Secretary of State Audit Report

Jeanne P. Atkins, Secretary of State

Gary Blackmer, Director, Audits Division

Oregon State Lottery: Unclear Laws May Let Prohibited Casinos Operate in Oregon

Executive Summary

The Oregon Constitution prohibits casinos, but enforcement is difficult because "casino" has not been clearly defined. The Oregon State Lottery's current rules and practices may not be detecting retailers that receive most of their income from video gambling machines. We recommend Lottery seek legislation to define "casino" and take several steps to improve compliance.

The Oregon State Lottery (Lottery) offers a variety of gambling options including Powerball, Mega Millions, and Oregon games: Megabucks, Raffle, Keno, Lucky Lines, Win for Life, Pick 4, Scratch Its, and video gambling machines (machines).

Machines are the largest annual revenue source with average net receipts of $727 million over the last five state fiscal years. Net receipts as used in this report are dollars deposited in machines minus dollars won. During fiscal year 2014, machines generated net receipts of $743 million, of which $178 million was paid in commissions to retailers and the remaining $565 million was used for state purposes. As of December 2014, there were about 2,300 retailers operating nearly 12,000 machines.

The Oregon Constitution prohibits the operation of casinos in the State of Oregon, but does not provide a definition for a casino. In 1994, the Oregon Supreme Court concluded that "voters intended to prohibit the operation of establishments whose dominant use or dominant purpose, or both, is for gambling." As of the date of our audit report, neither the court nor the legislature has defined the terms "casino," "dominant use," or "dominant purpose."

The Oregon Supreme Court concluded that "voters intended to prohibit the operation of establishments whose dominant use or dominant purpose, or both, is for gambling."

Lottery has established administrative rules to enforce casino prohibition. Under its current rule, retailers are not casinos if their non-lottery sales are at least 50% of their total income. For retailers whose non-lottery income may be less than 50%, the rule allows the Lottery to consider additional factors such as a visual inspection to determine if a retailer is operating as a casino.

In practice, Lottery is satisfied if a retailer's facility does not look like a casino, so they perform no review of retailer income.

Lottery has identified Limited Menu Retailers as posing a higher risk of operating as a casino because they tend to have limited sales of non-lottery products, thus, relying more on Lottery income for their business. In 2014, 234 Limited Menu Retailers operated 1,305 or 11% of the nearly 12,000 machines in use and generated about 21% or $158 million in machines net receipts.

We focused our procedures on the higher risk Limited Menu Retailers and found that Lottery's enforcement practices may not adequately address the Oregon Constitution's casino prohibition. We followed the procedures prescribed by Lottery's current enforcement program and found the program does not detect all retailers whose dominant income is gambling. While most of the Limited Menu Retailers we reviewed did not have the appearance of a casino, over half of these retailers derived more than 50% of their income from machine commissions. Many of these Limited Menu Retailers had difficulty generating non-lottery sales sufficient to comply with the income threshold.

To help Lottery strengthen existing controls and to facilitate compliance with casino prohibition, we recommend Lottery management work with the legislature and other stakeholders to develop a clear and enforceable definition of a casino that aligns with the 1994 supreme court ruling of dominant use/dominant purpose. Lottery should verify gross sales reports when using them to perform an income analysis. For retailers challenged with meeting the 50% non-lottery income threshold, Lottery should evaluate whether removing a machine would enable the retailer to comply with the dominant use/dominant purpose court ruling.

Agency Response

The Oregon Lottery Director agreed to work with the relevant policymakers and stakeholders to develop a more clear and enforceable definition of casino. The Director also agreed they should verify gross sales when performing an in-depth income analysis, though they hope to rely more on a totality of circumstances to determine whether a retailer operates within Lottery's standards. The Director questioned whether retailer revenues could be used as a standard for prohibiting casinos, but cautioned that fewer gambling machines would reduce funding for schools, parks, and economic development. Their full response is attached at the end of the report.

Background

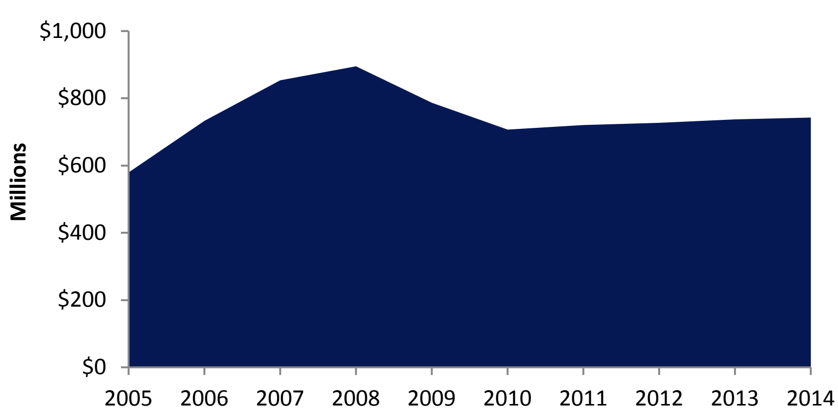
Overview

The Oregon State Lottery Commission (commission) was created through the initiative process by an amendment to the Oregon Constitution in 1984. The commission, created to establish and operate the Oregon State Lottery (Lottery), 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 rules and under the guidance of the commission. Lottery, as directed in statute, operates to produce the maximum amount of net revenues for Oregon commensurate with the public good. The Lottery offers a variety of gambling options to players including Powerball, Mega Millions, and Oregon games: Megabucks, Raffle, Keno, Lucky Lines, Win for Life, Pick 4, Scratch Its, and video gambling machines (machines). Along with authorizing the state to operate a lottery, the Oregon Constitution prohibits casinos from operating in Oregon.

Lottery's Impact on Oregon's Economy

The Lottery is funded entirely through revenues generated by games offered to the public with machines as the largest revenue source. Over the past 10 fiscal years, machine net receipts averaged $748 million per year. Net receipts have been relatively stable the past five fiscal years with annual receipts averaging $727 million. See Figure 1.

Figure 1: Video Machine Net Receipts, Fiscal Year Trend



During fiscal year 2014, nearly $2.7 billion in cash flowed through machines. Subsequent cash pay outs totaled nearly $2 billion, leaving net receipts of $743 million for commissions to retailers and income to the state.

Machine commissions are calculated on a percentage of net receipts. A retailer must choose between two commission rate options, Option A and Option B when it contracts with Lottery to provide machines to the public. See Figure 2.

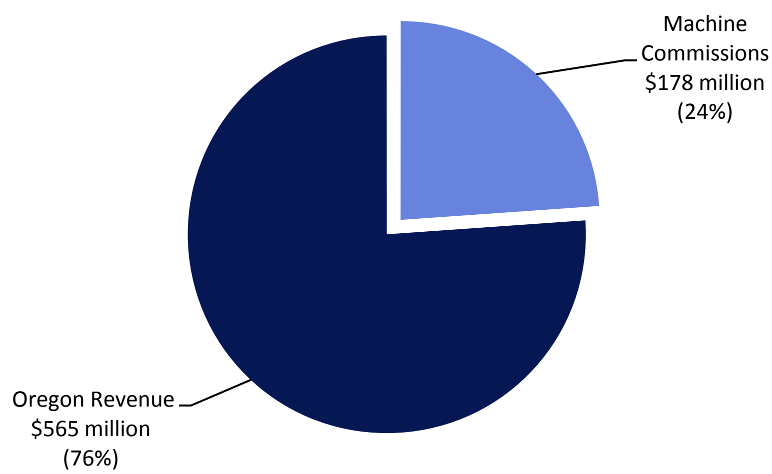
Figure 2: Machine Commission Rates, Effective June 2010 to June 2015

Option A	
Net Receipts per Year	**Commission – Percent of Net Receipts**
Up to $175,000	27.5%
$175,001 to $475,000	23%
$475,001 to $800,000	14%
$800,001 and up	11%

Option B	
Net Receipts per Year	**Commission – Percent of Net Receipts**
Up to $600,000	22%
$600,001 to $1,800,000	17.5%
$1,800,001 and up	11%

Of the fiscal year 2014 net receipts, Lottery paid $178 million (24%) in machine commissions and the remaining $565 million was retained by the state to pay Lottery's operating expenses and for other purposes (education, economic development, state parks, etc.) as mandated by the Oregon Constitution. See Figure 3.

Figure 3: Distribution of Machine Net Receipts, Fiscal Year 2014



Video Gambling Machine Retailers

In 1992 approximately 236 retailer establishments had a total of 550 machines. As of December 2014, there were about 2,300 retailers operating nearly 12,000 machines. In most cases, to qualify for selling Lottery products a business must be open and operating before the Lottery will accept an application. To operate machines, a retailer must have a liquor license that allows selling and serving alcoholic beverages for consumption on the premises and an age-controlled area where the machines would be placed that meets Lottery's requirements. Examples of the type of retailers generally approved for machines include bars and taverns, restaurants, fraternal organizations, delis and entertainment establishments (bowling alleys, pool halls, and golf courses).

Lottery categorizes retailers by business type, as shown in Figure 4. Bars, taverns, pubs, and restaurants received 70% of the total machine commissions paid during 2014 with Limited Menu Retailers receiving nearly 19%. All remaining retailer categories combined for the final 11% of machine commissions paid in 2014.

Figure 4: Calendar Year 2014 Total Commissions and Machines by Retailer Type

Description	Number of Retailers	Total Number of Machines	Total Commissions	Total Revenue for the State	Average Annual Commissions Per Machine
Bars/Taverns	642	3,432	$48,961,604	148,764,925	$14,266
Restaurants	457	2,366	36,331,781	116,726,868	15,356
Limited Menu Retailers	234	1,305	34,074,777	124,921,707	26,111
Sports Bars/Pubs	165	875	14,519,650	46,271,355	16,594
Asian Restaurants	221	1,157	14,487,304	42,531,066	12,521
Pizza Restaurants	118	629	7,919,845	22,913,181	12,591
Café/Small Eateries	75	430	7,689,476	25,289,420	17,883
Mexican Restaurants	75	375	3,823,769	10,966,763	10,197
Bowling Alleys	55	288	3,731,281	11,181,807	12,956
Exotic Dancing Clubs	46	230	3,315,187	9,950,985	14,414
Fraternal Organizations	125	513	2,884,387	7,748,302	5,623
Gaming & Recreation Sites	15	84	1,258,955	4,108,199	14,988
Hotel/Motel Restaurants	22	115	1,192,018	3,607,596	10,365
Truck Stops/Travel Centers	8	46	833,065	2,650,721	18,110
Golf Courses/Country Clubs	16	66	375,724	999,678	5,693
Totals	**2,274**	**11,911**	**$181,398,823**	**$578,632,573**	**$15,230**

Limited Menu Retailers

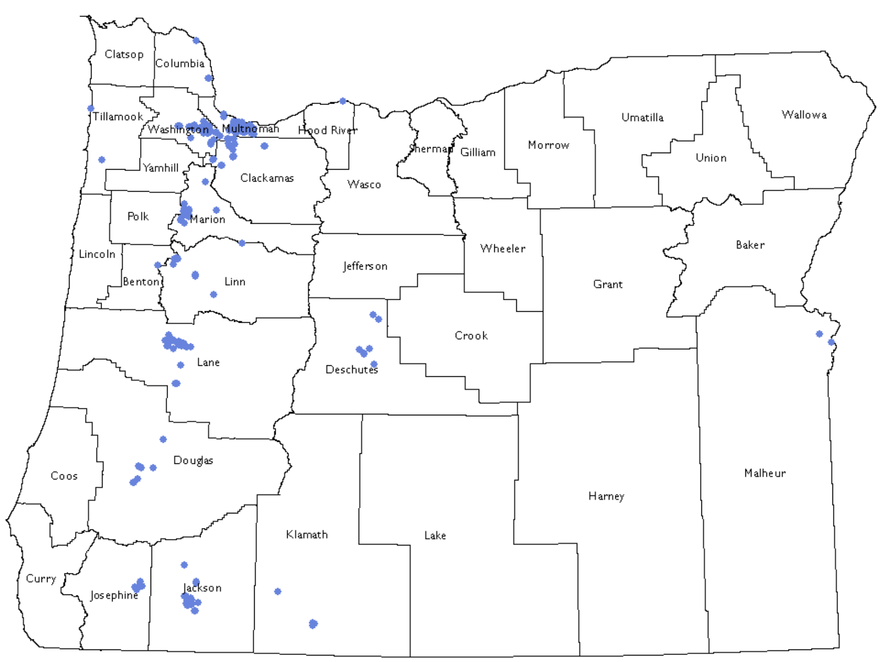
Lottery has identified Limited Menu Retailers as potentially posing a higher risk of operating as a casino because they tend to have limited sales of non-lottery products, thus, relying more heavily on Lottery commissions for their business income. A Limited Menu Retailer typically is small (under 800 square feet), has a limited selection of food items, offers no other type of non-lottery entertainment (TV's, pool tables, etc.), is open late, and has machines visible from all customer areas on the premises.

Limited Menu Retailers operated 1,305 machines, generated about $158 million or 21% of the machines net receipts, and received $34 million in related commissions for the year ending December 2014.

Several Limited Menu Retailers rely on the sale of tobacco products to increase their non-lottery income. For Limited Menu Retailers that provided tobacco sales information, sales ranged from about 32% to 97% of the retailer's total non-lottery sales in 2014.

During 2014, Lottery classified a total of 234 retailers as Limited Menu Retailers. These retailers are located primarily in the Willamette Valley along the Interstate 5 corridor, as shown in Figure 5. Concentrations of Limited Menu Retailers can be found in the Portland (43), Gresham (17), Springfield (16), Medford (15), Salem (14), and Eugene (11) metropolitan areas. Nine individuals or business entities own nearly half of the 234 Limited Menu Retailers.

Figure 5: Map of Limited Menu Retailer Distribution



Audit Results

> The Legislative Assembly has no power to authorize, and shall prohibit, casinos from operation in the State of Oregon (OR Const. art. XV, § 4(10)).

The Oregon Constitution prohibits the operation of casinos in the State of Oregon. The purpose of this audit was to evaluate the effectiveness of Lottery's controls that ensure machine retailers do not operate as casinos. Although the term "casino" has not been specifically defined, Lottery has established a casino prohibition rule and an enforcement program to help manage casino prohibition. Lottery's rule states that retailers are not casinos if their non-lottery sales are at least 50% of their total income. For retailers whose non-lottery income is less than 50% of total income, the rule allows the Lottery to consider additional factors such as a visual inspection to determine if a retailer is operating as a casino.

We focused on Limited Menu Retailers in operation during 2014 and found that Lottery's enforcement practices do not adequately address the Oregon Constitution's casino prohibition. We followed the procedures prescribed by Lottery's current enforcement program and found the program does not detect all retailers whose dominant income is gambling. While most of the Limited Menu Retailers we reviewed passed the visual inspection of not having the appearance of a casino, over half of these retailers derived more than 50% of their income from Lottery sales. Many of these Limited Menu Retailers had difficulty generating non-lottery sales sufficient to comply with the income threshold rule and relied heavily on the sale of tobacco products to increase their non-lottery income.

Constitution Prohibits Casinos, But Has No Clear Definition

The term "casino" has not been clearly defined

The Oregon Constitution prohibits the operation of casinos in the State of Oregon, but does not provide a definition for a casino. In 1994, the outcome of an Oregon Supreme Court (court) case provided a consideration that could be applied when determining whether an establishment operated as a casino; however, the decision stopped short of clearly defining a casino. Indian casinos are permitted in Oregon under federal laws.

The case alleged that state-sponsored video poker had the effect of creating casino gambling in the state. The court concluded that "voters intended to prohibit the operation of establishments whose dominant use or dominant purpose, or both, is for gambling." Neither the court nor the legislature has defined the terms "casino" or "dominant use or dominant purpose." The Lottery has implemented rules to provide a framework and a process for determining when an establishment is operating or may operate as a casino.

Lottery's rules now emphasize other factors rather than dominant use and dominant purpose

Following the 1994 court ruling, the Lottery Commission created a rule to identify retailers whose dominant use or dominant purpose was for gambling. Over time, the Lottery has amended its rules in an effort to manage the challenges of casino prohibition. The current rules emphasize other factors such as appearance rather than align with the Supreme Court ruling to use dominant use or dominant purpose when determining whether or not a retailer is operating as a casino.

The Lottery Commission created the first dominant use/dominate purpose rule in 1994. The rule provided that a retailer could not generate more than 66.67% of its income from machines. The rule also specified that if more than 15% of the retailer's total floor space was dedicated to machines the dominant use/dominant purpose of the business was for gambling.

- In June 1998 the Lottery reduced the dominant use/dominant purpose percentage; a retailer could not generate more than 60% of its income from machines. In addition, the terms "dominant use," "dominant purpose," and "annual non-lottery sales" were defined. Dominant purpose referred to the reasons for the retailer establishing its business; the rule provided that a retailer could not generate more than 60% of its income from machines. Dominant use referred to a retailer's primary business activity; the rule specified that if more than 15% of the retailer's total floor space was dedicated to machines the dominant use/dominant purpose of the business was gambling.
- In February 2007 the Lottery amended it rules to delete the process for determining a retailer's dominant use and dominant purpose and adopted the casino prohibition rule (OAR 177-040-0061) that set forth a new process for determining if an establishment is, or will be operating as a casino. The new rule reduced the lottery income threshold to 50% and included a number of subjective factors for determining whether a retailer is operating as a casino. These factors include, but are not limited to, appearance, floor space, meals and menus, business name, and non-lottery products and entertainment.

Lottery Struggles with Enforcement of Casino Prohibition

Without a clear definition of the terms "casino," "dominant use," or "dominant purpose," Lottery faces challenges with the enforcement of casino prohibition. In addition to modifying its rules to address casino prohibition, Lottery also periodically changes its casino prohibition enforcement program to identify and address retailers not complying with the casino prohibition rule. If identified, noncompliant retailers are placed on compliance plans, with Lottery personnel advising them on strategies to meet requirements. Rarely is a retailer terminated for noncompliance.

Over the years, Lottery has tightened the income requirement for compliance by lowering the Lottery income threshold; in 1994 a retailer could derive no more than 66.67% of its income from machine commissions whereas today a retailer must not derive more than 50% of its income from machine commissions. Currently, the Lottery does not obtain sales income from Limited Menu Retailers to determine compliance with its casino prohibition rule. The Lottery relies on visual inspection to determine if these retailers are operating as casinos.

Previous enforcement program began with income analysis

In early 2015, Lottery modified its casino prohibition enforcement program. The new program, as well as the previous program, has two compliance components: (1) income; and (2) appearance and other factors. Under both programs, a retailer may be considered in compliance with casino prohibition if it meets the requirements of either of the components. The enforcement program prior to 2015 emphasized the income component more than the current program.

Under the previous enforcement program, Lottery's process began with a sample selected from all retailers. Selected retailers were required to self-report their non-lottery gross sales figures for a one-year period. Lottery personnel calculated the percentage of the retailer's sales derived from non-lottery products. For retailers with non-lottery sales less than 50% of total gross sales, Lottery performed on-site reviews of supporting financial records. For those retailers that met the income threshold, Lottery relied on self-reported sales information and therefore may have made decisions about a retailer's compliance based on inaccurate sales information.

For non-compliant retailers, Lottery also performed visual inspections of their establishments. If Lottery personnel decided that a reasonable person would conclude, based on visual factors such as menu, seating, and appearance, that the business was not operating a casino then no further actions were required. If Lottery personnel determined the retailer had the appearance of operating as a casino, it was placed on a compliance plan, and monitored for a designated period of time. Continued noncompliance could result in termination of the retailer's contract. According to Lottery's records, it has rarely terminated a retailer due to operating as a casino.

New enforcement program begins with risk assessments and appearance

Lottery's new enforcement program was initiated in early 2015. Although similar to the previous program, the new program has two primary differences. The new program focuses on retailers Lottery has determined present a higher-risk for operating as a casino. Lottery categorizes retailers and evaluates the risk each category poses in terms of compliance with the casino prohibition rule. Limited Menu Retailers were identified as higher risk so Lottery is focusing its initial efforts on these retailers.

The new enforcement program focuses on subjective factors (menu, seating, appearance, etc.). Lottery personnel are performing on-site inspections of all higher risk machine retailers. During each inspection, Lottery personnel are focusing on the retailer's overall appearance, specifically considering the following:

- Exterior advertisement for on premise food and beverage consumption;
- Sufficient seating for the size of the dining area;
- Visible menus inside the business, menu items available for preparation, and a means to cook/prepare the food;
- Machines are obstructed from viewing by minors;
- Minor Prohibition Posting is properly placed; and
- Availability of other non-lottery products (TV, pool tables, etc.).

At the conclusion of the site inspection, a "reasonable person" test is applied: Would a reasonable person conclude based on the factors listed above that the business was not operating as a casino? If the answer is yes, no further action is taken. Otherwise, Lottery personnel offer the retailer advice on changes it could make to come into compliance with the appearance component, and the retailer is given 30 days to make the suggested changes. If adequate corrective action is not taken within that time frame, the retailer is then required to submit its non-lottery gross sales data for an income analysis. If Lottery then finds that the retailer's non-lottery income is less than 50% of its total income, Lottery places the retailer on a compliance action plan and monitors it for a designated period of time. Continued noncompliance may result in termination of the retailer's contract with Lottery.

New enforcement program may not detect retailers operating as casinos

To evaluate the effectiveness of Lottery's efforts, we followed the procedures prescribed by Lottery's new enforcement program. Lottery's reliance on an appearance standard may not adequately ensure that its 234 higher risk retailers avoid gambling as the dominant use or purpose.

We focused our audit procedures on Limited Menu Retailers as identified by Lottery. We conducted site inspections of selected Limited Menu Retailers using Lottery's site inspection checklist. We applied the "reasonable person" test to assess whether or not the retailer had the appearance of a casino. At this point, we concluded that the majority of Limited Menu Retailers we visited did not have the appearance of a casino.

Lottery's new enforcement program requires machine retailers to submit gross sales reports for further analysis only when the retailer has the appearance of a casino and fails to make adequate changes to the business premises within the allowed 30-day window. Based on our observations, only a few of the Limited Menu Retailers we reviewed would be required to submit non-lottery gross sales reports (disregarding the 30-day period).

We asked each selected Limited Menu Retailer to submit a non-lottery gross sales report for an income analysis. We compared machine commissions to total non-lottery gross sales for compliance with the casino prohibition rule's income threshold. We found over half of the selected retailers did not meet the 50% non-lottery income requirement and could therefore be considered as operating as a casino.

In addition to the income analysis, we performed procedures to determine whether or not the gross sales reports submitted by Limited Menu Retailers were accurate and reliable. We identified errors in over half of the gross sales reports we reviewed, mostly due to retailers overstating sales by including items that did not generate income. Other errors appeared to be minor mistakes when personnel rang up sales; these errors had a nominal effect on our audit results.

Regarding the overstated sales, we noted many of the Limited Menu Retailers we reviewed gave customers and employees food and beverages at no cost, and many of these retailers reported the free items in their monthly food sales total. Two Limited Menu Retailers that were initially in compliance with the 50% non-lottery income threshold based on their reported sales figures were found to be out of compliance once the gross sales report was adjusted for identified errors. By not verifying gross sales, Lottery may not identify overstated sales and may miss instances where retailers are not in compliance with the 50% non-lottery income threshold.

Six Machines May Produce Too Much Income for Limited Menu Retailers

Many of the Limited Menu Retailers we inspected had the maximum six machines allowed by law. Based on total machines operating in 2014, a single machine averaged commissions of $26,111. Extending this estimate, Limited Menu Retailers operating six machines earned annual commissions of $156,666.

Many Limited Menu Retailers we reviewed had difficulty generating non-lottery sales exceeding this amount, insufficient to comply with the court ruling for dominant purpose and with Lottery's casino prohibition rule. Menus at a majority of our selected retailers consisted primarily of prepackaged products such as frozen burritos, pizzas, corndogs, and hamburgers. Lottery stated that Limited Menu Retailers cannot force customers to purchase their food. The more successful retailers relied on the sale of tobacco products to increase their non-lottery income.

To move retailers into compliance, Lottery personnel advise retailers on strategies to increase non-lottery sales. Lottery could also consider reducing the number of machines of retailers who cannot increase their total sales to exceed their commissions.

Recommendations

To help Lottery strengthen existing controls and to facilitate compliance with the casino prohibition, we recommend management:

- Work with the Oregon Lottery Commission, the governor, legislature and other stakeholders to develop a clear and enforceable definition of a casino that aligns with the 1994 Supreme Court ruling of dominant use/dominant purpose.
- Verify gross sales reports when using them to perform an income analysis.
- For retailers challenged with meeting the 50% non-lottery income threshold, consider analyzing whether removing a machine would enable the retailer to comply with the dominant use/dominant purpose court ruling.

Objectives, Scope and Methodology

Our audit objective was to determine whether the Lottery has effective controls in place to ensure machine retailers do not operate as casinos.

To meet our objective, we interviewed Lottery managers and staff, and reviewed relevant records at the Lottery. We obtained information from the Lottery on machine retailer locations, the number of machines in operation and their respective locations, and commissions paid to all retailers during our audit period. We performed site inspections of 20 Limited Menu Retailers with machines. We completed an income analysis on 18 of the 20 retailers we visited; one retailer did not provide a gross sales report and one retailer's gross sales report was not analyzed as we determined the analysis would not alter the conclusions drawn. We also reviewed applicable laws and rules, policies and procedures.

We analyzed data from Lottery's accounting system to determine retailer commissions paid during the period reviewed by our audit. We conducted data reliability tests and concluded that the data was reliable for our audit purposes. Additional historical data was obtained from Lottery's audited financial statements and financial audit work papers.

Lottery classifies machine retailers by its internal coding system (LSIC). Our audit focused on retailers classified as Limited Menu Retailers (LSIC code 0007) because Lottery identified this category of retailer as having a higher risk of non-compliance with Lottery's casino prohibition rule. For testing purposes we identified Limited Menu Retailers that received commissions of $75,000 or more during 2014. From this list, we judgmentally selected two Limited Menu Retailers from the Hayden Island area in Portland, an area that has received media attention in the last few years. To select the remainder of our sample, we grouped the Limited Menu Retailers by city, summed the commissions paid to the Limited Menu Retailers in each city, then divided the number by total commissions paid to all Limited Menu Retailers during 2014. The resulting percentage was multiplied by our desired sample size to arrive at the number of retailers to sample for each city. This method gave us a sample disbursed throughout the state based on total commissions generated in each city.

After identifying and selecting our sample of Limited Menu Retailers, we obtained gross sales reports from all but one of the selected retailers for 2014. We compared the gross sales reports to underlying sales receipts and other documentation to determine their accuracy and reliability. We also reviewed the selected retailers' purchase invoices. Six Limited Menu Retailers did not retain adequate financial records for us to verify their reported gross sales; and one of these six did not provide us with a gross sales report.

The sample we selected was not intended to identify all weaknesses in Lottery's internal controls. Nor was the sample designed to be statistically representative of all Limited Menu Retailers. As such, we did not project our results based on the sample to the entire population of Limited Menu Retailers.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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August 21, 2015

Gary Blackmer, Director
Oregon Audits Division
255 Capitol Street NE, Suite 500
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Dear Director Blackmer,

The following is the formal response by the Oregon State Lottery (Oregon Lottery) to the Secretary of State's audit of compliance with the constitutional prohibition of casinos in Oregon and enforcement of the Lottery's casino prohibition rule, OAR 177-040-0061.

We agree with the report's conclusion that the constitutional prohibition of casinos in Oregon is imprecise and difficult to enforce. *Ecumenical Ministries v. State Lottery Commission*, 318 Or. 551 (1994), is the only court case presuming to define the intent of the constitutional language and it concluded "in adopting Article XV, section 4(7), prohibiting the operation of 'casinos,' the voters intended to prohibit the operation of establishments whose dominant use or dominant purpose, or both, is for gambling."

The *Ecumenical Ministries* case (in which plaintiffs claimed that the operation of electronic gaming machines on its face constitutes a violation of the constitutional ban on casinos) was actually decided on the basis of other language in the Oregon Constitution ("In games utilizing computer terminals or other devices, no coins or currency shall be dispensed directly to players from such computer terminals or devices."), which the Court ruled clearly contemplated games utilizing computer terminals or devices. Consequently, the language of the case defining a casino by its "dominant use or dominant purpose" may more properly be considered *obiter dicta* rather than an authoritative ruling of the court. That is particularly true considering the fact that in the 21 years since that case was decided, no court case has applied the "dominant use, dominant purpose" standard or any other standard to determine whether or not an Oregon Lottery retailer is operating as a "casino."

Consequently, while we agree with the Secretary of State's first recommendation that the Oregon Lottery work with relevant policymakers and stakeholders to develop a more clear and enforceable definition of a casino, we do not necessarily agree that this definition must be one that "aligns with the 1994 Supreme Court ruling of dominant use/dominant purpose."

While we also agree with the Secretary of State's second recommendation that we should "[v]erify gross sales reports when using them to perform an income analysis" it is also true that performing an in-depth income analysis of primary financial documents is time consuming for Lottery personnel, burdensome on the Lottery retailer and, when coupled with the required other operational factors analysis used in applying the Casino

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Prohibition Rule as currently written, rarely yields the need for further compliance action. The Oregon Lottery does in fact conduct a full review of primary financial documents after the required onsite evaluation of other operational factors is completed, and there is evidence the video lottery retailer may be out of compliance with the totality of the Casino Prohibition Rule. Further, the Oregon Lottery regularly reviews its operations and engages in process improvements in order to fully meet its regulatory requirements efficiently and effectively.

Going forward, we hope to rely less upon a strict arithmetical calculation of lottery versus non-lottery income for these establishments and more upon the totality of circumstances indicating whether or not a Lottery retailer is operating a "casino" and, beyond that, whether it is operated in accordance with the Oregon Lottery's standards for a retailer offering our games.

The third recommendation is that we "consider analyzing whether removing a machine would enable the retailer to comply with the dominant use/dominant purpose court ruling." Again, this assumes that the dominant use/dominant purpose standard is controlling and, furthermore, that the correct test for dominant use and dominant purpose is relative revenue, a standard which was never enunciated by the court in *Ecumenical Ministries* or any other court decision and which the Oregon Lottery has been trying to de-emphasize.

Nonetheless, this suggestion does seem to recognize that the efficacy of such remedial action would depend upon whether such a reduction in machines would reduce a retailer's lottery revenues without reducing its non-lottery revenues proportionately. While we believe this is a dubious proposition, if we continue to rely on a "dominant use/dominant purpose" standard based primarily on the relative proportion of lottery and non-lottery income, it may be a worthwhile experiment. However, it will be important for the legislature and the governor to understand that, in that case, every dollar of lottery revenue reduction to retailers represents approximately $3 in lost revenue available for schools, parks and economic development.

Overall, we are very appreciative of the professionalism and thoroughness of the auditors from the Secretary of State's office and found the report informative and helpful. We look forward to following up on their recommendations and perhaps exploring other alternatives that may be the result of the information they have supplied us and the probing questions they have asked.

Very truly yours,

Jack Roberts

Jack Roberts
Oregon Lottery Director

About the Secretary of State Audits Division

The Oregon Constitution provides that the Secretary of State shall be, by virtue of her 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 other agencies within 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.

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The courtesies and cooperation extended by officials and employees of the Oregon State Lottery and owners and employees of the Limited Menu Retailers during the course of this audit were commendable and sincerely appreciated.