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Articles

Emerging Issues in the Use of Free Play

by Andrew Klebanow

Emerging Issues in the Use of Free Play

Non-negotiable slot credits, or what is commonly called free play has become the primary form of customer incentives in many casinos around the globe and has essentially replaced cash in those jurisdictions that permit it. Free play is now used instead of cash for point redemptions, mail coupons and a variety of promotions including bounce back offers, hot seat awards and celebration jackpots. Combined, these various forms of free play have become the single greatest component of player reinvestment. The increased use of free play has also created unintended consequences that were not anticipated at its inception. Free play has affected multiple departments within the casino including Slots, Marketing, Accounting and Finance. For many casinos, the unanticipated impact of free play is only now being felt. This article attempts to identify the emerging issues of free play and how they are impacting customer satisfaction and casino profitability.

Accounting for free play

One of the primary issues regarding free play is how to account for it on the income statement and what costs should appear. There is a dramatic range of opinions on how free play should be accounted for and how its effects should be measured. Does a dollar in free play cost a dollar? Is it free or is its cost somewhere in between? Views differ depending if you are a regulator, accounting manager, marketing executive or senior executive.

There are those who would argue that free play is simply a marketing tool that allows a customer to initiate a handle pull and any winnings generated by that handle pull will eventually be cycled back into the machine. To them there is no real cost to the casino except perhaps, in a modest reduction of slot hold, which can be periodically increased to compensate for that loss. The "free play is free" contingent believes that, unlike cash, free play should not show up as a marketing expense on the income statement and can simply be tracked in a contra revenue account. Casino marketers in particular like this approach since it allows them to dramatically increase their marketing expense without requiring an increase in their marketing budgets.

Others would argue that free play should be booked as cash, less the aggregate hold of the slot floor. For example, if a customer receives \$100 in free play and the slot floor hold is 8%, then \$92 should be booked as an expense. Still others believe that, since free play can be cycled through the machine only once and any winnings generated from that cycle can be redeemed for cash, free play should be booked at 100% of its value, just as if it were cash.

In many jurisdictions, free play redemptions are treated just like cash coupons in which the state or governing body taxes free play at the same tax rate as gaming revenue. Until 2009, the West Virginia Lottery viewed free play issued by a racino to be the same as a cash coupon. Any coupons that were redeemed and played into a slot machine were taxed at an effective tax rate of 57% as if it were net machine revenue. This essentially made West Virginia's three racinos the state lottery's best customers. Pennsylvania on the other hand, allowed its casinos to deduct free play as a promotional expense from net machine revenue before gaming taxes were applied. This put West Virginia's casinos at a severe disadvantage to its competitors. In 2009 the West Virginia Lottery altered its regulations and allowed its three racinos to issue free play without tax implications with the hope that it would allow the racinos to generate more gaming revenue for the state and make the casinos more competitive.

Other jurisdictions continue to treat free play as if it were cash or prohibit its introduction. Both Colorado and South Dakota do not permit the issuance of free play. Casinos in those markets must issue cash coupons, which when played are taxed as gaming revenue. Casinos then book those cash redemptions as an expense on their income statements. Again, the sole beneficiaries of such regulations are the state governments. This policy also affects Indian casinos in those jurisdictions where a percentage of gaming revenue is shared with the state. Even though Indian casinos issue promotional free play offers, redemptions are still viewed by the state as gaming revenue, from which a share must be paid.

While there is no clear and consistent policies regarding free play on the income statement, failure to the

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very least note it (as revenue and offsetting expense) on the income statement creates a situation where management loses sight of the amount of free play issued. Contra revenue accounts alone cannot accomplish this. Marketing, Slots, Accounting and Finance all need to know how much free play the casino is issuing and both the daily operating report and monthly income statement are appropriate vehicles for that purpose.

Until the industry adopts standard accounting practices for free play, each casino company is left to decide how best to show this expense or whether to show it all.

Cash protection and free play protection

It can be argued, quite forcefully, that free play is much like cash. A patron can redeem a free play offer, wager that free play once and cash out whatever drops to the slot machine's win meter. In this case, free play is pretty much like cash and therefore it needs to be protected, just like cash.

Casino operators are very good at protecting cash and long ago developed controls to protect its most liquid asset. Cash is kept in a vault. The vault is usually surrounded by a cashier's cage. The cage is normally in clear view of a security officer seated in an elevated podium. A plethora of alarms and other security devices protect that cash and cameras monitor the movement of cash within the vault, the cage and at the cashier's cage window.

Casinos have long had in place methodologies to distribute cash and to properly account for those dispersals. Take for instance the redemption of slot club points for cash back. First a customer would go to the players' club booth and present their identification and players' club card. The players' club representative would verify the customer's identity; look up the customer's account and issue a redemption through the casino management system. A coupon, often called script, would then be printed on check-like paper (in triplicate) with a unique identifying number in red ink. Often a supervisor would be required to initial the script before giving it to the customer. The customer would then go to the cashier's cage, where once again identification would be requested. The cashier would verify the amount, verify the redemption on a computer terminal and then give the customer their cash. A security camera would record the transaction. The coupon would then be sent to revenue audit where the transaction would be reconciled. The total amount of cash issued for points would appear on the next day's daily operating report and on the monthly income statement as an expense, charged to either the slot department or players club.

Point redemptions for free play are, for the most part, electronic. A customer can simply sit down at a machine, insert their players' club card in a reader box, enter their personal identification number, and convert bonus points to free play. Some casinos, because of system limitations, make a customer stop by the rewards center to verify the account before issuing free play. The former is far more convenient for both the customer and casino operator and requires far less labor. There of course is an audit trail and the total amount of points redeemed may be accounted for in a contra revenue account or some other internal audit process. However, since it is no longer a cash expense, points redeemed for free play does have to appear on the daily operating report or the income statement. The cost of bonus point redemptions can easily fade from view.

Free play and promotions

Now compare a promotion that offers cash with one that offers free play. For example, casino marketing decides to offer new members \$10 if a customer brings in a coupon from a local newspaper. In a cash redemption setting, this promotion would require some kind of documentation before implementation. This may be in the form of a proposal form that requires the signature of the general manager and director of finance. Once approved, ads would be created, coupons would be printed and a process to issue the \$10 rewards would be designed. Memos would then be distributed to the cage manager, accounting department and others along with samples of the ads. New members would be required to present identification at the rewards center; enrolled into the system, issued a coupon, which would then be presented to the cashier's cage for redemption. Once again, those redeemed coupons would be audited and recorded in an account titled New Member promotion.

With electronic free play, the process is different. To create a promotion that rewards customers with free play, one must have access to an electronic marketing module in the casino management system and a "permission" to create a promotion. Normally those permissions are issued by the IT director to either a promotions manager or marketing director. Since there is no cash involved, the whole promotions approval process described above is easily eliminated. Neither the finance director nor accounting manager need be involved; nor does the cage manager, slot director or even the general manager. Marketing can now simply create a promotion, issue a memo to the rewards center and conduct the promotion. Revenue audit would record the issuance of the free play in the contra revenue account along with all other free play promotions.

The problem is that under the electronic free play scenario, marketing is free to create as many free play offers as it sees fit. Multiple free play offers can be easily layered on top of one another, blurring any analyst's ability to measure the effects of a particular promotion. Marketing could create one promotion where every hotel guest gets \$20 in free play and another one where every new member gets \$10 in free play and a third where buying a meal in a restaurant earns another \$10 in free play. These new members can then redeem \$40 in free play without ever having demonstrated any gaming worth. Worse, measuring the effects of any one promotion is now impossible.

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Furthermore, without a traditional promotions development process where a promotion is proposed, approved, implemented and measured, anyone with permission to create a free play promotion can do so. Marketing has the ability to create dozens of free play promotions. When free play is not accounted for as an expense on the income statement then Marketing is free to create an endless stream of offers with no consequence to their budget. After all, it's free play, which means it must be free.

Free play and slot hold

Free play in all its permutations can have a profound effect on the casino's slot hold. The slot hold percentage is a critical component of any casino's pricing strategy and pricing strategy is the domain of senior leadership – not the promotions manager. Leadership decides the marketing position of the property; the pricing strategy for the hotel, restaurants and casino and instructs the slot director what the target hold rate should be.

When marketing floods its database with free play offers, it artificially increases slot handle and decreases slot hold (because free play does not increase slot drop). When this happens, the inclination of the slot director, who is accountable for monitoring slot floor hold, is to gradually increase the hold percentage of his/her machines until the floor returns to its configured par. What happens is that frequent gamers who are members of the rewards program and are the recipients of most of the free play offers are incentivized to come into the casino and continue to receive sufficient gaming value, even if the slot hold has increased. On the other hand, casual gamers, first time visitors and those avid players who do not use their reward cards because of superstition begin to sense that the casino is tightening up their games. They see less value from their gaming budget and in turn reduce their levels of visitation or simply go elsewhere.

This problem is exacerbated by the fact that only a small percentage of a casino's customers actually receive free play offers. Typically, a casino will have a carded win rate of 40%-60% (revenue that is generated by patrons using their rewards cards). However, that carded revenue is not being generated by 50% of the casino's customers. In all likelihood it is being generated by less than 20% of all the customers that walk into the casino. Thus the higher slot hold affects most of the casino's customers since they do not receive free play offers.

Furthermore, casinos promotions often ebb and flow. Marketing may increase the volume of free play promotions during slow periods and decrease them during peak demand periods. In such situations, the slot director may not recognize nor care to react to the reduction in free play volume and lower his slot hold. The net result is that even past recipients of free play offers sense that the slot machines got tighter and their gaming experiences are soured.

Free play and participation agreements

Participation agreements are affected by free play. Indian casinos in Oklahoma offer an example. Class II game providers place their machines in casinos on a participation basis where a percentage of gaming revenue is paid to the game provider. Typically, the game provider would be paid 20% and the casino would retain 80%.

Recently, improvements in casino management systems have allowed Oklahoma casinos to offer free play and many have done so. However some casinos have introduced promotional free play without first negotiating revisions to those participation agreements. The net result is that the casino pays a participation fee not only on the gaming revenues that customers spend but also on the free play offers that are redeemed. It is therefore imperative that a casino operator insist that free play be deducted from net gaming revenue prior to participation. If the vendor refuses then those machines should be excluded from free play redemptions.

Free play and player reinvestment

Free play in all its iterations has now become the largest component of player reinvestment, surpassing meal comps, hotel offers and entertainment tickets. As such, when calculating the player reinvestment rate, whether at the player level, group level or total database level, it is essential that free play be booked just as one would cash, regardless how it is addressed on the income statement. Without monitoring the player reinvestment rate on an ongoing basis and the effect that free play has on it a casino could easily see its player reinvestment rate rise above 40%.

Free play is an invaluable tool for a casino. It allows the casino to reduce mail costs and eliminate paper coupons. It can eliminate lines at the reward center and incentive customers at the machine. It allows marketers to create new promotions that reward slot players. However, as its use proliferates, issues have arisen, and will continue to arise that were never anticipated when slot system programmers first began writing the software for free play.

How and when to use free play are decisions that Marketing alone cannot answer. The use free play must involve senior leadership, Accounting, Finance, Slots as well as Marketing. Free play must first be grounded in a sound player reinvestment strategy and be part of the casino's slot pricing strategy. Once strategies are formulated, free play tactics can be created along with accounting rules and measurement tools. Without a disciplined approach, free play has the potential of creating unintended consequences that can have a profound and negative effect on casino profitability.