Choice for the Modern Consumer: Lottery & Cashless Payments

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As lottery has historically been a cash-only industry, we are early on in the learning curve for accepting other forms of payment. With "cashless," a great opportunity awaits us—to embrace the next generation of lottery players and drive incremental sales and profits to good causes.

Cashless includes traditional credit, debit, and gift cards, as well as newer methods, such as PayPal or ApplePay and other mobile payment models. These are all well supported by the many technical solutions available in the market, but the greatest challenge for lotteries is to understand and accept the economics related to cashless—i.e., the benefits and costs of the investment in expanding the payment options available to lottery players.

Cashless is about customer service—for players and retailers.

Consumers prefer choice and respond much better when you bring your products to them, via their favored medium and channel, and support their ideal way of paying. While cash will never go away completely, it is no longer preferred, particularly with the younger generation, who shop with a card or their mobile device and often don't even carry cash.

Your retailers and players, current and prospective, will be more receptive to a cashless lottery, its brand, and its products.

Ultimately, this is about optimizing profits for the lottery and its retailer partners.

While there are costs related to cashless, they are an investment in the future growth of lottery sales.

It is important to view cashless as an "investment" as we review its related costs—the banking fees—and who should bear these costs—the lottery or the retailer.

Let's begin with an explanation of the components of banking fees related to accepting credit and debit cards. There are quite a few layers to this, each with fixed and/or variable cost components, including:

- **Interchange** that is paid to the issuer of the card.
- **Acquirer Fees** for the merchant banking partner who processes the transaction.
- **Network Assessments** owed to the payment network (e.g., Visa or MasterCard).
- **Chargebacks** related to customer disputes or fraud.

Most retailers don't review this at the individual transaction and fee component level. Rather, they typically review the total

Exhibit 1: An example of the banking fees involved in accepting credit and debit cards.

banking fees across all of their card sales and calculate a blended rate for accepting credit and debit cards.

Interchange:

Rather than go into the complexity and details of all of these fees, we'll focus on Interchange, the most prominent of the fees that best illustrates the concept of a blended rate and the impact of the fixed and variable components.

Interchange can be very complicated—there are many interchange categories established by each of the payment networks across their range of products (credit, debit, gold, platinum, corporate, etc.) as well as the different categories of merchant. For this exercise, we'll use the most common Visa interchange categories we expect to see for retail lottery transactions.

For "Regulated Visa Check Cards" (Visa Debit Cards issued by banks with more than $10B in assets), the rate of 0.05% + $0.21 is particularly illustrative of the challenges that exist for small-dollar transactions. On a $1 transaction, interchange alone would result in a blended rate of 22%. That is simply not sustainable in our business; however, as you move to $10 or $25 transactions, the blended rate drops quickly to a much more manageable level of 2.2% and 0.9%, respectively.

The Credit rate, "CPS/Retail 2" at $0.05 + 1.43%, has much less of an impact on small-dollar sales, with a blended rate for a $1 transaction down to 6.4%—still problematic for a $1 sale, but higher amounts also bring the credit interchange rate to a more manageable level.

To fully understand the impact of these fees, lotteries should think differently about Clerk-Activated vs. Self-Service sales.

Clerk-activated lottery sales are likely part of a larger shopping basket, for which the retailer will have already incurred all of the fixed banking fees for the non-lottery parts of the transaction. If a consumer adds lottery to an existing transaction for the purchase of bread, milk, and cereal, the retailer's banking fees only increase by the variable cost components. In the debit card example shown above, the $0.21 is already covered in the non-lottery purchase, so the incremental interchange on the lottery ticket is only 0.05%. We see the same effect on the credit interchange—only the 1.43% applies.

Therefore, for clerk-activated lottery transactions, a business case can be made for the retailer to incur the banking fees, since the lottery products are part of a larger transaction, and they're already paying the fixed fee components for the non-lottery items in the basket.

Clerk-Activated Transactions: Incremental cost of lottery to an existing shopping basket

DEBIT Card: $0.21 + 0.05%			CREDIT Card: $0.05 + 1.43%		
The Rate:			**The Rate:**		
Variable:	0.05%		Variable:	1.43%	
Fixed:	~~$0.21~~		Fixed:	~~$0.05~~	
The Impact:			**The Impact:**		
$1 purchase:	~~22.0%~~	0.05%	$1 purchase:	~~6.4%~~	1.43%
$10 purchase:	~~2.2%~~	0.05%	$10 purchase:	~~1.9%~~	1.43%
$25 purchase:	~~0.9%~~	0.05%	$25 purchase:	~~1.6%~~	1.43%

Exhibit 2: When lottery is part of a larger shopping basket, only the variable fees apply when looking at the marginal cost of accepting credit transactions.

However, self-service lottery sales must bear the full economics of the banking fees.

Unfortunately, self-service lottery sales stand alone and incur the full set of banking fees, fixed and variable; however, it is expected that enabling card purchases will drive incremental sales. After a review with Visa and leading merchant acquirer Vantiv, we looked at other markets, including fast-food restaurant, vending machines, etc.—lottery could see as much as an 18% sales lift on card-enabled self-service machines. While banking fees could consume much of a retailer's commission if the retailer pays them, lottery profits on these incremental sales should be at least five times the banking fees—a solid return on the "investment." Therefore, lotteries should consider bearing the cost of the banking fees for the self-service environment.

To illustrate the business case, the following is a simple example of the self-service machine economics.

Assumptions:

- Weekly sales per unit: $3,500.
- Incremental sales: 18%.
- Cannibalization of existing cash sales: 20%.
  - NOTE: the reality is that some existing cash transactions will convert to card sales, for which banking fees will incur.
- Average card transaction: $15 assumption.
  - NOTE: we have a few data points in the market that give us confidence this is a realistic benchmark, perhaps even conservative.
- Card type(s) accepted: debit cards only.
- Blended rate for all banking fees: 2.15%.
- Lottery profit: 30%.
- Retailer commission: 6%.

So what does all of that mean? If enabling cashless results in an 18% lift in sales, that is going to equate to another $630 in sales per week from that individual machine—that delivers an additional $189 in profit to the lottery and $38 in commission to the retailer. A 2.15% blended rate for banking fees on both the incremental and the cannibalized sales means a cost of around $29.

Were the Lottery to bear these fees, the investment of $29 will return $189 in additional profits to good causes—a very compelling case for cashless. In sharp contrast to that, if retailers have to pay the banking fees, they would lose the majority of their commission earned on those incremental sales.

Of course, we are not limited to all-or-nothing in the distribution of the fees between the lottery and the retailer—lotteries could also introduce a model where the retailer earns a slightly lower commission percentage on cashless sales and the lottery covers the rest of the banking fees.

Regardless, lotteries are encouraged to view cashless costs as an investment and embrace the expanded payment options, driving incremental sales and higher profits to good causes.

Cashless card brand (Visa/MasterCard) rules:

Lotteries should also be aware of the rules in place by Visa and MasterCard. Several lotteries have stated a preference to shift the costs to consumers by charging them a convenience fee. While this is quite common across state governments (for driver's licenses, tuition, tax payments, etc.), it is important to remember that those are mandatory government transactions—we are in the entertainment business. And again, if the goal is maximizing profits and engaging players, lotteries will not benefit by raising barriers.

Setting aside the philosophical debate, there are also challenges within the card brand rules. The rules, as they stand now, provide the ability to charge a fee for the convenience of a channel, but do not allow addition of a surcharge only to card transactions. So, while you may impose a convenience fee on all payment methods through a specific channel, you may not assign a surcharge to debit or credit cards when cash has no fee. Lottery does not qualify for the right to impose a surcharge similar to other areas of state government.

A second card rule that impacts the cashless business model regards requiring minimum transaction amounts for card transactions. While setting a minimum is an effective way for lotteries to manage the all-important average transaction amount and reduce the impact of the blended rate, this is quite limited under Visa/MasterCard rules. A minimum is permitted for credit cards; however, it can't be any higher than $10. As for debit card sales, lotteries are currently not permitted to enforce a minimum transaction amount.

Public policy and the need for a lottery industry cashless strategy.

Last, but not least, any discussion of cashless for lotteries must include an honest discussion of the public policy implications of accepting credit cards. Regardless of what a state statute allows, each lottery needs to have a thoughtful conversation with its stakeholders and decide whether the lottery should implement debit-only sales or also accept credit cards for lottery purchases.

Conclusion:

While we still have much to learn and prove about the benefits of cashless, it represents a significant opportunity for the lottery industry to engage the next generation of players, support retail partners, and drive incremental profits for good causes. This is a shared need across all lotteries and their technology partners which will benefit greatly from a concerted industry effort to share learnings and best practices, and engage the payment networks to optimize the positive impacts of enabling cashless payments across lottery retail networks. ■

Self-Service: Should lottery bear cost of banking fees?

Self-Services Assumptions:		LOTTERY	RETAILER
Debit card only Weekly Sales: $3,500 (self-service per unit)	Incremental Sales	$630	$630
Sales Lift: 18% Cannibalization of Cash: 20%	Profit / Commission	$189	$38
Average Ticket: $15 Banking Fees: 2.15%	Banking Fees	($29)	($29)
Lottery Profit 30% Retailer Commission 6%	Net	$160	$9

Exhibit 3: Hypothetical comparison of Return on Investment for lottery and retailer if banking fees are included.

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