U.S. lotteries in 2013: The state of play

A truly informative lottery map of the United States would need many colors. In addition to the usual need to show where one jurisdiction ends and another one begins, such a map ought to convey how the range of lottery products changes as state lines are crossed. The map is being re-colored as you read, and the palette required is growing.

In the U.S., 43 of the 50 states now have state lotteries. State lotteries began in the northeast and spread gradually across the country. The most recent additions have been in the south (Arkansas) and west (Wyoming).

The biggest variety of lottery products is sold in the northeast, where the product mix has long included both instant games and traditional draw games sold just within the state. After many states had established their own lotto games, some states began to cooperate to offer lotto games in bigger versions. Two multi-state "block" games – Powerball and Mega Millions – developed. In sparsely-populated Wyoming, where a lottery was first instituted in 2013, only the block games are on offer.

Several state lotteries also have Video Lottery Terminals (VLTs) as part of their product mix. In some states these are concentrated in gambling destinations like racetracks or casinos, while in others they can be found in convenience stores.

Until very recently, no U.S. state lottery offered any product for sale over the World Wide Web ('the web'). This began to change in 2012, after U.S. Federal Government regulations were reinterpreted. Sports betting in general has largely been avoided by U.S. lotteries.

Currently there are four major trends to watch in U.S. lotteries. First – and probably most significant – is the exploration of web commerce and even sports betting by some lotteries. Second is the continued development of multi-state lotto games. Third, the instant game business based on paper tickets has recovered from the financial crisis of 2008. Fourth, state governments have continued to make management agreements with private contractors about the outsourcing of lottery operations. We consider each of these developments in turn.

Exploring the web

The individual states have been exploring territory that was opened up by the reinterpretation, at the end of 2011, of the Federal Government's "Wire Act" of 1961. For many years, this law was interpreted as forbidding, for most kinds of wagering, the use of any electronic communications that cross state lines. Since the paths taken by data packets in our world of modern web-based communications very often cross state lines, the sale of lottery products through web-based commerce was believed to be prohibited. Under the 2011 interpretation, however, the Wire Act is understood to be limited in its scope to sporting events, races, and the like. Thus, on current understanding, no federal law prevents lotteries from selling their products over the web.

The question of whether to pursue development of lottery commerce on the web is therefore now up to the individual state lotteries. Delaware is the early leader in this field, having launched the first state-authorized web gaming systems in the country in October 2013. New Jersey passed legislation permitting similar systems in 2013 and is currently working to implement them.

Some other states are moving in the direction of web sales of more traditional lottery products. However, there is significant political opposition even to this trend. Convenience stores as a category (including those whose major sales volume is in motor fuels) account for more than 60% of lottery sales in the U.S., and the National Association of Convenience Stores has lobbied vigorously against web sales of lottery games. Other legal gaming operators, including some of the federally-recognized Native American tribes, have voiced opposition. In general, web commerce in lottery tickets is seen by many who oppose gaming as a significant expansion of gambling. The balance among these interests varies from state to state. Now that the uniform federal prohibition is lifted, there is reason to expect diversity in practice across the various jurisdictions.

Delaware is also taking an early lead in legitimizing the involvement of state lotteries in betting on sports. Sports betting across state lines is still understood to be prohibited by the Wire Act, so Delaware has taken care to keep its communications strictly within the state. As with gambling on the web, there is significant social opposition to government involvement in sports betting.

Block games produce record jackpots

The past few years in the U.S. have seen significant developments in two lotto-type games, Powerball and Mega Millions, that are intended to produce extremely large jackpots. These games are able to promote large jackpots because they are offered not to a single state, but to blocks of states whose populations collectively total in the hundreds of millions, and have top prize odds that support long jackpot progressions. Up until January 2010, most U.S. lotteries offered either Powerball or Mega Millions, with no state offering both. However since January 2010, nearly all the participating jurisdictions have offered both games. The combined population base of each game has consequently expanded. Since the advent of cross-selling, the governing bodies of the games have closely monitored the performance of the games. Initially, players showed a striking degree of "brand loyalty" toward the game more familiar to them. Consequently, cross-selling did not instantly expand the player base. However with time and increasing participation, the effective player base has expanded, prompting the governing bodies to modify game rules in order to preserve the likelihood of long jackpot progressions.

In the case of Powerball, the price of a single wager was doubled (to USD 2) in January 2012, and the starting jackpot was set at USD 40 million. The value of the second-tier prize was increased to USD 1 million. Other changes to the structure of the game were relatively minor. By the end of FY13, these changes were generally regarded as a great success. The number of wagers placed at "low" jackpots (that is, less than USD 200 million!) declined shortly after the price was doubled, but the net effect was an increase in dollars wagered even at low jackpots, and a decreased likelihood of drawing a winner. Of course, jackpots can still be won even when no one has bet on most of the possible combinations, and this in fact happened several times immediately after the price change. Nonetheless, within 18 months, the game produced jackpots of over USD 200 million seven times. Jackpots of this size have been accompanied by much attention in the popular media and an associated spike in wagers. The spikes have been exciting for the players and profitable for the lotteries. The highest Powerball jackpot, with an advertised value of USD 600 million, was won on May 18, 2013.

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The Mega Millions game actually produced a bigger jackpot, with no change in its basic structure, during the first few months after the Powerball price change. However in the 17 months after its record USD 656 million jackpot of March 31, 2012, Mega Millions did not produce any jackpots over USD 200 million. Meanwhile, the player loyalty that was so apparent right after cross-selling started seemed to decline, to Mega Millions' disadvantage. The governing body of the game changed the game matrix in October 2013, maintaining a USD 1 per wager price while increasing the size of the game matrix to decrease coverage, and making the second-tier prize USD 1 million. For further details about these recent changes to the Mega Millions games, see the article 'America's Mega Millions relaunches, looking for more mega jackpots' on pages 28–30.

In a period as short as a single fiscal year, results from either one of these big jackpot games can depart significantly from long-term expectation. There is a substantial advantage in year-to-year stability in having two such games, operating independently. The participating lotteries earn the same net win from each game. Keeping both games healthy is a management priority of the participating lotteries.

Instant game business rebounds from the recession

Many state lotteries had record sales of printed instant games in fiscal year 2013 (FY13), which ended for most U.S. lotteries on June 30, 2013. Significantly, this is the first fiscal year since the start of the financial crisis of 2008 and the accompanying recession in which the profit from sales of instant games had greater buying power than it did in FY08, the last pre-recession year. The instant ticket business may now be said to have truly recovered from the recession.

This is not to say, however, that sales of instant games have lagged all this time. By FY11, sales had, in fact, exceeded their FY08 levels. However, the net win (sales minus prize expense) from these sales was reduced by two factors: generally increased prize expense of the games offered by lotteries, and migration of player dollars across categories having different prize expense. These two factors kept the net win of the instant game business below the level that would have kept pace with general price inflation, until FY13.

The preceding conclusion is based on a detailed analysis of the instant game business of 32 U.S. lotteries[1]. The chart below shows the development of aggregate instant sales and net win across these 32 lotteries. The pre-recession year FY08 is contrasted with the recent years of recovery, with the early years of the recession being eliminated for simplicity.

Between FY08 and FY11, growth in sales occurred primarily in the USD 5 price category. Also in this time period, the proportion of the sales price paid back to players as prizes increased in every prize category. The net effect was that although sales increased between FY08 and FY11, net win actually decreased.

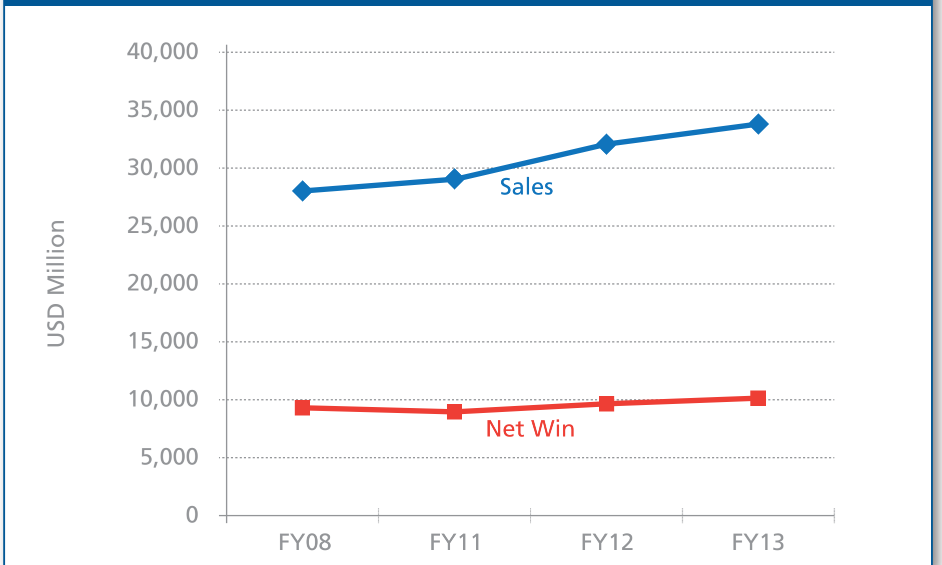
Since FY11, sales growth has occurred exclusively in games priced at USD 5 and higher. Prize expense within categories has been stable. In FY13, fully 63% of the net win of these U.S. lotteries came from sales of games with a prize expense of at least 70%.

State governments make management agreements with private contractors

Perhaps the most discussed trend of the past few years in the U.S. lottery world has been the initiative of state governments to shift substantial management responsibility for state lotteries onto private-sector contractors. Three states – Illinois, Indiana, and New Jersey – have implemented contracts that place operational management in the hands of a private contractor, while maintaining oversight through a reduced staff of lottery employees. In other states, including Pennsylvania, the executive branch of government has proposed similar arrangements. No such arrangement has been implemented without approval of the legislative branch of state government.

Private management agreements bring new significance to some of the opportunities and challenges that every lottery deals with. For instance, state legislatures have imposed limits on the types of games that can be offered by a state's lottery. These limits may be perceived as restricting the potential earnings of the lottery. The performance of the lottery may also be limited by the inability of a quasi-government entity to do things that require substantial capital commitments, in the way a private business might. A private manager may be willing to commit capital in a way that a quasi-government entity will not, but may nevertheless find its scope of action limited by legislation and public policy. While the balance between a profit imperative and other public policy considerations has always been important in U.S. lotteries, the private management agreement is a spotlight that shows up any imbalance.

Instant game sales and net win (32 U.S. lotteries)



Instant games sales and net win, FY08–FY13 (FY09–FY10 omitted for brevity). By FY11, the sales volume of instant games in the U.S. had largely recovered from the financial crisis of 2008. It has taken almost another two years, however, before net win (inflation adjusted) from instant games has returned to pre-recession levels.

Each instance of private lottery management currently operating in the U.S. has major participation by the multinational supplier of lottery infrastructure, GTECH S.p.A. In the long run, standardization of operating infrastructure across many jurisdictions may enable economies of scale that have not, up to this time, been fully realized.

2014 and beyond

As each of these four movements in the U.S. market continues to evolve, 2014 and beyond should witness developments along each front. The instant game business may continue to expand as players become accustomed to the more generous prize structures of higher-priced games, while the luck of the draw will continue to be a big factor in the block games. Private management agreements are offering new features with each subsequent iteration. Most significantly, all U.S. lotteries realize that the opportunity of web-based commerce calls for games specifically designed for that environment.

[1] The 32 states are: Arizona, California, Colorado, Connecticut, Florida, Georgia, Idaho, Illinois, Indiana, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, N. Carolina, Nebraska, New York, Ohio, Oregon, Pennsylvania, Rhode Island, S. Carolina, Texas, Vermont, Virginia, Washington, West Virginia, and Wisconsin. Details of the study are posted on the web at: www.lotterymanagementconsulting.com.