
Mystic Lake

Cash Back to Free Play

How we got from there to here

By Andrew Klebanow

Non-negotiable slot credits, or what is more commonly known as "free play," has emerged as the most often-used tool in the casino marketing arsenal. It has supplanted cash prizes, complimentary dining and invitations to special events as the primary incentive for rewarding player loyalty.

Its use, along with its occasional over-use, has had a profound effect on the slot-machine gaming experience, and while free play certainly has a wealth of benefits, both to casino operators and players, its prolific use has had unintended and often deleterious effects on both parties.

To understand free play, it is first important to understand how the industry came to rely on it. To do so, one must go back to the earliest days of casino management systems and player reward programs. Until the late 1970s, casinos did not possess electronic methodologies to measure slot machine performance or player participation. In fact, until the introduction of casinos in Atlantic City, slot machine players were not considered to be nearly as important as table game players. That changed with the opening of the Resorts Casino and the subsequent waves of casinos opening on the Boardwalk and in the Marina district.

The volume of slot machine handle that was seen in Atlantic City was mind-boggling, and slot machine revenue soon eclipsed table game revenue. While casino operators had previously developed basic manual methodologies to track and reward table game play, slot machine gaming required electronic methodologies. In Atlantic City, individual operators developed their own internal systems, some of which eventually were acquired by slot machine manufacturers. In fact, most of today's casino management systems have their roots in Atlantic City casinos.

Once casinos were able to link machines to central computer systems that monitored wagering volume, jackpots and hopper functions at the machine level, operators were able to add on rudimentary systems to track individual player activity. Slot clubs were developed so casino operators could identify their more profitable customers and encourage them to return.

To get customers to use their cards, operators had to offer some sort of incentive. The term "points" was introduced as an easy-to-understand benefit. Players earned points based on coin wagering volume, and those points could then be redeemed for something of value. While some casinos allowed patrons to redeem their points for logo wear, gift shop purchases or even merchandise in catalogues, the majority of operators opted for cash back, essentially a rebate on slot wagering volume.

Cash back was an ideal solution. Merchandise required casinos to keep an inventory of stuff on property and catalogues required frequent updates, as items often changed.

Unlike merchandise, casinos always had a sufficient inventory of cash on hand for point redemptions, and unlike merchandise, a player could always insert the cash they just received back into the slot machine.

Casino operators then introduced other marketing programs, most notably in the form of casino "cheques" mailed to players as an incentive to return. These cheques could be redeemed for cash only at the casino's cashier cage, and more or less guaranteed that a player returning to Atlantic City would stop by the casino to redeem their offer. This became the foundation of today's loyalty mail programs.

Unfortunately, cash was a very real and very large expense that appeared on casino income statements. Points redeemed for cash, direct mail offers redeemed for cash, and cash drawings all had their own line items on the income statement, and combined, made up the lion's share of casino marketing expenses. Casino leadership closely monitored the cost of each of these marketing incentives and tried to identify the optimal amount to give players.

From Cash to Free Play

As cash back became the standard reward for point redemptions and bounce-back mail offers, some casino operators sensed that some of the money that customers received was not getting played back in their slot machines. Casino operators wanted a chance to win some (or all) of the money they gave back to customers. What they wanted was free play, a non-negotiable slot credit that a customer had to cycle through a machine before they could hit the cash-out button.

By the mid 1990s, casino operators were clamoring slot system providers for free play. Unfortunately, there were a variety of technical and regulatory hurdles that had to be overcome. Machines from different manufacturers had to have common slot accounting system (SAS) protocols.

Regulators also wanted robust technical standards in place since the issuance of free play required a connection to the most valuable part of a slot machine: its credit meter. It was not until SAS 5 protocols were developed in the late 1990s, and tested in each individual jurisdiction, that free play could be introduced and made available on all new slot machines. Then, those new machines had to work their way onto casinos floors through normal replacement cycles. It was not until after 2005 that casino operators were able to offer free play on most, if not all of their machines.

Free Play and the Income Statement

Once free play became available, another issue arose. How should free play be treated on the income statement? Should points redeemable for free play, which are essentially a rebate for past gaming activity, remain as an expense on the income statement as points redeemed for cash back once were? Should direct mail offers, which are essentially incentives to return (and a discount on future wagering activity) be treated the same way? Should the cost of free play be discounted by the casino's aggregate slot hold to yield a net expense?

Accounting firms, regulators and auditors debated these questions. Accounting standards have evolved, and today the vast majority of free play has moved off the income statement. Free play is now deducted from gross slot revenue to yield net slot revenue. While the free play appears in a contra revenue account, it is no longer an expense on the income statement.

The effect of this has had a profound impact on casino marketing practices. No longer shackled by very real and large expenses that used to appear on their income statements, casino marketers were free to increase the amount of free play that they could offer, and they have developed a myriad of ways to issue it. Mail offers, points redeemed, new member incentives, drawings, hot seats, even rewards to people sitting next to a jackpot winner became common methods of issuing free play.

With the cost of free play removed from the income statement, other marketing expenses fell under greater cost scrutiny. Complimentary meals (comps) is one such example.

At one time, a casino viewed cash incentives and comps as more or less equal expenses. With free play removed from the income statement, the cost of comps became more glaring. Add in the fact that most casinos' food and beverage departments operate at a loss, and comps are now the most expensive component of a casino's loyalty program. In other words, it is far cheaper to give a customer $30 in free play than a coupon for a $20 meal.

Free Play and Taxation

Free play also has affected the amount of gaming taxes a commercial casino may pay to the jurisdiction in which it operates. Prior to the days of free play, a casino would issue cash as an incentive. Customers would in turn either wager that money or put it in their pockets. If they wagered it and casinos won their money back, the casinos were obligated to pay gaming taxes on the very money they gave to their players. Put more simply, casino operators were their own best customers and the states in which they operated reaped the most benefit.

The issue of free play and taxation is treated differently by each state and taxing jurisdiction. For example, in Pennsylvania, with an onerously high tax rate of 54 percent, casinos are permitted to deduct free play redeemed from their taxable gaming revenue. Casinos in some other jurisdictions are not. This allows Pennsylvania's casino operators to extend more generous free play offers than casinos in other states.

Free play is used so liberally there that it accounts for nearly 20 percent of Pennsylvania's gross slot revenue. While Pennsylvania represents an extreme example, the ability to keep free play costs off income statements has led many operators to issue free play well in excess of 10 percent of gross slot revenue.

Accounting standards have evolved, and today the vast majority of free play has moved off the income statement. Free play is now deducted from gross slot revenue to yield net slot revenue. While the free play appears in a contra revenue account, it is no longer an expense on the income statement.

[redacted]

Free play has certainly transformed the casino industry. It has allowed operators to find new ways to stimulate repeat visitation and foster loyalty. **It provides customers with convenient ways to redeem offers by eliminating the need for paper coupons.** It has made casinos appear more profitable by shifting certain marketing expenses off the income statement, and it has allowed casinos in some jurisdictions to reduce their gaming tax liability.

On the other hand, it has driven up slot hold percentages, created inequities for casinos in states that do not allow for the deductibility of free play from their gaming taxes **and, for those casinos that do not monitor and measure the effects of all of their free play campaigns, over-spend on marketing incentives.**

Free Play and Gaming Experiences

While one can argue that free play has no downside, the transition from cash back has had a number of unintended consequences. Its greatest impact is on slot floor hold. Since the early 2000s when free play was introduced, slot machine hold rates have steadily increased.

This was due to a number of factors, including the growing popularity of higher-hold multi-line video reel slot machines, which reduced the volatility associated with traditional reel machines. Nevertheless, slot directors, faced with ever-growing increases in gross wagering handle, comprised of both cash and free play, observed their slot hold percentages going down.

To counteract this trend, they would purchase machines with higher slot hold rates or switch out the chips in those machines already on their gaming floors. This in turn impacted players' gaming experiences, particularly for those customers who did not receive free play offers. A regular customer at a casino in Pennsylvania may receive a free play offer equal to 25 percent of their daily loss, and would not notice they were playing a very high-hold slot machine. On the other hand, a first-time visitor or anyone without a free play coupon would probably not have a favorable experience.

Where Will It End?

Taken to a logical progression, one can see free play being used for virtually all casino promotions. Take for example the time-honored "Win This Car" casino promotion. Often casinos will have a month-long promotion, culminating in a grand prize drawing for a free car. Typically, the winner is offered the option of taking the car or a lesser amount in cash. Since the winner is obligated to pay income taxes on the value of the car, a smaller cash option is often the better alternative.

Assuming the car has a retail price of $30,000, the winner would probably have a tax obligation of $9,000. The casino would in turn have a promotional expense of $30,000 that would appear on their income statement. By offering the winner a cash option of $20,000, the casino could reduce that expense by $10,000 and the customer could use a portion of the cash to pay their tax obligation, now around $6,000.

Alternatively, the casino might offer the winner a third option: $30,000 in free play, with some cap on the amount that could be redeemed on any one day. The advantage to the casino is that the $30,000 will not appear on the income statement. The advantage to the player is that the issuance of free play is not recognized as a taxable event. A regular visitor to the casino may find it more advantageous (and entertaining) to gamble with the casino's money for a few months. The problem again is the amount of free play that will be cycled through the casino's slot machines will bring down the slot floor's hold, thus stimulating the future purchase of even higher-hold machines.

What About Measurement?

Prior to the age of free play, when cash was the primary tool in casino marketing, each kind of promotion (points redeemed for cash, direct mail offers redeemed, drawings, etc.) had their own line items within the income statement. Each line item was budgeted, monitored, and their results measured. With free play, these line items have disappeared, and with it, the obligation to measure each marketing program's impact on profitability.

Free play has certainly transformed the casino industry. It has allowed operators to find new ways to stimulate repeat visitation and foster loyalty. It provides customers with convenient ways to redeem offers by eliminating the need for paper coupons. It has made casinos appear more profitable by shifting certain marketing expenses off the income statement, and it has allowed casinos in some jurisdictions to reduce their gaming tax liability. On the other hand, it has driven up slot hold percentages, created inequities for casinos in states that do not allow for the deductibility of free play from their gaming taxes and, for those casinos that do not monitor and measure the effects of all of their free play campaigns, over-spend on marketing incentives.

At some point, each casino operator needs to step back and recall how cash incentives were once seen as a very expensive way to reward loyalty and how, getting from there to here, they might have lost sight of the true value of free play.

Andrew Klebanow is a senior partner at Global Market Advisors, a hospitality and tourism consulting firm. He has worked in the hospitality and gaming industries since 1975, and in the fields of casino marketing and business planning since 1991. Klebanow has served in a number of management and executive positions in the gaming industry and is a periodic lecturer at the University of Nevada, Reno's School of Continuing Education and Cornell University's School of Hotel Administration.