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September 2015

Philip Nolan, President
Members of the Board of Directors
Suffolk Off-Track Betting Corporation
5 Davids Drive
Hauppauge, NY 11788

Report Number: S9-14-65

Dear Mr. Nolan and Members of the Board of Directors:

A top priority of the Office of the State Comptroller is to help local government officials manage government resources efficiently and effectively and, by so doing, provide accountability for tax dollars spent to support government operations. The Comptroller oversees the fiscal affairs of local governments statewide, as well as compliance with relevant statutes and observance of good business practices. This fiscal oversight is accomplished, in part, through our audits, which identify opportunities for improving operations and Board of Directors' governance. Audits also can identify strategies to reduce costs and to strengthen controls intended to safeguard local government assets.

In accordance with these goals, we conducted an audit of five regional Off-Track Betting Corporations (OTB) throughout New York State. We included the Suffolk OTB in this audit. The objective of our audit was to determine whether the financial condition of OTBs is deteriorating. The audit period was from January 1, 2009 through August 31, 2014. Following is a report of our audit of the Suffolk OTB. This audit was conducted pursuant to the State Comptroller's authority as set forth in Article 5, Section 516 of the New York State Racing, Pari-Mutuel Wagering and Breeding Law (Racing Law).

This report of examination letter contains our findings and recommendations specific to the Suffolk OTB. We discussed the findings and recommendations with Suffolk OTB officials and considered their comments, which appear in Appendix A, when preparing this report. Suffolk OTB officials generally agreed with our recommendations and indicated they planned to initiate corrective action. At the completion of our audit of the five OTBs, we prepared a global report that summarizes the significant issues we identified at all of the units audited.

Summary of Findings

Over the past five years, Suffolk OTB's overall financial condition has deteriorated at a steady pace. Suffolk OTB has experienced annual decreases in net handle (wagering) due to a general decline in interest in horse racing and increased competition from other entities in the racing industry. Net handle declined 29 percent ($44.3 million) over the past five years, and for the six months ended June 2014, was down approximately $2.8 million compared to the same period in 2013.

Suffolk OTB officials have implemented the previous recommendations from the Office of the State Comptroller (OSC).[1] However, the statutory and contractual expenses paid from the net handle makes operations difficult to sustain financially in an environment where net handle is declining. The declining handle has reduced distributions to local governments from Suffolk OTB as well.

Background and Methodology

Suffolk OTB was formed as a public benefit corporation in 1975 and its geographic area is comprised of Suffolk County. The Board of Directors (Board) is the governing body. The Board has three members, who are appointed by the Suffolk County Legislature. Suffolk OTB filed for Chapter 9[2] bankruptcy in May of 2012, with the anticipation of relieving this through the acquisition of new video gaming revenue.

Suffolk OTB offers off-track pari-mutuel[3] wagering on horse racing for the objective of promoting the horse racing industry, providing revenues to State and local governments and diminishing the role of illegal bookmakers. As of September 24, 2014, Suffolk OTB operated five branch locations, 34 Qwik Bet locations,[4] one tele-theater, an Internet wagering system and telephone account wagering operations. However, during the audit period, additional facilities were in operation that were subsequently closed by September 2014, including seven branches and five Qwik Bet locations.

While an OTB collects revenue, it does not retain these funds; rather it must distribute funds to various entities according to statutes and contracts. An OTB may not retain its net revenues to fund future operations. Net handle (wagers) represents the amount wagered by patrons throughout branches, Qwik Bet locations, tele-theater and telephone and Internet venues. The winning patrons receive back a percentage of the net handle on each race. Each OTB retains a percentage that must be distributed to various entities across New York State, including the State's horse racing industry, New York State and local governments. These statutory distributions are based on formulas in the Racing Law. In addition, OTBs makes payments to certain out-of-state racetracks with negotiated simulcast contracts. These statutory and contractual expenses represent a

1 Suffolk Off-Track Betting Corporation, Report Number S9-9-84, issued May 20, 2010

2 United States Bankruptcy Code

3 Pari-mutuel refers to a betting pool in which winners divide the total amount wagered, after management expenses are deducted.

4 Qwik Bet is a machine in an establishment where patrons can place bets through the machine.

significant portion of the OTB's annual expenses, with the remaining expenses attributed to maintaining operations.

Racing Law governs how an OTB distributes surcharge revenues and net revenues derived from the operations. Each regional OTB or off-track betting operator conducting off-track betting must impose a surcharge of 5 percent on the portion of pari-mutuel wagering pools distributable to persons placing bets at OTB facilities. OTBs distribute these surcharge revenues monthly to the participating local governments and to local governments where the tracks are located. The net revenues from operations are distributed on a quarterly basis to the participating local governments after contributions to the capital acquisitions fund[5] are deducted. For the year ended December 31, 2013, Suffolk OTB distributed surcharge revenues and net revenues of $1.2 million to Suffolk County.

We examined the financial condition of Suffolk OTB for the period January 1, 2009 through August 31, 2014. We conducted our audit in accordance with generally accepted government auditing standards (GAGAS). Such standards require that we plan and conduct our audit to adequately assess Suffolk OTB operations within our audit scope. Further, those standards require that we understand Suffolk OTB's management controls and those laws, rules and regulations that are relevant to Suffolk OTB operations included in our scope. An audit includes examining, on a test basis, evidence supporting financial activities and applying such other auditing procedures we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for the findings, conclusions and recommendations contained in this report. More information on such standards and the methodology used in performing this audit are included in Appendix B of this report.

Audit Results

Financial Condition Analysis

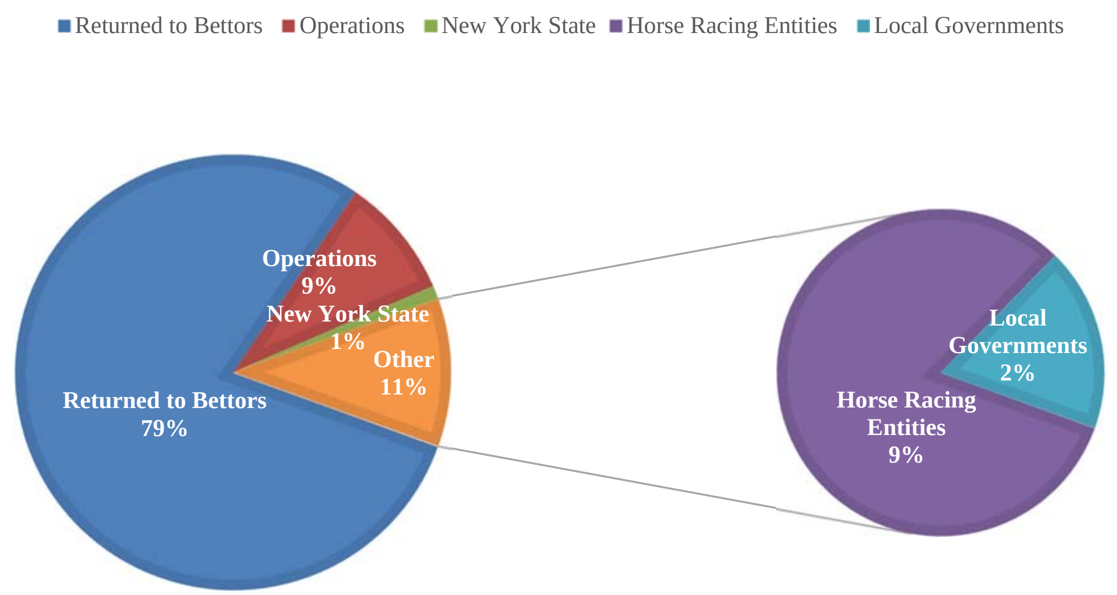
<u>Net Handle</u> – Over the five-year period 2009 through 2013, Suffolk OTB has experienced a 29 percent decline ($44.3 million) in net handle, from $153.5 million to $109.2 million. Further, the net handle for the six months ended June 30, 2014 was lower by approximately $2.8 million compared to the same period in the prior year. Figure 1 shows the change in Suffolk OTB's net handle during the last five years:

Figure 1: Suffolk OTB Net Handle					
	2009	**2010**	**2011**	**2012**	**2013**
Net Handle	$153,501,836	$139,052,540	$122,693,944	$113,311,268	$109,200,645
Dollar Value Change From Prior Year	N/A	($14,449,296)	($16,358,596)	($9,382,676)	($4,110,623)
Percent Change From Prior Year	N/A	(9.41%)	(11.76%)	(7.65%)	(3.63%)

[5] The intent of the capital acquisition fund is to permit OTBs to reserve revenue for the payment of debt service and acquisition of capital assets without negatively affecting the respective OTB's cash flow required for operations.

In 2013, Suffolk OTB paid over 79 percent (over $86 million) of the net OTB handle collected to winning patrons. It also paid a portion of the surcharge revenues, as stipulated by statute, to participating local governments (over $1.2 million) and local governments with tracks (approximately $519,900). Suffolk OTB kept the remaining surcharge revenues collected by funding its capital acquisition fund (approximately $304,600). For perspective, Figure 2 demonstrates the distribution of handle generated by the OTB.

Figure 2: Breakdown of $1 Wager



Several factors have contributed to the decline in overall net handle at the Suffolk OTB. These include a fluctuating economy, a general decline in interest in horse racing (as evidenced by declines from 2009 to 2013 of net handle of the racing industry) and competition from other entities in the racing industry, such as out-of-state and offshore advance deposit wagering sites. Suffolk OTB officials have also attributed the decline in net handle to race cancellations due to weather-related events.

<u>Statutory Distributions</u> – Suffolk OTB must make statutory distributions before paying its operating expenses. These distributions represent a significant financial outlay and the largest is made to the horse racing industry.[6] During the five years ended December 31, 2013, these distributions totaled approximately $57 million and accounted for 83 percent of Suffolk OTB's total $68.6 million in statutory distributions. The distributions to the horse racing industry are made to the following entities:

6 These payments are commissions to the tracks and payments for breeding and developmental funds.

- In-state racetracks, based on statutory rates dependent on the type of wager and other contractual agreements;
- Out-of-state racetracks, based on specific contractual agreements; and
- Certain designated horse breeding funds that were created to support and promote in-State activities related to horse breeding and racing.

Figure 3 details the statutory distributions paid during the five years ended December 31, 2013.

Figure 3: Statutory Distributions 2009-2013					
	2009	**2010**	**2011**	**2012**	**2013**
Track Compensations	$13,070,291	$12,035,526	$11,018,301	$10,527,469	$10,304,282
New York State	$2,010,358	$1,841,838	$1,605,413	$1,488,750	$1,435,360
Allocations to Local Governments	$843,768	$723,111	$609,853	$550,610	$519,831
Total	**$15,924,417**	**$14,600,475**	**$13,233,567**	**$12,566,829**	**$12,259,473**

Track Compensation – Suffolk OTB features broadcasted races from various locations in both the United States and Canada. Those raced in New York, as well as the Triple Crown and Breeders' Cup races, are subject to statutory limitations on what can be charged. Any other racetrack or conglomeration of tracks hosting a race individually negotiates track compensation with Suffolk OTB. Suffolk OTB relies on having races to broadcast in its betting parlors.

The contractually negotiated fee paid to broadcast races is a percentage of the handle derived from the races at the applicable tracks. For example, if the average fee in 2014 on all tracks totaled 6.07 percent for every $100 in handle, then Suffolk OTB would pay $6.76 to broadcast a race. This is in addition to other statutory payments that Suffolk OTB makes. The major tracks throughout the country have consolidated into collective organizations and contracted with OTBs to simulcast races. The two largest organizations have increased rates 300 percent over the six-year period from 2009 through 2014. Because of these increases, Suffolk OTB retains smaller percentages of the funds remaining after paying winners and, as such, retains less for operations.

Due to the declining handle, allocations to local governments have decreased approximately 38 percent over the five-year period. Suffolk OTB officials have indicated that the statutory structure they are held to prevents them from being competitive in the industry and significantly limits their ability to fund operations.

Operating Revenues and Expenses

Suffolk OTB operating revenues consist of the remaining net handle after winning bettors are paid and statutory distributions are allocated, plus other miscellaneous revenues. These revenues are generated from branch locations with restaurant operations, income from commissions earned and other miscellaneous incomes. Over the five-year period from 2009 through 2013, Suffolk OTB operating revenue has decreased approximately $7.6 million (34 percent).

Suffolk OTB's operating expenses have decreased about $8.8 million (35 percent) over the same five-year period, excluding statutory payments. When statutory payments and legal fees associated with the bankruptcy[7] are included, the overall operating expenses decreased 27 percent or approximately $11.1 million over the last five years. A significant portion of Suffolk OTB's operating expenses is employment-related (e.g., employee salaries and fringe benefits[8]). While branch and corporate salaries and fringe benefits accounted for approximately $10.5 million (60 percent) of Suffolk OTB's operating expenses in 2013, salaries have decreased by approximately 36 percent and fringe benefits have decreased by approximately 17 percent since 2009. Figure 4 illustrates these financial trends for Suffolk OTB:

Figure 4: Suffolk OTB Financial Trends

	2009	2010	2011	2012	2013	Percentage Change 2009-2013
Racing and Gaming Revenue	$36,982,747	$33,263,533	$29,403,037	$26,785,531	$25,544,274	(31%)
Other Revenue	$889,262	$1,102,593	$600,458	$490,452	$1,100,572	24%
Total Revenue	$37,872,009	$34,366,126	$30,003,495	$27,275,983	$26,644,846	(30%)
Bankruptcy Legal Fees[a]	$0	$0	$1,372,422	$1,177,942	$1,327,917	100%
OTB Operating Expenses	$24,855,816	$22,764,648	$19,196,841	$16,128,988	$16,053,046	(35%)
Total Statutory Payments	$15,924,417	$14,600,475	$13,233,567	$12,566,829	$12,259,473	(23%)
Total Expenses	$40,780,233	$37,365,123	$33,802,830	$29,873,759	$29,640,436	(27%)
Net Revenue From Operations	($2,908,224)	($2,998,997)	($3,799,335)	($2,597,776)	($2,995,590)	(3%)

[a] Creditors' attorney fees, Suffolk OTB attorney fees, court filing fees and related expenses

Previous Audit

Our previous audit recommended Suffolk OTB review its operational locations to shift to the most cost effective means of operation. This included exploring the expansion of Qwik Bet locations as a cost effective alternative to branch locations. From 2009 through 2013, Suffolk OTB increased the number of Qwik Bet locations from 18 to 28 locations. During our audit scope period, Suffolk OTB had up to 13 branch locations and 28 Qwik Bet locations opened. However, by the end of 2013, only six branch locations and 28 Qwik Bet locations were open. For the six branch locations that were active in 2013, two had operating losses ranging from $63,479 to $161,972. For the 28 Qwik Bet locations that were active in 2013, only one had an operating loss of $595.

We analyzed handle and expenses by location and found the branch locations have an average of approximately 12 percent ratio of expenses to handle over the period 2009 to 2013, while the Qwik Bet locations have a ratio of approximately 4 percent expenses to handle over the period 2009 to

[7] These legal fees represents the legal fees that the Suffolk OTB has to pay to their creditors' attorneys and their attorney, court filing fees and related expenses. According to Suffolk OTB officials, the bankruptcy plan was approved in October 2014.

[8] Fringe benefits include medical, dental and optical insurance; payroll taxes; retirement contributions; workers' compensation; disability and life insurance; union welfare fund contributions; unemployment benefits; and earned time accruals. Also factored in the fringe benefits are employee benefits billed to Nassau OTB for shared services.

2013. Qwik Bet locations, however, only accounted for approximately 6 percent of the net handle generated during the audit scope period.

While Suffolk OTB has implemented the recommendations from the previous audit by closing poorer performing branch locations and expanding Qwik Bet locations, it continues to experience a decline in financial condition.

Recommendations

The Board should:

1. Explore opportunities to increase revenues to stabilize the continuing declining net handle.

2. Review and renegotiate contractual expenses to achieve lower costs.

3. Continue to analyze the cost-benefit of operations and determine the appropriate mix of business activities.

Good management practices dictate that the Board has the responsibility to initiate corrective action. As such, the Board should prepare a corrective action plan (CAP) that addresses the recommendations in this report and forward the plan to our office. For more information on preparing and filing your CAP, please refer to our brochure, *Responding to an OSC Audit Report*, which you received with the draft audit report. The Board should make the CAP available for public review in the Suffolk OTB's administrative offices.

We thank the officials and staff of the Suffolk OTB for the courtesies and cooperation extended to our auditors during this audit.

Sincerely,

Gabriel F. Deyo
Deputy Comptroller

APPENDIX A

RESPONSE FROM SUFFOLK OTB OFFICIALS

The Suffolk OTB officials’ response to this audit can be found on the following pages.

SUFFOLK REGIONAL
OFF-TRACK BETTING CORPORATION

PHILIP C. NOLAN
President and CEO

5 Davids Drive
Hauppauge, New York 11788
Phone: 631.853.1000, ext. 3504

February 5, 2015

Ann C. Singer, Chief Examiner
Office of The State Comptroller
State Office Building, Suite 1702
44 Hawley Street
Binghamton, New York 13901-4417

RE: Audit Report S9-14-65

Ms. Singer,

This letter is in response to the findings and recommendations outlined in your draft audit report S9-14-65, covering the period January 1, 2009 through August 31, 2014 and discussed at the exit conference dated January 13, 2015 at Suffolk Off Track Betting Corporation's offices.

For each recommendation included in the audit report, the following is our corrective action(s) taken or proposed.

Audit Recommendation #1.

Explore opportunities to increase revenues to stabilize the continuing declining net handle.

Implementation Plan of Action(s):

We have a two tier strategy regarding increasing pari-mutuel revenue in 2015.

- First we will continue to expand QWIKbetz franchise operations. This revenue segment consists primarily of 34 licensed sports restaurants and generated $11.2 million in revenue in 2014. QWIKbetz revenue has grown from 8.5 percent of total wagers in 2012 to 10.7 percent of total wagers in 2014. Our franchise marketing team has identified card stores, bowling alleys and public golf course in communities that are not currently served and have initiated direct contact communications to convey the advantages of establishing a QWIKbetz franchise at their locations. It is our goal to increase this segment of revenue to 13 percent or $13.7 million in 2015.

- Secondly during 2014 we improved our Internet Wagering Platform. This revenue segment generated $10.2 million in 2014. Internet revenue has grown from 7.3 percent in 2012 to 9.8 percent of total wagers in 2014. Our marketing team is developing a new marketing plan which leverages on-line advertising, internet key-words subscriptions, direct-mail and print advertising during premier racing events through-out the year. It is our goal to increase this segment of revenue to 11 percent or $ 11.6 million in 2015.

Implementation date:

Marketing teams have been working on this since January 1, 2015.

Person Responsible for Implementation:

Phil Nolan, President/CEO is responsible for this implementation.

Audit Recommendation #2.

Review and renegotiate contractual expenses to achieve lower costs.

Implementation Plan of Action(s):

As discussed in the audit report, Suffolk OTB has reduced operational expenses by 35% since 2009 by continually examining our operations for cost saving opportunities. In order to enhance this effort, and to ensure that contractual expenses are fair, reasonable or lower than previous periods when possible, an executive management team has been identified to create an 18- month, rolling master contracts calendar. The team of facilities, planning, purchasing, budget and finance personnel will meet monthly to review upcoming contracts. Utilizing available state contract cost guidelines or to recommend public bid.

Implementation date:

March 1, 2015.

Person Responsible for Implementation:

Anthony Pancella, Vice President is responsible for this implementation.

Audit Recommendation #3.

Continue to analyze the cost-benefit of operations and determine the appropriate mix of business activities.

Implementation Plan of Action(s):

Selected finance and budget personnel have been tasked with preparing a monthly cost benefit analysis for review and development of quarterly recommendations to determine the cost benefit effectiveness of current branch, tele-a-bet, internet and franchise business strategies. Recommendations to close, consolidate or move wagering high cost locations and promote the most profitable will be presented to the President and Vice President for their review, guidance and action. In addition, we will be examining the possibility of shared services where appropriate with the VLT facility when it begins operations in order to achieve economies of scale and cost savings.

Implementation date:

June 1, 2015

Person Responsible for Implementation:

Celine Gazes, Comptroller is responsible for this implementation.

In conclusion, our ability to reduce expenses and modify our business model has enabled us to maintain operations during this audit period. However, these measures alone will not enable us to meet our future financial obligations and continue our mission as legislatively intended.

We urge the State Legislature and the Governor to review the facts outlined in the State Comptroller's audits of New York State Off Track Betting (OTB) Corporations and provide the following legislative relief which addresses the antiquated and inequitable statutory revenue distributions all OTB's are required to administer.

- **Repeal the 2003 Hold Harmless and Maintenance of Effort Racing Laws which require additional payments to NYS harness tracks.** New York State enacted legislation in 2003 authorizing the Off-Track Betting Corporations to accept wagers on nighttime thoroughbred racing. In return, the Corporations were required to pay the in-state regional harness tracks additional "Maintenance of Effort" payments based upon the 2002 handle. The payments were intended to replace the revenue lost to NYS harness tracks once OTB bettors could wager on out-of-state thoroughbred racing. Nighttime racing is defined as races having a post time after 7:30 PM. In 2003, it was projected that the increase in net handle from these nighttime races would generate as much as $400 million in additional revenue for the OTB Corporations, which would significantly exceed the additional payments required based on the 2002 net handle (one of the highest in OTB history). However, the increase in net handle never materialized, and, in fact, handle has declined significantly since 2003. As a result, OTB Corporations must pay a much higher percentage of their revenue to these harness tracks than they did in 2002. Lastly, these privately owned harness tracks have significantly benefited from the additional revenue generated by Video Lottery Terminals and no longer need the taxpayer funded subsidy which this law provides.

- **Amending the out-of-state Advanced Deposit Wagering (ADW) Law.** In September of 2012 the State of New York issued a Report of the Impact of Advance Deposit Wagering on its' pari-mutuel industry. According to the report New York lost an estimated $200 million in wagers placed by New York State residents through ADW accounts at out of state entities primarily at NYS race tracks in 2012 alone. Those are wagers that were not reported and not taxed. In 2013 NYS passed legislation to require out of state entities that accept wagers from New York State residents pay a percentage of those wagers to New York State, which then shares those payments with the tracks and the OTB Corporations to partially reimburse them for the lost revenue. However, certain out of state entities have "partnered" with NYS tracks to avoid making these payments. We recommend that the state law be amended to close this loophole.

- **Repeal of "dark day" payments.** "Dark days" occur when the New York State Racing Association is not conducting a thoroughbred race meeting, and no licensed harness track is accepting wagers on or displaying the signal of any thoroughbred. On dark days, OTB Corporations may broadcast out-of-state thoroughbred races, but they must pay a portion of those wagers to NYS harness tracks in accordance with a statutory formula. This again represents an unnecessary publicly funded subsidy to these privately held tracks.

Such legislative changes would bring New York State in line with other racing jurisdictions, level the playing field for New York entities and enable us to eliminate operating deficits, distribute additional local government aid and fulfill our mission.

Sincerely,

Phil Nolan
President/CEO

Cc: Board of Directors

APPENDIX B

AUDIT METHODOLOGY AND STANDARDS

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

To complete the audit objective, we interviewed Suffolk OTB officials regarding budgeting practices and monitoring. We reviewed documents prepared by Suffolk OTB's external CPA firm regarding Suffolk OTB's financial activities and financial information provided by the Suffolk OTB. We analyzed trends of revenue, expenses and gambling activity to reach our conclusions.