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Semiannual Report On Lottery Operations

To: Members of the House Government Oversight Committee and Senate Government Oversight Committee

From: Ed Stanek

Date: Nov. 10, 2004

The Iowa Lottery Authority ended its first year of operations with an increase of millions of dollars in its profits to the state – a 16.4 percent improvement over the previous year's results. And while the Lottery continues to explore new product concepts and make other strategic marketing and budgeting decisions to increase sales and profits, early results from FY 2005 show that high fuel prices and concerns about upcoming home heating bills are having an effect on lottery returns.

Lottery profits to state programs totaled nearly \$55.8 million in fiscal year 2004, which ended June 30. Total sales for the year were \$208.5 million. Comparative figures for FY 2003 were \$187.8 in sales and \$47.9 million in proceeds.

The lottery achieved FY 2004 sales increases in nearly all of its products, most notably in instant-scratch games (12.1 percent sales increase to \$95.3 million) and Powerball (14.6 percent sales increase to \$66 million). The creation of the Iowa Lottery Authority, with its accompanying freedom to operate as a business with business-type incentives, continues to set the stage for future lottery success.

However, fuel and energy prices this year in Iowa are taking a toll on lottery sales and lottery proceeds to the state in early FY 2005. Gas stations and convenience stores make up about 75 percent of the Iowa Lottery's approximately 2,500 retailers. When gasoline prices in Iowa hit an average of \$1.96 a gallon in mid-May (the highest average on record since the Dept. of Natural Resources began surveying fuel prices in 1980), the price spike drove down sales of the Iowa Lottery's instant-scratch tickets, which like snacks, pop and magazines, are discretionary purchases often made at c-stores. Instant-scratch ticket sales in Iowa fell from \$8.3 million in April to \$8 million in May.

Summer months, when many people are on vacation and away from their day-to-day routines, traditionally are a slower time for lottery sales. However, lottery sales generally pick back up in the fall and increase further during winter months. The Iowa Lottery

should have seen a sales increase beginning in September of this year, but the effect of high fuel prices continued to show through.

Instant-scratch sales in September were \$7.3 million, down from \$7.4 million in August. And, while lottery sales did rebound in October, total Iowa Lottery sales are down in the first four months of fiscal year 2005 compared to FY 2004 (\$65.5 million in 2005 compared to \$70 million in 2004 with some of that difference due to variations in the Powerball jackpot).

Gas prices in October averaged \$1.94 a gallon, according to the DNR's monthly fuel survey. Energy analysts at the DNR also began warning in October about higher home heating costs this winter. Natural gas prices are expected to be as much as 29 percent higher this winter, according to the DNR, and approximately 69 percent of Iowans heat their homes with natural gas.

Fuel prices also had a noticeable effect on Iowa Lottery sales in spring 2001, when high gasoline prices drove down sales in many areas of discretionary spending. The Iowa Lottery responded at that time by working with the Iowa Corn Growers Association to design a promotion to give away free fuel. The "It's a Gas" promotion that began in January 2002 awarded seven grand prizes of \$1,040 in ethanol certificates – enough to buy \$20 in fuel each week for a year.

The Iowa Lottery is looking into that and other innovative ideas to respond to the current high energy prices, but realizes that in the end, consumers do have to make common-sense choices in their purchases.

Lottery Legislation Planned For 2005 Session

During the 2005 legislative session, the Iowa Lottery will introduce legislation to close a bit of a loophole in Iowa law that has allowed the spread of a "grey area" product that competes with lottery pull-tab tickets.

The product is known in Iowa as "Ad-Tab" tickets, but similar products by different names have been the subject of court action in other states, including Minnesota, Michigan and Maryland. The tickets, which look much like Iowa Lottery pull-tab tickets, are sold by private operators in the state and presented as promotional/advertising materials. There is no regulation of the product and it is having a detrimental effect on the sale of Lottery pull-tab tickets and their income to the state.

Pull-tab tickets are the only lottery product that saw a sales drop in fiscal year 2004, with sales in the category down 10 percent, or about \$2.8 million.

The Iowa Lottery believes that a change in Iowa's Vice Law, Iowa Code Chapter 725, will address the Ad-Tab situation in Iowa without involvement of the courts, as has been the case in other states. The Lottery plans to introduce language to make the Code change in the 2005 session. The proposed language is included at the end of this report as Attachment A.

Court decisions in other states highlight the need for legislative action in Iowa:

- In Minnesota, the state Court of Appeals ruled in October that a promotional game sponsored by a company called Minnesota Souvenir Milkcaps is illegal in that state. The appeals court upheld a lower court ruling that the game is really a lottery because customers pay for the chance to win a cash prize – not for any tangible good.
- In Michigan, an Ingham County Circuit Court judge ruled in June that Ad-Tabs coupons being sold in that state were an illegal lottery.
- In Maryland, the Circuit Court for Worcester County in July 1993 granted summary judgment to a county attorney who had removed a vending machine containing Ad-Tabs coupons from a pizza restaurant. The court noted in its ruling that “the undisputed facts support the supposition that the Ad-Tab campaign is a pretext, designed to evade Maryland’s gambling statutes.”

Monitor Vending Machines

(marketed under the brand name TouchPlay)



Statewide rollout of the lottery’s monitor vending machines began in late April and the project has produced more than \$1.3 million in net sales since that time. The machines, being marketed under the brand name “TouchPlay,” are being installed in businesses across the state by amusement operators, small-business owners who have been licensed to sell lottery products.

Players insert money into the monitor vending machines as they do with any other vending machine. When the play is made, the TouchPlay machine’s video monitor displays the results of the play while electronic tones indicate whether the play has won a prize. The machines do not pay out money. Players receive tickets that can be redeemed for cash prizes at the businesses where they play or at Lottery regional offices. The machines do not utilize a randomizer or random internal selection of plays. All plays come from a predetermined pool. The machines are located in age-controlled environments (premises where the age of patrons is monitored by the employees of the establishment).

The lottery has been discussing the vending machines with legislators since late 2001. A test period for the machines started in May 2003, with 30 machines installed at businesses from Des Moines to the Waterloo-Cedar Falls area. In the test, the lottery measured the machines’ revenue potential, reliability and serviceability and tracked whether there were any calls to the state Gamblers’ Treatment program related to the machines. After a six-month test period in which the 30 machines produced average weekly sales of \$900 and there were no reports related to the machines made to the

gambling treatment hotline, the lottery decided to move forward with statewide sales from the devices.

The Lottery Board has approved a limit of two TouchPlay machines per location with the exception of fraternal and charitable social clubs, which can have up to four MVMs each. The TouchPlay machines are connected to a central system and the lottery and machine operators have access to the reports produced to track sales and prize information.

Operators are gradually buying and deploying TouchPlay machines at age-restricted locations in Iowa. As of Nov. 6, 69 operators had been licensed by the lottery and had installed nearly 400 machines in retail locations across the state.

During the 2004 session, legislation was approved that established a minimum playing age for amusement devices in Iowa but left the machines in all of the locations that currently had them, including bars, taverns, restaurants and convenience stores. The Lottery warned legislators during discussions about the devices (there are about 7,000 in operation in Iowa) that they were proving to be a significant form of competition to lottery products and were having a detrimental effect on the sale of lottery products, especially pull-tab and instant-scratch games. Members of the Oversight Committees suggested that the Lottery, amusement operators and convenience stores work together to try to develop a cooperative program. The lottery has responded in an effort to preserve its revenue to the state.

In August, the Lottery began a market test of TouchPlay machines at 20 convenience stores in Iowa, many of which also offer amusement devices to their customers. As with its initial test of TouchPlay technology, the lottery is measuring results of the c-store test on a number of fronts, including the machines' overall revenue potential, their effect on the sale of other lottery products and any effect on calls to the state Gamblers' Treatment program.

The TouchPlay machines have performed well in the c-store market test, with the businesses that offer them and those businesses' customers both appreciating a new entertainment option. The machines also are providing a valuable new revenue stream to the c-stores. The addition of TouchPlay machines in the c-stores has had an effect on the sale of some other lottery products there, but overall sales at stores involved in the test have increased – and increased at a higher rate than sales at the lottery's other retail locations. Officials at the state Gambling Treatment Program report no calls to the gambling hot line related to the TouchPlay machines and no reports of underage use have been received.

Purchase of Vending Machines and Lottery Headquarters Building



Earlier this year, the Lottery notified members of the Oversight Committees about its plans to issue revenue bonds to pay for a headquarters location in Des Moines and vending machines for its instant-scratch and pull-tab tickets. Both purchases should mean long-term savings to the state and plans on both fronts are moving forward.

The revenue bonds to pay for the projects were issued in early October.

On Nov. 15, the Lottery will begin replacing its existing leased vending machines for instant-scratch and pull-tab tickets with new machines that the lottery has purchased. The transition to the new equipment will continue through April, with a total of about 1,020 new pull-tab vending machines and 300 new instant-ticket vending machines installed in retail locations.

The Lottery expects to close by the end of the calendar year on its purchase of a headquarters location at 2323 Grand Ave. in Des Moines. Moving the Lottery's operations to the new building is planned for summer 2005. The building currently is home to Farmers Mutual Hail Insurance Co., which is constructing a new headquarters location in West Des Moines.

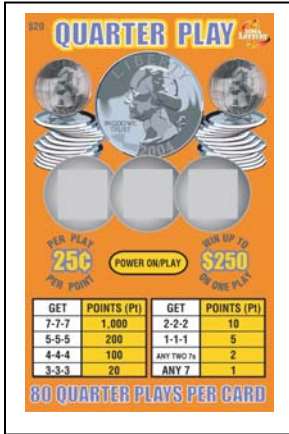
The 2003 legislation that created the Iowa Lottery Authority included language authorizing the Authority to "enter into contracts to incur debt in its own name and enter into financing agreements with the state, agencies or instrumentalities of the state, or with any commercial bank or credit provider." Written notice to the Legislative Oversight Committee and approval from the Executive Council is required for the lottery to borrow more than \$1 million.

In investigating options available to the lottery, lottery executives found that the Authority could obtain federally tax-exempt financing as an instrumentality of the state. With the assistance of the State Treasurer's office, lottery executives prepared the necessary paperwork and received approval from the state Executive Council to borrow up to \$10 million to buy the headquarters building and vending machines.

To recap both projects for you:

- The Lottery is purchasing the vending machines from Pollard Banknote, based in Winnipeg, Canada. The machines are being manufactured in Council Bluffs by Pollard's subsidiary, American Games Inc., which also will provide maintenance for them. American Games already employs 220 people in Council Bluffs and the company expects to add between 50 and 75 additional jobs to fulfill the Iowa Lottery contract. Financial projections show that by purchasing the machines instead of using traditional six-year leasing arrangements, the lottery should save about \$1.7 million in that time. The lottery could extend the machines' use even beyond that, resulting in further savings to the state.
- Purchasing the building at 2323 Grand Ave. also is projected to produce annual savings for the Lottery. Rent on the Lottery's current headquarters at 2015 Grand

Ave. totals \$348,000 per year, with no accumulation of equity. The lottery's annual payment on the bonds issued to buy 2323 Grand Ave. will total \$200,345 and the lottery will build up equity during the 15-year amortization period for the bonds.



Electronic Game Card Update

In October, the Iowa Lottery became the first in the world to sell an electronic version of the traditional instant-scratch game with a market test of a product called “Quarter Play.”

Initial sales of the battery-powered cards were strong, with an enthusiastic response from both retailers and players. More than 60 percent of the electronic game cards ordered for the market test had been sold in the product's first five weeks on the market.

Based on the market test's strong results, the lottery plans to begin statewide sales of electronic game cards in May 2005. The initial game sold statewide also will be called Quarter Play, with future games planned for fall 2005.

Each Quarter Play card, about the size of a driver's license, is battery powered and loaded with dozens of random plays. Players activate the cards by pulling off a plastic tab on the back. Pushing a “play” button on the front of each card activates one of the plays on the card – essentially the same as an individual scratch ticket. But in the case of the game card, an electronic play replaces the traditional scratch play of a paper ticket. Three small LCD screens on the front of the card display the numbers in a particular play and show whether it has won a prize.

Each card features 80 plays and sells for \$20 (25 cents per play). Players accumulate points, each having a value of 25 cents, by matching three like numbers as they advance through the 80 plays.

At the conclusion of all the plays, the game card displays the total points accumulated. Each card in the market test offers a guaranteed \$5 prize and the chance to win a top prize of \$300. Players redeem the cards as they do any other lottery product – by having their ticket validated at an Iowa Lottery retailer or one of the lottery's regional offices.

The market test of the cards was conducted at about 10 percent of Lottery retailers in the Cedar Rapids, Waterloo-Cedar Falls and Dubuque areas. The Lottery chose eastern Iowa for the test because of its heavy population base and variety of retailers and sales markets.

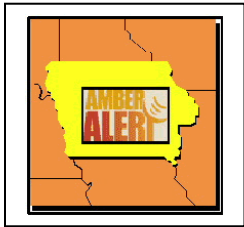


Casey's General Stores

In mid-September, Casey's General Stores began selling Iowa Lottery products again. A decade earlier, the Ankeny-based convenience store chain had made a corporate-wide decision to stop selling lottery products in all states where it did business. The decision was based on a variety of reasons, including accounting issues. Casey's is gradually installing equipment and training its staffers to sell Iowa Lottery products with final installations at its 335 stores in this state scheduled for early January. The Lottery will invest \$1.8 million in fiscal year 2005 for satellite communications equipment, ticket-vending equipment and point-of-sale materials at Casey's stores. However, the addition of 335 stores to the Lottery's retail base will mean significant long-term benefits to Lottery sales and proceeds.

Promoting Iowa

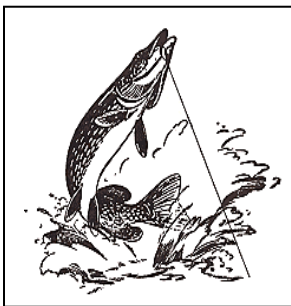
Fiscal year 2005 finds the Lottery continuing the important work of highlighting the state's success stories. Examples of projects include:



The Lottery's participation in the Amber Alert emergency notification system, which has been used multiple times to successfully locate missing children and return them to safety. The lottery has provided information to the public about abducted and endangered children by printing messages on its lotto tickets, displaying information on its customer display units at retail locations and through detailed messages sent to each of the 2,200 retailers that sell lotto and instant-scratch tickets in Iowa.



The "Cash on a Stick" instant-scratch game and "Iowa State Fair 150th Anniversary Sweepstakes" promotion both celebrated the fair, Iowa's largest tourism event and one of the nation's oldest and largest agricultural expositions. The sweepstakes promotion concluded with a prize drawing during the fair in August. The Lottery and State Fair had worked together to design a contest featuring Iowa-made and Iowa-marketed products. Contestants in the prize drawing won one of 12 cash prizes of \$1,500; a Dave Lennox Signature Collection® furnace installed in the winner's home; a 2004 Dodge Ram pickup; or a 2005 Winnebago 22-foot Minnie® motor home.



In April, the Lottery will release a fishing-themed instant-scratch game as part of a joint project with the Department of Natural Resources designed to encourage people to buy fishing licenses in Iowa. Sales of resident fishing licenses have fallen nearly 9 percent since 2000, resulting in a budget cut to the DNR's fisheries, wildlife and conservation law enforcement bureaus in FY 2004. The Lottery and DNR are working together to develop the fishing-themed scratch game and each ticket will feature a message encouraging players to visit the DNR's web site (www.iowadnr.com) to buy their fishing licenses.

Turning 20

In 2005, the Iowa Lottery will mark its 20th birthday. Lottery sales in Iowa began on Aug. 22, 1985. Total lottery revenues to the state will top the \$900 million mark in its anniversary year, while prizes to players will continue to climb towards \$1.8 billion. The lottery is planning several games and promotions throughout the year to celebrate the milestone and highlight the revenues it has provided to the state through the years.

On-Going Issues

Gambling Decisions: With the Racing and Gaming Commission's decision in June to begin the process of rescinding its rule putting a moratorium on gambling licenses, the stage is set for a gambling expansion in Iowa. New casinos and the addition of table games at racetracks in Iowa will create more competition for consumers' discretionary income, meaning more competition for the Iowa Lottery and other businesses in the entertainment industry. The lottery will continue to monitor the expansion of gambling in Iowa and what impact that could have on lottery income to the state.