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Good morning, Chairman Santoni, Chairman Schroder and members of the House Gaming Oversight Committee. My name is Susan Walker and I am a lottery and gaming consultant with over 20 years executive management experience in the gaming and lottery industry. I have worked for publicly traded gaming companies and was the first appointed Executive Director of the South Dakota Lottery that pioneered the first state video lottery program in the nation in 1989. In the past, I have advised the Pennsylvania Amusement and Music Machine Association (PAMMA) on proposed video lottery legislation in the Commonwealth of Pennsylvania. PAMMA contacted me earlier this year to advise and provide information on video lottery program operations in the United States and asked if I would appear today to share my experience. I wish to thank the committee for graciously allowing me the opportunity to testify today on HB 1317, an act to provide tuition relief through the introduction of a video lottery program.

On October 16, 1989, the South Dakota Lottery pioneered the first state video lottery program controlled and monitored through a central computer system, which has been a model for many video gaming operations in several US and international gaming jurisdictions. The period of time from the date of legislative enactment to start-up was slightly over six (6) months. Since its launch, video lottery has continued to be a highly successful product providing more than \$1 billion in revenue to the State of South Dakota, with a population base of nearly 800,000.

Video Lottery legislation was introduced as a means to eliminate gray area machines in the state and generate tax revenue by regulating the activities to ensure the security and integrity of the operations. While gray area games were legally designated for amusement only (any winnings as credits must be played off or lost), they were often used for illegal gambling with winning credits being paid off in cash. The ability to use them for amusement made it difficult and expensive for law enforcement personnel to prove their use as illegal gambling devices. Video lottery legislation in South Dakota included a provision making it a felony for any person to possess any device that awards credits and contains a circuit, meter or switch capable of removing and recording the removal of credits when the award of credits is dependent upon chance. Before the authorization of video lottery, it was estimated there were over 10,000 gray area games in the state. Waves of machines leaving the state were reported prior to the effective date of the video lottery legislation. To the best of my knowledge, there have been no reported cases of gray area machines in the state since video lottery started.

There are 6 lotteries that regulate the placement and operation of video lottery terminals (VLTs) in their states. The placement of VLTs is authorized on a state wide basis in establishments licensed for the on-sale consumption of alcoholic beverages in three states: South Dakota, Oregon, and West Virginia. The other VLT lottery operations in Delaware, New York, and Rhode Island restrict placement of VLTs to racetracks in the state, with the exception of West Virginia

that authorizes VLTs on both a state-wide level and at the state's four racetracks. There are 3 other states that regulate video gaming devices through other state agencies or gaming boards on a state-wide level in Montana, Louisiana, and New Mexico.

The types of games, wagers, prize amounts and number of VLTs vary among these states as do the models for ownership and operations of state-authorized VLTs.

A major question to be considered in legislation for a state-wide video lottery program is what type of ownership and operation model should be adopted. In general there are three types of models for ownership and operation of state-authorized VLTs:

(1) Private-Sector Operator model where the lottery licenses operators who make the necessary capital investment to purchase the lottery approved VLTs and games from licensed manufacturers and are responsible for maintaining and placing the VLTs in licensed establishments in the state (South Dakota and West Virginia follow this model); (Although not regulated by state lotteries, Montana, Louisiana, and New Mexico follow this model).

(2) Hybrid State-Operator model where the state licenses the racetrack that is responsible for the daily operations at the licensed location. The state provides the VLTs through a lease and maintenance agreement with manufacturers (this is commonly associated with a high concentration of VLTs at racetrack only locations and is the model used by Delaware, New York, and Rhode Island); and

(3) State-Operator model where the state is responsible for the purchase, placement, and maintenance of the VLTs and pays retailer commissions to contracted establishments where the VLTs are placed (Oregon uses this model).

Two models have emerged for a state-wide video lottery, which is proposed in HB 1317, with the placement of VLTs in thousands of licensed liquor/beer establishments throughout the state: the Private Sector Operator model and the State-Owned model. The difficulty legislators will face is that both models are operating successfully in other states. Legislators need to consider a number of factors in each type of model:

Costs.

Under the State-Owned model, there is a large associated state cost in operating the video lottery program, both in terms of capital outlay for the purchase of the VLTs, staffing, and administrative operations. In an early report issued by the Oregon State Lottery in 1992, it stated that 154 new staff positions were added in the first year of the video lottery program. In comparison, the South Dakota Lottery, which uses the Private Sector Operator model, added 11 new positions.

There are a number of new positions required in a state-owned model to handle the responsibilities under a video lottery program in areas not otherwise handled by state lottery employees in the operation of traditional lottery products, such as the instant scratch tickets and on-line lotto type games : These include: VLT field maintenance technicians; VLT installations and removals; bench technicians for repairs; warehouse and inventory; training and

support; product management; VLT acceptance testing; and an increased hot-line support staff to address service problems and to dispatch service technicians to the locations manned 7 days a week during the business hours of the establishment locations.

I attempted to find the Oregon Lottery's video lottery program administrative expenses in the early years of operation. The Oregon Lottery Annual Audit Reports, however, are only available in the state's archive directory from 1997 under their records retention act. I did find references to the administrative costs in legislative hearing testimony in searching the Internet and the estimated first year expenses from an earlier report I had on file compiled by the Indiana Lottery in December 1992 in an overview of video lottery operations at that time. The report stated that administrative costs for the first year (1992) of video lottery operations in Oregon will be approximately \$13.8 million compared to South Dakota of \$1.6 million (1990).

Oregon's video lottery start up costs of \$13.8 million would have represented associated costs over 17 years ago with central computer lease and communication costs, the purchase of slightly over 4,000 VLTs under 5 year lease purchase agreements with manufactures (averaging around \$8,000 per VLT), warehouse rental space, fleet and vehicle leases, and staffing. Start up costs for Pennsylvania would need to be adjusted for today's costs and the inherent increases based on a population of 12.45 million compared to Oregon's population at that time of 2.2 million. Capital out lay for initial VLT placement in Pennsylvania estimated at 28,000 alone would likely be over \$80 million based in the first year under a 5 year lease purchase arrangement with manufacturers with the cost of VLTs averaging around \$15,000 each.

South Dakota's first year video lottery costs were \$1.6 million, which primarily represented the cost of the central computer system the SD Lottery purchased and operates to monitor video lottery financial and play transactions. It does not pay an on-going percentage of net machine or lease payments for the operation of the central computer.

Revenue to the State

A primary question is what video lottery model would generate the most revenue for the state. It is tempting to conclude that the State-Owned model where the state receives a higher percentage of Net Machine Income ("NMI" money put into a video lottery machine minus credits paid out in cash) will yield greater state revenue than the Private Sector Operator model. In comparing the two models, however, the state costs in administering a State-Owned model must be taken into account in determining the effective rate returned to the state as a percentage of NMI. Reports that list the state's tax rate under the various video lottery programs can be misleading by lending the impression that the state is earning a much larger percentage when that percentage is not reduced by the costs in administering the video lottery programs.

As stated earlier, although I do not have audited financial statements in the earlier years of the Oregon video lottery program, based on my research it appears that the effective rate of return to the state for funding the dedicated state programs in the first 3 years of operations was 45% to 48% of NMI, which increased to 52% in 1995 with the reduction of retailer commissions. The state's effective rate grew gradually upwards over the years by further reductions in retailer commissions to its current level in FY 2008 of 64%.

Under the Private Sector Operator model, the state percentage is less, but what also needs to be factored in is the greater overall NMI on a per capita basis through a larger participation by eligible on-sale alcohol beverage licensees and VLT placement. These types of establishments typically do not carry traditional lottery products. On the other hand, coin operators have developed a long-standing business relationship with bars and taverns in providing and servicing equipment and will be more successful in gaining a greater market penetration for the placement of VLTs.

The percentage of video lottery establishments of the total eligible on-premises alcohol establishments in the three state-wide video lottery program operations is estimated at: Oregon 36%; South Dakota 85%; and West Virginia 78%. Based on the percentages of eligible liquor licensees participating in video lottery, Oregon has a much lower level indicating a loss of potential revenue.

The Private Sector Operator model out paces the state-owned model in terms of VLT placement and NMI per capita. South Dakota (operating nearly 20 years) still exceeds Oregon (operating 17 years) by \$43 in NMI per capita, although SD has a maximum of 10 machines (averaging 6 per location) vs. Oregon that now has a maximum 6 (averaging 5.5) per establishment location.

HB 1317 is unique in that it appears the random number generator will not reside on the VLTs, but on the central computer. This is referred to as a central determinant system. Although it is not clear, the definition of the central computer system in HB 1317 contains language that it must be capable of generating games, which suggests that it could be like the video lottery games offered under the New York Lottery video lottery program.

Under the New York video lottery, the central computer randomly selects "electronic tickets" from a finite prize pool of winning and losing combinations with various prize amounts. Similar to instant or scratch tickets, the vendor produces the winning and losing combinations for each of their electronic games played on its VLT. The central computer "shuffles" and randomly selects pools of 10,000-100,000 of the electronic tickets, which are downloaded to each racetrack for the play of that game offered on the VLTs at its location. When the game is played, the winning or losing combination is displayed on the VLT through the use of spinning reels or playing cards, which correlate to the pay table of that game. The central computer automatically orders new pools of electronic tickets and downloads it to the racetrack when the current pool for that game nears completion of play. Although this gives the appearance of playing a slot machine, it is different from a slot machine where the RNG and game software reside on the VLT and the game outcome is totally random and not based on a finite or predetermined amount of winning and losing tickets.

The New York Lottery is the only US video lottery operating under a central determinant system. There are currently around 13,000 VLTs operating at 8 racetrack locations in the state. In terms of per capita net machine income, the New York video lottery ranks last out of the nine states offering video lottery or gaming. For comparison purposes in FY 2008, the Delaware Lottery's per capita NMI (that only operates at racetrack locations) was \$718; and the two state-wide video lottery operations in South Dakota was \$282 and Oregon \$239 compared to New York's of \$45.

Although it is not clear in HB 1317, it would appear based on the initial appropriation of \$20 million that the VLTs would be leased and maintained through manufacturers for a percentage share of the states' NMI. As mentioned earlier, this Hybrid State-Operator model has only been used in video lottery operations at racetrack locations with a high concentration of VLTs in a few racetrack locations and not on a state wide video lottery operation with thousands of VLTs in thousands of establishments located throughout the state.

Since a central determinant system is rather unique, another factor that needs to be taken into consideration is the ability of manufacturers to develop the necessary software to communicate with the selected vendor's central computer system.

Since 1995, South Dakota's state percentage of NMI has been at 49.5% with the South Dakota Lottery receiving one half of one percent of the state's share and license fees for the video lottery administrative costs. West Virginia's state rate for its state-wide limited video lottery is based on a sliding scale between 30% - 50% depending on a statewide average of revenue generated by the VLTs the previous quarter. It is currently at 50%. The West Virginia Lottery receives 2% of the total state wide net machine income and license fees for administrative costs.

Oregon has been more successful in its ability to make the continuing necessary investment through retained earnings to keep the video lottery market fresh with new games and machines. Under a Private Sector Operator model, the state rate must account for the ability of operators to maintain reserves to replace VLTs, offer new games, and keep pace with advances in new technology. It is apparent that the state can have an effective tax rate of 50% of net machine income under the Private Sector Operator model, the same percentage to the state as proposed in HB 1317. The legislation should consider allowing for graduating increases to that percentage rate recognizing that in the first couple of years there will be major capital outlay by operators.

The state owned model was adopted as a means to gain greater control over video lottery operations and shielding the state from possible participation by unsavory individuals and entities. A state can ensure the security and integrity of video lottery operations in a private sector model by thorough background investigations conducted by state law enforcement agencies, strict licensing standards and VLT game testing requirements. It is also important from the start that the legislation require licensed on-sale alcohol establishments with general access areas to restrict the placement of VLTs in age controlled locations separated from the general access area. With sound legislation and regulation, video lottery has proven highly successful in generating additional tax dollars for beneficial state programs.

SUSAN L. WALKER. Ms. Walker has over 20 years executive management experience in the gaming and lottery industry. She has worked in management positions and as a consultant over the past 15 years in the areas of regulatory compliance, business development and legal for several publicly traded gaming companies with manufacturing, casino, video lottery, on-line lottery and pari-mutuel operations in the United States and international gaming jurisdictions. Most recently she served from 2003-2008 as Legal and Regulatory Compliance Director for Cyberview Technology, Inc., a leading technology provider in server based gaming systems and products until the company's purchase in 2008.

Ms. Walker was appointed by the late Governor George Mickelson as the first Executive Director of the South Dakota Lottery in 1987 and served in the position through 1994. She lead the start-up operations, including pioneering in 1989 the first state video lottery program in the United States. The South Dakota Lottery is recognized as one of the most successful U.S. lotteries in per capita sales and return to the state. From 1993-1994, she served as President of the Multi-State Lottery Association comprised of several state lotteries offering the multimillion jackpot Power Ball game. Ms. Walker was a member of the Executive Committee and chaired a number of committees of the National Association of State and Provincial Lotteries from 1990-1994. She was the recipient of the Lottery Pioneer Award by the Public Gaming Research Institute and Newsmaker of the Year Award by the International Gaming & Wagering Business publication in 1990.

Prior to her appointment as Executive Director, she served as Director of Insurance from 1984-1987 and Deputy Director of Securities from 1980-1983 for the State of South Dakota. Ms. Walker clerked for the South Dakota Supreme Court for one year following her admittance to the South Dakota Bar. Ms. Walker earned Bachelor of Science and Juris Doctorate degrees from the University of South Dakota.