

MINUTES OF THE JOINT HOUSE
and SENATE COMMITTEE ON FEDERAL AND STATE AFFAIRS

The meeting was called to order by Senator Ed Reilly and Representative Kathleen Sebelius a
Chairperson

1:00 ~~am~~ p.m. on Wednesday, January 22, 1992 in room 313-S of the Capitol

All members were present except:

Representative Barbara Allen - Excused
Representative Don Smith - Excused
Senator Norma Daniels and Senator Roy Ehrlich - Excused

Committee staff present:

Connie Craig, House Committee Secretary
Jeanne Eudaley, Senate Committee Secretary
Lynne Holt and Mary Galligan, Legislative Research
Mary Torrence, Office of the Revisor

Conferees appearing before the committee:

Ralph Decker, Director, Kansas Lottery

Chair Sebelius called the meeting to order.

Lynne Holt read her memorandum on video lottery, Attachment #1.

Ralph Decker appeared before the Committee with brief comments on staff's review of video lottery. He stated that both the on-line and the dial-up systems of video lottery are secure, but the on-line is more expensive. Mr. Decker added that the footnote on page 12 of the memo from Research, Attachment #1, is incorrect. He informed the Committee that Mr. Maida feels that he was misquoted and that he took exception to those recommendations. He stressed that background checks were vital to eliminating any criminal problems.

Chairman Reilly announced that the joint hearing will be continued so that Committee members can have a chance to ask questions on Tuesday, January 28, 1992 at 1:00 in Room 313-S. He added that one of the video lottery machines may be available for demonstration.

Chairman Reilly adjourned the meeting

GUEST LIST

FEDERAL & STATE AFFAIRS COMMITTEE

DATE 1-22-92

(PLEASE PRINT)

NAME	ADDRESS	WHO YOU REPRESENT
Richard Taylor	Topeka	Life as the Best
Allen E. Baumgartner	Haworth, KS	Ministerial Association
Matt Muel	Topeka	APF
J.P. Small	Topeka	Kans. Ants. Musch. Ass'n
Sindy Saunders	Horton KS	Bureau of Indian Affairs
Brenda Lee Shadwick	Horton, KS	Bureau of Indian Affairs
Patrick Whurley	Topeka	STEEN
Whitney B. Gamm	Topeka	Pete McGill & Associates
Dick Carter	Topeka	Pete McGill & Associates
Debbie Green	Topeka	Sen. F. Kerr's office
Jim McBride	Topeka	observer
Chauleng Wilson	Topeka	Unit. Meth. Church of Ks.
Art Brown	K.C.	KS - Lumber Dealer
Bob Storey	Topeka	JGT
Kevin Smith	Topeka	KANSAS Lottery
John N. Roberts	Topeka	Kansas Lottery
Ralph Decker	Topeka	Kansas Lottery
Deieth L. Stilton	Topeka	Kansas Lottery
John C. Peterson	Topeka	
Lana Vanderplas	Topeka	Intern
Nick Roach	Topeka	Barber & Assoc.
MATT BAUER	TOPEKA	DATA SYSTEMS INT'L
GEORGE PUCKETT	WICHITA / TOPEKA	KS RESTAURANT & HOSPITALITY ASSN (KRNA)
Thomas FRENW	1250 MEDFORD	KANS CHARITIES COOPERATIVE
John C. Botenberg	Topeka	Video Lottery

MEMORANDUM

Kansas Legislative Research Department

Room 545-N – Statehouse
Topeka, Kansas 66612-1586
(913) 296-3181

Revised
January 20, 1992

To: Legislative Coordinating Council

Re: Video Lottery

This memorandum responds to a request by the Legislative Coordinating Council on May 29, 1991, to review information already prepared on video lottery and to refine material on this subject matter and generate revenue estimates in order to provide as much "hard data" as possible for the 1992 Session.

This memorandum is divided into six sections. The first section provides background information about video lottery games and raises policy questions which are further addressed in the ensuing sections of the memorandum. The second section reviews the major provisions of legislation authorizing video gambling in the states of Montana, South Dakota, Oregon, Louisiana, and West Virginia. The third section raises policy concerns and issues stemming from legislation governing regulation of video gambling machines, as well as implementation of this form of gambling. The fourth section examines revenues generated by video lottery games in South Dakota, Montana, West Virginia, and Oregon (projected) where state-regulated video gambling machines are in operation. The fifth section addresses possible implications of video lottery for state revenues in Kansas, using assumptions extrapolated from South Dakota's experience. South Dakota was chosen as a basis for comparison because video lottery in that state is regulated by the South Dakota Lottery and has been in operation since October, 1989. Moreover, 1991 Sub. for S.B. 449 was patterned after South Dakota's video lottery law. The Kansas bill was passed out of the Senate Committee on Federal and State Affairs but was subsequently killed by the Senate during the 1991 Session. The sixth section raises major policy questions to be considered by the Legislature in formulating legislation.

It should be noted at the outset that a provision in the *Kansas Constitution* (Article 15, Section 3c) authorizes the Legislature to "provide for a state-owned and operated lottery." This provision has certain implications for video lottery implementation in Kansas (to be further discussed below). One major implication is that video lottery statutes in other states might not be completely compatible with this constitutional provision.

House Federal & State Affairs
January 22, 1992
Attachment #1

SECTION I – BACKGROUND

Where Are Video Lottery Games Regulated?

Video gambling is currently regulated by the states of South Dakota, Montana, and West Virginia, and by Manitoba, Alberta, New Brunswick, Prince Edward Island, Newfoundland, and Nova Scotia, Canada. Oregon and Louisiana authorized regulation of video lottery in 1991 but have not yet initiated games. In South Carolina, cash-payoff poker machines are legal but not state regulated. In most states, including Kansas, possession of video gambling machines is legal but cash payouts to winners are illegal under federal and state laws.¹

What Are Video Lottery Machines and Video Lottery Games?

Video lottery is an electronic game of chance. An example would be a machine that "deals" a hand of draw poker. Video gambling machines or devices are either part of an automated network or they are not. For example, in Montana the machines must have internalized meters but they are not hooked to a centralized computer. By contrast, South Dakota regulates video lottery terminals (VLTs). A VLT in that state is an "on line" coin-operated video gambling machine that allows one to play bingo, keno, blackjack, and draw poker games. VLTs do not pay out money but instead generate vouchers from an internal printer. The voucher is then given to the owner of the establishment who pays the winner.²

In South Dakota, West Virginia, and the Canadian provinces the VLT, which is hooked up by modem to the central computer in the state lottery, transmits data to the central headquarters each day. The computer prints information that includes such items as cash deposited into the VLT, net income, number of credits played, number of credits won, and game play statistics, such as winning combinations and frequency of play. In Oregon, the State Lottery decided in November, 1991 to connect VLTs via dedicated telephone lines to the central computer; the intent is for VLTs to transmit data on a continual basis to the computer, instead of at certain intervals, as is the case with the "dial-up" mode of linkage.³

¹Throughout the memorandum, reference is made to "gray machines" which are video lottery machines not licensed or certified by a government which regulates video lottery games. For example, if Kansas were to regulate video lottery machines, machines currently in operation which would not become certified by the state would be considered "gray machines." "Gray machines" may be operating either legally or illegally.

²Payouts to winners from video lottery games are generally set in statute at a higher maximum percentage (80-92 percent) of total gross revenues than they are for other types of lottery games. However, the tendency of individuals to play more video lottery games after they have won lowers the percentage of actual payouts or prizes to 55-64 percent of total gross revenues.

³West Virginia uses a dedicated line to link its VLTs to the central site but data are not polled on an ongoing basis.

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The advantage of an on-line system, in contrast to a decentralized system, is greater security because more information is being imparted to regulators on an ongoing basis. The disadvantage is the initial installation expense.

What Is a State's Primary Objective for System Implementation?

There are several options for configuring a state video lottery system and each state has embarked upon a different course of action. However, prior to making determinations about configurations, states are faced with the central policy question about their primary objective for involvement in video lottery. Is the primary objective to ensure maximum security and regulation of a formerly illegal activity? Alternatively, is the primary objective to maximize state return from a new revenue source?

States and those Canadian provinces which regulate video lottery games have made different choices in their implementation strategies and those choices were largely dictated by their policy objective. These two objectives are not mutually exclusive and, as will be evident from the discussion below, all governmental participants in video lottery systems have concerns related to each objective.

Which Entities Run Video Lottery Programs?

Video lottery programs are operated by either private parties (operators) or state or provincial governments. Montana, South Dakota, West Virginia, New Brunswick, and Prince Edward Island have implemented systems in which private operators purchase video lottery machines and install, service, and repair equipment at licensed retail locations. Louisiana intends to have private operator participation, as well. By contrast, Nova Scotia, Newfoundland, Manitoba, and Alberta have government-operated programs and Oregon intends to do the same. There are no private operators in those programs and the government has direct responsibility for the purchase, installation, service, and repair of the VLTs.

At least in theory, greater state control suggests fewer outside participants (operators, service, and maintenance personnel) and greater system security which might be offset to varying degrees by less aggressive market penetration and more modest gross revenues (points addressed below). Once again, the state's primary objective for involvement in video lottery would affect its decision on who should operate the games.

Which Agency or Agencies Oversee Video Lottery Games?

In Montana video lottery operations are regulated by the Department of Justice and in Louisiana by the Department of Public Safety and Corrections.⁴ In South Dakota, West Virginia, and Oregon, oversight of operations is the responsibility of these states' lotteries. Because the *Kansas Constitution* requires lottery games to be operated by the state (see Attorney General's Opinion No. 87-38), one might assume that, at a minimum, the responsibilities associated with the operation of video games would ultimately have to be the domain of the Kansas Lottery. Law enforcement

⁴Both states also have Lottery Commissions.

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entities could become involved in associated regulatory activities. To the extent that the role of the Kansas Lottery historically has been to promote participation in lottery games, such a separation of responsibilities might be considered by the Legislature if the basic policy objective is to regulate a heretofore illegal business rather than to maximize participation and revenue.

What Are Options for Operation of Video Lottery?

If one assumes that the Kansas Lottery would own and operate video lottery games in accordance with the *Kansas Constitution* (see above), there are several options which the Legislature might consider in assigning such oversight responsibility.⁵

1. The Lottery could own or lease VLTs and provide placement and maintenance services to retailers.
2. The Lottery could own or lease VLTs and contract for services to retailers.
3. The Lottery could administer the games with retailers owning the VLTs. Services could be provided either by the Lottery or operators.
4. The Lottery could contract with operators for the placement of games within retail establishments. Operators could own VLTs or gaming devices and provide all applicable service.
5. The Lottery could contract with operators for the placement of VLTs within retail establishments. Retailers could own and operate VLTs. Operators could provide applicable services.

SECTION II – LEGISLATION ON VIDEO LOTTERY

Montana

Video gambling is currently regulated by the Montana Gambling Control Division of the Department of Justice under the Attorney General and has been subject to regulatory oversight since 1985 with the enactment of the Video Draw Poker Control Act. In 1987 the Legislature expanded regulation over video gambling machines to include, in addition to draw poker, keno and bingo. Only keno machines were "grandfathered in" upon enactment of the laws governing video lottery. Video gambling machines may be placed in a room or area of a licensed operator's premises where alcohol is sold or consumed (also includes convenience stores and truck stops) and must be located within

⁵If one does not automatically assume that the Lottery would own and operate video lottery games, the word "Lottery" in the options below should be replaced by the word "state." Options 3-5 might be of questionable constitutionality if certain factors are not addressed sufficiently in implementing the statute. Attorney General's Opinion No. 92-1 cites some of the elements necessary for state control of video lottery games.

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the operator's control to prevent the play of machines by persons under age 18.⁶ An operator is allowed to place any combination of up to 20 machines (poker, keno, or bingo) on the licensed premises. Unless permitted by local ordinance, no video gambling machine may be played between 2:00 a.m. and 8:00 a.m.

The statutorily-prescribed percentage of credits won to credits played must be at least 80 percent. Not more than \$2 may be played per game and free games or credits may not be awarded in excess of the following amounts: \$100 a game for draw poker and \$800 a game for keno or bingo.

Each operator must pay an annual machine permit fee of \$200; the fee must be prorated on a quarterly basis. Fifty percent of the fee is retained by the Department of Justice for administrative purposes and the remainder is returned on a quarterly basis to the local governmental jurisdiction in which the machine is located.

A licensed operator also must pay the Department of Justice a video gambling machine tax of 15 percent of the gross income from each video gambling machine; this is 15 percent of the money put into the machine minus credits paid out in cash and minus amounts stolen from machines if such amounts are uninsured and under investigation by a law enforcement agency for theft. Of the 15 percent received, one-third is credited to the State General Fund and two-thirds are remitted to local governments.

Each manufacturer-distributor of video gambling machines must pay an annual license fee of \$1,000. Statutory provisions allow the Department to charge one-time application processing fees for such licenses. Licensed operators who are not licensed as manufacturer-distributors may sell up to 20 machines within a calendar year under certain specified conditions.

The Department of Justice is authorized to inspect, test, approve, disapprove, or place a condition upon a video gambling machine prior to its distribution and placement for play by the public. The manufacturer-distributor is required to pay the Department for costs of examining the machine.

There are criminal penalties for violations of this Act.

Given the decentralized nature of system (machines are not on-line to a central computer), the scope of participants which includes operators, and the absence of statutes to prohibit vertical integration, the state apparently viewed its primary objective as that of reaping some but not maximum revenue from regulation of activities that were previously illegal. Because Montana (July 1, 1987) was the first state or province to regulate video lottery, its configuration lacks the sophistication and initial capital outlay found in states with on-line systems.

South Dakota

The South Dakota Lottery has licensed and regulated video gaming activities since October 16, 1989. Video games presently authorized are blackjack, poker, bingo, and keno. VLTs

⁶In Montana's statutes, the term "operator" encompasses retailer responsibilities in contrast to the meaning of that term in other states' video lottery statutes.

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must be located in licensed establishments at which alcoholic beverages (liquor, malt, and wine beverages) are dispensed and consumed. Laws for licensed establishments initially allowed convenience stores to qualify for licensure, but the 1991 Legislature essentially eliminated the entry of convenience stores into video lottery by tightening restrictions on eligible establishments. Establishments licensed prior to January 1, 1991 were "grandfathered in."

VLTs must be located in areas that are monitored at all times by the owner, manager, or an employee of the licensed establishment to prevent access to or play of VLTs by persons under the age of 21. If a licensed establishment allows multiple uses of its premises which serve various age groups, a permanent physical barrier (statutorily defined) must be erected to prevent under-age individuals who are unaccompanied by individuals of 21 years or older from gaining access to VLTs. No more than ten machines may be located at any licensed establishment. No licensed VLT may be played except during hours when on-premise consumption of alcohol is allowed.

Players may wager a minimum of \$0.25 per game and a maximum of \$2.00. The maximum payout per game is \$1,000 if \$2.00 is wagered. The payback value of one credit is at least 80 percent of the value of the credit.

Manufacturers, distributors, machine operators, and retail establishments must be licensed and license fees are retained by the state. The Lottery requires an application fee of \$50. Annual license fees are: \$5,000 for manufacturers; \$5,000 for distributors; for operators, the greater of \$1,000 or \$100 for each machine licensed; and \$100 for establishments. Vertical integration of licensees (and therefore multiple types of licenses) is prohibited, except for retailers functioning as operators provided that such retailers meet operator licensee requirements. The state's portion of net machine income is currently 35 percent, recently changed from 25 percent.

The Lottery is required to examine prototypes of video lottery machines and associated equipment of manufacturers seeking a license.

There are criminal sanctions for violations of this Act.

Although South Dakota provides for measures to ensure security in the regulatory system (on-line VLT system, background checks on licensees, prohibitions against vertical integration, unannounced spot-checks by state inspectors of VLTs), the state's dominant objective appears to be the use of video lottery games as a source of additional revenue. However, operators are active participants and realize a substantial share of net proceeds. The on-line system, while more secure than Montana's decentralized system, is, at least in theory, not as secure as a state-owned and operated system with dedicated lines linking VLTs to a central computer.

West Virginia

The West Virginia Lottery regulates, on a trial basis, VLTs which are located exclusively at Mountaineer Park (a horsetrack and convention center) in Chester. The Lottery maintains security, approves licensing in accordance with procedures followed for all lottery retailers, and ensures expenditures of funds are made in accordance with the legal contract between the Lottery and Mountaineer Park. All terminals are tied through a dedicated line into a central computer system in Charleston although game activity is monitored periodically. There is no legislation specifically authorizing video lottery operation because such activities appear to be covered by a

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general statute and the state's *Constitution*, according to an opinion of the West Virginia Attorney General issued on February 14, 1991.

Louisiana

The Video Gaming Division of the Gaming Enforcement Section of the Office of State Police within the Department of Public Safety and Corrections regulates video draw poker devices. These devices must contain meters to record revenues, prizes, credits, and other game performance data. They also must be linked to a central computer for purposes of polling or reading device activities and for remote shutdown of device operations.

These devices may be placed in a licensed establishment (restaurant, bar, tavern, motel, hotel, club, or other premises) where alcoholic beverages are sold for on-premise consumption. The statutes also provide that areas of adult patronage and truck stop facilities may install devices even if alcoholic beverages are not sold on the premises. Draft regulations on video poker include off-track betting or licensed parimutuel wagering facilities in the definition of "licensed establishment."

If installed in a truck stop, video draw poker devices must be placed in an area which is segregated for adult patronage only and the facility must meet certain usage and physical criteria. A licensed establishment may have no more than three devices except if there is more than one lounge or facility in an establishment, in which case the maximum number of devices per lounge is three. However, there is no limit on the number of devices at truck stops or at licensed establishments at which licensed off-track betting and parimutuel wagering are permitted. No person under 18 may play or operate a device at a licensed establishment.

No more than \$2 may be spent per game, nor may awards or credits per game exceed \$500. The statutorily-prescribed percentage of credits won to credits played must be at least 80 percent.

Annual licensing fees are the following: \$5,000 for manufacturers; \$3,000 for distributors; \$2,000 for service entities; \$1,000 for device operation; \$1,000 for device owners; and \$100 for licensed establishments. The device operation fee, payable by the device owner, is levied for each machine placed at a licensed establishment. That fee may be paid in quarterly installments. The draft regulations for video draw poker state that "the primary purpose of the license/application fee is to defray the costs of conducting background investigations and any other security or financial investigations conducted on applicants." Video poker devices are exempt from taxes, fees, or licensing restrictions imposed by any governmental entity except that a local governing authority may levy an occupational license tax, not to exceed \$50 per device.

In addition, the device owner is required to remit to the Video Gaming Division a franchise payment in an amount equal to 22.5 percent of net revenues (gross revenues less the value of prizes) derived from the operation of each video poker device.

All fees, fines, and penalties collected by the Division are credited to the Video Draw Poker Device Fund and distributed pursuant to appropriations as follows: 75 percent is applied to the Division's enforcement responsibilities and 25 percent is provided to local governing authorities in which devices are operated. The distribution is to be based upon the proportion of the total amount each local unit contributes to the statewide total. These funds also must be used for enforcement purposes.

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With respect to devices located at parimutuel wagering facilities, a specified funding formula is applied to supplement purses for horsemen. This formula is different for owners of licensed establishments who are not licensed device owners than for establishment owners who are likewise device owners.

There are provisions for suspension and revocation of licenses. In addition, there is a provision for the Division to conduct any investigations, hearings, and inquiries deemed necessary to fulfill its responsibilities.

Louisiana's video poker system is expected to be a hybrid on-line operation. The intent is to link to the central computer via dedicated lines video poker devices which are located in busy places, such as in truck stops and at race tracks. In less busy places, those devices will be linked to the computer through a dial-up system.

In response to the policy question of overriding objective, in Louisiana it appears to be maximizing security although not to the extent anticipated by Oregon which uses only dedicated lines to connect VLTs to the central computer and which does not permit private operators. To date, the Department of Public Safety and Corrections has developed draft rules and regulations which must be approved by a legislative oversight board.

Oregon

The Oregon Lottery is authorized to regulate video lottery games. Although this authorization existed as early as 1989 there was no statutory prohibition against private possession of video gaming devices (defined statutorily as "gray machines"; see Footnote No. 1) until the enactment of 1991 H.B. 3151. This bill makes it a crime for a person to possess such devices on or after December 1, 1991. This ban resulted from concerns about law enforcement problems that were expected to arise from the operation of a legal, publicly-sanctioned system coexisting with "gray" games. A recent court case challenged the constitutionality of H.B. 3151, but it was dismissed in October, 1991 and is currently being appealed.

A VLT may operate only in the establishment of a video lottery game retailer under contract with the Lottery. The Lottery Commission adopted rules which specify the terms and conditions for such contracts. A VLT must be placed in an establishment licensed by the Oregon Liquor Control Commission to sell alcoholic beverages primarily for on-premise consumption by persons of at least 21 years of age. Access to terminals must be restricted to persons who are at least 21 years old. No more than five VLTs may be placed in authorized liquor establishments. The establishment is the licensee. For example, if an airport is the licensee for VLTs and it houses five bars, only five VLTs can be located within the entire airport facility.

The revenue distribution also has been left, for the most part, to rule and regulation authority. The only allocation requirements prescribed by statute relate to county entitlements. Pursuant to 1991 H.B. 3151, an amount equal to 6 percent of net revenues generated from video lottery games in a county must be distributed to that county as administrative expenses, to be expended for gaming law enforcement (3 percent) and community mental health programs to treat gambling addiction (3 percent). In addition, 2.5 percent of net receipts is to be allotted to county economic development programs pursuant to 1991 S.B. 562. Of that 2.5 percent, 80 percent will be distributed to each county in proportion to the gross receipts from video lottery games in each county while the remaining 20 percent will be distributed in equal amounts to each county.

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The Lottery's rules authorize the Lottery to own and maintain video lottery machines and serve as the regulatory, enforcement, and licensing agency for video lottery games. For the most part, the Lottery will assume all those responsibilities but might contract for some of those services in outlying areas of the state. These regulations allot 8.5 percent of net revenues or receipts to counties, as required by statute; the balance would be divided between retailers (35 percent) and the state (56.5 percent) for administration, operation, and maintenance of the system and for various economic development projects. State funding for those purposes would be subject to appropriations. Finally, the Lottery is assuming in its rules a theoretical percentage payout of not to exceed 92 percent of gross revenues.⁷

In addition to its projected share of video lottery net revenues, the state will receive proceeds from a tax of \$100 imposed on each device which is classified as a game of chance (amusement tax).

Oregon statutes provide the Lottery with considerable rule and regulation authority concerning: types of games (only video poker games will be offered initially); number and value of prizes in each game; method for determining winners in each game; the retail sales price for a ticket or share; a validation system and means of paying prizes; method for determining the manner in which tickets should be sold to the public; basis for approval of in-state manufacturing and servicing of video devices; selection of retailers; and other facets of regulatory oversight. The Lottery also is to contract for an outside review of the cost of operating video lottery games.

On December 16, 1991, the Lottery selected its central site computer vendor. By the end of December, 1991, the Lottery intended to select a vendor for all state-owned VLTs.

To a greater extent than other states addressed above, Oregon appears to have based its system's configuration on the primary objective of ensuring maximum security in its regulatory oversight responsibilities. Examples of adherence to this objective include: the ban on "gray machines"; the requirement that VLTs be placed only in licensed establishments which sell alcoholic beverages for on-premises consumption; a limitation on the type of games offered; and the decision to designate the Lottery as the sole source of game operations. Adherence to this objective also is reflected in the Lottery's commitment to a provision in the state's constitution that rules and statutes implemented by the Lottery "insure the integrity, security, honesty, and fairness of the Lottery." Oregon's implementation plan reflects greater concern for security and system control than for maximizing revenues.

⁷ The *Oregon Constitution* specifies that "at least 84 percent of the total annual revenues from the sale of all lottery tickets or shares shall be returned to the public in the form of prizes and net revenues benefiting the public purpose."

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SECTION III – POLICY CONCERNS

In conversations with various contact persons from states with video lottery authorization, staff obtained information about concerns related to the location of video gambling machines, reduced revenue for parimutuel wagering and other forms of entertainment, problems with conflict of interest, and problems with ensuring Lottery system security. A summary of those issues follows.

Location of Machines

The Public Relations Director for the South Dakota Lottery noted that instant lottery ticket sales "took a 25 percent hit" in the first year of video lottery. She ascribed this reduction in sales to the fact that VLTs are often located in convenience stores which were able to get liquor licenses in South Dakota. These stores have traditionally been the primary site for sales of instant lottery tickets. Many of these stores did not intend to sell liquor for consumption on the premises but due to a "loop-hole" in the law obtained liquor licenses which therefore enabled them to house VLTs. The law authorizing video lottery in South Dakota initially licensed convenience stores, but a law enacted during the 1991 Session would in effect prohibit licensure of those stores unless they were "grandfathered in."

Parimutuel Competition and Competition With Other Forms of Entertainment

Dana Nelson, Executive Director of the Kansas Racing Commission, served in the capacity of Executive Director of the Racing Commission in South Dakota until February, 1991. He observed that video gambling was devastating to the racing industry in South Dakota where one dog track closed after video lottery was introduced and a second track experienced a 15-17 percent reduction in handles after the first year of video lottery. Greyhound simulcasting likewise experienced a serious revenue reduction. (See Section IV for an analysis of the possible impact of video lottery on racing revenues in South Dakota.) Mr. Nelson expressed uncertainty as to whether the two race tracks in Kansas could be sustained with a 15-17 percent reduction in handles. He noted that racetracks have fixed costs (note payments, utilities, property taxes, and administrative costs) and that, given fixed costs, reductions in revenues probably could not be offset by a reduction in expenses.

The in-house auditor for the West Virginia Racing Commission indicated that video gambling machines at Mountaineer Park are authorized and regulated by the Lottery. There are approximately 150 video gambling machines, many of which are located at a motel facility less than a mile from the racetrack in the Park. According to the auditor, parimutuel wagering is down approximately 10 percent since the installation of video gambling machines. (After a full year of video lottery operations at Mountaineer Park, the handle was down 6.48 percent from the prior year and attendance was down 7.24 percent.) The auditor explained that the state's gaming officials argue, however, that the reduction would have been even worse without the video gambling machines. (Revenues from wagering were not as reduced at this track as at another in the state.) Approximately the same time as the video gambling machines were installed in Mountaineer Park, four or five off-track wagering sites were authorized in Pennsylvania, within 50-60 miles of Mountaineer Park. These sites are considered to be in the marketing area of the racetrack.

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On July 27, 1991, the Lottery and racetrack owners signed a contract which allows a portion of revenues derived from video gambling machines to be applied to purses, thus offsetting one effect of reduced revenues at the racetrack. (Note that a similar provision is in Louisiana's law.)

Not only does parimutuel wagering appear to be affected by the presence of video lottery games, but other forms of entertainment might be likewise affected. Restaurant owners who own and lease video lottery equipment in South Dakota opposed a proposal (subsequently adopted by the Lottery Commission) to increase the state's share of net lottery proceeds from 25 percent to 35 percent. They claimed that video lottery games reduced drink sales and revenue from pool tables, pinball machines, and other amusement devices.⁸ Moreover, at hearings on the proposed Oregon rules, although no precise figure was offered or study conducted to support a particular estimate, testimony indicated a reduction in income to coin operators of 50 to 80 percent of their total sales.⁹ (Coin operators are individuals who have owned video machines and other types of gaming machines or leased them to bars and taverns.) Finally, the Oregon Lottery Commission projected that video lottery games could produce an \$8 million drop in revenues of other lottery games.

Conflict of Interest

There is no prohibition against vertical integration of licensees in the Montana statutes as there is, to a certain extent, in the South Dakota statutes.¹⁰ What is meant by "vertical integration" in this context is that operators may not be manufacturers or distributors, nor may manufacturers and distributors own, manage, or control a licensed establishment. The Montana Gambling Control Division has experienced problems with undisclosed interests in business and reporting on income sources and will be considering the imposition of a prohibition against vertical integration.

Security

An administrative officer for the Montana Gambling Control Division explained that Montana has been considering an on-line system for video gambling. As previously noted, machines in Montana are metered but are not part of a central site automated system. According to the administrative officer, some problems with tampering with machines, such as the bill acceptors, have been reported and meters do not always function properly. The administrative officer observed that an on-line system could be more effective in identifying such problems and instilling more security into the regulatory process. Montana is considering conversion to an on-line system.

⁸William Koupal, "South Dakota: Video Lottery Tax May Rise," *State Tax Notes*, December 2, 1991, page 473.

⁹Memorandum to the Oregon Lottery Commissioners from Gary Williams, Hearings Officer, regarding Determination of Economic Effect Upon Small Businesses, November 21, 1991.

¹⁰In South Dakota, despite other prohibitions against vertical integration, retailers may also be operators. Retailers who are also licensed as operators sometimes experience problems, not with conflict of interest, but with obtaining service contracts for their VLTs, according to the Public Relations Director for the South Dakota Lottery.

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The Oregon Lottery utilized a report with recommendations on security matters prepared by the Oregon State Police, Department of Justice (1991). This report (on file in the Kansas Legislative Research Department) noted certain recommendations that:¹¹

1. all terminals be approved by Underwriters' Laboratories;
2. bill acceptors be used in lieu of coin operated machines because their ability to detect noncurrency is superior to coin acceptors;
3. bar codes be used as a method of validating winning tickets; with an on-line system, security would be heightened and no ticket could be copied and claimed twice;
4. the Lottery logo appear on the video screen of each device via the software and be controlled by the central system, thus preventing duplication from another source (this would serve to distinguish gray machines or unlicensed machines);
5. the system be on-line and use dedicated lines; if coupled with data encryption during transmission, security would be maximized;
6. an in-house central site system be operated which would involve the purchase of the system and possibly the employment of a vendor to serve as a consultant, upgrade the system, and train Lottery personnel;
7. if the vendor operates the system, the Lottery closely monitor daily operations with particular attention to electronic funds transfer; by not operating its own site the Lottery could be subject to shutdown in the event the vendor is subject to a lawsuit, restraining order, bankruptcy, or receivership; and
8. any operator participation include a yearly review, including examination of income tax returns and other financial information to prevent cheating of the entire system through the retention of illegal games with look-alike devices at retail locations and the skimming of money from the retailer.

The Oregon report on security measures also noted that a major concern of the Atlantic Lottery, which operates video lottery in New Brunswick and Nova Scotia, is the continued use of "gray machines" despite their ban from those provinces. Apparently local police have not enforced the ban because it is a low priority. Consequently, according to the report, there has been widespread use of these machines not only in drinking establishments but also in convenience stores,

¹¹These recommendations were attributed to James Maida, President of Gaming Laboratories International, Inc., a company which performs various hardware and software tests to insure that terminals and games operate within set specifications. These recommendations were used to support the Oregon Department of Justice's position that private operators should not be permitted. Mr. Maida claims that these recommendations were taken out of context and misrepresent his position. These recommendations apparently assumed that costs were not a factor. Therefore, one should probably view those recommendations in the context of realizing the objective of security regardless of attendant costs.

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bowling alleys, and other locations accessible to the general public. The report maintains that lax enforcement has resulted in competition between the two systems -- one illegal, the other legal. The Atlantic Lottery also advised that it has been difficult to keep operators from participating who have been involved with unlawful gambling prior to the inception of the video lottery law. Incidents of illegal video gambling operations in Canada, Nevada, Oregon, and Montana are cited in the Oregon report. Drawing from experiences in Oregon and other states, the report concludes with the following recommendations:

1. The ban on gray machines should be strictly enforced.
2. If the Lottery chooses to run a video lottery system, private operators should not be permitted. The Lottery itself should operate the central site and the field operations.
3. If operators are allowed to participate in the video lottery system, no one who has been involved in any gambling offense, any felony, or any crime involving theft or deception should be allowed to participate in the video lottery endeavor.¹²

According to the Public Relations Director of the South Dakota Lottery, security has not been a problem. She cited the safeguards of an annual in-depth licensing procedure which examines the personal and financial profiles of all system participants and provides for unannounced inspections of VLTs conducted by five inspectors statewide.

SECTION IV -- REVENUES (OTHER STATES)

South Dakota

In South Dakota, revenues from VLTS are treated as follows: From all moneys generated from VLTs (gross revenues), actual cash paid out (prizes) is subtracted. Although the statutory minimum prize payout is 80 percent, player behavior affects the actual percent of gross paid out. This translated in South Dakota in the first year of operations (October 16, 1989-October 20, 1990) to 63.9 percent of gross revenues or \$132.3 million paid out in prizes of gross revenues of \$207.1 million.¹³ Net machine income is the cash into the terminal minus all cash paid out in prizes which totaled \$74.8 million (36.1 percent) in the first year of operations. In South Dakota, the state's share of net machine income during the first year was 22.5 percent. (The state's share was subsequently changed to 25 percent and on December 12, 1991, the Lottery Commission voted to

¹²Countering the above concerns with security, James Maida of Gaming Laboratories International indicated in the December, 1991 issue of *Play Meter*: "As I've said numerous times this year, video lottery terminals and systems are virtually impossible to cheat. Don't let anyone tell you differently. After all, would more than 7,000 machines be installed to date if the video lottery system was easily cheated?"

¹³These sales figures were cited in *South Dakota's Facts and Figures* (10/20/90).

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increase it to 35 percent effective through administrative rules in January, 1992.) The 22.5 percent share for the first year totaled approximately \$16.8 million. The remaining 77.5 percent of first year net revenues (\$58 million) was shared by video operators and video establishments. In South Dakota, video operators are licensed by the Lottery to purchase and place video lottery machines and associated equipment in establishments.

South Dakota FY 1991 Profiles

July 1, 1990-June 30, 1991

Net Revenue (after payout of prizes)	\$107 million
State's share of net revenue	\$25.1 million*
Number of establishments	1,358
Number of operators	67
Number of operators/establishments	43
Number of distributors	9
Number of manufacturers	14
Number of terminals	5,763

* 22.5 percent prior to 1-1-91 when 25 percent went into effect.

Data received on October 15, 1991 suggest that after two years of operation, video lottery in South Dakota may be approaching saturation in terms of the number of establishments, operators, operators/establishments, distributors, and manufacturers. The number of establishments increased by two, whereas the number of all other types of participants declined since June 30, 1991. The number of terminals increased from 5,763 to 6,116, bringing the ratio of terminal to establishment from 4.2 (June 30, 1991) to 4.5 (October 15, 1991)

The South Dakota Lottery does not, with the exception of operators' fees, segregate revenues received from licensure by game. Initial fees and renewal fees for operators (exclusively video lottery) in FY 1990 totaled \$426,000; in FY 1991, it totaled \$657,500. For all lottery games (instant lottery, Lotto America, and video lottery), licensure for retailers (manufacturers, distributors, establishments, and first-time operators' application) totaled \$128,300 in FY 1990 and \$252,970 in FY 1991.

The state's share of net revenue from nonlicensure sources continues to increase. In the first four months of FY 1992 the state's share of net revenue was \$9,989,121. If this amount is annualized the total is almost \$30 million. However, since the state's share of net revenue was subsequently increased from 25 percent to 35 percent in January, 1992, state lottery officials expect

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additional revenue of \$6.2 million in FY 1992 and \$13 million in FY 1993. Given the fact that the number of establishments remained fairly constant during the first four months of FY 1992, the increase in revenues can be attributed to an increase in terminals.

However, one might predict a flattening of revenues for the years after FY 1992 because the median net revenue per terminal continues to increase but at a slower rate over time. In FY 1990, it was \$12,064. In FY 1991, it was \$18,567. Based on the first four months in FY 1992, the annualization amount would be \$19,599.

According to the South Dakota Lottery, 69.4 percent of all terminals are found in bars (32.6 percent), lounges (17 percent), and restaurants (19.8 percent). Terminals are also located at other sites authorized to sell liquor for consumption: bowling alleys (3.7 percent), fraternal clubs (8.2 percent), liquor stores (2.3 percent), recreation (3.4 percent), motels or hotels (4.0 percent), and other establishments, mostly grocery and convenience stores (7.0 percent). The remaining 1.8 percent of terminals are reported as "not enrolled," meaning that they are inactive.

The budget for the Lottery to oversee operations was \$937,000 in FY 1991 and an estimated \$1.1 million in FY 1992. There was a one-time initial start-up cost of \$1.5 million for the video lottery central computer system. There were 13 positions at the outset of video lottery operations and that number has not increased.

At least two other games regulated by the state appear to be affected by video gambling. Prior to October, 1989 the Lottery only offered instant lottery. In FY 1988 the state's share for instant lottery was \$7.8 million and, in FY 1989, \$6.3 million. In FY 1990, the state's share for instant lottery was reduced to \$5.2 million, although the state's share for both games was \$15.6 million. In FY 1991, the state's share for both instant lottery and Lotto America totaled \$3.9 million (\$2.7 million for instant lottery and \$1.2 million for Lotto America which started in November, 1990). However, the state's share for all three games, including video lottery, was approximately \$29 million in that fiscal year.

Parimutuel wagering (greyhound and horse racing) revenues have likewise declined. In 1990 South Dakota had two race tracks for greyhounds: Sodrac and Black Hills. Black Hills' handles dropped from over \$4 million in 1989 to \$2.5 million in 1990 and the track closed in 1991. Sodrac's handles dropped from almost \$5.5 million in 1989 to almost \$4.6 million in 1990. Greyhound simulcast handles declined less dramatically from 1989 (\$7.5 million) to 1990 (\$7.1 million). However, the decrease from 1990 to 1991 was particularly notable -- approximately 52 percent. Likewise, Sodrac's live racing handle decreased in that interval by over 40 percent. Horse racing handles have also declined each year since 1989 at the tracks in Ft. Pierre and Aberdeen. However, simulcast of horse races has caused total handles for horses to almost double from 1990 to 1991.

The extent to which video lottery games affect parimutuel wagering is an open question because in certain parts of the country where statewide video lottery games are not available, parimutuel wagering handles also have declined.¹⁴ It appears that parimutuel wagering could be correlated to economic downturns and competition from other forms of entertainment.

¹⁴From 1990 to 1991 handles were down 25-30 percent at greyhound tracks in Wisconsin, 35 percent in Dubuque, Iowa, 34.4 percent in Jacksonville, Florida, and 17.4 percent in Orlando. Horsetrack betting for the same period was down 35 percent at Canterbury Downs, Minneapolis and Prairie Meadows, Iowa even closed because of reduced revenues.

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Montana

Unlike South Dakota, revenues to Montana are used primarily for oversight responsibilities of the Department of Justice. They are derived from: the video gambling machine tax (15 percent of the gross income of each machine with two-thirds returned to local governments); annual license fees of manufacturer-distributors (\$1,000 annually); and the annual machine permit fee (\$200 on a quarterly basis with half going to counties).

The table below illustrates moneys collected from each source:

Montana Video Gambling Machine Permits*

<u>Year</u>	<u>Poker No. of Permits</u>	<u>Video No. of Permits</u>	<u>Bingo No. of Permits</u>	<u>Total No. of Permits</u>	<u>Total Amount</u>
FY 1990	6,223	4,803	22	11,048	\$2,209,600
FY 1991	7,411	5,317	0	12,728	2,545,600

* The number of permits apparently overstates the number of actual machines since each time a machine is relocated another permit must be issued. The actual number of machines is not tracked.

Manufacturer/Distributor Licenses

<u>Fiscal Year</u>	<u>No. of Licenses</u>	<u>Total Fees</u>
FY 1990	125	\$ 125,000
FY 1991	132	132,000
FY 1992	119	119,000

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Video Gambling Machine Tax Collection and Distribution

<u>Fiscal Year</u>	<u>Total Revenue (In Millions)</u>	<u>Local Government (In Millions)</u>	<u>General Fund (In Millions)</u>
FY 1990	\$17.0	\$11.3	\$5.7
FY 1991	20.7	13.8	6.9

Total video gambling machine net (now statutorily defined in Montana as "gross") income (money put into machines minus prizes) was \$113,360,000 in FY 1990. The average net income per machine (permittee) was \$10,261. Based on the reported machine net income, the Department of Justice estimated that the total amount wagered was \$251,800,000. This amount was calculated by using the estimated payback to players of approximately 55 percent. For FY 1991, video gambling machine gross income totaled \$137,044,407. Assuming an estimated 55 percent payback, the total amount wagered was \$304,543,126. The average net income per machine (permittee) was \$10,767. The tax collected on machines for the first quarter of FY 1992 was \$5.8 million. Given this is 15 percent of video gambling machine statutory gross income, that income, if annualized, is \$154,666,667.

Oregon

The Oregon Lottery Commission currently estimates that annual net receipts from video lottery games will be \$219 million. (Net receipts are defined as "the amount of money that is received from the sale of video lottery games after payment of prizes but prior to any other payment.") On November 25, 1991, the Lottery Commission decided to authorize the Lottery to operate the video lottery games. Therefore, private sector operators will not receive a portion of net revenues generated from such games. Counties receive 8.5 percent of net revenues and, according to the Lottery's rules, retailers will receive 35 percent and the state the remaining 56.5 percent, although the internal allocations for the state have yet to be determined.

Counties (8.5%)	\$ 18,615,000*
State (56.5%)	123,735,000
Retailers (35%)	76,650,000
TOTAL	<u>\$ 219,000,000</u>

* There is some discussion of subtracting 2.5 percent for county economic development activities from \$219 million (\$5,475,000) and from that total taking 3 percent for each of the other programs sharing the allocation to counties. This means that gaming law enforcement would be allotted \$6,405,750, as would community health programs to treat gambling addictions. See page 8 for further discussion on the allocation of the 8.5 percent for counties.

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In addition to the state's share of video lottery proceeds, the state will receive proceeds from amusement taxes paid on amusement devices (including VLTs). The Lottery Commission apparently intends to install approximately 10,000 devices. As the tax is \$100 per device, the Commission would receive \$1 million. "Gray" games were banned on December 1, 1991 and there are an estimated 5,000 "gray machines." Prior to that date these machines (classified before the ban as a game of chance) had paid \$100 annually. This translates into a total of \$500,000 in amusement taxes due to the ban which must be subtracted after 1991 from the \$1 million collected on new machines.

A financial study conducted on the Oregon Lottery (October, 1991) projects state operator administrative expenses¹⁵ to be \$22.6 million assuming 2,600 locations and 10,500 terminals.

West Virginia

The West Virginia Lottery authorized video lottery games at Mountaineer Park in June 1990. Therefore, only the first year of operations (June 9, 1990-June 8, 1991) has been reported. The first year realized gross sales of \$8,071,658; a 70 percent prize payout of \$5,619,221; funding to the Lottery (and transferred in part to other state agencies) totaling \$995,215; and allocation to Mountaineer Park of \$1,457,222. At the end of the first year of operations, there were 150 terminals in Mountaineer Park realizing a median net revenue per terminal of \$16,350. In the first year of video lottery operations, the contract between Mountaineer Park and the Lottery provided allocations of gross machine income of 65 percent for prizes, 14 percent to the state, 9 percent for Mountaineer Park, 6 percent to the track for initial investment capital, 3 percent for advertising, and 3 percent to the Lottery for operations. The formula governing allocations of net lottery proceeds (after payment of prizes) was renegotiated in July, 1991 and the following allocation formula is currently in effect: Mountaineer Park -- 70 percent; horsemen -- 10 percent; and Lottery -- 20 percent. A contact person from the Lottery noted that the Lottery had made no upfront investments in the video lottery games. In FY 1991, video lottery accounted for 9 percent of all gross lottery sales.

SECTION V – KANSAS PROJECTED REVENUES

A significant amount of discussion of video lottery in Kansas has centered on its potential revenue generating ability. Most of that discussion has been based on the experience of South Dakota. Clearly, an alternative revenue projection could be made based on Montana's experience since its policy objective appears to be aimed more toward regulation than toward maximizing state revenue. Under any circumstance, using another state's experience as a basis for revenue projection prior to definition of statutory parameters is problematic. At least some reasons for being cautious about basing expectations on South Dakota's experience are outlined below.

This discussion of potential state revenue from video lottery includes projections for the first two 12-month periods of operation. As stated elsewhere, it appears that South Dakota (which began video lottery in October, 1989) has almost reached a leveling-off point in regard to placement

¹⁵The term "operator" is defined here as engaging in the following activities: acquisition and financing of terminals; insurance of equipment; maintenance of equipment; purchase of equipment parts; sales and troubleshooting; and administrative overhead costs (mainly FTEs).

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of terminals and expansion to new retailers. There is no way of knowing how "maturity" will affect the ability of video lottery games to attract and retain players.

These projections attempt to take into account commerce across state lines. For that purpose, two per capita revenue figures for South Dakota were derived. One calculation includes the approximately 100,000 population of Sioux City, Iowa which is on the South Dakota border. The other includes only the 696,004 persons reported by the 1990 U.S. Census. Those two per capita figures were used to derive two projected video lottery net revenue figures for Kansas. One figure is a per capita calculation based solely on the 2,477,574 population of Kansas as reported by the 1990 U.S. Census. The other figure is a per capita calculation that also includes the population of neighboring Missouri counties of Jackson, Platt, and Clay (Kansas City metropolitan area); Buchanan (St. Joseph) and Jasper (Joplin). Those counties were chosen because of the concentration of population in them and the fact that there is commerce across the state line in those areas.

	Kansas Population Only	Kansas + Missouri Counties
1st Year	\$ 266,266,480	\$ 328,482,361
2nd Year	406,606,468	501,614,220

* Net revenue represents the amount of money that goes into video lottery machines, minus the amount paid out in prizes. Revenue to Kansas would be some percentage of net revenue, presumably set in statute. Kansas' current lottery law requires that no less than 30 percent of gross lottery sales revenue be transferred to the State Gaming Revenues Fund.

Initially South Dakota collected 22.5 percent of video lottery net revenue as a tax. That assessment totaled \$16.8 million during the first 12 months of video lottery operation. If that percentage is applied to the figures above for Kansas, receipts would be estimated to range between \$60 million and \$74 million during the first year. Each percent of net revenue would be approximately \$3 million.

The Legislature should bear in mind that revenue from video lottery probably would be realized by the state at an accelerated rate throughout the first year as terminals are installed and

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the player base expands. If the Kansas experience were to mimic that of South Dakota exactly, with video lottery play beginning in October, only slightly more than half the annual revenue for the first 12 months of operation could be expected during the first fiscal year.

Inclusion of Sioux City population in the South Dakota player base results in a slightly lower weekly per capita revenue figure for South Dakota, but the addition of over a million Missouri people to the Kansas player base increases the revenue projection significantly. This should illustrate that the validity of a revenue projection is often extremely subjective, especially when there is no way to predict which relevant variables will affect play in different areas.

A number of factors may impact the amount of revenue realized from video lottery machines and the relationship between that revenue and the population of the state. Clearly, one factor is the presence of concentrations of population on the borders. Another is the number of tourists who visit the state and who participate in lottery games. The South Dakota Lottery was unable to provide an estimate of the number of tourists in South Dakota's player base; however, South Dakota's tourist industry has a long history. South Dakota also has casino-style gambling in one town, Deadwood. A lottery official said most of the gambling hall operators did not install video lottery terminals until they had reached the maximum number of other games. He also commented that video lottery games do "OK" in Deadwood, but the perception is that tourists play them more than South Dakotans.

Player behavior accounts for differences in net revenue which is the amount of money wagered that machines retain. That is because, to some degree, the amount of money retained is a function of how machines are played. When people do not play for extended periods of time, payout as a percent of money played is higher; therefore, the amount of money retained is lower. More player turnover results in less cash retained in machines.

During the first year of video lottery operation in South Dakota, the Lottery reported that net machine income represented 36.1 percent of total cash wagered in VLTs. The gross amount wagered during the first 12 months was \$207.1 million which equates to \$444 in wagers during the year per person over the age of 21 (persons under 21 cannot legally play video lottery in South Dakota).

Using that same ratio of net to gross, the net figure in the table above for the Kansas population only would require gross revenue of \$737.6 million. That equates to \$406 in wagers during the first year for every Kansan over the age of 18 (currently, persons under the age of 18 are prohibited from participating in the Kansas Lottery) or \$433 in wagers during the first year for every Kansans over the age of 21. In order to generate the net amount shown in the table above for the second year for Kansas population only, the annual per capita wager for the population over the age of 18 would increase to \$620. If play were restricted to persons over the age of 21, annual per capita wagers would have to average \$662.

Another variable that impacts revenue is the number of machines and their locations. As discussed earlier in this memorandum, every state that has authorized the conduct of video lottery games has placed some restriction on where terminals can be located and the number of terminals that can be placed in a single establishment. By the end of the first year of video lottery operation in South Dakota, there were approximately 4,600 machines located in 1,252 establishments. In South Dakota video lottery terminals are currently restricted to those places that sell liquor for on-premise consumption. Kansas does not appear to have liquor laws that are analogous to those of South Dakota, but if video lottery games were limited to entities licensed to serve liquor or cereal malt

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beverage (CMB) for on-premise consumption, there would be a potential group of 3,000 establishments, approximately 1,600 of which are Class A or B clubs or drinking establishments. The remainder are "beer bars" and other restaurants that only serve CMB.

In South Dakota an average of approximately four terminals per establishment were placed during the first year of video lottery operation. That experience would translate to placement of 12,000 terminals in Kansas during the same time period if all on-premise establishments are permitted to have VLTs under Kansas' law. If, however, placement is allowed only in clubs and drinking establishments, there would have to be approximately eight VLTs per establishment to reach the 12,000 figure. As another example of the lack of precision involved in projecting revenue that might accrue to the state, applying the South Dakota average annual net revenue per terminal figure to 12,000 VLTs results in an estimate of annual net revenue of only approximately \$194 million. A state share of 22.5 percent of that amount would be approximately \$43.7 million.

In connection with developing estimates of potential state revenue from video lottery games, the Legislature might want to consider the impact on other sources of state revenue. Competition with, and potential diversion of, funds from other lottery games and from parimutuel wagering appear to be a real possibility, and are somewhat difficult to predict. According to reports from other states, all of these types of wagering compete for at least some of the same discretionary entertainment dollars. As was previously noted, instant lottery ticket sales were adversely affected by the introduction of video lottery games. An official of the South Dakota Lottery stated that the Lottery might have prevented some of that loss by increasing the instant ticket prize amount to 65 percent prior to implementing video lottery. The prize percentage did not increase to that level until after video lottery was implemented. The same Lottery official indicated that while the parimutuel wagering handle was in decline prior to the advent of video lottery, video lottery probably exacerbated the decline. VLTs were initially located at both parimutuel tracks in South Dakota. (See the discussion of this in Section IV on South Dakota.)

There also could be an impact on sales and excise taxes forgone as consumer spending shifts from goods and services to video lottery. An obvious excise tax that might be impacted is the "drink tax" imposed on liquor sold by the drink. Projecting the magnitude of any such offsetting revenue decline would be very difficult at best.

In summary, any projection of potential additional state revenue from video lottery is problematic for several reasons. First, the amount of revenue that might accrue to the state is dependent on a number of variables, many of which will not be clearly defined until statutes are enacted. Probably the most important issue to affect those variables is the state's policy objective: whether to regulate a previously illegal activity or to maximize state revenue. Certain variables to be considered include: the percentage of wagers returned in prizes; types of establishments eligible to become retailers; limits on the maximum number of terminals per establishment; minimum age of players; means of distribution of terminals and promotion of games; prohibition of competing, illegal games; and monitoring, management and security of the system. Second, player acceptance and behavior is a crucial variable in determining whether video lottery becomes a significant, reliable, ongoing source of revenue. Third, other revenue sources could be affected at an unpredictable level. Fourth, video lottery has not been implemented in a sufficient number of states for a clear picture of revenue potential to emerge.

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SECTION VI – LEGISLATIVE POLICY CONSIDERATIONS

The following questions might be addressed in formulating video lottery legislation for Kansas:

General Policy Framework

1. Should the state promote a policy which would encourage Kansans to spend money for video lottery gambling?

Policy Implication. In support of state promotion of video lottery, it could be argued that Article 15, Section 3c of the *Kansas Constitution* authorizes state operation of a lottery, as ratified by the voters in 1986, and that video lottery is just another type of lottery game. In addition, there are apparently thousands of video lottery machines being played in the state, although financial payouts from video lottery games are currently illegal. State regulation or operation of such games could conceivably reduce the illegal activities while allowing the state to share in the profits. Arguably, participants in state video lottery games might otherwise use their money for recreational purposes from which the state would not benefit. Consequently, it might be more appropriate for the state to derive some benefit from those recreational dollars.

In opposition to state promotion of video lottery, reports from other states (as indicated above) suggest that moneys available for recreational activities, and particularly gambling activities, are not unlimited. Indeed, to some extent, additional revenue from video lottery are offset by decreased revenues from other lottery games and parimutuel wagering. Moreover, video lottery may have an adverse impact on nongambling revenues, such as the sales tax, although there is no accurate method of capturing that impact. Admittedly, at least in the short term (if South Dakota's experience can be generalized to other states), net video lottery revenues to the state offset reductions in revenues from those other activities. Moreover, demographic information from the Kansas Lottery on recent claimants for "instant scratch" prizes indicates that households with incomes of \$15,000 to \$25,000 were most representative of the claimant population. These households, while over the poverty threshold, are certainly vulnerable to economic downturns. While it is conceivable that video lottery games may attract a higher proportion of affluent consumers than would other types of lottery games, more analysis would be needed to substantiate that assumption.¹⁶ The same question applies to video lottery as it did in 1986 when other forms of gambling were being considered: is good public policy for the state to encourage gambling?

2. What is the state's primary objective for involvement in video lottery games?

Policy Implication. The configuration of a state's video lottery system is determined to a large extent by the response to this question. If the state has as its primary objective ensuring

¹⁶The profile of the average video lottery player in South Dakota is a male, in his mid-30s, with a \$25,000 plus income, and little interest in playing regular lottery games. See Erik Calonijs, "The Big Payoff from Lotteries," *Fortune*, March 25, 1991, page 110.

maximum security in the regulatory process and safeguarding the system against illegal activities, it would design a system, like Oregon intends to do, that assigns most of the control to the state. In such a system, ensuring that a formerly illegal activity is properly regulated takes precedence over the infusion of greater amounts of revenue into state coffers. Such an objective might be motivated by state constitutional provisions requiring regulation of the Lottery to insure integrity and security, as is the case in Oregon. There also may be an assumption that more revenues will be realized in the long term because fewer categories of participants would be seeking to realize a profit from these activities and because strong enforcement would ensure honesty and accountability.

Alternatively, if the state has as its overriding objective increased revenue collections, a more decentralized process with many participants, potential for greater market penetration, and less direct state control might be the appropriate approach. This conclusion is based on an assumption that very active and aggressive promotion of video lottery games would not occur under centralized state operation. While one study attempts to make the argument that greater market penetration is correlated with private operator participation, those conclusions might not be firmly based on currently available data.¹⁷

However, just because under one scenario maximizing security takes precedence over revenue enhancements, and under the other scenario revenue enhancements take precedence over maximized security, does not mean that those goals are mutually exclusive. States have obviously reached some accommodation of these two policy positions.

3. What agency should administer video lottery games?

Policy Implication. Although video lottery games are regulated by the Department of Justice in Montana and the Department of Public Safety and Corrections in Louisiana, it seems likely that such games would be under the administrative control of the State Lottery in Kansas, primarily because Article 15, Section 3c authorizes the Legislature to "provide for state-owned and operated lottery." However, other agencies probably could be included statutorily in certain aspects of enforcement and regulation. Involvement of enforcement agencies might be one means of accommodating the apparent conceptual conflict created by having the Lottery be both the promoter of video games and a regulator of various industry subgroups.

4. Should private operators or state government operate and maintain video lottery games?

Policy Implication. This question gets to the heart of issue of state control of video lottery games and also depends on the state's primary objective for involvement in video lottery games. In Attorney General's Opinion 92-1, it was noted that contractual agreements with private

¹⁷This is the *Study of Operating Data of Video Lottery Programs in The United States and Canada*, September, 1991 (Arthur Andersen). Questions about methodology include the difference in governmental structures between Canadian provinces and the states and the difference in limitation on the number of terminals in the Canadian provinces. Moreover, if problems exist with "gray machines," as they do in Nova Scotia, the existence of those machines could be expected to affect market penetration because these machines serve as a disincentive for retailers to become involved with legitimate games. The methodology might have been more solid if only the Canadian provinces had been subject to comparison given the similarity in governance, configuration, and start-up dates (all since December, 1990.)

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operators to place and maintain privately-owned VLTs would not necessarily violate the requirement for state control and ownership of lottery games, included in the *Kansas Constitution*, provided that the state meets certain conditions to demonstrate control over the games and machines. Once again, there is a trade off between increased security and greater access to information versus increased cost to the state. There are other factors which affect a response to this question. Under a state-run scenario, the state would have to invest more money upfront to hire staff and purchase equipment (assuming these functions are not contracted out) but it would recoup a larger percentage of gaming proceeds as the private operators would not be sharing in the proceeds and making a profit from them.

According to one recent study, video lottery games run by private operators have significantly higher market penetration than such games run directly by states. (See Footnote No. 17.) Assuming this finding is correct, net proceeds would be greater when games are by operators. If operators are involved in the games, the state would probably share some of the net proceeds with operators and would need to dedicate moneys for licensing, oversight, and enforcement activities related to operator participation. If the state runs games itself, using the model of Oregon, it could incur greater administrative and capital outlay expenses which would at least initially exceed revenue intake; however, the state would most likely partake of a greater portion of net revenues since no private operators would be involved.

With respect to eliminating "gray machines," operators might be more effective than the state in promoting cooperation of machine owners to not use them. However, the opportunity for operators to cut private deals with retailers would not necessarily be eliminated under either the state-run or operator-run scenarios.

Obviously, operators will not be able to earn income, at least legally, from video lottery games if they are not authorized by the state to operate games. The Oregon Lottery estimated that under its rules which eliminate private operator participation in video lottery games, the average operator will not have the opportunity to earn a gross income of \$515 per week per retailer from state regulated video lottery games.¹⁸

Finally, if the state decides to operate video lottery games and the Legislature subsequently bans them, the state would have considerable capital outlay investments (ownership of machines) that operators otherwise would have under the operator-run scenario. This presumes, of course, that compensation for banned machines in that event is not a contractual provision in any agreement between the state and operators.

Retailers

1. Should Class A clubs (country clubs, fraternal, and social organizations), Class B clubs (dinner clubs), drinking establishments, and caterers be authorized to permit video lottery games in their facilities? Should retailers who sell cereal malt beverages (CMBs) and/or alcoholic beverages exclusively for off-premises consumption, such as liquor stores, convenience stores, or grocery stores, be authorized to permit video lottery games in their facilities?

¹⁸Memorandum to Oregon Lottery Commissioners from Gary Williams, Hearings Officer, concerning Determination of Economic Effect Upon Small Businesses, November 21, 1991.

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Policy Implication. As of November 30, 1991, there were 1,641 licensees which sold alcoholic beverages for consumption on the premises. The bulk of such establishments were drinking establishments (828). Clubs constituted another 760 on-premise liquor licensees. Clearly, if additional types of establishments are permitted to offer video games, the number of terminals should increase, resulting in increased revenues. In particular, with convenience stores, there may be difficulty in ensuring that minors are not playing and there may be some adverse fiscal impact on other types of lottery games, as was reported in South Dakota.

Also to be considered is that in Kansas individuals under 21 years old may go into a bar or drinking establishment, even if they cannot consume alcohol. This could make enforcement of laws relating to age restrictions of video lottery players somewhat difficult.

2. Should an establishment's eligibility for video lottery certification be dependent upon its possession of a current certificate to sell other lottery products?

Policy Implication. There are arguments to support and oppose such a requirement. In support, this requirement consolidates lottery sales activities and makes it easier for the state to exercise appropriate oversight. It also could allow the Lottery the opportunity of creating an incentive system related to sales of a variety of products that might mitigate some effects of product competition. In opposition, this requirement might result in lower revenues from other lottery games since, to some extent, those games will compete with each other.

3. Should background investigations be conducted of persons who intend to contract with the Lottery as video lottery retailers, machine manufacturers, distributors, or operators?

Policy Implication. Personal and financial background investigations are conducted on manufacturers, distributors, operators, and retailers in South Dakota. This type of investigation is performed annually. It would appear that the more extensive the investigation and the more frequently it is done, the more likely the integrity of the games would be upheld. More oversight activity translates into greater expenses. Conversely, lax security could result in foregone revenues to the state due to illicit activities by private sector participants.

Security personnel at the Kansas Lottery currently conduct background investigations on vendors who print lottery tickets and retailers who sell tickets.

4. Should there be a limit imposed on the number of machines which may be placed in any one establishment?

Policy Implication. Limits on the number of video lottery machines or terminals placed in licensed liquor establishments vary among the states. In Montana, up to 20 machines are authorized per establishment; in South Dakota, the limit is ten; in Louisiana, at least in licensed establishments and with some qualifications, the limit is three; in the Canadian provinces and Oregon, the limit is five. Such limits prevent development of establishments that would be essentially "video casinos" containing multiple rows of VLTs.

A related issue is that the states do not necessarily define "licensed establishment" in the same manner. In Oregon, for example, an airport would be treated like a licensed establishment. In Louisiana video lottery games may be placed in truck stops and facilities which authorize

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parimutuel wagering. In West Virginia those games are authorized for placement at Mountaineer Park, a horsetrack and convention center.

5. Should VLTs be permitted on racetracks?

Policy Implication. As previously noted, video lottery machines are permitted at racetracks in West Virginia and Louisiana. In both cases, the horsemen are authorized a portion of net proceeds. The assumption is that parimutuel revenues will be affected adversely where video lottery games compete directly with them. However, the attraction for some people may be the opportunity to play those games at the tracks. In the first year of video lottery (June, 1990 through May, 1991) handles were down from the year prior to the games' introduction by 6.48 percent at Mountaineer Park, West Virginia compared to 8.08 percent reductions for the same time period at Charles Town Races, West Virginia where video lottery games are not available. The unanswerable question is: to what extent do VLTs contribute to or mitigate declines of wagering when placed at racetracks?

Division of Revenue

1. What percentage of total video lottery revenues should be allocated for lottery prizes for winning tickets or shares?

Policy Implication. Statutory percentages vary but the minimum appears to be 80 percent. In actuality, the winning percentage is considerably lower due to replays. Montana estimates annual paybacks to players of 55 percent and South Dakota realizes paybacks of not quite 64 percent. Nonetheless, paybacks for individual games could be greater and statutory provisions should allow for such fluctuations.

2. Should annual fees be set for video lottery machine manufacturers, distributors, operators, service personnel, and retailers and machines (provided that all the above are authorized participants under state law)? If such fees should be imposed, how much should they be?

Policy Implication. The higher the fee, the more the state collects but the greater the entry barrier for some potential participants. Conversely, more retailers might become involved in video lottery if entry barriers are not prohibitive. The trade off might be to impose lower certification fees and forego upfront revenue from such fees but realize greater net proceeds from an increased number of terminals and higher market penetration. Another consideration is the possibility that annual fees would become the stable, ongoing source of operating income for the regulatory portion of the state's responsibilities.

3. Should a one-time application fee be imposed?

Policy Implication. An application fee might eliminate frivolous applications for participation in the operation and other aspects of a video lottery program. In addition, it could defray part or all of the costs associated with processing of such applications.

4. What percentage of net VLT income should the state retain?

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Policy Implication. For those states which decided to regulate video lottery games through their lotteries, the percentage of income allotted them is generally based on net revenues from video games (total revenue after prizes have been subtracted). The percentage the state takes depends, to a certain degree, on the involvement of other participants. In South Dakota, the state's share of net proceeds is now 35 percent and the remaining 65 percent is split between operators and retailers with no state involvement. If there are no private operators, as in Oregon, the state assumes the operator's portion of net proceeds. In Oregon, the state's share is projected to be 56.5 percent.

For those states, such as Montana, which are intent on collecting revenues from now legalized activities but adhere to a decentralized system with provisions for licensure and enforcement, the state's share is collected exclusively in the form of fees and taxes.

If states take a portion of net proceeds from video lottery games, that could use a portion of such proceeds for nonregulatory purposes. As previously noted, Louisiana and West Virginia provide for compensation to horsemen to offset projected revenue shortfalls caused by competing video lottery games. Video lottery proceeds in South Dakota are credited to the State General Fund and are not earmarked but are subject to appropriations for projects determined by the Legislature. Oregon had originally earmarked its video lottery proceeds but subsequently rescinded that statutory provision and proceeds are credited to the General Fund and subject to appropriations.

Suppliers, Operators, and Other Industry Participants

1. Should there be any prohibitions against vertical integration in the video lottery industry?

Policy Implication. Montana does not have prohibitions against vertical integration but, due to reported abuses, is considering them. Such prohibitions are contained to some extent in South Dakota's statutes although retailers may also be operators (a policy consideration if the state opts for operator participation). The intent of prohibitions against vertical integration is to dilute the control of private entities over video lottery games and thereby reduce the potential for illicit activity associated with those games. The operating assumption of such policies is the wider the array of private participants in providing video products and services, the greater the potential for abuse. Therefore, these prohibitions, coupled with the state's commitment to adequately enforce them, should be considered an option if a multi-tiered private system of distribution and operation is implemented.

2. Should "gray machines" be banned? Should "gray machines" be "grandfathered in"? If not, what should be done to ensure that a video lottery machine is not a "gray machine" and has been certified by the Lottery?

Policy Implication. The argument for banning "gray machines" is that, if not banned, they will compete with state licensed machines and there will be inducements for operators to offer establishment owners a higher revenue return since the state's share would not be involved. Naturally, this course of action will impact negatively market penetration of state licensed machines. However, it is not sufficient to ban "gray machines" if the state does not adequately enforce the ban. In the Oregon State Police report to the Oregon Lottery Commission on security issues, it was reported that a major concern of the Atlantic Lottery (New Brunswick and Nova Scotia) was the continued use of "gray machines" despite the ban and the failure of the local police to enforce the

ban. Another problem that might arise is the seizure without compensation to owners of "gray machines," which were purchased prior to state regulation.

With respect to "grandfathering in" "gray machines," the policy consideration is that all machines should meet uniform standards established by the state. If they fail to do so, these machines would only succeed in undermining the integrity of the program.

Finally, the question arises as to how to inform players that they are playing on state-approved machines and not on "gray machines." To that end, a recommendation by the Oregon State Police would require the screen on the machine to display the state logo at all times during operation and require the capability of the Central Site to change the color of the logo within 250 lines of color. If it is feasible to manufacture machines with this feature, such a safeguard might be an option for consideration.

Games

1. Should a county be allowed to prohibit video lottery games?

Policy Implication. All current lottery games in Kansas are available on a statewide basis. Therefore, any provision to authorize counties the option of prohibiting video lottery games is a departure from the policy governing other forms of lottery games. However, if video lottery machines can only be placed in establishments which sell alcoholic beverages, "dry" counties, which do not permit sales of liquor by the drink at eating establishments, might not want these machines at dinner clubs. Moreover, video lottery games, if not adequately monitored by the state, could involve opportunities for participant abuse, resulting in increased criminal activity in counties. These games also could impact adversely other already established forms of entertainment in a given locale.

2. Should limits be placed on the bets and prizes for a single game?

Policy Implication. Provisions vary among states with respect to the highest amount bet and the highest amount for which credit may given per game. Montana, South Dakota, Louisiana, and Oregon set the limit for a bet per game at \$2.00 but treat credits differently. In Montana credits may not be awarded in excess of the following amounts: \$100 a game for draw poker and \$800 a game for keno or bingo. In South Dakota, credits or free games may not be awarded in excess of the value of \$125 per credit value of \$0.25 played. In Louisiana, awards or credits per game may not exceed \$500. In Oregon, the maximum prize paid for any game will be \$600. One might argue that the greater the amount available for prizes per game, the greater the inducement to play, and, potentially, the greater the amount in gross revenues that will be generated.

Regulation

1. Should the video lottery machine be automated and connected to the regulatory agency's central computer?

Policy Implication. A response to this question is affected by a response to the second question, General Policy Frameworks section. If VLTs are part of an automated network, the regulatory agency has more direct control over, and easier access to, information about machine performance. However, automated networks are undoubtedly more expensive than decentralized

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unautomated systems, such as the one in Montana. If a state chooses to use an automated system with dedicated lines linking VLTs to the mainframe computer in the Lottery, as Oregon intends to do and Louisiana intends to do to a more limited extent, information will be transmitted immediately and security will be tighter and control over the system will be greater than is the case with the dial-up arrangements, found in South Dakota. In that state, information on machine performance is transmitted on a periodic basis. However, costs associated with dedicated lines could be greater than those associated with dial-up linkages if all other conditions are equal. To establish that fact for a given state, a cost-benefit analysis might be advisable.

Furthermore, to the extent that all of the machines on-line have to be compatible, one or two vendors may have a defacto monopoly on providing equipment.

2. What measures should the Lottery undertake to ensure that VLTs and associated equipment meet acceptable standards for certification?

Policy Implication. This question is relevant to states which permit more than one manufacturer or distributor of video lottery equipment. South Dakota statutes, for example, include several provisions to ensure that VLTs meet certain standards. A manufacturer or distributor may not distribute a machine for placement in the state unless it has been approved by the Lottery. A manufacturer licensed by the state must submit to the Lottery information specified in statute for purposes of testing and analyzing the machine or associated equipment. The Lottery may also request that two working models of a machine be transported to the location the Lottery designates for testing, examination, and analysis, all of which would be done at the manufacturer's expense. Other statutory provisions address reporting of test results, procedures for allowing manufacturers to modify previously approved models, the need for machines to conform to prototypes, hardware and software requirements, transportation of machines, required training programs for operators and service personnel, and machine maintenance requirements. The more extensive the requirements concerning the condition and maintenance of the machines and the training of those licensed to operate and service them, the fewer problems the state should encounter with respect to machine operations. This assumes, of course, that the state commits to enforcing those requirements.

3. On what basis should lottery devices be deemed "illegal"? What judicial recourse should be available in the event that "illegal" devices are seized?

Policy Implication. There should be some basis for determining noncompliance of machines. South Dakota's law permits seizure or sealing of machines if these machines are found to be in noncompliance with the specifications required for Lottery approval. A notice and hearing must be conducted on the violations prior to making determinations.