



State of Arizona
Office
of the
Auditor General

PERFORMANCE AUDIT

**ARIZONA
DEPARTMENT
OF
GAMING**

**Report to the Arizona Legislature
By Douglas R. Norton
Auditor General**

**April 1999
Report No. 99-5**



DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

**STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL**

DEBRA K. DAVENPORT, CPA
DEPUTY AUDITOR GENERAL

April 9, 1999

Members of the Arizona Legislature

The Honorable Jane Dee Hull, Governor

Mr. Stephen Hart, Director
Arizona Department of Gaming

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Arizona Department of Gaming. This report is in response to a May 27, 1997, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the Sunset review set forth in A.R.S. §§41-2951 through 41-2957.

The report recommends that state officials, including the Governor and Legislature, determine whether the Department's current regulatory stance is the optimal approach for monitoring Indian gaming operations in Arizona. Though the Department employs extensive oversight activities that are well designed for ensuring the integrity of gaming operations, its approach is among the most extensive and costly in the nation. Further, since the tribal-state gaming compacts negotiated between the State and tribes do not clearly delineate the extent of state oversight or provide the State with any sanction authority to enforce compliance, disagreement exists in Arizona between the Department and several tribes regarding what level of involvement the State should have within Indian gaming. In light of such disagreement, the report recommends that state policymakers decide if the current approach best meets the State's needs or if a different, less extensive approach is warranted. Regardless of the approach chosen, the report strongly recommends that the Department continue working to improve relations with tribal officials to ensure a more effective sphere of gaming regulation.

The report also contains findings about the gaming device assessment fees tribes pay for state oversight activities and about the Department's certification process for vendors providing services to gaming operations. Specifically, the report recommends that the Department, as the State's representative, work with tribes to renegotiate the

April 9, 1999

Page -2-

gaming device assessments tribes pay to fund the Department's oversight activities. Such negotiations are important because without them, the Department's operating budget could be threatened and inequities between tribes may result. The Department could foster such negotiations by providing more specific information to tribes about its use of these fees. The report also notes that the Department has made several improvements to its process used to investigate and certify vendors providing services to tribal gaming operations and recommends that the Department consider implementing several additional changes to further streamline the process.

As outlined in its response, the Department takes no position on the first finding which is primarily addressed to the State's policymakers. The Department does agree with the second and third findings and has agreed to implement the recommendations to the extent it is able to do so within the provisions of the current compacts.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on April 12, 1999.

Sincerely,

A handwritten signature in black ink, appearing to read "Douglas R. Norton". The signature is written in a cursive style with a large, looping initial "D".

Douglas R. Norton
Auditor General

Enclosure

SUMMARY

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Gaming pursuant to a May 27, 1997, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the Sunset review set forth in A.R.S. §§41-2951 through 41-2957.

The Legislature established the Arizona Department of Gaming (Department) in 1995 to monitor Indian gaming operations on behalf of the State of Arizona. Formal agreements required by federal law known as tribal-state gaming compacts, negotiated between the State and tribes seeking to conduct gaming activities, provide a regulatory framework whereby the State and tribes share responsibility for maintaining the integrity of Class III gaming operations. These compacts are unique because they provide the State with an active role within tribal affairs, whereas the State generally has very limited jurisdiction on tribal lands.

The Department has 56 employees who perform a variety of functions to meet the State's compacted responsibilities. These employees carry out compact enforcement activities such as gaming device inspections, and certification activities such as background investigations on individuals and companies who wish to provide services to gaming operations.

State Should Review the Department's Role (See pages 9 through 16)

State officials should determine whether the Department's current regulatory stance is the optimal approach for monitoring Indian gaming operations in Arizona. The tribal-state gaming compacts negotiated between the State and the tribes do not clearly delineate the extent of state oversight, nor do they provide the State with any sanction authority to enforce compliance. As a result, disagreement exists in Arizona between the Department and several tribes regarding what level of involvement the State should have within Indian gaming.

Audit work revealed that the Department's extensive oversight activities are well designed for ensuring the integrity of Class III gaming operations. For example, at each gaming facility, the Department performs pre-operation inspections, randomly inspects gaming devices every 4 weeks, conducts compact compliance reviews every 18 months, and maintains an ongoing presence through its investigators, who visit casinos on a weekly basis to inspect operations and investigate possible compact violations. These activities are generally well-designed and are accepted practices among gaming regulators. Further, based on Department records, they effectively identify compact violations at gaming facilities.

The Department's approach is, however, among the most extensive nationally. The Department has more staff monitoring Indian gaming than any other state and maintains a larger budget than states with comparable numbers of casinos. The Department also conducts its activities more frequently than most other states.

Although the Department operates an extensive regulatory program, it lacks the authority to impose sanctions for noncompliance and must rely on voluntary compliance by casino operators or enforcement actions by tribal regulators. This is especially significant because tribal officials do not always agree that compact violations identified by the Department are, indeed, violations.

In light of the issues related to state oversight activities, state policymakers should decide if the Department's current approach best meets the State's needs and the intent of the compacts or if a different approach is warranted. State officials may want to retain the current approach because it allows the Department to quickly identify potential threats to gaming operations and the public. However, state officials may opt for a more targeted oversight approach. Under such an approach, the Department would continue to conduct its current activities, but in some cases at a less frequent rate. The frequency of activities would be based on the violation history of each gaming operation, and the experience and expertise of the tribal regulatory body. As a third alternative, state officials may decide that the Department should play a much more limited oversight role. Several states and the federal government allow some tribes to completely self-regulate their operations.

Regardless of the approach chosen by state policymakers, the Department should continue working to improve its relations with tribal officials. Gaming regulation is unique in that it requires two distinct, sovereign governments to work together as co-regulators. The Department's dependence on the cooperation of tribal regulators makes it essential that effective working relationships exist. The Department should strengthen these relationships by consistently holding quarterly meetings with tribal officials to identify and resolve issues as they arise, and by continuing to improve the information provided to tribal officials regarding the Department's enforcement activities. According to the agency's new Director, improving relations with tribes is a high departmental priority.

**The Department Should Work
with Tribes to Reach an
Agreement on Gaming Device
Assessment Fees
(See pages 17 through 20)**

A tribal-state gaming compact provision requiring that the State and tribes renegotiate tribal assessment fees after the compact's first two years has not been met. The compacts initially required that tribes pay an assessment fee of \$500 per gaming device to fund the Department's enforcement activities. The amount of this fee was arbitrary since the costs of state

oversight were unknown. The compacts include a provision requiring that fees be renegotiated once the costs of state oversight became clearer. Despite this provision, assessment fees have not been renegotiated for most tribes, even though 13 of the 17 compacts have been in effect for more than 2 years. Most attempts to renegotiate fees have resulted in an impasse though, according to Department officials, two tribes have renegotiated the fee and agreed to pay the \$500 assessment for the duration of the compact.

The inability to renegotiate fees could threaten the Department's operating budget, and could also result in inequities between tribes. To date, assessment fees have exceeded the amount needed to fund Department operations, and the surplus has been returned or credited to the tribes each year. However, the amount of the reversionment has declined as the Department's costs have increased. If this trend continues, the Department may soon experience a shortfall in revenues.

In order to foster renegotiations, the Department should consider providing more specific information to tribes about its use of these fees. Specifically, the Department could revise the quarterly expenditure reports the compacts require so that they include more detail about its expenditures. Since providing more details may increase its administrative costs, the Department should consult with tribal officials to determine the appropriate balance between the competing needs for more information and for minimizing costs.

Finally, the Department, as the representative of the State, should work with tribal officials to generate amended or new compact language that identifies a tangible and fair basis from which fees can be renegotiated. Current compact language requires that fees be renegotiated based on the "actual and projected costs and expenses incurred for State regulation enforcement duties." If interpreted to mean that every Department expense is subject to separate negotiation, this language could make it difficult to complete negotiations with each of the 17 tribes. Further, because the cost of regulation depends on the extent and frequency of regulatory activities, negotiation based on this language could falter over disagreements about the need for specific Department activities.

Improved Vendor Certification Process Can Be Further Streamlined (See pages 21 through 26)

The Department should consider making additional refinements to its process for certifying vendors that provide services for tribal gaming operations. Currently, the Department, per compact requirements, certifies businesses that provide more than \$10,000 in goods and services to a gaming operation in any given month. The certification process helps to ensure that only those companies that are found to be suitable under the provisions of the compact are permitted to conduct business at Class III tribal casinos. Compacts do not specify how the Department should carry out the certification process, but only list the offenses that would

justify denying certification. The Department developed an investigative process designed to identify these offenses. Initially, the Department subjected all vendors to the same level of investigation, but now varies the level of review depending on the services provided and the risks associated with these services.

During the audit, several tribal officials and vendors identified concerns about the certification process. However, recent changes to the process should address many of these concerns. For example, a more streamlined investigation process now in place for many types of vendors should alleviate complaints that the process is too onerous for certain types of vendors. Similarly, recent Department practices of providing monthly certification status reports to tribal officials, and of more thoroughly itemizing the invoices vendors receive for investigative costs, should help to allay concerns raised by vendors.

The Department may wish to consider implementing additional changes to further streamline this process. For example, the Department could consider reclassifying additional vendors so that they require less extensive investigations, automatically certifying vendors who received comparable certification from other states, certifying only vendors of gaming-related services, or altering the monetary threshold required for certification. Several of these suggestions would require amended compact language. Further, the Department should carefully assess the risks associated with any of these refinements before implementing them.

Other Pertinent Information (See pages 27 through 31)

During the audit, other pertinent information was collected regarding the status of cases in the dispute resolution process. Due to the complexities related to regulating gaming, disputes sometimes arise between the Department and tribes. Under such circumstances, they enter a dispute resolution process prescribed by the compacts. It appears that this process is used much more frequently in Arizona than in other states with Indian gaming. In fact, there are currently five pending cases in arbitration or litigation. These disputes cover a wide range of issues. For example, one dispute concerns whether tribal assessment fees should be used to pay the State's legal costs. Another is about whether the Department has to provide tribes with advance notice for device inspections. As of December 1998, there were seven pending cases, some of which were long-standing, meaning that potentially serious matters were not being quickly addressed. Additionally, the Department's legal costs steadily increased because of these disputes. However, the Department settled two cases being litigated with separate tribes in 1999.

Table of Contents

	<u>Page</u>
Introduction and Background	1
Finding I: State Should Review the Department’s Role	9
Appropriate Role for State in Regulating Indian Gaming Not Well-Defined.....	9
Department’s Regulatory Tools Are Well-Designed for Ensuring Integrity of Gaming Operations.....	10
Department’s Approach Among Most Extensive Nationally.....	11
Alternative Oversight Approaches Exist.....	12
State Should Determine How to Best Monitor Indian Gaming.....	14
Regardless of Approach, Department Should Work with Tribes to Improve Cooperative Relationship.....	15
Recommendations.....	16
Finding II: The Department Should Work with Tribes to Reach an Agreement on Gaming Device Assessment Fees	17
Most Fees Have Not Been Renegotiated.....	17
Providing More Cost Information Could Facilitate Negotiations.....	18

Table of Contents (cont'd)

	<u>Page</u>
Finding II: (cont'd)	
Department Making Progress Toward Renegotiating Fees	19
If Possible, Compact Language Should Be Clarified or Changed for Fee Renegotiations.....	19
Recommendations.....	20
Finding III: Improved Vendor Certification Process Can Be Further Streamlined	21
Vendor Certification Process	21
Problems Identified with Certification Process	23
Improvements to Certification Process	24
Recommendation	26
Other Pertinent Information	27
Dispute Resolution Process.....	27
Disputes Costly and Long-Standing	27
Some Current Disputes	28
Sunset Factors.....	33
Agency Response	

Table of Contents (concl'd)

		<u>Page</u>
	Tables	
Table 1	Arizona Department of Gaming Status of Tribal Gaming in Arizona As of November 1, 1998.....	4
Table 2	Arizona Department of Gaming Statement of Revenues, Expenditures, and Changes in Fund Balance Years Ended or Ending June 30, 1997, 1998, and 1999 (Unaudited).....	6
Table 3	Arizona Department of Gaming Vendor Classifications	22
Table 4	Arizona Department of Gaming Cases in the Dispute Resolution Process As of March 1999	31

(This Page Intentionally Left Blank)

INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit and Sunset review of the Arizona Department of Gaming pursuant to a May 27, 1997, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the Sunset review as set forth in A.R.S. §§41-2951 through 41-2957.

The Arizona Department of Gaming (Department) was established in 1995 to regulate and monitor Indian gaming on behalf of the State of Arizona. Previously, from 1992-1995, a division within the Department of Racing handled this function. The Department's stated mission is to protect the public by ensuring the integrity of the Indian gaming industry. Formal agreements, called tribal-state gaming compacts, negotiated between the State and tribes, provide a regulatory framework for the operation of Class III gaming activities conducted on Indian lands. The Department carries out the State's responsibilities as prescribed in the compacts. Department staff monitor gaming operations to ensure compliance with compact provisions and certify gaming employees and providers of gaming services to prevent unsuitable individuals or companies from becoming involved in Arizona's gaming industry. Each tribe must establish a Tribal Gaming Office to perform similar functions on its behalf.

Federal Law Establishes Basic Regulatory Structure for Indian Gaming

In 1987, the United States Supreme Court rendered a decision entitling Indian tribes to conduct gaming on their lands if a state does not expressly prohibit all forms of gaming. In response to this decision, Congress enacted the Indian Gaming Regulatory Act of 1988 (IGRA). IGRA supports the promotion of tribal economic development while establishing basic regulations and outlining federal, state, and tribal enforcement responsibilities for Indian gaming. IGRA defines three classifications of Indian gaming, each with a different regulatory structure.

- **Class I Gaming (regulated exclusively by tribes)**—Tribes exclusively regulate Class I gaming, including social games or gaming related to tribal celebrations or ceremonies.
- **Class II Gaming (regulated by tribes with federal oversight)**—Tribes regulate Class II gaming, such as bingo and certain card games. The National Indian Gaming Commission (NIGC), created within the Department of the Interior, provides federal oversight of Class II games.

- **Class III Gaming (regulated by tribes with state oversight)**—IGRA requires states and tribes to regulate all other forms of gaming, defined as Class III games, such as electronic gaming devices, keno, pari-mutuel wagering, and lotteries.

IGRA also restricts how tribes can use revenues derived from gaming operations. Tribes may use revenues to fund tribal government operations, promote tribal economic development, make donations to charitable organizations, and help fund local government operations. Additionally, a tribe may choose to give a percentage of revenues directly to its members. In Arizona, tribes have used gaming revenues for many of these purposes including hiring police officers, building medical facilities and community centers, and improving utility services.

States Usually Have Limited Involvement in Tribal Affairs

Oversight of Class III gaming activities is one of the few areas of tribal affairs over which states have any regulatory responsibility. Due to the reservations' status as sovereign nations, states have only limited jurisdiction over tribal affairs. For example, states generally lack jurisdiction over criminal and civil cases on reservations, lack authority to regulate traffic and safety laws, and cannot impose taxes on tribal governments. However, IGRA established a regulatory framework for Class III gaming that provides states with the authority to monitor such Indian gaming activities within their borders. IGRA attempts to balance a state's right to maintain public health and safety with a tribe's right to promote economic development and self-sufficiency. Thus, both states and tribes conduct activities necessary to regulate gaming.

Development of Gaming Compacts in Arizona Was Highly Contentious

Indian gaming in Arizona had a turbulent beginning. The State initially refused to negotiate compacts with tribes until ordered to do so by a federal court after several tribes sued the State in 1992 for violation of IGRA. Despite this court order, the State could not reach agreement with the tribes. As a result, the Department of the Interior intervened. The Secretary of the Interior mediated negotiations that finally resulted in eight signed compacts in June 1993. Though various states have needed federal assistance to resolve state-tribal differences, and some states with Indian gaming have been unable to agree on compacts with tribes, only one other state (Connecticut) required this level of federal intervention to secure compacts. The State eventually signed tribal-state compacts with a total of 17 tribes, each containing basic provisions in the following areas.¹

¹ Two of the 17 tribes with compacts no longer operate casinos.

- **Compacts place limits on types of games and number of gaming devices**—The compacts permit the following Class III gaming activities: gaming devices (slot machines), keno, lottery, off-track pari-mutuel wagering, and pari-mutuel wagering on horse and dog racing. The compacts limit the number of gaming facilities and gaming devices based on a tribe’s enrolled membership. Tribes with 4,000 or fewer members can operate 2 casinos with a total of 475 devices. Larger tribes can open more casinos with additional devices. Further, a tribe can operate no more than 500 devices at each facility. See Table 1 (page 4), for a list of tribes with compacts and the extent of their gaming operations.
- **Tribes have specific regulatory responsibilities**—Tribes are solely responsible for the operation and management of all gaming activities. They must establish a tribal gaming office, independent of the tribal government, to regulate gaming and enforce compliance with compact provisions on the tribe’s behalf. The tribal gaming offices inspect gaming facilities, approve internal control systems for the gaming operations, investigate suspected compact violations, and license gaming employees, casino management companies, manufacturers of gaming devices, and providers of gaming services.
- **State has monitoring role**—The compacts set forth a monitoring role for the State. Like the tribal gaming offices, the Department also monitors all gaming operations for compact compliance. Further per compact provisions, the Department must also investigate and certify all non-tribal gaming employees, casino management companies, suppliers and manufacturers of gaming devices, and providers of gaming services. The Department conducts background investigations and makes recommendations to tribes regarding licensing tribal members but does not actually certify them.
- **Other provisions**—The compacts establish other provisions such as fees for state certification, reporting requirements between the State and tribes, a dispute resolution process, and technical standards for Class III gaming activities. After ten years the compacts can be extended for additional five-year terms or new compacts can be negotiated. The first compacts will expire in 2002.

Budget and Staffing

Gaming device assessment fees and certification fees fund the Department’s operations. Tribes are assessed \$500 per gaming device per year. The compacts set initial certification fees that range from \$150 for gaming employees to \$1,500 for casino management companies. Investigative costs that exceed the initial fee must be paid by the applicant. Revenues from both sources are deposited into the Permanent Tribal-State Compact Fund established by A.R.S. §5-601(F). The Legislature appropriates money from the Fund for Department operations, and any gaming device assessment fee revenue remaining in the Fund at the end of the

Table 1
Arizona Department of Gaming
Status of Tribal Gaming in Arizona
As of November 1, 1998

Compacted Tribe	Number of Tribal Members	Compact Date	Number of Sites ¹ Authorized	Current Number of Sites	Number of Devices ¹ Authorized	Current Number of Devices
Ak-Chin Indian Community	575	1993	2	1	475	475
Cocopah Tribe	774	1993	2	1	475	475
Colorado River Indian Tribes	3,095	1994	2	1	475	331
Fort McDowell Mohave-Apache Indian Community	849	1993	2	1	475	475
Fort Mojave Indian Tribe	997	1993	2	1	475	171
Gila River Indian Community	11,550	1993	3	2	900	900
Hualapai Tribe	1,562	1994	2	Closed 9/95	475	0
Kaibab-Paiute Tribe	245	1994	2	Closed 9/96	475	0
Pascua Yaqui Tribe	8,299	1993	3	1	900	500
Quechan Indian Tribe	2,419	1993	2	1	475	475
Salt River Pima-Maricopa Indian Community	6,202	1998	3	1	700	250
San Carlos Apache Tribe	10,500	1993	3	1	900	500
Tohono O'Odham Nation	18,061	1993	4	1	1,400	500
Tonto Apache Tribe	103	1993	2	1	475	318
White Mountain Apache Tribe	12,000	1993	3	1	900	496
Yavapai-Apache Tribe	1,200	1993	2	1	475	458
Yavapai-Prescott Indian Tribe	<u>139</u>	1993	<u>2</u>	2	<u>475</u>	<u>475</u>
Total	<u>78,570</u>		<u>41</u>	<u>17</u>	<u>10,925</u>	<u>6,799</u>

¹ The number of authorized sites and devices is based on a tribe's population. Tribes with populations of 4,000 or fewer members are allowed 2 sites and a total of 475 devices. Tribes with 4,001 to 8,000 members are authorized 3 sites and a total of 700 devices, and tribes with 8,000 to 16,000 members are allowed 3 sites and a total of 900 devices. Tribes with more than 16,000 members may have up to 4 sites and a total of 1,400 devices.

Source: Arizona Department of Gaming document "Status of Tribal Gaming in Arizona as of 11/1/98."

fiscal year is returned to the tribes or applied to the following year's gaming device assessment. The Legislature appropriated \$4,505,200 to the Department for fiscal year 1998-99. See Table 2 (page 6) for the Department's Statement of Revenues, Expenditures, and Changes in Fund Balance for Years Ended or Ending June 30, 1997, 1998, and 1999 (unaudited).

The Department has 56 full-time equivalent (FTE) positions to fulfill the State's responsibilities set forth in the compacts. Forty of these positions are assigned to the following five compact enforcement units:

- **Games and Devices Compliance Unit (6 FTE)**—These staff verify that electronic games comply with the technical standards set forth in the compacts.
- **Tribal Gaming Affairs Unit (7 FTE)**—These staff are assigned to specific tribes and perform weekly on-site inspections of casinos and investigate suspected or actual compact violations.
- **Compliance Audit Unit (6 FTE)**—These staff conduct extensive compact compliance reviews for each casino every other year.
- **Corporate Investigations Unit (8 FTE)**—These staff conduct background investigations on all casino management companies, suppliers and manufacturers of gaming devices, and providers of gaming services as required by the compacts.
- **Applications/Records Unit (13 FTE)**—These staff conduct background investigations on non-tribal individuals seeking state certification and on tribal members to make recommendations for tribal licensure. The unit also maintains all individual certification records and provides computer support services for the Department.

Eight of the remaining 16 positions reside in the Department's Administrative Division. The Division is responsible for accounting, budget, purchasing, vendor billing, and processing administrative hearings resulting from the certification process. The remaining eight positions are as follows: the Executive Director, a Public Information Officer, a Legislative Liaison, and five Enforcement Support staff who provide clerical services for the Enforcement Division.

Since fiscal year 1995, the Department's budget has tripled and the size of its staff has doubled, although the number of gaming facilities and devices in the State has not grown to the same extent. According to Department officials, when it was a new agency the Department's activities were focused on gaming operation start-up, but once the gaming operations were established it required additional staff and budget to conduct the continuing activities required by the State's compacted responsibilities.

Table 2
Arizona Department of Gaming
Statement of Revenues, Expenditures, and Changes in Fund Balance
Years Ended or Ending June 30, 1997, 1998, and 1999
(Unaudited)

	1997 (Actual)	1998 (Actual)	1999 (Estimated)
Revenues:			
Compact enforcement, regulation, and certification fees ¹	<u>\$3,940,145</u>	<u>\$4,122,913</u> ²	<u>\$4,508,000</u>
Expenditures:			
Personal services	1,798,878	2,052,883	2,311,100
Employee related	372,436	411,618	514,800
Professional and outside services	300,964	295,284	465,200
Travel, in-state	173,423	130,198	165,000
Travel, out-of-state	74,043	62,454	136,000
Other operating	479,311	483,994	656,300
Capital outlay	13,006	16,825	35,600
Arbitration	<u>272,556</u>	<u>319,340</u>	<u>220,000</u>
Total expenditures	<u>3,484,617</u>	<u>3,772,596</u>	<u>4,504,000</u>
Excess of revenues over expenditures	<u>455,528</u>	<u>350,317</u>	<u>4,000</u>
Other financing uses:			
Reversions to Indian tribes ³	605,515	269,381	
Operating transfers out ⁴	<u>6,015</u>	<u>2,577</u>	<u>4,000</u>
Total other financing uses	<u>611,530</u>	<u>271,958</u>	<u>4,000</u>
Excess of revenues over (under) expenditures and other uses	(156,002)	78,359	
Fund balance, beginning of year	<u>517,743</u>	<u>361,741</u>	<u>440,100</u>
Fund balance, end of year ⁵	<u>\$ 361,741</u>	<u>\$ 440,100</u>	<u>\$ 440,100</u>

¹ Compact enforcement and regulation fees are based on gaming device assessments as established by tribal-state gaming compacts. These fees support the Department's enforcement and regulation functions. Certification and renewal fees are assessed to persons seeking employment at a gaming facility and vendors providing gaming services costing more than \$10,000 per month. These fees support the Department's certification functions.

² Excludes \$177,500 due from one tribe.

³ Includes amounts applied to gaming assessments due in the next fiscal year, in accordance with the compacts. The tribes can choose to have monies returned to them at fiscal year-end or have the monies applied to gaming assessments due in the next fiscal year. 1999 reversions to Indian tribes cannot be determined until the end of the fiscal year.

⁴ Transfers are made to the Office of Administrative Hearings for appeals services provided during the certification process.

⁵ Fiscal year-end fund balances consist of working capital and certification fee balances for certifications not completed at year-end.

Source: The Uniform Statewide Accounting System *Revenues and Expenditures by Fund, Program, Organization, and Object* and *Trial Balance by Fund* reports, the *State of Arizona Appropriations Report*, and the Department's *Tribal Reversion* schedule for the years ended June 30, 1997, and 1998; and Department-estimated financial activity for the year ending June 30, 1999.

Litigation and Access Issues Affected Audit Scope

Audit work focused on the Department's compact enforcement responsibilities. Specifically, the Department's regulatory activities, such as compact compliance reviews, device inspections, and certification activities, were reviewed.

The audit faced several scope limitations. First, several important issues regarding Indian gaming are currently in arbitration or litigation and therefore not amenable to review. For example, cases pending involve the Department's authority to conduct unannounced gaming device inspections and whether poker is an allowable game under the compacts (see Other Pertinent Information, pages 27 through 31, for the current status of all pending cases). Second, compact provisions do not provide the Auditor General with access to tribe-specific information, such as investigative or monitoring reports. Reviewing this information is critical to analyzing and documenting the Department's performance enforcing compact requirements. However, 10 of the 17 tribes with compacts gave the Auditor General permission to review enforcement files maintained by the Department. Finally, while the audit's scope is limited to the Department, the tribes are mutually responsible for ensuring the integrity of Indian gaming in Arizona. It is difficult to assess the impact of the Department's activities on Indian gaming when the Department comprises only part of the regulatory structure. Thus, while audit work and the subsequent recommendations were focused on the Department, effective gaming regulation in Arizona also depends on tribal regulatory activities.

Working within these limitations, auditors employed the following methods to determine the Department's performance:

- Interviewing Department staff to document processes related to monitoring compact compliance and certifying gaming companies and observing Department activities, such as machine inspections and compact compliance reviews;
- Interviewing tribal government officials, tribal gaming officials, and/or casino operators at 13 of the 15 tribes operating gaming facilities¹;
- Reviewing Department correspondence and all relevant reports regarding gaming device inspections, compact compliance reviews, and other regulatory activities for the ten tribes granting auditors permission;

¹ Tribal or casino officials from the following tribes were interviewed: Ak-Chin Indian Community, Cocopah Indian Tribe, Colorado River Indian Tribes, Fort McDowell Mohave-Apache Indian Community, Fort Mojave Indian Tribe, Gila River Indian Community, Quechan Indian Tribe, San Carlos Apache Tribe, Tohono O'Odham Nation, Tonto Apache Tribe, White Mountain Apache Tribe, Yavapai-Apache Tribe, and Yavapai-Prescott Indian Tribe.

- Reviewing Department certification files for both individuals and vendors and interviewing 19 vendors to document their experiences obtaining certification;¹
- Surveying gaming officials in 18 states with Indian gaming and interviewing gaming officials in Nevada and New Jersey to determine how non-Indian gaming is regulated;² and
- Reviewing literature and interviewing gaming experts, federal gaming officials, and federal law enforcement authorities to document the history, current status, and risks associated with Indian gaming.

This report presents findings and recommendations in three areas:

- The need for state officials, including the Governor and Legislature, to review the Department's oversight role;
- The inability to meet a compact provision requiring the State and the tribes to renegotiate the gaming device assessment fees charged to tribes to cover the Department's regulatory costs; and
- Additional changes the Department should consider to further streamline its vendor certification process.

The report also includes information regarding the status of cases in the dispute resolution process.

This audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the Arizona Department of Gaming Director and staff, tribal government officials, tribal gaming offices, and casino staff for their cooperation and assistance throughout the audit.

¹ The types of vendors contacted included gaming equipment manufacturers and suppliers, financiers, food service, change cart and coin counter, janitorial service, advertising, and entertainment companies.

² The following states were contacted: Colorado, Connecticut, Idaho, Iowa, Kansas, Louisiana, Michigan, Minnesota, Montana, Nevada, New Jersey, New Mexico, New York, North Dakota, North Carolina, Oregon, South Dakota, Washington, and Wisconsin.

FINDING I

STATE SHOULD REVIEW THE DEPARTMENT'S ROLE

The State needs to determine whether the Department's current regulatory stance is the most optimal approach for monitoring Indian gaming operations in Arizona. The compacts between the State and the tribes do not clearly delineate the extent of the State's regulatory role. The Department uses regulatory tools that are well designed to ensure the integrity of gaming operations, but compared with other states, its actions are among the most extensive and frequent. Regardless of whether the State decides to retain the current approach or change it, efforts should be taken to ensure a more cooperative regulatory relationship between the State and the tribes.

Appropriate Role for State in Regulating Indian Gaming Not Well-Defined

As noted previously, the federal Indian Gaming Regulatory Act of 1988 (IGRA) established a regulatory structure for gaming that is shared between states and tribes. This has led to a national debate over the appropriate state role in regulating Indian gaming. Organizations with an interest in Indian gaming, such as the National Indian Gaming Association and the National Governor's Association, disagree about what this role should be. Further, federal agencies and courts have not provided clear guidance. Federal agency officials with the U.S. Department of Justice, the Bureau of Indian Affairs, and the National Indian Gaming Commission have stated that tribes should be the primary regulators, but have not specified the appropriate level of state oversight. By contrast, the National Governor's Association and some experts assert that the State should be the primary regulator. Additionally, federal courts have been examining this issue since before IGRA's passage, without a definitive resolution.

Mirroring this national debate, disagreement also exists in Arizona about the appropriate state oversight role. While gaming compacts assign extensive regulatory responsibilities to the tribes and authorize the State to monitor compliance, they do not clearly outline the State's role, nor do they provide the State with any sanction authority to enforce compliance. While tribal officials support a state role within Indian gaming, most believe that such a role should be limited to occasionally monitoring activities rather than performing regulatory functions on a day-to-day basis, because tribal gaming offices serve as the primary regulators of gaming activities. Several tribes maintain Tribal Gaming Offices with annual budgets of

over \$1 million. Conversely, Department officials believe such an approach is warranted because of the Department's duty under the compacts to protect the public. They note the approach also assists tribal regulatory bodies and casinos to safeguard tribal assets in a high-risk, cash-intensive industry.

Department's Regulatory Tools Are Well-Designed for Ensuring Integrity of Gaming Operations

The Department employs extensive oversight activities for monitoring Indian gaming. These activities appear to be well-designed and effective in identifying gaming operations' potential compact violations.

Department conducts extensive monitoring activities—The Department's enforcement activities reflect its philosophy of thorough regulation. For example, at each gaming facility, the Department performs a pre-operation inspection, and inspects all gaming devices prior to operation. In addition, it randomly samples and inspects 50 gaming devices at each casino on a monthly basis, and conducts a comprehensive compact compliance review approximately every 18 months. For these reviews, Department officials use a standard instrument to examine tribal compliance with every compact provision. Further, the Department maintains an ongoing presence through its investigators, who visit casinos weekly to inspect operations and investigate suspected or actual compact violations.

Regulatory procedures sound—The Department's enforcement activities are generally well-designed, and consistently implemented, and effectively identify occasional problem areas with gaming operations. As with tribal regulatory activities, the Department's procedures are intended to ensure the fairness of gaming activities and the safety of patrons as well as to prevent organized crime from infiltrating casinos. Gaming device inspections, surveillance log reviews, employee background checks, and other Department procedures are accepted practices among gaming regulators, including those in such states as Nevada and New Jersey as well as those within tribal governments.

Procedures effectively identify violations—Audit work revealed that the Department's activities effectively discover weaknesses that can be corrected to ensure the integrity of operations. For example, violations discovered in compact compliance reviews and weekly investigator visits include vendors providing services without state certification, the absence of a posted emergency evacuation plan, tribal gaming ordinances that require revision, and the failure to provide the Department with a list of persons barred from the casino for unacceptable behavior. Similarly, gaming device inspections discover violations of technical standards, such as requirements to keep computer logic boards locked and to fill out an access form every time an employee opens a device.

Department's Approach Among Most Extensive Nationally

Under the direction of Arizona's former Governor, the Department adopted a regulatory position focused on carefully monitoring gaming operations on a day-to-day basis to ensure that compact provisions are met. As a result, the Department's size and costs are greater than gaming agencies in comparable states. Further, the Department carries out its enforcement activities much more frequently than most other states. However, when violations occur, the Department must rely on voluntary compliance by casino operators, or enforcement actions by tribal regulators, since it lacks any sanction authority over gaming operations.

Activities costly—To carry out its enforcement activities, Arizona uses a larger staff and incurs higher costs than gaming departments in other states with similar numbers of gaming operations. Of the states with 10 or more compacted Indian gaming operations, Arizona's gaming department staff and expenditures are by far the highest.¹ The Department's staff and expenditures grew rapidly during its first two years of operation, doubling and tripling, respectively. According to Department officials, in the agency's first year of operation its resources were focused on gaming operation start-up, and additional staff were required to carry out continuing activities to comply with compact provisions regarding established operations.

High frequency of activities—While its activities are consistent with best practices nationally for both gaming and Indian gaming regulation, the Department conducts them more frequently than most other states. Though some states, such as Nevada and Washington, conduct activities as frequently, they differ from Arizona because they have the authority to impose sanctions for noncompliance. The Department has not determined the optimal frequency for its enforcement activities, but instead conducts them based on what staffing allows. For example, the Department initially conducted random monthly inspections of 100 gaming devices rather than 50, until it determined that such a high number of inspections were not feasible. Further, the Department, through its investigators who make at least weekly visits to each facility, maintains a much more visible presence on-site at gaming operations than most other states.

Department must rely on voluntary compliance—Even though the Department employs comprehensive enforcement activities, its lack of sanction authority over gaming operations limits its overall effectiveness. Though these activities can detect alleged compact violations, the State has no recourse, outside of legal action, to force gaming operations to address them. As a result, the Department must rely on casino operations' voluntary compliance and the assistance of tribal regulators. In many cases, tribal officials concur with and quickly address compact violations identified by the Department. However, in other cases, tribal officials dis-

¹ In 1998, 5 other states had 10 or more compacted gaming operations: Washington (10), Minnesota (18), Wisconsin (21), Michigan (15), and New Mexico (11). At the time of the audit, New Mexico had not yet begun regulatory activities. The other 4 states ranged from 2 to 12 staff, compared to Arizona's 56, and from \$125,000 to \$1.7 million in expenditures, compared to Arizona's \$3.8 million.

agree with alleged compact violations. Usually such disagreements stem from differing interpretations of compact provisions. Such disagreements are not easily resolved and sometimes result in legal disputes (see Other Pertinent Information, pages 27 through 31).

Alternative Oversight Approaches Exist

Other states with Indian gaming adhere to a wide spectrum of oversight approaches and, as a result, have wide variances in the resources they allocate to monitor operations. Only a few states employ comprehensive oversight activities similar to those the Department uses, while other states employ the same types of activities but conduct them less frequently. Finally, some states rely mostly on tribal self-regulation. Additionally, the National Indian Gaming Commission is currently allowing some tribes to self-regulate their operations for Class II games.

States with strong oversight positions—Several states adhere to proactive regulatory positions, including Nevada, Oregon, and Washington. While the type and frequency of their oversight functions vary, they all maintain a strong presence within gaming operations. For example,

- **Oregon**—The Oregon Department of State Police oversees Indian gaming. Oregon appears to conduct activities similar in type and frequency to those used by the Department. Oregon staff conduct annual comprehensive compact compliance reviews and randomly inspect gaming devices monthly. The state also inspects all gaming devices prior to installation. However, the state assigns 21 staff to monitor 8 gaming operations containing 3,865 devices, which is about a 35 percent lower ratio of staff-to-devices than the Department's (56 staff and 6,799 devices). Like Arizona, Oregon lacks enforcement options and relies on voluntary compliance.
- **Nevada**—Although it has much greater enforcement authority than Arizona, and the majority of its workload consists of non-Indian gaming operations, the Nevada Gaming Control Board resembles Arizona's Gaming Department in its approach to gaming regulation. In two of Nevada's three Indian gaming facilities, compacts allow the state to conduct the same oversight activities as are conducted for non-Indian gaming facilities. These activities include weekly reviews of surveillance systems, informal inspections of operations, and comprehensive compliance reviews every three years. The state has the authority to seize devices, resolve patron disputes, and impose fines for noncompliance. In the third Indian gaming facility, the state allows the tribe to self-regulate the operation because its casino contains only gaming devices.
- **Washington**—Washington's compacted Indian gaming operations do not have slot machines, but do operate card games, wheel games, pari-mutuel gambling, and lottery

games. The Washington State Gambling Commission extensively regulates these gaming activities by maintaining a weekly presence at gaming operations during which staff review, among other things, the casino's compliance with compact provisions, internal controls, and gaming operation surveillance systems. As in Nevada, the state has the authority to resolve patron disputes and impose fines or penalties for noncompliance.

States with moderate oversight functions—Some states use the same type of oversight activities employed by those states with strong oversight approaches, such as compliance reviews and device inspections, but do not conduct them as frequently. As a result, these states employ fewer staff and maintain smaller budgets than the Department. For example:

- **Wisconsin**—The Wisconsin Division of Gaming, housed within the State Department of Administration, has a staff of 10 with an annual budget of approximately \$850,000 to oversee 17 casinos containing 13,000 gaming devices (nearly double the 6,799 devices in Arizona's casinos). The Division conducts annual compact compliance reviews and occasionally inspects a random number of devices (approximately once a year at each facility). The state does not have the authority to impose sanctions for noncompliance.
- **Minnesota**—Minnesota's Department of Public Safety oversees Indian gaming operations. The state employs two staff with an annual budget of approximately \$300,000 to monitor 17 casinos with 12,500 devices. Staff review annual financial audits, conduct investigations, and randomly inspect gaming devices. However, during fiscal year 1997, the Department tested only 427 devices and conducted a total of 13 undercover investigations of blackjack games.
- **Michigan**—Michigan's Gaming Control Board monitors gaming operations in the State using two staff with an annual budget of \$175,000 to oversee 17 casinos with 7,100 gaming devices. The State reviews annual financial reports and occasionally inspects gaming devices. State officials visit each casino on a quarterly basis.

States with limited oversight functions—Many states provide only limited oversight of Indian gaming and rely mostly on tribal self-regulation. For example, compacts limit South Dakota's ability to inspect each of the 8 Indian gaming facilities in the State to a maximum of 100 hours per year. North Dakota monitors 5 casinos with an annual budget of under \$100,000. Further, several states with limited Indian gaming, such as Colorado, Idaho, and North Carolina,¹ do not commit any full-time staff for monitoring Indian gaming. In fact, state officials from Colorado and Idaho indicated that they allow the tribes to completely self-regulate their gaming activities.

¹ These states have two, four, and one Indian gaming operation(s), respectively.

Federal government promoting tribal self-regulation—The National Indian Gaming Commission is currently promoting enhanced tribal self-regulation of gaming activities by issuing “Certificates of Self Regulation” to tribes that meet prescribed regulatory requirements for Class II games.¹ Once certified, federal oversight of Class II games on reservations diminishes significantly, thereby allowing the Commission to focus its oversight efforts on tribes that are unable to meet these requirements.

State Should Determine How to Best Monitor Indian Gaming

State policymakers should review the Department’s current regulatory approach to determine if it best meets the needs of the State and the intent of the compacts or if a different approach is warranted. It may be a good time to examine this issue since the State now has some experience with Indian gaming and because gaming compacts begin to expire in just a few years. Any changes should be made with caution to ensure risks to the state gaming operations and gaming patrons do not increase to an unacceptable level. The State should consider the following options.

- **Maintain current approach**—The State may want to consider retaining the current approach with some refinements. Even though the current approach is costly compared to most other states, it also has some tangible benefits. For example, the approach allows the State to quickly identify potential threats to Indian gaming operations and, thereby, assist tribes to ensure the integrity of their operations. Further, the Department’s current activities, such as compliance review and device inspections, are consistent with national gaming regulatory standards.
- **Adopt a more targeted approach**—Alternatively, the Department could adopt a targeted oversight approach. Under such an approach, the Department would continue to conduct its current enforcement activities but the frequency of the Department’s enforcement activities would be directly correlated to a casino’s violation history and the tribal gaming office’s level of experience and expertise. Several tribes maintain large tribal gaming offices with substantial budgets. For example, 1 tribal gaming office maintains a staff of 50 with an annual budget of \$3.5 million. Other tribes maintain gaming offices with staffs of 17 to 32 people and annual budgets of over \$1 million. Many of these tribal gaming offices conduct enforcement activities similar to those of the Department, such as device inspections, employee licensure, and internal control reviews and audits. However, some tribal gaming offices have limited staff and budgets, and cannot conduct such extensive oversight activities.

¹ The commission monitors Class II Indian gaming activities such as bingo and card games, while states monitor Class III Indian gaming activities such as slot machines and lotteries.

As a result, the Department could develop a system that would allow it to formally assess the performance of each gaming operation over time and account for differences among them so that resources could be better allocated. Under such a system, the Department would conduct fewer oversight activities at casinos with good performance records and sophisticated regulatory bodies. This would allow the Department to use its resources to assist and monitor gaming operations that have not yet established expert regulatory entities.

- **Limit state role**—A third alternative would be to significantly diminish the Department’s role. Rather than conducting its current enforcement activities, the Department would mostly rely on tribal self-regulation and would only occasionally monitor gaming operations to determine if compact provisions are being met. Such a change should not alter the Department’s certification activities. Further, the Department would retain the same authority it currently has to investigate and review casino operations at any time.

Regardless of Approach, Department Should Work with Tribes to Improve Cooperative Relationship

Regardless of whether the State decides to retain the current approach or not, efforts should be made to improve relations with tribal officials to ensure more cooperative regulation. The IGRA established a unique regulatory system where two sovereign governments agree by compact to work together as co-regulators over Indian gaming activities. The ability of tribal and state officials to maintain sound working relationships is critical to the success of this unusual regulatory structure, reflected by compact language that prescribes regular meetings between state and tribal officials as well as a dispute resolution process. Maintaining good communications with tribal officials is especially important to the Department since it does not have any authority to impose sanctions on gaming operations for violating compact provisions and must instead rely on voluntary compliance. As a result, the Department should work with tribal officials to improve its cooperative relationship with several tribes.

Specifically, the Department could enhance its communication with tribal officials by continuing to hold quarterly meetings, as required by compact, that focus solely on identifying, discussing, and resolving problems before legal disputes arise. Though these meetings have been held in the past, evidence suggests that they were not completely effective for addressing and resolving many existing issues between the Department and tribes. Further, the Department should continue to improve information provided to tribes about its enforcement policies and activities. Recent improvements the Department made to its compact compliance reports serve as a good example of how better and more detailed information could be provided to tribes. Finally, the Department, as the representative of the State, should work with tribes to identify ambiguous compact provisions and attempt to clarify such provisions based on consensus building and upon a common understanding. According to the agency’s

new Director, improving tribal relations is currently a high Departmental priority witnessed by his recent efforts to meet with tribal officials throughout the State.

Recommendations

1. State policymakers, including the Governor and Legislature, should determine the appropriate regulatory philosophy for the Department, and direct the Department to act in accordance with this philosophy. In making this determination, policymakers should consider the following three alternatives:
 - Option 1—Taking a strong regulatory approach toward all Indian gaming operations (the Department’s current practice).
 - Option 2—Varying the approach according to the violation history of the Indian gaming operation, or according to the effectiveness of the associated tribal gaming office.
 - Option 3—Limiting the Department’s role in all Indian gaming operations to occasional monitoring.
2. If state policymakers select the second option, the Department should:
 - a) Create a model for determining the appropriate frequency of monitoring activities according to violation history or tribal gaming office effectiveness. It should consider:
 - 1) Maintaining its current high-frequency monitoring activities at gaming operations where violations exceed a predetermined level or where the tribal gaming office lacks the capacity to effectively enforce regulations.
 - 2) Reducing monitoring activities at gaming operations where violations do not exceed predetermined levels and where the tribal gaming office has the capability to effectively enforce regulations.
3. The Department should work to improve relationships with tribal officials by:
 - a) Continuing to hold quarterly meetings with tribal gaming office representatives to identify, discuss, and resolve problems.
 - b) Continuing to seek opportunities to improve information provided to tribal officials regarding Department policies and activities, as the Department did by making its compact compliance review report more informative.
 - c) Working with tribes to identify ambiguous compact provisions and clarifying such provisions based on consensus building and upon a common understanding.

FINDING II

THE DEPARTMENT SHOULD WORK WITH TRIBES TO REACH AN AGREEMENT ON GAMING DEVICE ASSESSMENT FEES

A compact provision requiring that the State and tribes renegotiate the assessment fees paid by tribes to fund the Department's enforcement activities has not been met. Compacts required these fees to be renegotiated two years after their enactment. However, most fees have not yet been renegotiated. The inability to renegotiate new fees has some detrimental impacts on both tribes and the State. Therefore, the Department should consider providing more specific cost information to tribes in order to foster renegotiations. Finally, the Department, as the representative for the State, should consider working with tribes to generate improved compact language that identifies a more tangible fee renegotiation process.

Most Fees Have Not Been Renegotiated

The State and tribes have not fulfilled a compact requirement to renegotiate the fees tribes pay to fund the State's regulatory activities. The compacts initially required that tribes pay an assessment fee of \$500 per gaming device per year to fund the Department's regulatory activities. According to the original drafters of the compacts, gaming device assessment fees were arbitrarily set at \$500 per machine since the actual costs of state oversight were unknown. The compacts include a mechanism to address the costs of state oversight once these costs became clearer. The compacts require that:

"After the initial two (2) years, the regulatory assessment per Gaming Device shall be renegotiated by the Tribe and the State based upon actual and projected costs and expenses incurred for State regulation and enforcement duties pursuant to this Compact."

Although 14 of the 17 compacts have been in effect for more than two years, only two of the fees have so far been renegotiated. Attempts made by both tribal and Department officials to renegotiate assessment fees have generally resulted in an impasse though, according to Department officials, two tribes have agreed to pay the \$500 assessment for the duration of the compact.

A continued inability to renegotiate fees could threaten the Department's operating budget, and could also result in inequities between tribes. To date, assessment fees have exceeded the

amount needed to fund Department operations, and the surplus has been returned or credited to the tribes each year. However, the amount of the refund has declined, dropping from \$605,515 out of a total of \$2,764,673 collected in fiscal year 1997 to \$269,381 out of a total of \$2,819,063 collected in fiscal year 1998. If this trend continues and fees are not renegotiated, the Department will soon experience a shortfall in revenues.

Futhermore, the failure to renegotiate these fees has a detrimental impact on tribes that continue to pay their full assessment. Three tribes reduced the amounts they paid to the Department, citing the compact's renegotiation requirement as justification. Though one tribe has since agreed to pay the full assessment, two others continue to pay a reduced amount throughout the year and then make up the difference at the end of the fiscal year based on the actual costs incurred by the Department to monitor their operations. As a result, these tribes have the use of these monies throughout the fiscal year while tribes that pay the full assessment at the beginning of the year do not. Further, should any tribes reduce their payments to an amount less than the costs incurred by the State to monitor their operations, the Department may be unable to refund the correct amount at the end of the fiscal year to tribes paying the full assessment.

Providing More Cost Information Could Facilitate Negotiations

Although the Department provides quarterly expenditure reports to tribes as required by the compacts, and allows tribal representatives to review supporting documentation at the Department, the information provided may not be sufficient for the purpose of negotiating new fees based upon "actual and projected costs and expenses." According to some tribal officials, the reports are too general in nature, and the Department does not adequately identify costs associated with individual tribes. The Department could provide more specific information to tribes in order to foster renegotiations and to alleviate suspicions some tribal officials hold regarding the Department's spending practices. However, to avoid unnecessary increases in the administrative costs of tracking and reporting expenditures, the Department should work with tribal officials to determine the appropriate balance between the competing needs for more information and for minimizing costs.

Cost information provided to tribes could be enhanced in two ways:

- **Including more specific expenditure information on quarterly reports**—Currently, the quarterly expenditure reports show general categories such as "personal services" and "professional and outside services," and do not provide information about the nature of expenses included in the category totals. For example, a reviewer of the reports cannot determine how much of the personal services category derives from compact compliance reviews, gaming device inspectors, or other specific casino monitoring activities.

- **Identifying individual tribal costs more fully**—Although the Department tracks some expenditures attributable to specific tribes, nearly all of its expenditures (86 percent in fiscal year 1998) are allocated proportionally based on the number of gaming devices operated by each tribe. Because casinos vary in their costs to regulate based on size of operations, location, and other factors, fuller identification of costs might facilitate negotiation of more appropriate fees for individual tribes.

Since providing more detail could result in increased administrative costs for tracking expenditures and preparing reports, the Department should solicit input from tribal officials regarding the level of detail desired.

Department Making Progress Toward Renegotiating Fees

Recent policies adopted by the Department's new leadership should aid fee renegotiation efforts. In fact, the Department recently entered fee renegotiations with one tribe in December of 1998. In addition to making renegotiations a priority, the Department has changed its position on negotiating separate fees for individual tribes. Previously, the State held that fees must be uniform for all tribes, although the actual costs varied by casino. This position made successful renegotiations less likely, since all 17 separate negotiations would have to end in agreement for the exact same fee. Currently, the Department's Director adheres to the position that fees can vary by tribe based on their individual costs for state oversight.

If Possible, Compact Language Should Be Clarified or Changed for Fee Renegotiations

The compact language stating that the assessment fees must be renegotiated based on the "actual and projected costs and expenses incurred for State regulation and enforcement duties" is problematic. State officials hold that the Department's actual costs are not subject to negotiation because the Legislature, rather than the Department or tribes, determines the Department's necessary costs through the state appropriation process. In fact, the previous Governor informed tribal officials from one tribe that any comments regarding the Department's costs should be directed to the Legislature during the annual budget-setting process.

This compact language could make it difficult to complete negotiations, if interpreted to mean that every Department expenditure is subject to separate negotiation. Further, because the cost of regulation depends on the oversight duties conducted, negotiation based on this language could falter over disagreements about the need for specific Department activities. Alternatively, even if such negotiations were successful they could conflict with the State's ability to independently carry out its oversight duties, since the nature and extent of Depart-

ment activities are influenced by the amount and allocation of its authorized expenditures. Therefore, the Department, as the representative of the State, should consider working with tribes to generate amended or new compact language that specifically identifies a tangible and fair basis from which fees can be renegotiated.

Recommendations

1. The Department should consider providing more detailed cost information to tribes. Since providing such information could increase the Department's costs, Department officials should meet with tribal officials to solicit input on the specific level of detail the tribes desire and are willing to pay for.

In providing additional detail, the Department should consider:

- a) Including descriptions of various activities on quarterly assessment reports;
 - b) Classifying expenditures by activity on the quarterly expenditure reports; for example, creating an expenditure category for gaming device inspections and compact compliance reviews;
 - c) Identifying and providing more detail about costs incurred to monitor tribes individually. Accomplishing this may require modifying the time accounting process the Department uses to capture additional detail about employee activities.
2. The Department, as the representative of the State, should consider working with tribes to amend compact language that specifically identifies a tangible basis from which fees can be renegotiated, and should endeavor to include such language in new compacts when the existing compacts expire.
 3. The Department should continue the renegotiation efforts with tribal officials.

FINDING III

IMPROVED VENDOR CERTIFICATION PROCESS CAN BE FURTHER STREAMLINED

The Department should consider making additional refinements to its process for certifying vendors that provide services for tribal gaming operations. In response to concerns from some tribes and vendors that certification was slow, cumbersome, and overly expensive, the Department made some changes to streamline the process and make it more open. However, additional options exist for streamlining the process, such as automatically certifying vendors who have successfully undergone comparably stringent certification processes from other states.

Vendor Certification Process

The Department certifies manufacturers and suppliers of gaming devices and providers of gaming services to ensure that unsuitable companies are not conducting business at tribal casinos. While the Department will only certify a vendor sponsored by a tribe, once certified, these vendors may conduct business with any tribe in the State. The compacts define gaming services as the provision of:

“any goods or services, except for legal services,...in connection with the operation of Class III Gaming in a Gaming Facility, including but not limited to equipment, transportation, food, linens, janitorial supplies, maintenance, or security services for the Gaming Facility, in an amount in excess of \$10,000 in any single month.”

The compacts do not specify how the State should certify vendors, but lists only what offenses would justify denying certification. Therefore, the Department developed an investigative process designed to identify these problems. Investigations typically involve interviewing high-level company officials and key personnel, conducting criminal background and credit checks, and reviewing financial information, such as tax returns. In fiscal year 1998, the Department certified 98 vendors and denied certification for 7 vendors.

Initially, the Department subjected all vendors to the same level of investigation, but now classifies vendors into one of five categories with varying levels of review required for certification based on the nature of gaming services being provided. This system allows the

Table 3

**Arizona Department of Gaming
Vendor Classifications**

Classification	Description	Current Number of Vendors¹
A	Management contractors, consultants, financiers, gaming device manufacturers or suppliers, and any providers with direct access to restricted areas in the gaming facility.	54
B	Providers of security systems, gaming supplies, computer services, currency equipment, signage, cash register/point of sales, gaming device locks, alarms systems, and ATM devices.	42
C	Providers that are currently regulated by other state or federal agencies in which a background investigation is conducted such as insurance companies, banks, and liquor license sales. The Department reviews the investigative files of regulatory agency and asks for more information only if warranted.	8
D	Services that can be provided within or without the gaming facility such as advertising, uniforms, office supplies, construction companies, printing, gaming furniture, travel agents, food service, gift shop, vehicle sales, landscape companies, etc.	188
E	Exempt from certification process. Providers approved by the Department Director, such as television or radio advertising, or entities doing advertising business in association with and under the rules of the Major League Baseball Association, National Basketball Association, etc.	N/A

¹ Includes both vendors already certified and those currently being investigated.

Source: Arizona Department of Gaming State Certification Classifications.

Department to more effectively use its resources to investigate companies providing higher-risk services. Table 3 identifies the five classes of vendors and the number and type of vendors in each class. The Department more thoroughly investigates Class A vendors, who provide services critical to the integrity and fairness of casino operations and games, such as casino management contractors or gaming device manufacturers and suppliers. The Department also thoroughly investigates Class B vendors who provide a variety of services including computer and security system services (see Table 3). For these vendors, Department staff conduct a more comprehensive financial review, including visits to the company's headquarters, even if they are located out of the state or country. Once permanently certified, companies are required to renew their certification annually.

Problems Identified with Certification Process

During the audit, several tribal officials and vendors identified concerns with the Department's certification process. Tribes requested more clarification about the process and questioned the length of time it takes some vendors to become certified. Vendors, on the other hand, were more concerned with certification costs.

Tribal concerns—Several tribal officials complained that the certification process is too long and cumbersome, impacting their ability to obtain services. For example, while vendors that provide services critical to the integrity of gaming operations, such as gaming equipment manufacturers, may be accustomed to submitting to state certification requirements, other vendors that do not contract exclusively with casinos, such as food service providers, may be unwilling to undergo a lengthy or expensive certification process. This could potentially limit the pool of available vendors for certain services.

Additionally, some tribal officials expressed frustration with recent Department policies requiring certification for certain vendors who were not previously required to obtain certification. While the compact specifies that all vendors contracting for supplies or services of more than \$10,000 a month must be certified, the Department initially lacked enough staff to investigate all vendors. However, as the Department increased the number of staff assigned to the certification unit, it has required additional types of vendors to obtain certification. For example, the Department recently began requiring construction companies to obtain certification. Further, the Department is considering requiring insurance and audit companies to be certified after they develop an application form for companies regulated by other state or federal agencies.

Some tribal officials also expressed confusion about how the Department classifies vendors into the five categories. They do not understand the differences between some of the categories nor how certain types of vendors are included in each class. Further, many do not see the need for the Department to certify vendors that do not provide services critical to the integrity and fairness of casino operations and games, such as food service and janitorial companies. However, current compact language requires that all vendors providing more than \$10,000 per month in services be certified. Finally, certain tribal officials also were frustrated that the current system lacks an explicit mechanism for dealing with emergencies, such as repairs to their facilities.

Vendor concerns—Some vendors also cited concerns with the process. During the audit, staff interviewed a total of 19 vendors across classifications. These vendors described a wide range of experiences with Arizona's process, from complete satisfaction to intense frustration. Vendors satisfied with the certification process believed that it is consistent with gaming industry standards. Other vendors, especially vendors not providing services critical to the integrity and fairness of casino operations and games, reported that the Department requested an excessive amount of information for certification.

Vendors more commonly complained that the Department did not provide sufficient information about the costs associated with certification. Certain vendors thought the cost to obtain certification was reasonable, while others found it excessive. Many wanted to know upfront what it would cost to obtain state certification. According to the compacts, vendors must pay all of the Department's costs incurred during their investigation prior to obtaining certification.

While vendors pay an initial fee (\$1,500 for Class A vendors and \$150 for other types), investigative costs often exceed these amounts, depending on the extent of the review. The Department bills vendors monthly for costs that exceed the initial fee. However, since total certification costs vary considerably between vendors even within the same classification, Department officials cannot provide vendors with the exact amount required to obtain certification upon receiving an application. For example, according to Department billing data, one Class B vendor paid approximately \$900 for certification while another paid over \$10,000. Similarly, one class D vendor, an advertising firm, paid approximately \$93 for certification while another, a provider of kitchen equipment, paid over \$1,000. According to a Department official, differences in cost result from problems identified during an investigation that need to be further reviewed prior to granting certification.

Some vendors also stated that the Department's monthly billing statements lack sufficient detail about costs incurred. These vendors wanted to know how much time was spent and what activities were conducted to investigate their company.

Improvements to Certification Process

Several recent changes to the certification process should address many of the concerns raised by tribal officials and vendors. However, the Department should consider whether additional changes would further improve the process without exposing tribal gaming operations to a greater risk of infiltration by unsuitable companies.

Recent improvements implemented by the Department—The Department has recently taken several steps to address many of the concerns raised by tribes and vendors. First, the Department streamlined the investigation process for Class D vendors (those providing services that are not critical to the integrity and fairness of casino operations and games). The Department now requires less information from these companies and conducts less extensive investigations. Previously, Class D vendors had to submit the same information as vendors providing direct gaming services, such as financial statements, other gaming licenses, tax returns for the last three to five years for both the company and its owners, articles of incorporation, stock certificates, and fingerprint cards for owners and key personnel. Now Class D vendors must submit only an application, information release forms, and fingerprints.

Second, the Department now subjects more vendors to the streamlined investigation process. In January 1998, the Department reclassified several Class B vendors as Class D vendors such as office supply, janitorial supply, food service and advertising companies. As a result, as seen in Table 3 (see page 22), the majority of vendors, 64 percent, are now classified as Class D vendors. Finally, the Department began providing monthly certification status reports to tribes. As of April 1998, tribes receive information on the status of individual vendors' applications and a report indicating the classification, status, assigned investigator, and key dates for each vendor.

The Department recently revised its vendor billing system. As of August 1998, the Department provides more detailed monthly bills to vendors. Bills now detail the exact time spent by investigators on an application. Further, they include detail on other costs, such as phone calls.

Other potential changes—The Department may wish to consider implementing additional changes to the vendor certification process suggested by tribal officials, vendors, and gaming regulators in other states. Several would require changes to the compacts.

For example, the Department could:

- **Classify additional vendors as Class D vendors**—The Department could reclassify additional vendors not providing gaming services critical to the integrity and fairness of casino operations and games, such as computer service vendors, as Class D vendors, thereby subjecting these vendors to a less stringent review process.
- **Automatically certify vendors who have received comparable certification from other states**—The Department could automatically certify vendors already certified by other states that have investigation processes as stringent as Arizona's. For instance, gaming officials in North Dakota automatically certify vendors who have obtained certification in Nevada, New Jersey, or South Dakota. Similarly, Connecticut officials do not investigate vendors certified by the New Jersey Division of Gaming Enforcement.
- **Certify only vendors of gaming-related services**—The Department could certify only vendors providing services critical to the integrity and fairness of gaming operations. Compact language would have to be amended to allow such a change. Several states certify only vendors who provide services critical to the integrity of Class III gaming, such as gaming device manufacturers. State officials in Connecticut, Kansas, Minnesota, New Mexico, Nevada, North Dakota, Oregon, Washington, and Wisconsin certify only companies providing these critical services. For instance, in these states, office supply and janitorial companies are not investigated or certified. Further, the Department could retain the authority to investigate these vendors when deemed necessary. The Department could also develop formal policies that account for emergency situations, such as facility repairs.

- **Altering the monetary threshold for certification**—Finally, the Department could raise the certification threshold above \$10,000 monthly for either all vendors or only for those providing services not critical to the integrity of gaming operations. Alternatively, the Department could use an annual, rather than monthly, monetary threshold for certification. For example, in New York, all vendors providing services critical to the integrity of gaming operations are certified as well as all other vendors that do not provide services critical to the integrity of operations and that provide more than \$50,000 in services annually. In New Jersey, state officials conduct a limited investigation of non-gaming related vendors providing between \$500 and \$75,000 in services annually, while those providing more than \$75,000 in services are subject to a more comprehensive review. Using a larger, annual monetary threshold would allow casinos to more easily contract with one-time vendors, such as major repair companies who may charge more than \$10,000, but only for one-time services. Either change would require amending the compacts' certification requirements.

Department officials should continually assess the risks associated with various vendor types to determine if a less stringent process is appropriate based on their experiences in the first few years of operation and because they adhere to one of the most stringent certification processes in the country. If found to be appropriate, the Department could implement certain changes immediately and/or request amendments to the compacts in order to implement other changes.

Recommendation

1. The Department should assess the risk associated with each vendor type and consider making further changes to its vendor certification process as appropriate.
 - a) Changes could include streamlining the investigation process for additional vendors and/or granting reciprocity to vendors certified in other states.
 - b) If deemed appropriate, the Department would need to negotiate amendments to the compacts to make additional changes, such as certifying only vendors providing services critical to the integrity and fairness of gaming operations and/or changing the monetary threshold for certification.

OTHER PERTINENT INFORMATION

As part of the audit of the Department of Gaming, auditors examined the status of cases in the dispute resolution process. Currently, the Department has five cases pending in arbitration or litigation.

Dispute Resolution Process

Due to the complexities related to gaming regulation, disputes sometimes arise between the Department and the tribes. When tribes and the Department disagree over compact provisions, they can attempt to resolve disputes through informal negotiations. For those disputes that cannot be resolved informally, the compacts prescribe a mechanism for dispute resolution, *“...if the Tribe or the State believes that the other party has failed to comply with the requirements of [the Compact], the party asserting non-compliance shall serve written notice to the other party.”* Once a notice of noncompliance has been issued, the compact allows for a meeting of voluntary resolution to take place, including representatives from the State and tribe. If the dispute is not resolved to the satisfaction of the parties, *“...the dispute shall be adjudicated through arbitration in Arizona or such other place as the parties may agree.”*

The dispute resolution process in Arizona appears to be used more frequently than in some other states with Indian gaming. The audit team contacted 18 of the states with compacted Class III gaming, 3 of which do not have a formal dispute resolution process in place. For the remaining 15 states, 12 have never invoked their dispute resolution process. For states that have invoked the process, disputes have concerned such issues as the timeliness of licensing employees and tribal revenue sharing.

Disputes Costly and Long-Standing

The State and four tribes have invoked the dispute resolution process over several issues. There are currently four cases in arbitration and one case in litigation. In addition, there were two other cases previously in litigation that were recently settled. Current disputes concern differing compact interpretations and range from disagreements over allowable games to who is responsible for paying the State’s legal costs.

Once in the dispute resolution process, cases last for years. In fact, one case was in the dispute resolution process for nearly three years until a settlement was reached in February 1999. The

long-standing nature of such cases means that potentially serious matters are not being quickly addressed.

Additionally, the Department's legal costs have steadily increased because of these disputes. For example, the Department expended approximately \$487,000 over a 2-year period for its recently settled case against the Tohono O'Odham Tribe.¹ Overall, the Department expended \$242,325 in fiscal year 1997 and \$318,754 in fiscal year 1998. In fact, the Department received a supplemental appropriation of \$220,000 from the Permanent Tribal-State Compact Fund to cover its arbitration expenses in fiscal year 1998.

Some Current Disputes

The following issues are currently in the dispute resolution process.

- **State's legal costs**—The Colorado River Indian Tribes are contesting the State's policy for paying its legal costs incurred from disputes. The compacts state that:

“The costs of arbitration shall be borne equally by the parties, with one-half of the expenses charged to the Tribe and one-half charged to the State. The parties shall bear their own costs and attorney's fees associated with their participation in the arbitration unless the decision of the arbitrator shall specify otherwise.”

The Department currently uses monies from the Tribal-State Compact Fund to pay its legal costs. Tribal officials contend that, since the fund is comprised of gaming device assessment fees, tribes are paying for both their own legal costs as well as the State's legal costs resulting from the dispute resolution process. Under these circumstances, tribal officials argue that the tribes lack incentive to enter the dispute resolution process and that the Department has no incentive to avoid the process if possible. Further, tribal officials believe that the Department's policy of billing all tribes for these costs as a shared expense is unfair since not all tribes are involved in the disputes. Some tribal officials believe that the Department's legal costs should be paid from State General Fund revenues. Although only one tribe is formally contesting this issue, many tribes expressed concern over the matter. Department officials contend that monies deposited in the Tribal-State Compact Fund are state monies to be used to pay for all state expenses incurred from monitoring Class III Indian gaming activities.

¹ According to Department officials, the Tribe reimbursed the State for approximately half of the legal costs incurred for this litigation. This money was then reverted to the tribes.

- **Advance notice for device inspections**—The Colorado River Indian Tribes and Ak-Chin Indian Community are disputing the Department’s policy of advanced notice for inspections of gaming devices. The compacts state that:

“Agents of the State Gaming Agency shall be entitled to enter the non-public areas of any Gaming Facility licensed by the Tribe after such state agents have provided proper identification... (and) given notice to the Tribal Gaming Office...”

The compacts do not specify what constitutes notice. Tribal officials contend that some advance notice is necessary because gaming operations need to ensure that enough staff are present to accommodate Department inspectors and to maintain regular gaming operations. Without such notice, tribal officials believe these inspections unduly interfere with gaming operations, which is prohibited by compacts. Department officials contend that they provide adequate notice when they arrive at the casino. Additional notice could diminish the intent and effectiveness of surprise inspections.

- **Multi-player gaming devices**—Another issue currently in litigation concerns multi-player gaming devices. The Gila River and Ak-Chin Indian Communities have jointly entered litigation against the State regarding multi-player gaming devices, which allow five players to play at once. However, since the device has only one random number generator, the tribes consider them to be a single gaming device. The compacts state that:

“Each electronic game of chance must have a true random generator which will determine the occurrence of a specific symbol or specific number to be displayed on the video screen where such symbol, card, or number is wholly or partially determinative of the outcome of the game...”

The litigation resulted because the Department changed its initial position regarding these devices. Initially, Department officials considered these devices as single machines. Subsequently, some tribes purchased and installed these machines. However, in 1996, under a new Director, the Department reversed its position by adopting a policy that counted each device as five machines rather than one. Tribes took exception to this policy change since compacts limit the number of devices allowed at each casino.

- **Poker**—The Gila River Indian Community has entered into arbitration with the Department over poker games. Tribal officials contend that poker is a Class II game that is not subject to state regulation. The National Indian Gaming Commission supports this position. However, Department officials contend that poker as played in the gaming facilities is an unauthorized Class III game.

- **Employee certification**—There are other issues in the dispute resolution process regarding the certification of employees. For instance, the Ak-Chin Indian Community is in arbitration over whether employees who work exclusively in Class II gaming and have access to non-public areas of the casino require state certification. Additionally, the Colorado River Indian Tribes are disputing whether the tribe is required to submit renewal applications for gaming employees who are tribal members, since the State does not certify these staff. Table 4 (see page 31), provides further information about the current status of the cases in arbitration and litigation.

Table 4

**Arizona Department of Gaming
Cases in the Dispute Resolution Process
As of March 1999¹**

Plaintiff	Defendant	Year Action Initiated	Nature of Case	Legal Action Taken	Status
Colorado River Indian Tribes	Director and the Arizona Department of Gaming	1996	Arbitration based on the tribes' objection to paying the State's legal costs and conducting unannounced machine inspections.	Arbitration; litigation as of August, 1996.	One settlement will resolve both issues.
State of Arizona	Ak-Chin Indian Community	1996	State brought action to allow unannounced machine inspection and to require the certification of employees who have access to non-public areas of the casino.	Arbitration	Department is currently preparing a memorandum of understanding.
Colorado River Indian Tribes	Arizona Department of Gaming	1997	Arbitration based on whether the tribe must submit renewal applications for the certification of tribal member gaming employees.	Arbitration	Awaiting selection of a third arbitrator.
Gila River and Ak-Chin Indian Communities	Director and Arizona Department of Gaming	1997	The tribes sued to prevent the Director from threatening to act against the state certification of any corporation or individual, and to determine if the tribes are authorized to operate multi-player devices.	Litigation	The Department dismissed as a defendant; however, case remains against the Director of the Arizona Department of Gaming and is currently being reviewed by the court.
Gila River Indian Community	Arizona Department of Gaming	1998	The tribe took action to determine whether poker is considered Class II gaming that is not subject to state regulation, or Class III gaming that is subject to state regulation.	Arbitration	State selected a third arbitrator in August 1998.

¹ In February 1999, the Department reached an agreement with the Tohono O'Odham tribe, resolving litigation that had been initiated in 1996. The State had sued to close the tribe's casino, alleging multiple violations, and the tribe had counter-sued. The agreement allowed the casino to remain open, and resolved questions regarding the violations and the costs of litigation.

Source: Arizona Department of Gaming.

(This Page Intentionally Left Blank)

SUNSET FACTORS

In accordance with Arizona Revised Statutes (A.R.S.) §41-2354, the Legislature should consider the following 12 factors in determining whether the Arizona Department of Gaming should be continued or terminated.

1. The objective and purpose of establishing the Department.

Laws 1995, Chapter 76, established the Arizona Department of Gaming to carry out the State's responsibilities as outlined in the federal Indian Gaming Regulatory Act and in the tribal-state gaming compacts. The Act requires that states enter tribal-state gaming compacts with tribes who conduct Class III gaming activities. These compacts establish a shared regulatory framework endowing both the State and tribes with responsibilities related to ensuring the integrity of gaming operations. As discussed in the Introduction, the Department employs a number of activities to meet its compact responsibilities. Currently, the State has entered gaming compacts with 17 tribal governments throughout Arizona.

2. The effectiveness with which the Department has met its objective and purpose and the efficiency with which it has operated.

Activities the Department uses appear to be effective for meeting its oversight responsibilities. These activities are well-designed and consistently implemented, and mirror practices used by other states to monitor gaming operations. For example, the Department conducts regular inspections of gaming operations, including the testing and inspection of gaming devices; conducts investigations of alleged compact violations; and investigates and certifies gaming employees as well as vendors providing services. Inspection functions are conducted frequently and certification investigations are ongoing. The Department has recently improved and streamlined some of these functions, such as compact compliance reviews and its certification process (discussed in Finding III, see pages 21 through 26). These activities provide the State with detailed information about Indian gaming activities and allow the Department to help tribes to ensure the integrity of their gaming operations.

As discussed in Finding I (see pages 9 through 16), determining how efficiently the Department operates is problematic because of the current debate about the Department's role in regulating Indian gaming. This debate stems from ambiguous tribal-state gaming compacts that do not clearly define the extent of the State's role and authority. Tribal officials argue that the Department could meet its compacted re-

sponsibilities without conducting its current day-to-day regulatory activities that require substantial staff resources and contend that some Department activities, such as machine inspections, duplicate the activities conducted by tribal regulatory entities. Department officials contend that the State's current oversight activities and the frequency of these activities are appropriate because they help the Department to protect the public and to assist tribal regulatory bodies and casinos to safeguard tribal assets. They also believe that some activities such as vendor certifications are performed more efficiently by the Department than by tribes.

As discussed in Finding I (see pages 9 through 16), the Department's extensive enforcement activities have some high costs compared to other states. In fact, the Department is one of the largest state gaming agencies in the nation and has more staff overseeing Indian gaming operations than any other state. It has grown rapidly since its inception. The Department's staff doubled and its budget tripled in a two-year period after its inception in 1995. This growth did not coincide with a significant increase in Indian gaming. Department officials attribute this growth to the newness of the agency and concede that the Department did not initially conduct all necessary activities to meet its compacted responsibilities because it lacked adequate resources.

Determining whether the Department is operating efficiently is directly linked to what oversight level of Indian gaming state policymakers desire. If state leaders want to continue the current oversight level, then the Department is operating fairly efficiently since its activities are well-designed and consistently implemented. However, if state leaders believe that such extensive oversight activities are not warranted, the Department will have to streamline its operations by decreasing its activities and reducing its costs.

3. The extent to which the Department has operated in the public interest.

Despite the dispute regarding the appropriate state oversight role, the Department operates in the public interest by monitoring tribal gaming operations. The Department has implemented activities designed to identify criminal activity and to ensure the safety of gaming patrons. For example, device inspections ensure the games are fair and certification activities prevent criminal elements from infiltrating gaming operations. These activities help the Department to comply with federal and state statutes related to Indian gaming. Further, they complement the regulatory activities conducted by tribal gaming offices.

- 4. The extent to which rules and regulations promulgated by the Department are consistent with the legislative mandate.**

The Department has not promulgated any rules or regulations. In 1996, the Legislature amended A.R.S. §5-601(D), exempting the Department from the state rulemaking requirements of Title 41, Chapter 6. According to Department officials, the Department cannot follow the state rulemaking process rules since it must adhere to provisions outlined in the compacts.

- 5. The extent to which the Department has encouraged input from the public before promulgating its rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public.**

As mentioned previously, the Department is exempt from the rulemaking requirements of Title 41, Chapter 6. According to Department officials, the Department informs the public of its activities through news releases, published articles, and by speaking to community service groups and other organizations. In addition, the Department disseminates information consistent with public record laws. Compacts prohibit the Department from disseminating tribal proprietary information and other tribal documents to the public.

- 6. The extent to which the Department has been able to investigate and resolve complaints within its jurisdiction.**

Tribal-state gaming compacts limit the Department's ability to investigate and resolve complaints. For example, the Department has authority under the tribal-state compacts to investigate complaints involving compact provision violations and to investigate complaints of illegal activities at Indian casinos. However, the Department does not have the authority to investigate and resolve patron disputes involving casinos.

- 7. The extent to which the Attorney General or any other applicable agency of state government has the authority to prosecute actions under enabling legislation.**

Under A.R.S. §5-602, the Department's enabling legislation, and A.R.S. §11-952, the Department has the authority to enter into intergovernmental agreements with other public agencies, including the Attorney General's Office for legal services. The Attorney General's Office, on behalf of the Department/State, has the authority to take action against the tribes for compact violations and to represent the Department in administrative hearings regarding state certification.

8. The extent to which the Department has addressed deficiencies in the enabling statutes which prevent it from fulfilling its statutory mandate.

In accordance with federal law, tribal-state gaming compacts, rather than state statute, dictate the conditions and terms for state involvement within Indian gaming. As a result, the Department's enabling statutes are narrow in scope and cannot be amended to override negotiated compact provisions since the State does not generally have jurisdiction on tribal lands. Therefore, only deficiencies in the negotiated compacts, not enabling statutes, may prevent the Department from fulfilling its statutory mandate. As a result, the Department can only address perceived deficiencies with the compacts by entering negotiations with tribal officials to amend them.

Despite this limitation, the Department has sponsored legislation in the past to address perceived deficiencies in its enabling statutes. For example, Laws 1996, Chapter 203 exempted the Department from state rule-making requirements. Department officials contend that this exemption was necessary because the Department must adhere to the specific provisions of the compacts. The Department also sponsored unsuccessful legislation that would have provided the Department with the ability to assess civil fines to those companies that violate compact provisions. Department officials argued that a civil fine structure would allow companies to pay fines in lieu of complete suspension or revocation of state certification.

9. The extent to which changes are necessary in the laws of the Department to adequately comply with the factors listed in the Sunset law.

As noted in Sunset Factor 8, tribal-state gaming compacts, rather than state statute, dictate the conditions and terms for state involvement within Indian gaming.

10. The extent to which the termination of the agency would significantly harm the public health, safety, or welfare.

Terminating the Arizona Department of Gaming could have a detrimental impact on the public's welfare. The Department conducts a number of activities designed to diminish threats to the integrity of Indian gaming. By eliminating the Department, the State would have no ready mechanism to monitor gaming operations and, thereby, could not ensure that tribal gaming operations meet compact gaming requirements and standards. Further, the State has already entered gaming compacts with 17 tribal governments. Eliminating the Department would cause the State to be out of compliance with compact provisions negotiated with each tribe since it is assigned various responsibilities.

11. The extent to which the level of regulation exercised by the Department is appropriate and whether less or more stringent levels of regulation would be appropriate.

It is difficult to ascertain whether the Department exercises the appropriate level of regulation since compact language does not define the proper level of state oversight. Compacts only require that the State “monitor” operations to ensure compliance with compact provisions and that such monitoring should “not unduly interfere” with tribal gaming operations.

Because of this ambiguous compact language, two divergent positions exist regarding the ideal level of state regulation for Indian gaming. As discussed in Finding I (see pages 9 through 16), and Sunset Factor 2 (see pages 33 through 34) Department and tribal officials differ regarding the appropriate level of regulation to be exercised by the State. Department officials contend that, while its current level of oversight is appropriate, the Department requires additional authority to support its enforcement activities. Conversely, several tribal officials believe that the Department currently over-regulates gaming operations.

A review of other state gaming agencies does not provide definitive criteria about what the proper level of state regulation should be since these states employed a wide range of regulatory practices. A few states adhere to practices similar to those used by the Department. However, in most of these cases, the state gaming agency has sanction authority over tribal gaming operations, unlike the Department. Many other state gaming agencies conduct less frequent and extensive oversight activities of Indian gaming operations and some states rely on tribal self-regulation.

12. The extent to which the Department has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished.

The Department uses private sector contractors for a variety of purposes. For example, the Department hired external auditors to design an audit program based on compact provisions for its compact compliance review process. The Department also utilizes the services of private legal firms. These firms assist the Department with arbitration and litigation cases with tribes. As discussed in the section on Other Pertinent Information (see pages 27 through 30), costs associated with these cases have increased significantly. For example, the Department expended \$318,754 in legal fees alone in fiscal year 1998. In addition, the Department uses consultants to provide in-house training for its employees. The Department also has a contract with the Federal Bureau of Investigation for conducting criminal background checks on gaming employees.

(This Page Intentionally Left Blank)

Agency Response

April 6, 1999

Mr. Douglas R. Norton, Auditor General
State Office of the Auditor General
2910 North 44th Street, Suite 410
Phoenix, Arizona 85018

Dear Mr. Norton:

On April 2, 1999, we received your revised report regarding the Office of the Auditor General's performance audit of the Arizona Department of Gaming. The Department's final response to the findings and recommendations is set forth in the attached document.

This Department will be giving careful consideration to your recommendations. Where possible, those recommendations will be implemented. For example, your report suggests discussing with the Tribes ambiguities in the compacts and making clarifications thereto. To that end, I am enclosing a copy of my March 11, 1999, letter that I provided to Tribal leadership, suggesting proposed amendments to the compacts to clarify certain ambiguities. We are currently in the process of setting up follow-up meetings with the Tribal leaders to obtain their input on these proposals.

Thank you for this opportunity to respond to the Auditor General's draft report. On behalf of the Department, it was a pleasure working with your auditors. We greatly appreciate their professionalism and cooperation during the course of the audit.

Sincerely,

Stephen M. Hart
Director

SMH\ll

Enclosure

cc: Penny Taylor Moore
Edwin J. Grohe

March 11, 1999

Dear Tribal Representative:

I want to thank you for attending today's meeting. I appreciate the opportunity to speak with you concerning House Bill 2062 and to listen to your comments.

I believe that HB2062, in its current form, could improve long term cooperation between the State and the Tribes as individuals would become familiar with both parties' approaches to gaming. I hope that you feel the same way and share my belief that the interests of the Indian Tribes of Arizona and the State of Arizona are best served through communication, cooperation and mutual respect.

I hope that this is but the first of a number of meetings between Tribal Representatives and the Department of Gaming concerning the issues which arise and interest all of us involved in Indian Gaming. I would like to suggest that we hold another meeting in thirty (30) to sixty (60) days and work together to set a specific date for the meeting, a location for the meeting and an agenda.

During my meetings over the last month with various Tribal Representatives and Executive Directors of Tribal Gaming Agencies, people have frequently suggested that improvements should be made to the Tribal/State compact provisions concerning gaming employee licensing and certification, as well as the surveillance of gaming facilities. In response, I have attached to this letter copies of the following documents:

1. Proposed Gaming Compact Amendment re: Limited Gaming Employees; and
2. Proposed Gaming Compact Amendment re: Video Surveillance and Security System.

I hope that these draft proposed amendments interest you and we can discuss them, among other items, at our next meeting. Please note that, while I have taken the liberty of preparing the first draft of the above documents, the documents are merely drafts intended to stimulate

Thursday, March 11, 1999
Page two

discussion and comment. Towards that end, I invite any and all comments. It would be helpful to have any written comments within the next thirty (30) days, and it is my hope that we will be able to meet shortly after that to discuss these and any other gaming issues which may be of interest to us all.

Thank you for your consideration.

Sincerely,

Stephen M. Hart
Director

SMH/rr
Attachments



STATE OF ARIZONA
ARIZONA DEPARTMENT OF GAMING
202 EAST EARLL DRIVE, SUITE 200, PHOENIX, ARIZONA 85012
PHONE (602) 604-1801 FAX (602) 255-3883

JANE DEE HULL
Governor

STEPHEN M. HART
Director

AUDIT REPORT RESPONSE

I. Finding: State Should Review the Department's Oversight Role

Response

This finding is directed to State policymakers, including the Governor and Legislature. Therefore, it would not be appropriate for the Department to take a position on this finding. However, since its inception the Department, following the requirements of the compacts, has carried out the State's philosophy of having a strong state regulatory presence in the Indian gaming industry in Arizona. We agree with the Auditor General that the Department's regulatory tools are well designed for ensuring the integrity of Indian gaming operations.

Department's Regulatory Role

The Department's regulatory role is set out in the tribal-state compacts. The compacts expressly provide that the Department "has the regulatory responsibility over Gaming Activities which is specifically set out in this Compact."¹ To clarify, the compacts do not provide for the Department to have an "oversight" role. As the Department indicated to the audit team, nowhere is the term "oversight" used in the compacts to describe the Department's regulatory role. Rather, the compacts authorize the Department "to monitor the Tribe's Gaming Operation to ensure that the operation is conducted in compliance with the provisions of the Compact" including those governing the nature, extent, and conduct of the gaming activities; public health, safety, and welfare; and ensuring the integrity of the Indian gaming industry.² To that end, the Department, on behalf of the State, conducts regular inspections of the gaming operations, including the inspection and testing of gaming devices and related equipment; conducts investigations on all compact violations and suspected violations by gaming employees; performs compact compliance reviews to monitor the tribe's compliance with all the provisions of the compact; and performs compliance testing of the gaming operations for standard minimum internal controls unique to the gaming industry.

In addition, under the compacts, the Department is responsible for issuing state certification for non-tribal individuals seeking employment in a Class III gaming facility and companies seeking to provide gaming services to such facilities in an amount greater than ten thousand dollars (\$10,000.00) in any given month. The Department also makes recommendations with respect to tribal members seeking employment in Class III gaming facilities. As part of the certification process, the State is authorized to conduct background investigations in order to ensure that unsuitable individuals and companies are not involved in Arizona's Indian gaming industry.

¹ Section 6, Standard Form Compact

² Section 7, Standard Form Compact

Although the Department's regulatory role is clearly specified in the compacts, the manner in which it is conducted is not. Consequently, the Department implemented effective and efficient procedures, set forth above, to carry out its responsibilities under the compacts. As the Auditor General points out in his report, these procedures are generally well designed, consistently implemented, and are accepted practices among state and tribal gaming regulators. They effectively identify compact violations at gaming facilities and problem areas within the gaming operations that can be corrected to ensure the integrity of the operations. As indicated in the report, the Department's procedures are intended to ensure the fairness of the gaming activities and the safety of patrons, as well as to prevent organized crime and other illegal activities from infiltrating the gaming activities.

Comparisons with Other States

Because tribal-state compacts vary from state to state both in the gaming activities permitted and the scope of regulation for the state and the tribe, it is difficult to compare the staff and budget of one state gaming agency to that of another. One factor to consider is the number of gaming facilities and their geographical locations. For instance, the 21 staff members in the Oregon Department of State Police that regulate Indian gaming monitor only 8 gaming facilities with 3,865 devices compared to Arizona's 19 gaming facilities with 7,222 devices.

Another factor is how long the state gaming regulator has been in existence. Arizona's State Gaming Agency, the precursor to the Department, was established in 1992. Many of the state gaming agencies such as Oregon, Washington, and New Mexico came into existence much later. Accordingly, they may be behind the Department in staff and budget resources, which effects their ability to conduct all the regulatory activities required under the compacts, similar to where the Department was in 1995. The Department has since moved into the forefront of state regulators in Indian gaming. It has assisted other state gaming agencies such as Washington and New Mexico, by providing training and guidance in regulating Indian gaming.

An additional factor to consider in comparing staff and budgets of state gaming regulators is the amount of gaming revenue generated by the gaming facilities. For instance, according to a recent GAO report, Atlantic City had \$3.9 billion in gross gaming revenue in 1997. The New Jersey Division of Gaming Enforcement & Casino Control Commission had a staff of 731 to provide state regulation of the 12 gaming facilities located in one city generating this revenue. In comparison, Indian gaming revenue in Arizona for 1998 was estimated to be \$800 million to \$1 billion, approximately one fourth of Atlantic City's gaming revenue for 1997. However, Arizona's gaming agency had a staff of only 56 to provide state regulation of the 17 gaming facilities located across the state generating this revenue. More telling is New Jersey's expenditures for gaming regulation in 1997, which were \$53.7 million compared with Arizona's expenditures in 1998 in the amount of \$3.7 million. Comparing New Jersey and Arizona is appropriate in that they are very similar in their monitoring and enforcement activities, as well as their mutual philosophy in having a strong state regulatory presence over the gaming activities.

Basis for State's Philosophy

The State's philosophy in maintaining a strong and extensive regulatory presence is based on a number of reasons. Under the compacts, the State has a duty to protect the health, welfare, and safety of the patrons in the gaming facilities. In addition, the State has a duty to protect the public by ensuring the integrity of the gaming activities. The tribes benefit from State regulation of the gaming operations, including its internal controls, which is essential in protecting tribal assets. The gaming operations benefit

from the Department's monitoring of the gaming devices, surveillance, internal controls, and investigations of compact violations by gaming employees. Further, the Department's regulatory presence is efficient and cost effective for the tribes when considering the number of gaming facilities and devices in operation in Arizona and the amount of revenue they produce. Given the high risk and cash intensive nature of the gaming industry, the tribes and the State benefit from a system of checks and balances which the dual regulatory framework provides.

Cooperation Through Communication

To help facilitate the dual regulatory system established in the compacts, the Department has frequent meetings and almost daily communications with the tribal gaming offices and gaming operators. These are necessary to address and resolve enforcement issues as they arise. Further, Department tribal gaming affairs staff spend a portion of their week at the gaming facilities, which serves to keep open the lines of communication regarding compact enforcement activities and to develop a cooperative relationship with the tribal regulators and gaming operators. Also, as noted in the Auditor General's report, it enables the Department to quickly identify potential threats to Indian gaming operations and thereby, assists tribes to ensure the integrity of their operations. The Department has had and continues to have quarterly meetings with the tribes, as required by the compacts, to address general issues. Some tribes have requested biannual meetings as permitted by the compacts rather than quarterly meetings. As always, the Department strives to accommodate the tribes' requests.

II. Finding: The Department Should Work With Tribes To Reach An Agreement On Tribal Assessment Fees

Response

The finding of the Auditor General is agreed to, and the audit recommendations will be implemented to the extent the Department has authority to do so, that such recommendations are not in violation of the compacts, and, if appropriate, that the tribes support the recommendations.

Pursuant to the tribal-state compacts, the State has the responsibility to renegotiate the gaming device assessment fees. That notwithstanding, the Department, on behalf of the State, successfully renegotiated the gaming device assessments with the Fort McDowell Mohave-Apache Indian Community (1996) and the White Mountain Apache Tribe (1996). The State and the Tohono O'odham Nation have commenced renegotiation of the gaming device assessment and have agreed to conclude that process promptly.

The Department agrees with the Auditor General's recommendation that the State should continue the renegotiation efforts with tribal officials. The Department has, on behalf of the State, repeatedly invited the other compacted tribes to begin the renegotiation process, but has received little, if any, response to the invitations.

With respect to the information provided to the tribes in the quarterly statements, the Department agrees with the Auditor General's recommendation that the Department should consider providing more detailed cost information to the tribes. However, the current amount of detail provided is fairly extensive. It includes an itemized statement of shared expenses, which are those regulatory costs incurred by the Department necessary to carry out the duties in the compacts. It also includes an itemized statement of

direct expenses, which are those regulatory costs incurred by the Department with respect to a specific tribe. The statements do not include the cost of certification activity since those expenses, per compact, are the sole responsibility of the individual and vendor applicants. The level of detail provided in the quarterly statements is limited, however, by the State's accounting system, i.e. the Uniform Statewide Accounting System ("U.S.A.S.") and by the Department's internal accounting system. The Department is in the process of purchasing a new accounting system that will provide more detail in the quarterly statements. In addition to the quarterly statements, the Department makes available other documents such as receipts, travel claims, purchase orders, and more in support of the Department's regulatory costs.

The Department agrees with the Auditor General's recommendation that the Department, on behalf of the State, should consider working with the tribes to amend compact language that specifically identifies a tangible basis from which fees can be renegotiated, and should endeavor to include such language in new compacts when the existing compacts expire.

III. Finding: Improved Vendor Certification Process Can Be Further Streamlined

Response

The finding of the Auditor General is agreed to, and the audit recommendation will be implemented to the extent the Department has authority to do so, that such recommendations are not in violation of the compacts, and, if appropriate, that the tribes support the recommendations.

The Department agrees with the Auditor General's recommendation that it should continue to assess the risk associated with each vendor type and consider making further changes to its vendor certification as appropriate. Thus far, the Department has made significant strides in streamlining the vendor certification process, as well as in accommodating the needs of the tribes in emergency situations. However, it must be cautious in making further changes to the vendor certification process so as not to violate the Department's certification duties and responsibilities in the compacts.

The compacts require manufacturers and suppliers of gaming devices and providers of gaming services, within or without the gaming facility, to be certified by the Department prior to the sale or lease of any gaming devices or gaming services. Gaming services is defined in the compacts to include any goods or services, except legal services, to the tribe in connection with the operation of Class III gaming in a gaming facility, including but not limited to equipment, transportation, food, linens, janitorial supplies, maintenance, or security services in the gaming facility, in an amount in excess of \$10,000 in any single month.

The definition of gaming services is expansive and encompasses virtually all goods and services provided in connection with a Class III gaming operation. That being the case, all vendors who provide gaming services, as defined in the compacts, must be certified by the State. The Department may and has varied the level of review of certain vendors depending on the type of gaming services provided and whether the vendor has direct contact within the gaming facilities to provide such service. To further streamline the certification process and limit the cost thereof, the Department obtains information from other jurisdictions inside and outside of the United States through memorandums of understanding.

As to the recommendation that the Department automatically certify vendors already certified by other states, the compacts set forth specific requirements for certification of applicants. Other states may not have the same requirements. To automatically certify vendors, the Department may potentially compromise the integrity of Indian gaming in Arizona as well as violate the State's responsibilities under the compacts.

Also, the Department must be extremely cautious with respect to the Auditor General's recommendation to amend the compacts to limit state certification for only vendors providing "services critical to the integrity and fairness of gaming operations" or raising the monetary threshold for certification. Such an amendment would increase the risk that some unsuitable companies receive state certification simply because their services did not fall within the limited category or the monetary threshold. Further, since this recommendation requires an amendment to the compacts, implementation by the Department is dependent on the cooperation and support of all the gaming tribes.