
Secretary of State

State of Oregon

OREGON STATE LOTTERY COMMISSION

Lottery Retailer Oversight



Audits Division

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This report contains the results of our audit of the Oregon State Lottery Commission (Lottery). Our audit found that the Lottery is not effectively enforcing its rule intended to prevent retailers from operating as casinos. The Oregon Constitution prohibits casinos from operating in Oregon. While the Legislative Assembly and the courts have not defined the term "casino," our review found that a number of businesses in Oregon appear to be primarily in the business of making money from video poker. In our opinion, these are the types of businesses that the people did not want when they agreed to a constitutional ban on casinos.

OREGON AUDITS DIVISION

John N. Lattimer
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EXECUTIVE SUMMARY

Background and Purpose

The Oregon Lottery operates video poker machines through 1,850 video poker retailers. Last year, more than \$5 billion was wagered on video poker in Oregon.

The purpose of this audit was to review the Oregon Lottery to assess its oversight of several retailer-related issues, including whether Lottery is taking sufficient steps to ensure that lottery retailers are not operating as casinos. The Oregon Constitution prohibits casinos from operating in Oregon. The Oregon Supreme Court concluded that the voters intended to prohibit “the operation of establishments whose dominant use or dominant purpose, or both, is for gambling.” Lottery games are supposed to be an adjunct to an existing business — not the business’ primary focus.

Results in Brief

Fourteen percent of the high-volume video poker retailers appeared to be casinos.

Specifically, we found that:

- Lottery was not effectively enforcing its rule intended to prevent retailers from operating as casinos. We found that 14 percent of the high-volume video poker retailers appeared to be casinos, in that more than 60 percent of their income came from video poker. We further found several weaknesses in Lottery’s initial application process and its process to ensure ongoing compliance.

In addition we noted:

- Lottery’s administrative expense limit may be too high. Currently, Lottery can spend up to 16 percent of its total revenues on administrative expenses. When determining the amount of revenue to base its administrative expenses on, Lottery includes video poker credits played in its revenue figures, rather than actual cash received. By using this figure, Lottery theoretically could spend as much as \$958 million. This amount, however, is more than the actual cash received by the state. If the purpose of the 16 percent limit is to act as a cost control, it is not accomplishing this.

- The award of some Lottery contracts is questionable. In one case, Lottery granted a contract to a retailer who was in violation of Lottery Commission rules. This retailer's control person had a felony conviction within 10 years of the application date.
- Lottery retailers are not all wheelchair accessible. We found that 48 percent of our sample of high-volume video poker retailers were not adhering to the Lottery commission's wheelchair rule. Many retailers lacked wheelchair parking spaces, aisles, or signs, yet most of these retailers certified to Lottery that they were accessible.
- We reviewed a sample of the Lottery retailer reviews and retailer files and found some files lacked adequate documentation to support its conclusions and the decisions that were made.

Agency Response

The Oregon State Lottery's response can be found on page 23.

Background and Introduction

The Oregon State Lottery Commission was created through the initiative process by an amendment to the Oregon Constitution in 1984.¹ The commission was created to establish and operate the Oregon State Lottery (Lottery) and is comprised of five members appointed by the governor and confirmed by the Senate. The governor also appoints a director, subject to confirmation of the Senate, who is responsible for operating the Lottery pursuant to the rules and under the guidance of the commission. Lottery offers gambling games to players such as its instant games (Scratch-its and Breakopens) and on-line games (Megabucks, Powerball, Keno, and Sports Action). The commission added video games (Video Poker) in 1992.

The commission has the authority to adopt and enforce rules to carry out Oregon law. The commission is required to adopt rules specifying the terms and conditions for contracting with Lottery game retailers so as to provide adequate and convenient availability of tickets to prospective buyers of each lottery game as appropriate for each such game.²

The director shall, pursuant to Oregon law and the rules of the commission, select as Lottery game retailers, such persons as deemed to best serve the public convenience and promote the sale of tickets or shares.³ Currently, there are approximately 2,500 “traditional” Lottery retailers and about 1,850 video poker retailers. Some retailers have both traditional and video poker games.

¹ Article XV, Section 4(3)

² ORS 461.300(1)

³ ORS 461.300(2)(a)

Audit Results: Lottery is Not Effectively Enforcing Its Rule Intended to Prevent Retailers From Operating as Casinos

The Oregon Constitution prohibits casinos from operating in Oregon.

The Oregon Supreme Court concluded that the dominant use or purpose of an establishment could not be gambling.

Lottery Commission defined “dominant use or purpose” as lottery commissions not exceeding 60 percent of total income.

The Oregon Constitution prohibits casinos from operating in the state of Oregon.⁴ In 1989 and 1991, Oregon laws were passed allowing Lottery to offer and regulate video poker in retail establishments. By 1992, Lottery video poker was operating in Oregon retailer establishments.

In 1994, a case went before the Oregon Supreme Court alleging that state-sponsored video poker has the effect of creating casino gambling in the State of Oregon. According to the Oregon Supreme Court, examining the text and context of the constitutional prohibition against “casinos,” the Court concluded that in adopting that provision, the voters intended to prohibit “the operation of establishments whose dominant use or dominant purpose, or both, is for gambling.”⁵ In other words, the courts held that the presence of Video Lottery did not constitute a casino unless gambling was the dominant use or dominant purpose of the business. Because the courts and the Legislative Assembly have not defined the terms “casino” or “dominant use or dominant purpose,” the Lottery Commission subsequently adopted a dominant use/dominant purpose rule to regulate these activities.

The Lottery Commission's rule defined the “dominant use or dominant purpose” of a retailer as the sale of Lottery games if the retailer's Lottery commissions exceed 60 percent of their total income from sales. The Lottery Commission rule requires the Lottery director to make a determination that the dominant use or dominant purpose of a retailer will not be Lottery games before entering into a contract with any person.⁶

⁴ Oregon Constitution, Article XV, Section 4. (7): "The Legislative Assembly has no power to authorize, and shall prohibit, casinos from operation in the State of Oregon."

⁵ Supreme Court Media Release dated April 7, 1994. Ecumenical Ministries of Oregon et al v. Oregon State Lottery Commission et al, 318 Or. 551, 871 P2d 106 (1994).

⁶ OAR 177-100-0155(3). The percentage was sixty-six and two-thirds prior to January 1, 1999.

Some Lottery Retailers Appear to Be Casinos

Fourteen percent of the retailers appear to be casinos.

We found that 14 percent of the high volume video poker retailers we sampled were in violation of the commission's 60 percent rule. We, therefore, estimate that between 60 and 73 of Lottery's 464 high-volume video poker retailers may be casinos, in that their dominant use or dominant purpose is gambling, as defined by the commission rule.⁷

A variety of retail establishments offer Oregon video poker:

- Restaurant and Lounge.
- Tavern.
- Deli.
- Convenience Store.

None of the restaurants and lounges we reviewed were out of compliance with the 60 percent rule.

Restaurant and Lounge. We found that this type of a retailer typically offers a wide assortment of food and beverages. With these retailers, the Lottery is clearly an adjunct to the business of selling food and beverages. These types of retailers tend to be at a lower risk of being out of compliance with the 60 percent rule because of their large volume of food and beverage sales. Two retailers we reviewed are good examples of Lottery as an adjunct to the business of selling food and beverages in the 1999 fiscal year. One restaurant and lounge had \$1.6 million in food sales and \$124,000 in alcohol sales.⁸ This retailer's Lottery commissions were \$247,000, or 12 percent of total sales. Another retailer sold \$1.3 million in food and \$371,000 in alcohol. This retailer's Lottery commissions were \$106,000, or 6 percent of total sales. Of the 25 restaurants and lounges we visited, none were out of compliance with the 60 percent rule.

Tavern. We found that this type of retailer typically offers an assortment of beer and a limited number of food items. Because of their low volume of food sales and low beer prices, these types of retailers are at higher risk of being in violation of the Lottery Commission's 60 percent rule. For example, we noted a tavern that had \$22,000 in food sales and \$110,000 in alcohol sales, and

⁷ Based on our sample methodology, we extrapolated our results to the population, with 95 percent confidence and a precision rate of 10 percent; the high volume retailers earned over \$100,000 in Lottery commissions.

⁸ The food category includes nonalcoholic beverages.

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One of the nine taverns we reviewed was out of compliance with the 60 percent rule.

All of the five delis we reviewed were out of compliance with the 60 percent rule.

We reviewed three lottery retailers that appeared to be convenience stores, contrary to rule.

Lottery commissions of \$141,000, or 51 percent of total annual sales.⁹ Another tavern had food sales of \$11,000, alcohol sales of \$155,000, and Lottery commissions of \$291,000, or 63 percent of total annual sales. Of the nine taverns we visited, one was operating out of compliance with the 60 percent rule.

Deli. We found this type of retailer typically has a menu that includes sandwiches and snack foods. Because of their low volume of food sales, these types of retailers are at higher risk of being in violation of the 60 percent rule. Based on a review of sales information for the delis we visited, it was clear that their businesses were not primarily the sale of food or beverages. Lottery was their main business and was not an adjunct to their deli business. All of the five delis we visited were operating out of compliance with the 60 percent rule.

Three of the delis we visited gave away items such as soft drinks, hot beverages, candy and snacks. In addition to giving away items, the records for one month indicated that the deli purchased cigarettes for \$27.64 a carton and sold them at a loss for \$24.94 per carton.

Convenience Store. This type of retailer offers a variety of take-out items such as greeting cards, newspapers, cigarettes, etc. A Lottery Commission rule prohibits convenience stores from being video poker retailers. The commission defines a convenience store as a retailer that offers a relatively limited line of high-volume grocery and beverage products, and the majority of the products are for consumption off the premises. A convenience store may also sell gasoline and motor vehicle related commodities.¹⁰

We visited three retailers that were in compliance with the 60 percent rule, but appeared to be operating as convenience stores, as that rule is defined in the Lottery Commission rules. One retailer offered a variety of take-out items such as greeting cards, newspapers, laundry items, food and beverages. The majority of its non-lottery sales were grocery and cigarette sales.

The two other retailers we visited in this category appear to be convenience stores, due to the large volume of cigarettes they sell for consumption off the premises. These two retailers were part of a chain of seven similar stores in Southern Oregon. We reviewed the non-lottery sales for a 28-day period and determined that the sales for one retailer were \$60 in food, \$40 in alcohol and \$1,470 in

⁹ The food category includes nonalcoholic beverages.

¹⁰ OAR 177-100-0030 (6) (c)

cigarettes.¹¹ For the two 28-day periods we reviewed, we found that cartons of cigarettes were being sold for little or no profit based on the fact that the cost of cigarettes were greater than the sales for the period. In a period of 15 minutes at one retailer and 30 minutes at the other, we observed that approximately 75 percent of the cigarette sales were for off-premise consumption.

While none of these three retailers were in violation of the 60 percent rule, they did appear to be convenience stores. Under Lottery Commission's current rules, convenience stores are not allowed to offer video poker.

Reasons Casinos are Allowed to Operate

During our review, we noted a number of reasons why casinos have been allowed to operate in Oregon. These reasons fall into two main categories: (1) Weaknesses in Lottery's initial application process, and (2) Weaknesses in Lottery's process to ensure ongoing compliance with the dominant use/purpose rule.

Weaknesses in the Initial Application Process

Retailers interested in selling Lottery products are required to go through an extensive application process. The applicants are required to submit an application that includes information on their past financial and criminal history. The application is then submitted to Lottery and given to the state police. The state police then review and confirm much of the information in the application.

During our review, we noted the following problems with this process that have contributed to the existence of casinos in Oregon:

- Lottery waived the requirement that retailers be in business for a period of time before contracting with them; and
- Lottery did not follow the state police's advice to deny certain contracts.

Lottery waived the rule requiring retailers to prove they are self-sufficient. A Lottery Commission rule restricts the director from contracting with a prospective video poker retailer unless they have been operating continuously for a period of time. The

¹¹ The food category includes nonalcoholic beverages.

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importance of the commission's rule was to ensure that the income from video poker would not be the dominant purpose of the business and that the retailer is a self-sufficient seller of food and beverages. In the past, this rule could be waived if the applicant could demonstrate with clear and convincing information that the income from video poker would not be the dominant purpose of the business.¹² The rule has since been changed in that a waiver is no longer possible. However, we found that the waiver of this rule in the past has contributed to the existence of some of the current casinos in Oregon. Of the six retailers in our sample who were found to be operating in violation of the Lottery's 60 percent rule, three were granted a waiver and were awarded video poker contracts prior to being established for the required period of time. In addition, two other retailers were awarded contracts after only being opened for approximately a month. At the time these two retailers were approved for a lottery contract, the rule that required them to be in business for a specified length of time in order to prove that they were self-sufficient businesses was not yet in existence.

Lottery did not follow the state police's advice to deny certain contracts. Lottery contracts with the state police to operate a security division. When a retailer applies to sell lottery products, the state police receive and review the retailer application. A recommendation is then made about whether or not the retailer should become a Lottery venue. When the state police recommends denial of an application, Lottery reviews the recommendation to see if it is in agreement with the state police. The Lottery director is allowed to reject the state police recommendation and award a contract. Conflicting opinions are not reviewed by or justified to the commission or any other administrative body. We found that the Lottery's not following the state police's advice has contributed to the existence of some of the current casinos in Oregon. Of the six retailers we found operating essentially as casinos, the state police recommended denying three.

Three delis in our sample are part of a chain of 22 delis in the Portland/Metropolitan area. A state police detective and lieutenant had recommended that the delis not be approved for Lottery contracts. A state police report filed with the director explained:

¹² OAR 177-100-030 (3) (d) (A)(B) and (D) The rule has varied from six months with the director able to waive, to one year with the commission able to waive, and finally the current nine months without a waiver.

...as previously stated in the referred memos and 15 previous denials of all *delis for this chain*, the *owner* had originally opened these establishments to accommodate video poker.¹³ As I reported a year-and-a-half ago, the *chain of delis* was to be opened to place the maximum number of VLTs (video lottery terminals) in as many locations as possible. It was, and still is, obvious that these locations are mini-casinos. It is also clear by the *delis'* décor and store advertising, that they are actively promoting a gambling atmosphere.

Another police detective investigated one of the *delis*, and stated, "In an interview with an employee at another *deli* location I was informed that when they received their video poker machines that they would gross four to five thousand dollars a day. This same employee also said, "*the chain of delis* is in the business for gambling, and not for food service."

During our review, we also noted that the state police recommended that Lottery not contract with one of the retailers in our sample that appeared to be a convenience store. During the video poker application process, the state police did an investigation that resulted in a recommendation for denial of video poker. The state police's reasons for the denial recommendation were (1) the age control area had not been set up yet, and (2) "this establishment is a quick stop type of market selling everything from deli type food to small sundries. It is not a tavern or lounge and is not established for these purposes." Lottery did not follow this advice and awarded a contract.

Weaknesses in the Process to Ensure Ongoing Compliance

During our review, we also noted weaknesses in the Lottery's process to ensure ongoing compliance with the 60 percent rule. These weaknesses include the following:

- Lottery does not select retailers for review based on risk;
- Lottery has not continually clarified its policy on what items can be included as non-lottery sales;
- Lottery does not review retailer compliance plans to ensure that

¹³ Italics used when we replaced the actual names of the establishment and owner.

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changes are allowable under Lottery rules;

- Lottery's follow-up reviews are not always timely; and
- Lottery Commission's rule for what constitutes "back in compliance" is weak.

Lottery does not select retailers for review based on risk. A Lottery Commission rule states that the director may initiate reviews of existing retailers as part of a random sample or whenever there is reason to believe that the sale of Lottery games has become the dominant use or purpose of the video poker retailer.¹⁴ Lottery selects its retailers for review based on random selection, with one third of the population being randomly selected for review each year. Using this process can lead to significant delays in detecting retailers who are out of compliance. For example, we reviewed a retailer with a Lottery Auditor in June 2000. This retailer's contract was signed by Lottery in February 1997 and the review in June 2000 was their first dominant use/dominant purpose review. During this review the retailer was found out of compliance with the 60 percent rule. Theoretically, a Lottery retailer could be out of compliance with the 60 percent rule for three years or longer without detection. This method of selecting retailers for review is not the most efficient because Lottery does not obtain and use information on its retailers' total sales to analytically review whether lottery games are becoming a dominant use or purpose of an establishment. Using this information to determine the high-risk retailers for review (e.g. those retailers whose lottery commissions make up more than half of their income) would help Lottery focus its resources on those establishments whose dominant use or dominant purpose is gambling.

Lottery has not continually clarified its policy on what items can be included as non-lottery sales. Lottery's policy on what items are allowed and disallowed when calculating non-lottery sales has not been clearly defined. Lottery's policy lists in general terms items that cannot be included as non-lottery sales, such as the sale of products or services that are not usually sold by or associated with the type of retail establishment being reviewed. However, when issues come up on specific items, and Lottery makes a decision as to whether they are allowed or disallowed, it has not taken sufficient steps to clarify its policy and communicate those decisions to its retailers. For example, a copy of a note in a retailer file, sent from a Lottery Manager to the Field Auditor on

¹⁴ OAR 177-100-0155 (3).

July 13, 1998, explained that Lottery would not include visa surcharges as part of the retailer's non-lottery sales. However, there was no evidence in the file that formal communication was ever sent to the retailer and information regarding these items has not been added to the Lottery Commission rules. In April 2000, nearly two years after Lottery made a determination not to allow visa surcharges, Lottery attempted to terminate this retailer's contract. However, the retailer requested reconsideration on the basis that they should be able to include the visa surcharges as a portion of their non-lottery sales. Lottery did not take steps to clarify the policy in 1998, when it made the determination to not include visa surcharges. In addition to visa surcharges, Lottery has not clarified whether other items, such as ATM fees and long-distance phone cards, should be included when calculating non-lottery sales.

In addition, during our review we noted several items that do not appear to meet the policy, yet they have been allowed in the past. By allowing items that do not appear to meet the rule, Lottery has set a precedent that will be difficult to reverse. For example, Lottery has allowed retailers to count items such as bottles of wine and cases of beer that were sold for consumption off premises, cartons of cigarettes that were sold at cost, and horse racing commissions. These items do not appear to meet Lottery's policy.

Lottery does not review retailer compliance plans to ensure that changes are allowable under Lottery rules. If a retailer is found out of compliance with the 60 percent rule, they are required to submit to Lottery a compliance plan that outlines what changes they will be making during the next six months to get back into compliance. According to Lottery staff, the compliance plans are not reviewed to determine whether the changes are allowable under Lottery rules. By not providing feedback to retailers that the changes they are proposing will be not allowed for inclusion in their next compliance review, it is further opening itself up to legal challenges. For example, one compliance plan we reviewed stated that part of its plan was to begin the sale of decorative glass and other art. At this point, Lottery should have informed the retailer that these items would not be allowed when calculating non-lottery sales in its next review.

Lottery's follow-up reviews are not always timely. When Lottery determines that a retailer is out of compliance with the 60 percent rule, its policy is to conduct a follow-up review six months later to see if the retailer is back in compliance. If the retailer is found to be back in compliance, Lottery's policy is to do another review one year later. While reviewing some of the retailer files, we noted that

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these reviews are not always timely. For example, one retailer was notified that they were out of compliance with the dominant use/dominant purpose rule on November 20, 1997. Lottery notified the retailer nine months later that they were back in compliance (the results of the “six month” review). Finally, Lottery sent the retailer a termination letter because they were back out of compliance on April 5, 2000 (the results of their “one year” review). This termination letter was sent 20 months after the “six month” review letter. Based on the dates that the letters were sent, 29 months had elapsed from initial detection to final termination, whereas only 18 months should have according to Lottery policy. By not conducting follow-up reviews in a timely manner, Lottery is allowing retailers to operate out of compliance for longer periods of time.

Lottery Commission’s rule for what constitutes “back in compliance” is weak. As stated earlier, Lottery’s policy is to go back to the retailer after six months to determine if they are back in compliance. Lottery’s rule for determining whether they are back in compliance with the 60 percent rule is if the retailer’s lottery commissions are less than 60 percent of their total sales for the entire six-month period or for just the sixth month. Allowing the retailer to be considered “back into compliance” by showing compliance for just one month does not appear reasonable. For example, one retailer was found out of compliance during their random audit. The Lottery’s follow-up review at six months found their average Lottery sales over the six-month period to be 65 percent of their total sales. However, during the sixth month the retailer’s Lottery sales were 53 percent of total sales and the retailer was found to be “back in compliance.” This retailer will be allowed to operate for another 12 months before they will be reviewed again. As shown in this case, a retailer can be out of compliance with the 60 percent rule for 17 months, yet be considered in compliance with the rule because of one single month. In addition, this retailer will be allowed to operate for another 12 months before their next review.

Recommendations

We recommend that Lottery do the following:

- Continue to ensure that retailers are viable businesses without Lottery by making businesses operate for the required period of time before entering into contracts with them.
- Work with the state police to ensure that the retail application

process is adequately screening out retailers who will not be able to comply with the 60 percent rule. In addition, the director should justify to the commission decisions to reject state police recommendations for denial.

- Use a risk-based approach (i.e. review those retailers whose lottery commissions make up more than half of their income) when selecting video poker retailers for review. The retailer sales data could be obtained annually, and computer software could be used to aid analytical reviews.
- Further clarify its policy on sales items allowed and disallowed and continually update the policy when rulings are made. Policy clarifications should be clearly and timely communicated to the retailers.
- Review the compliance plans submitted by retailers and provide feedback to retailers if their plans are contrary to Lottery policy.
- Ensure that six-month and one-year follow-up reviews are conducted in a timely manner.
- Consider modifying the rule that constitutes “back in compliance” by removing the sixth month provision.
- Ensure that the six retailers we found out of compliance with the 60 percent rule and the other retailers Lottery has found to be out of compliance are dealt with in a timely manner.
- Consider whether delis and convenience stores are the types of establishments that should be Lottery venues and, if not, work with the Department of Justice to determine the best course of action.

Other Matters

During our audit other issues came to our attention that warrant management's attention. These issues include the following: (1) The administrative expense limit may be too high, (2) The award of some Lottery contracts was questionable, (3) Lottery retailers are not all wheelchair accessible, and (4) Lottery does not maintain adequate documentation.

Administrative Expense Limit May Be Too High

Oregon Law states that Lottery should not spend more than 16 percent of total annual revenues on expenses. Expenses of Lottery include all costs incurred in the operation and administration of the state lottery including compensation paid to lottery game retailers.¹⁵ This law was initially established for traditional lottery games, prior to the existence of Lottery video poker. This administrative expense limit has not been evaluated and adjusted to reflect the impact that video poker has had on administrative expenses.

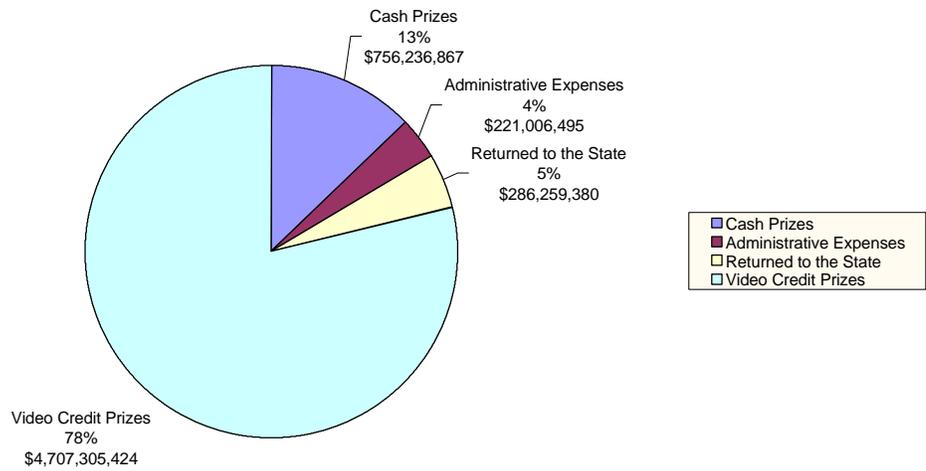
Lottery had approximately \$6 billion in revenue in fiscal year 1999, with video poker being by far the largest revenue source. This figure includes the cash that players put into the video poker and traditional games and the winnings played. Of this amount, the Lottery returned to players \$4.7 billion in computer credits and \$756 million in cash prizes, transferred \$286 million to the state of Oregon, and spent \$221 million to operate the Lottery in 1999.

Lottery refers to credits won as "churn." For example, a player inserts \$10 into a video poker machine and over the course of play wins \$30 in computer credits but continues to play until all the credits are used up. The Lottery would report the \$10 cash received and the \$30 in computer credits played (churn) for a total of \$40 "revenue." However, the actual cash received from the player was \$10. Lottery uses the revenue figure, with churn, when calculating its administrative expense percentage.

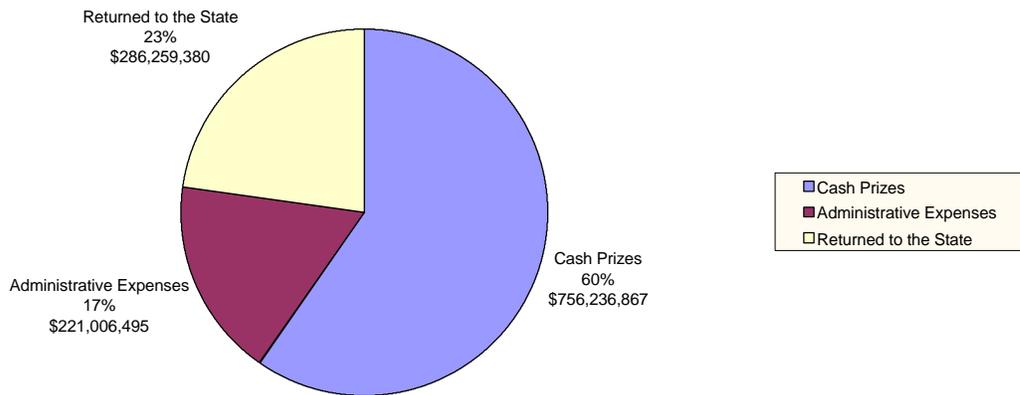
¹⁵ Oregon Revised Statute (ORS) 461.510 (4) lists expenses of the state lottery and states, "No more than 16 percent of the total annual revenues accruing from the sale of all lottery tickets and shares from all lottery games shall be allocated for all payment of the expenses of the state lottery."

The charts below illustrate the two ways that total annual revenues and the administrative expense percentage can be calculated. The first graph shows Lottery’s administrative expense percent using “churn.” The second graph shows the administrative expense percentage using actual cash received.

**Distribution of Revenue Including Churn
\$5,970,808,166**



**Distribution of Actual Cash Received
\$1,263,502,742**



As shown in the charts above, the administrative expense amount, the amount returned to the state, and the actual cash prizes do not change. The only thing that changes when adding video credits is the percentages. Using “churn” makes the administrative expense percentage appear smaller. If the administrative expense percentage of revenue was calculated based on actual cash received (without churn), the administrative expenses would be 17 percent of the total revenue received. If the percentage was calculated including churn, the administrative expenses would be 4 percent of the total revenue with churn. Since Oregon law restricts Lottery’s administrative expenses to only 16 percent of total revenue, and Lottery includes “churn” in its calculation of total revenue, Lottery could theoretically spend up to approximately \$958 million. This amount, however, is more than the actual cash received after removing cash prizes. If the purpose of the 16 percent limit is to act as a cost control, it is not accomplishing this.

The Award of Some Lottery Contracts was Questionable

We found that the director awarded some questionable contracts to retailers. In some cases, such as an applicant’s conviction of gambling laws, the director **shall refuse** a contract to the applicant. In other cases, such as an applicant’s conviction of a felony more than 10 years old, the director **may refuse** a contract. The table below illustrates some examples of criteria for director denial:

Other Matters

Shall Refuse:	May Refuse:
The Director shall refuse to enter into a contract with any applicant when the applicant or any control person has been convicted of violating any gambling laws. (177-040-0010(8)a)	The Director may refuse to enter into a contract with any applicant when the applicant or any control person of an applicant has a conviction more than 10 years old. The Director shall consider the nature and severity of the offense, the time that has passed, and the number of offenses or crimes. (177-040-0010(8)c)
The Director shall refuse to enter into a contract with any applicant when the applicant or any control person has been convicted within 10 years of any felony, offense involving prostitution, or any offense involving the manufacture, sale, delivery, or felony possession of a controlled substance. (177-040-0010(8)b)	The Director shall consider the financial responsibility and security of the person and the person's business or activity. The Director shall consider the person's creditworthiness and integrity in past financial transactions. (177-040-0010)(1)
A person shall not be considered for a video lottery game contract if the person entered into a contract for the purchase of the establishment or the premises, and the purchase is contingent upon the Oregon State Lottery granting the person a video lottery game contract. (177-100-0030(3)e)	The Director may reject an application if the applicant has not provided all the information requested in the application. (177-100-0060(5))

From January 1, 1999 to March 14, 2000, the director received 122 state police denial recommendations. We reviewed 75 of the denial recommendations and found:

- One file in which the Lottery awarded a contract that it should not have because it was in direct conflict with one of the Lottery Commission's rules (listed as "shall refuse" in the table above). In this case, the contract was granted to a retailer whose control person had a felony conviction within 10 years of application date; and
- At least eight files in which the Lottery awarded contracts that it could have denied based on the Lottery Commission's rules (listed as "may refuse" in the table above). For example, an applicant had a criminal history including two felony arrests and convictions, and had been arrested twice since he was released from prison. The applicant received an undesirable discharge from the military and had accumulated past-due property taxes. Another applicant failed to disclose several arrests. The applicant demonstrated a behavior problem that is violent in nature, resulting in arrests for harassment,

unlawful possession of a firearm, and violation of a restraining order. The applicant also had Oregon Liquor Control Commission violations.

Despite these issues, the above applicants were granted Lottery contracts. We could not find evidence or records in the files to explain how the director reached a decision to grant Lottery contracts, against state police recommendations, in any of these cases. As stated earlier in the report, the Lottery director is allowed to reject the state police recommendations and award a contract. Conflicting opinions are not reviewed by or justified to the commission or any other administrative body.

Lottery Retailers are Not All Wheelchair Accessible

The Lottery provides new retailers with a Wheelchair Accessibility Affidavit (affidavit) and an information packet on the Americans with Disabilities Act Accessibility Guidelines (ADAAG). The retailer is instructed to evaluate their establishment using the affidavit and the information packet. For example, a retailer should determine if it has the correct number of wheelchair accessible parking spaces. The retailer then completes and submits the notarized affidavit. At the time this process was initiated, existing retailers also were required to become wheelchair accessible and submit the affidavit.

During our review, we found that 20 out of 42 retailers visited, or 48 percent, had one or more areas in which they were not adhering to the rules. Specifically, we found:

- Ten percent of retailers we visited did not have the correct size accessible parking space.
- Twelve percent of retailers reviewed did not have the correct number of accessible parking spaces based on the total number of parking spaces.
- Fourteen percent of retailers reviewed did not have the required accessible parking space sign (a sign showing the international Symbol of Accessibility).
- Nineteen percent of retailers reviewed did not have the adjacent access aisle. Access aisles must have the appropriate surface markings and allow vehicles with wheelchair lifts to load and unload wheelchairs.

In addition, we identified two retailers that did not have the required curb ramp, and one retailer that did not have an accessible route into the public entrance.

We compared the results of our site visit observations with the retailer affidavits on file at Lottery. Of the 20 retailers who did not adhere to the wheelchair accessibility rules, all had a signed affidavit on file. Seventeen of the 20 had filed a notarized statement declaring that they were wheelchair accessible, although our review found that in one or more areas, the same retailers were not wheelchair accessible. Three of the 20 either answered negatively or left a question blank. One retailer stated that it was not yet wheelchair accessible, and two did not respond to a particular issue.

Of the 20 affidavits reviewed, we noted that six had been submitted with at least one question not answered. In five of these six cases, the question that had been left blank on the notarized affidavit by the retailer was then completed by Lottery. We also noted one that had completed the affidavit with several “no” answers, meaning that the retailer was not adhering to all wheelchair accessibility rules. The retailer noted that the requirements had been contracted for installation. In this case, Lottery changed the retailer’s “no” answers on the notarized affidavit to “yes.”

The commission implemented the Retailer Wheelchair Accessibility Program Rule in response to a complaint filed with the United States Department of Justice under the Americans with Disabilities Act.¹⁶ The complaint alleged that the Lottery contracts with private businesses in the operation of their lottery games in such a way that the lottery is inaccessible to persons who use wheelchairs. In response to the settlement agreement, Lottery established a rule that was approved by United States Department of Justice that would allow retailers to self-verify their adherence to the wheelchair accessibility rules. Lottery does not check the retailer’s premises for wheelchair accessibility during the initial application process, retailer site visits, or financial reviews. While Lottery has been following its established process of self-verification, this process has not been effective in ensuring that retailers are providing access to Lottery games to people who use wheelchairs.

¹⁶ Oregon Administrative Rule 177-040-0070 (1) states, “To ensure that all new and existing retailers provide access to lottery games and services to people who use wheelchairs.”

Lottery should implement a standard method for ensuring that all retailers provide access to lottery games and services to people who use wheelchairs. This method should include regular physical verification by Lottery that the retailers provide access to people who use wheelchairs. In addition, Lottery should not make changes to notarized documents.

Lottery Does Not Maintain Adequate Documentation

We reviewed a sample of the Lottery retailer reviews and found that they generally do not maintain adequate documentation to support their conclusions. For example, we noted:

- No dates on Lottery retailer review summaries to show when the review was performed.
- No information in most files regarding which month(s) of detailed data was reviewed.
- Multiple draft copies of letters, which made it difficult to determine which items had been sent to the retailer.
- Pages of accounting data and financial statements without explanation of how or if Lottery used the information.
- No documentation in one file on the date that a Lottery six-month retailer review was performed.

We reviewed a sample of retailer applications, and found a lack of documentation supporting Lottery decisions. For example, we noted:

- The reasons for rejecting state police recommendations were not always clearly presented.
- Some issues that the state police brought up were not addressed in the files, which makes it appear that they were not considered by the director's office.
- Lack of evidence that retailers took action to correct problems. This includes cases in which proof of worker's compensation and debts paid-off should have been kept in the retailer's file.

Such lack of documentation may reduce Lottery's ability to effectively defend its decisions and conclusions, especially when lawsuits arise. A lack of documentation could also lead to Lottery's inconsistently applying commission rules to the retailer applications.

Lottery should maintain adequate documentation to support its reviews and communication with the retailer, and its decisions made. In cases of state police denial recommendations, each reason listed for the denial recommendation should be specifically addressed and documented by the director.

Objectives, Scope and Methodology

We conducted a risk assessment of the Lottery to determine whether we could add value to public accountability and management decision-making by auditing issues related to the Lottery. Our risk assessment, completed in March, concluded that an audit of Lottery's monitoring of its retailers' compliance, retailer application process, and operating and administrative expense limit would be an appropriate and value-added audit.

The objectives of our audit were to determine if:

- Lottery is effectively regulating its retailers to ensure compliance with Lottery Commission rules,
- Lottery is contracting with retailers it should not, based on established criteria, and
- The limit for Lottery expenses in Oregon law continues to be an effective cost control.

To accomplish these objectives, we:

- Interviewed management and staff of the Lottery.
- Visited 42 Lottery retailers to verify their compliance with the 60 percent or dominant use/purpose rule and the wheelchair accessibility rules. For the 60 percent rule testing, we relied on the work of the Lottery's financial auditors for 12 of these retailers, as a Lottery review had been done recently. Both the Audits Division and the Lottery's financial auditors reviewed five of the 42. Although we do not have specific Americans with Disabilities Act training, we used the same guidelines and questionnaires that the retailers receive. In order to determine if the retailers were in compliance with the 60 percent rule, we reviewed sales information, invoices, and bank statements, and calculated cost-of-sales for reasonableness.
- We reviewed the files of 17 state police approval recommendations and 75 denial recommendations rejected by the director, for applications received from the January 1999 through mid March 2000 (the date that the Retail Management System data was given to us).
- We reviewed Attorney General opinions and legislative minutes regarding Lottery cost controls.

We conducted our audit from March to June 2000 in accordance with generally accepted government auditing standards.

Commendation

The courtesies and cooperation extended by the officials and staff at the Oregon State Lottery were commendable and much appreciated.

Audit Team

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Mr. John N. Lattimer, Director
Secretary of State Audits Division
255 Capitol Street NE, Suite 500
Salem, OR 97310



September 27, 2000

It Does Good Things

Dear Mr. Lattimer:

The Oregon Lottery appreciates the work performed by the Secretary of State Audits Division and will take the recommendations contained in its report under consideration. The fundamental issues addressed in the Audits Division report seem to center around the definition of "casino," which the Lottery believes ultimately rests with the Legislative Assembly or citizens of Oregon.

In response to specific Audits Division recommendations:

- 1) The Lottery will continue to actively enforce its dominant use/dominant purpose rule based on current rule language and policy interpretations adopted by the Lottery Commission. This rule is intended to prevent the sale of lottery games from being the dominant use or dominant purpose of an establishment. The definition and prohibition of "casinos" continues to be the responsibility of the Legislative Assembly. The Lottery will continue to follow Attorney General advice and will continue to vigorously pursue termination of retailer contracts when an establishment is found to be in violation of the Lottery's dominant use/dominant purpose rules. The Director will take the suggested process and procedural changes under advisement.
- 2) The 16 percent limitation on Lottery administrative expenses is based on constitutional provisions and is not subject to change without a vote of the people. However, the Lottery Commission has set an administrative expense target for the agency of four percent of Total Annual Sales. The Lottery will continue to manage to the four percent target and will continue to work closely with the Lottery Commission each year to establish appropriate cost controls. The Lottery will continue to calculate Total Annual Sales in the same way for all its games. This means continuing to record all wagers made by players as Total Annual Sales.
- 3) The Lottery staff will continue to seriously consider all State Police recommendations relating to retailer contracts. Most examples cited by the Audits Division regarding the initial application process were events that occurred in the early 1990's, and have been addressed through rule changes. In the future, when the Retail Contract Administration manager and Assistant Director of Security occasionally disagree, the Lottery Director will review the file and make the final decision.
- 4) Although not currently a part of our Wheelchair Accessibility rule, which was approved by the U.S. Department of Justice, the Lottery Director will consider whether to add regular physical verifications of wheelchair accessibility to our inspection of retailer locations.
- 5) The Lottery appreciates the recommendations regarding documentation and Lottery management will establish clearer guidelines and standards for staff. We also will assign Internal Audit to periodically verify that documentation procedures are being adequately followed.

Sincerely,

Chris Lyons
Director

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AUDITING TO PROTECT THE PUBLIC INTEREST AND IMPROVE OREGON GOVERNMENT

The Oregon Constitution provides that the Secretary of State shall be, by virtue of his office, Auditor of Public Accounts. The Audits Division exists to carry out this duty. The division reports to the elected Secretary of State and is independent of the Executive, Legislative, and Judicial branches of Oregon government. The division audits all state officers, agencies, boards, and commissions and oversees audits and financial reporting for local governments.

DIRECTORY OF KEY OFFICIALS

<i>Director</i>	John N. Lattimer
<i>Deputy Director</i>	Catherine E. Pollino, CGFM
<i>Deputy Director</i>	Sharron E. Walker, CPA, CFE

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