

REPORT HIGHLIGHTS
PERFORMANCE AUDIT

Subject

The Legislature created the Department of Racing in 1982 to regulate and supervise pari-mutuel horse and dog racing and wagering in Arizona. The Racing Commission has existed since 1949 and previously performed the Department's regulatory activities. Both the Commission and the Department have authority to adopt rules and racing policy, but the Commission, which oversees the Department's director, has authority to reject the department director's recommendations in such matters.

Our Conclusion

The Department should improve its oversight of pari-mutuel wagering, including ensuring the security of the computerized systems used for betting. The Department should also continue to align its animal drug-testing practices with national standards. Further, the report provides information on the impact of tax relief on racing regulation funding.



2007

Arizona Department of Racing and Arizona Racing Commission

Department should improve pari-mutuel wagering oversight

Arizona is one of 11 states that operate both horse and greyhound tracks. Commercial races take place at three horse tracks in the State—Turf Paradise in Phoenix, Yavapai Downs in Prescott Valley, and Rillito Park in Tucson—and two greyhound tracks—Phoenix Greyhound Park and Tucson Greyhound Park. Horse racing also occurs at county fairs.

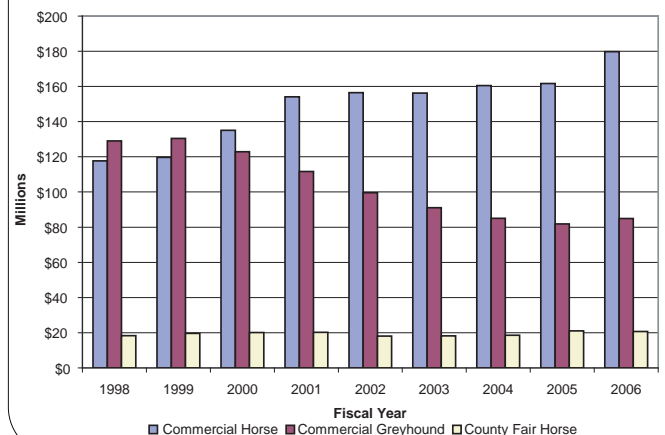
In fiscal year 2006, the total amount bet on horse and dog racing (the "handle") in Arizona was \$285.4 million. The handle for horse racing has increased since 1998, while the handle for dog racing has decreased.

Computerized "tote" systems manage wagering—Racetracks contract with one of three national companies to operate computerized systems called totalisator, or "tote," systems. These systems compute the odds, estimated payoff, and bettors' payouts for each race. Each track once had a tote system physically located at the track, but since the mid-1990s, the systems have generally operated from a remote "hub" that provides the service to many tracks. Therefore, wagering data at Arizona tracks is often sent to a centralized computer system that processes the data at an out-of-state location.



Controls needed over tote systems—In 2002, in New York State, a tote company programmer altered tickets in the tote system to create winning tickets. In addition, he found serial numbers for unclaimed winning tickets, and two accomplices then cashed tickets with those numbers on them. In response, the racing industry took steps to strengthen oversight of the pari-mutuel wagering system by proposing additions to its Model Rules for prospective adoption by the entire racing industry. The proposed Model Rules amendments put great emphasis on information technology security controls.

Arizona Racing Handle
 Fiscal Years 1998 through 2006
 (Unaudited)



Department can improve efficiency of its oversight—Part of the Department's oversight involves testing the tote systems to ensure that calculations are accurate. Department auditors do this by manually calculating what the results should be for different wagering scenarios and comparing their results to the tote system's. In 2006, a form of wagering called "net pool pricing" was introduced and increased the number of calculations the auditors need to perform to complete their test work. In May 2007, the Department's audit manager reported that it took 51.5 hours to conduct net pool pricing as compared to 25 hours to conduct standard pool pricing.

Department auditors could improve their efficiency by:

- Using booklets that provide the correct outcome for the potential wagering scenarios. Using the books, auditors only need to make a visual comparison between the book's results and the tote system's results. Texas and Colorado use such books.
- Using spreadsheets to perform the calculations rather than relying on manual calculations.

Department needs to strengthen tote company licensing and ensure IT controls are in place—The proposed Model Rules amendments recommend that states license tote companies and include licensing requirements to monitor information technology (IT) controls. Standard IT controls monitor and test programming changes, limit who can access the systems and what actions they can perform, and monitor who has accessed the systems.

To improve oversight of tote system security, the Department should work with the Legislature to obtain statutory authority to license tote companies. It should then modify its rules to identify tote companies as a license category and include licensing requirements recommended in the proposed Model Rules, such as hardware and software testing, and independent reviews of controls known as SAS 70 reviews. Illinois requires such reviews, and New York plans to do so.

Monitoring of wagering anomalies—To help protect wagering integrity, the Department must explore the feasibility of adopting automated systems to improve its monitoring of wagering anomalies. An example of such an anomaly would be if a large wager was made to significantly affect the odds and then intentionally canceled right before betting closed.

Racing stewards reported that they respond to potential anomalies only if someone brings an issue to their attention. However, automated systems now exist that can perform such monitoring on a real-time basis and also allow for a post-race analysis. Only two monitoring systems are available, including one that would cost the Department an estimated \$64,000.

Department should explore expanding its financial analyses—The Department does not perform some forms of financial analysis that other states perform regularly, such as reviews of purse distributions. In 2006 the Department performed an analysis of purse distributions at one track, and it found the greyhound owners' purses had been shorted by 15 percent.

Recommendations

The Department should:

- Improve its tote testing's efficiency.
- Work with the Legislature to obtain statutory authority to license tote companies.
- If statutory authority is granted, identify tote companies as a licensing category in its rules and add licensing requirements.
- Explore the feasibility of using automated systems to improve monitoring of wagering systems for anomalies.
- Consider expanding the scope of its financial analyses.

Department should continue to align animal drug testing with national standards

For the past 15 years, racing industry regulators have been in the process of standardizing animal drug-testing practices across the country.

According to the Model Rules, racing regulators should conduct a drug test on every winning racehorse. Drugs are categorized in five classes. Penalties for medication-use violations are based on the drug classification system. Penalties are more severe for the use of substances that have a higher potential to affect the racehorse's performance. For example, Class 1 drugs have more of a potential to affect a horse's performance than Class 5 drugs. Greyhounds are also tested, but the model guidelines do not recommend that the regulator require testing for each winning dog.

Tests consistent with racing regulation practices— Experts consider the primary drug tests used for horses and dogs in Arizona standard practice, and many other states use them. The Department initially uses two different screening methods to detect drugs in urine samples. One method can detect a variety of drugs, while the other can detect more minute amounts of specific drug classes. If there is a positive result from these two initial screenings, then an additional screening is performed using an even more sensitive method to confirm the results.

The Department also has the ability to obtain special tests that target specific drugs its other tests do not cover.

Department has improved its drug testing—The Department has increased the number of tests it performs on horses and dogs. Previously it performed 15 drug class tests, but now it performs at least 25 and can request as many as 45. In addition, as noted above, it now performs some special tests for drugs not screened with its other tests.

The Department also has classified its drug categories according to the Model Rules. However, the Department's threshold levels (the amount of medication allowed in an animal's system) for two drugs are five times higher than recommended by the Model Rules.

Although the Department is trying to align its policies with the Model Rules, industry stakeholders have recommended that the Department adopt different requirements in five areas of the Model Rules.

Budget pressures limited conformity with Model Rules—Although the Department was making progress with its drug-testing program, in fiscal year 2006 it experienced unexpected expenses and mandates that caused it to not test every winning horse and reduce testing of greyhounds for a 60-day period. The Department resumed regular testing in fiscal year 2007.

The unexpected budget expenses included:

- Higher travel expenses;
- Emergency computer programming needs;
- Pay parity for department employees paid by the county fair fund; and
- Salary and operation expenses for department employees working at county fairs.

Recommendations

The Department should:

- Continue to align its drug testing with the Model Rules.

Other pertinent information

Historically, Arizona's racing regulation was self-funded through pari-mutuel taxes. Pari-mutuel taxes are paid on the racing handle of races in the State. Fiscal year 1995 was the last year that pari-mutuel taxes were enough to more than cover the Department's expenditures. In that year, the State collected \$8.5 million in pari-mutuel taxes, and of that, \$5 million was paid into the General Fund.

Beginning in 1995, the racing industry received tax credits and exemptions, including:

- An exemption of simulcast pari-mutuel handle from taxation;
- A hardship tax credit; and
- Tax reductions for greyhound racetracks.

The value of these credits and exemptions is estimated at more than \$44 million between 2001 and 2006. Of that, the simulcast wagering tax exemption is worth more than \$29.2 million.

Because of the tax relief provided to the industry, in fiscal year 1996 the tax revenue dropped to \$2.8 million. Further, of that, only \$165,878 was remitted to the General Fund. This is because, as required by law, most revenues from racing (pari-mutuel taxes, license fees) were paid into eight separate racing and agriculture funds:

- County Fairs Racing Betterment Fund;
- Arizona Breeders' Award Fund;
- County Fairs Racing Fund;
- County Fairs Racing Betterment and Breeders' Awards Administration Fund;
- Arizona Stallion Award Fund;
- County Fairs Livestock and Agriculture Promotion Fund;
- Agriculture Consulting and Training Fund; and
- Arizona Exposition and State Fair Fund.

Starting in 1998, these funds began to receive support from the State Unclaimed Property Fund since racing revenues were no longer sufficient to fund them to their statutory allowed maximums.

TO OBTAIN MORE INFORMATION

A copy of the full report
can be obtained by calling
(602) 553-0333



or by visiting
our Web site at:
www.azauditor.gov

Contact person for
this report:
Melanie Chesney