent increase over fiscal year 2011-12. Fiscal year 2012-13 Powerball/Powerplay sales increased by 44 percent while MegaMillion/MegaPlier declined by 45 percent over fiscal year 2011-12. This is not surprising given the changes in the average jackpot for each as seen in the table below.

Size of Average Jackpot (\$M)

| | Powerball | Mega Millions |
|----------|-----------|---------------|
| FY 11-12 | \$86M | \$68M |
| FY 12-13 | \$124M | \$44M |

The category accounts for 13.1 percent of total sales.

In-State Lotto: Cash 5, Match 6, Treasure Hunt

The in-state lotto games were up 3.2 percent over fiscal year 2011-12. The category accounted for 7.0 percent of total sales. The Lottery is diligent in maintaining the vitality of this category with the understanding that it is experiencing increased competition from the multi-state lotto games and the higher price point instant games.

Numbers Games: The Daily Number, Big 4, Quinto

Numbers games ended down 2.3 percent under fiscal year 2011-12. Although numbers games have a loyal player base, industry-wide sales show that it has a shrinking player base as well. Due to shifting consumer preference for other Lottery products, the Lottery anticipates that the numbers games player base will continue to shrink. The Lottery will continue to support the numbers games through promotion and advertising. The Lottery continues to research possible add-on games that could spur additional sales in this category. Numbers games accounted for 17.1 percent of total sales in fiscal year 2012-13.

Millionaire Raffle

The Lottery sold out both Millionaire Raffles in fiscal year 2012-13. The Lottery has sold out all 16 Millionaire Raffles. The Pennsylvania Lottery remains the only U.S. lottery to have sold out all its Raffle games on schedule.

PLANNING FISCAL YEAR 2013-14 AND BEYOND

The Lottery has established five key strategies for continued success that will be utilized to meet its fiscal commitments for fiscal year 2013-14 and beyond.

Key strategy #1 – Expand and Evolve the Benefits Campaign

Recent research indicates that separating the benefits advertising from sales-oriented advertising is more effective in delivering stronger messaging on both accounts. Through research, the Lottery is in the process of identifying and launching a new creative strategy that better communicates all the Lottery supported benefits that are available to Pennsylvania's seniors. The Lottery is confident that increasing awareness of all the good things that Lottery revenues provide will improve the Lottery brand as a whole.

Key strategy #2 – Expand the Player Base

In an effort to protect the revenue stream and prepare for long-term success, the Lottery understands that it must recruit and retain new players. As with any retail business, new customers are the hardest ones to get. The Lottery will develop and implement a plan to broaden its player base. The foundation of this plan requires a significant amount of consumer research designed to learn about non-players and their barriers to Lottery play.

Key strategy #3 – Improve and Expand Product Distribution

There are many facets of product distribution. The Lottery has learned through experience that more points of distribution will result in incremental sales. The Lottery will investigate private sector practices to increase product facings and merchandising opportunities.

Another important component in expanding product distribution is growing the retailer base. Quite simply, expanding the retailer base will expand the distribution of the Lottery's products. The Lottery's goal is to recruit 200 additional retailers during fiscal year 13-14. The Lottery is also purchasing additional self-service terminals and vending machines to further expand points of distribution.

Key strategy #4 – Continue the Growth of Instant Game Category

Pennsylvania is not unique in experiencing tremendous growth in instant sales, particularly in the \$5 and above price point games. The \$20 price point saw 22 percent growth in fiscal year 2012-13. The Lottery believes the time is now right to try and establish a new price point at \$30. The plan is to launch a \$30 game in January 2014 and monitor its sales along with any signs of cannibalization of the rest of the instant game portfolio.

Key strategy #5 – Grow Draw Games

With their higher profit margins, draw-based games are an important component to a profitable product portfolio. Across the industry, numbers and in-state lotto games are slowly declining. The Lottery will be re-evaluating the in-state lotto and numbers games with the purpose of optimizing the presence of the higher profit draw games in the overall game portfolio.

Conclusion: Further Legislative Relief from 30 Percent Profit Mandate Critical to Continued Profit Growth

As the 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 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 temporary relief was granted in 2008 and again in 2011. In fact, 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 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 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, a lower profit margin for the Lottery. The disparity between profit margins for instant and terminal-based games is significant; currently, the rate of return for terminal-based games is two times the return realized on instant lottery games sales.

Without legislative action to extend or make the profit margin reduction permanent, the Lottery will have to make adjustments to its marketing plan, including diminished payouts, which will likely reduce total sales and profits.

After operating for years with the flexibility to increase prize payouts, without legislative action on this issue the 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.

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 Lottery to balance product portfolio to respond to consumer demand and maximize sales, thereby increasing profits.

Independent, private-sector evidence supports Lottery's position as well. The November 2012 bid on the 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 illustrates the commonwealth could stand to sacrifice more than \$800 million in lost profit, should it return to a 30 percent profit mandate.

The Pennsylvania Lottery has never reduced prize payouts in its 42-year history, and we cannot afford to test this proposition now. In fact, the Lottery estimates that revising its fiscal year 2015-16 marketing plan to ensure a 30 percent rate of return would entail cutting product line offerings and payouts, with a resulting reduction of \$933 million in sales and \$205 million less in profit next year.

Setting the rate of return below 30 percent permanently permits the Lottery to continue reacting to consumer demand and allow market forces to drive sales. It will empower the Lottery to add new games, expand the higher-price-point instant games and provide extended play value as demanded by consumers. Finally, it will allow the Lottery to plan for increased profitability.