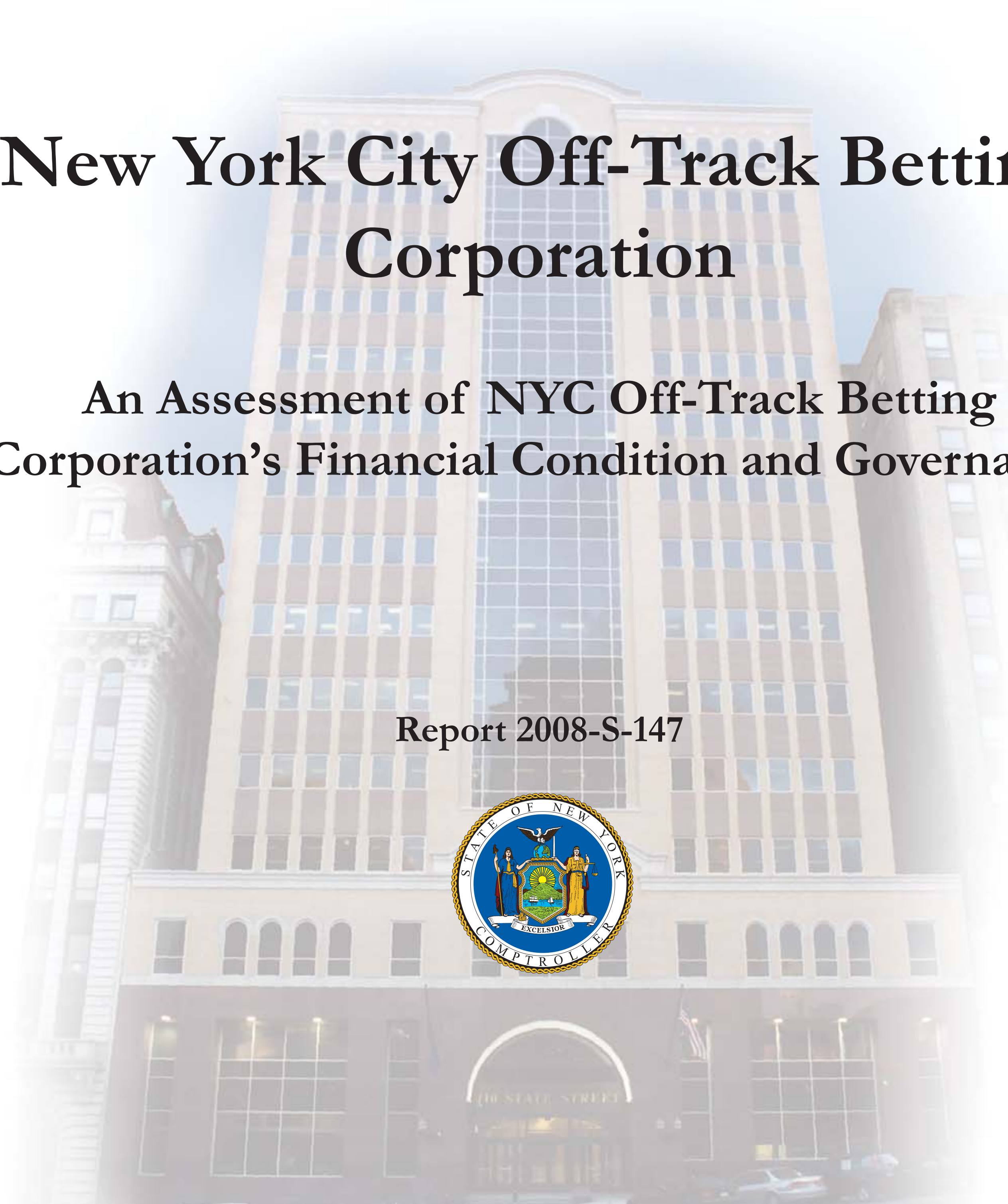
Office of the New York State Comptroller

Division of State Government Accountability



New York City Off-Track Betting Corporation

An Assessment of NYC Off-Track Betting Corporation's Financial Condition and Governance

Report 2008-S-147

Thomas P. DiNapoli

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State of New York
Office of the State Comptroller

Division of State Government Accountability

August 13, 2009

Mr. Meyer Frucher
Chairman
New York City Off-Track Betting Corporation
1501 Broadway
New York, NY 10036

Dear Mr. Frucher:

The Office of the State Comptroller is committed to helping State agencies, public authorities and local government agencies manage government resources efficiently and effectively and, by so doing, providing accountability for tax dollars spent to support government operations. The Comptroller oversees the fiscal affairs of State agencies, public authorities and local government agencies, as well as their compliance with relevant statutes and their observance of good business practices. This fiscal oversight is accomplished, in part, through our audits, which identify opportunities for improving operations. Audits can also identify strategies for reducing costs and strengthening controls that are intended to safeguard assets.

Following is a report of our audit of NYC Off-Track Betting Corporation entitled "An Assessment of NYC Off-Track Betting Corporation's Financial Condition and Governance." This audit was performed pursuant to the State Comptroller's authority under Article X, Section 5 of the State Constitution.

This audit's results and recommendations are resources for you to use in effectively managing your operations and in meeting the expectations of taxpayers. If you have any questions about this report, please feel free to contact us.

Respectfully submitted,

Office of the State Comptroller
Division of State Government Accountability

State of New York
Office of the State Comptroller

EXECUTIVE SUMMARY

Audit Objectives

Our objectives were to assess the financial condition of the New York City Off-Track Betting Corporation (Corporation) upon its acquisition by the State, and the actions taken by Corporation management to reduce operating costs.

Audit Results - Summary

The New York City Off-Track Betting Corporation is a public benefit corporation that was created in 1970 pursuant to State legislation allowing local governments to operate systems of off-track pari-mutuel betting. Under the enabling legislation, the Corporation is required to distribute certain percentages of its betting revenue to New York City and other local governments, to the State's horse racing industry, and to New York State. In addition, any year-end surplus would be remitted to New York City.

However, in recent years, the Corporation has been unable to cover all of its operating expenses without depleting its surplus funds and delaying certain statutory payments, and its CPA has questioned its ability to remain a going concern. The CPA concluded statutory relief would be needed to correct the problem.

In the four years ended June 30, 2008, the Corporation accumulated about $38 million in operating deficits. The Corporation had planned to shut down in June 2008, but instead, the State took it over pursuant to Legislation enacted on June 17, 2008.

We found that the Corporation is unlikely to avoid financial insolvency if its current financial trends continue. In addition, we found that management has taken steps to contain its operating expenses. However, management must pursue additional operational cost-saving opportunities to prolong solvency.

For example, we recommend Corporation management perform a comprehensive assessment of the Corporation's operations, develop a detailed plan for achieving certain specified reductions in its operating expenses by certain specified dates, and incorporate this cost-reduction plan into an overall plan. We noted that the Corporation has not conducted a staffing study since 1981, prior to its initiation of telephone and internet betting and prior to the installation of automated betting

betting terminals at its branch locations. We believe such a study should be conducted.

We also identified opportunities for possible cost reductions in the areas of administrative staffing, consultant contracts and simulcast contracts, and questioned whether the Corporation needed all 87 of its sedans, vans and sport utility vehicles for business purposes. We further noted that the Corporation had yet to implement two cost-saving recommendations made by an independent consultant hired by New York City prior to the State's takeover.

In responding to our draft audit report, Corporation officials commented that their newly constituted Board is committed to reexamining all aspects of operations to identify further savings opportunities. However, officials emphasized that more global actions such as changing the mandatory distribution system and aligning the business interests of the State's various racing institutions was necessary to stave off ultimate insolvency. We acknowledge both the Corporation's continual focus on examining operations for cost savings and its concern that ultimate solvency is dependent on factors outside their control.

Our audit report contains two recommendations addressing the Corporation's solvency and cost savings opportunities. Corporation officials indicate that they agree to the recommendations.

This report dated August 13, 2009, is available on our website at: http://www.osc.state.ny.us.
Add or update your mailing list address by contacting us at: (518) 474-3271 or
Office of the State Comptroller
Division of State Government Accountability
110 State Street, 11th Floor
Albany, NY 12236

Introduction

Background

State legislation enacted in 1970 and 1973 (Articles V and VI of the State Racing, Pari-Mutuel Wagering and Breeding Law) authorized local governments within New York State to operate systems of off-track pari-mutuel betting (OTB) as a method of raising revenue for the local governments, the State's horse racing industry, and New York State. The legislation was also intended to prevent and curb unlawful bookmaking and illegal wagering on horse races, and ensure that OTB activities were conducted in a manner compatible with the well-being of the State's horse racing industry.

As such, six regional off-track betting corporations were created pursuant to this legislation including the New York City Off-Track Betting Corporation (Corporation). As provided for under the authorizing legislation, the Corporation was created as a public benefit corporation governed by a Board of Directors whose members were appointed by the Mayor of New York City.

The Corporation offers off-track pari-mutuel wagering on thoroughbred and harness horse races held at all 11 race tracks located in the State, and certain race tracks located outside the State which have simulcast contracts with the Corporation. As of September 2008, the Corporation was accepting wagers at 68 locations including 57 branch offices, 8 restaurants and 3 teletheaters. It also accepts wagers over the phone and via the internet. In the four fiscal years ended June 30, 2008, the Corporation collected an average of about $1 billion a year in wagers (handle).

The winning bettors receive a major percentage of the amounts wagered on each race, and the Corporation, like the State's other five regional OTB corporations, must distribute certain percentages of the remaining betting wagers to (1) the applicable local government(s); (2) the State's horse racing industry, which comprises various race tracks and horse breeding funds; and (3) New York State. These statutory distributions are made on the basis of complex formulas contained in the State's Racing, Pari-Mutuel Wagering and Breeding Law (Racing Law).

The Corporation makes payments to certain race tracks, both in and out-of-state, pursuant to its negotiated simulcast contracts, and incurs various other operating expenses.

According to its certified financial statements, in the fiscal year ended June 30, 2008, the Corporation received a total of $998.2 million in wagers. The winning bettors received about $760.9 million of this amount, leaving the Corporation with $244.7 million (which includes $7.2 million in miscellaneous other revenues not retained by the Corporation). The Corporation made statutory distributions totaling $128.6 million to the horse racing industry ($93.2 million), New York City and other local governments ($20.2 million), and New York State ($15.2 million), leaving $116.1 million to cover its own operating expenses. Since the Corporation's operating expenses for the year totaled $133.9 million (excluding certain non-cash expenses), it incurred an operating deficit of $17.8 million for the year.

This was the Corporation's fifth consecutive year of operating deficits, and in the four years ended June 30, 2008, it incurred a total of about $38 million in such deficits. Moreover, as of that date, the Corporation had an accumulated balance sheet deficit (liabilities exceeding assets) of more than $228 million mostly the result of accrued post-employment retirement benefits. It has been able to meet its operating costs by spending its cash reserves and deferring certain statutory payments.

In response to the Corporation's deteriorating financial condition, its Board of Directors instructed Corporation management to prepare a "closure plan", and such a plan was prepared. Under this plan, the Corporation would have ceased operations in June 2008.

However, on June 17, 2008, the State Racing Law was amended to make the Corporation a State entity rather than a City entity. The Corporation is still a public benefit corporation, but its Board members are now appointed by the Governor. This change, and certain changes in the statutory revenue distributions required of the Corporation, became effective in June and September of 2008.

As of September 1, 2008, the Corporation had a total of 1,366 employees: 806 at its branch locations; 274 at its administrative headquarters; 236 at its Telephone Betting Center; and 50 at its warehouse. The Corporation's management team is headed by a President and Chief Executive Officer. The Corporation's operations continue to be overseen by the New York State Racing and Wagering Board, a State agency that regulates horse racing and pari-mutuel betting activities in the State.

Audit Scope and Methodology

We assessed the Corporation's financial condition, selected governance activities and potential cost savings opportunities for the period July 1, 2004 through October 24, 2008. To accomplish our objectives, we interviewed officials at the Corporation, the Corporation's CPA firm, the New York State Racing and Wagering Board, and other regional OTB corporations in New

York State. We also reviewed the State Racing Law and Corporation records and reports. In particular, we analyzed the Corporation's audited financial statements for the four years ended June 30, 2008. We also reviewed a report entitled "New York City Off-Track Betting Corporation: A Plan for Transformation and Growth" that was prepared for the New York City Economic Development Corporation by the Boston Consulting Group. In addition, we visited selected Corporation branch offices to observe wagering activities at the offices.

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

In addition to being the State Auditor, the Comptroller performs certain other constitutionally and statutorily mandated duties as the chief fiscal officer of New York State. These include operating the State's accounting system; preparing the State's financial statements; and approving State contracts, refunds and other payments. In addition, the Comptroller appoints members to certain boards, commissions and public authorities, some of whom have minority voting rights. These duties may be considered management functions for purposes of evaluating organizational independence under generally accepted government auditing standards. In our opinion, these functions do not affect our ability to conduct independent audits or assessments of program activities.

Authority

This audit was performed pursuant to the State Comptroller's authority under Article X, Section 5 of the State Constitution.

Reporting Requirements

A draft copy of this report was submitted to Corporation officials for their review and comment. Agency Comments and State Comptroller's Comments are included at the end of this report.

Within 90 days of the issuance of this report, in accordance with Section 170 of the Executive Law, the President of the Corporation shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, indicating the steps taken by Corporation officials to implement our report recommendations, and where they have not been implemented, the reasons therefor.

Contributors to the Report

Major contributors to this report include Frank Patone, Mike Solomon, Stu Dolgon, Sal D'Amato, John Ames, Margarita Ledezma and Dana Newhouse.

Audit Findings and Recommendations

Financial Condition

The Corporation's financial statements must be audited annually by an independent auditor. Because of the Corporation's deteriorating financial condition, beginning with the fiscal year ended June 30, 2004, this auditor (a private CPA firm) has questioned the Corporation's ability to continue to operate as a going concern. The CPA cited mandatory increases in personnel and other costs and increases in statutory distribution requirements as primary factors. The CPA concluded statutory relief would be needed to correct the problem.

The following table summarizes certain key financial information from the independent audit reports covering the four fiscal years ended June 30, 2008:

	(in Thousands)			
	2004-05	**2005-06**	**2006-07**	**2007-08**
Operating Revenues	$ 251,266	$ 261,325	$ 255,883	$ 244,696
Statutory Distributions *				
Local Governments	22,095	22,405	21,574	20,167
Racing Industry	94,511	100,904	97,338	93,211
New York State	14,925	15,962	15,251	15,167
Total Statutory Distributions	131,531	139,271	134,163	128,545
Revenue After Distributions	119,735	122,054	121,720	116,151
Operating expenses **	125,510	128,177	130,352	133,931
Net loss **	$ (5,775)	$ (6,123)	$ (8,632)	$ (17,780)

Notes - * The Corporation's payments to various race tracks under its simulcast contracts are regularly included with its statutory distributions to the racing industry, even though these contract payments are not "statutory" (i.e., not required by law). In the four years shown, these contract payments totaled between $23.5 and $24.2 million a year.

** Not including the non-cash expense for the unfunded portion of certain post-employment benefits, which totaled $58.7 million in 2007-08, $21.5 million in 2006-07, and $115.5 million in 2005-06 (the first year these expenses had to be disclosed in the audited financial statements).

As is shown in the above table, the Corporation's operating expenses and accumulated losses have increased steadily since fiscal year 2004-05. However, its statutory distributions and operating revenues have declined since fiscal year 2005-06, since they are generally a percentage of handle.

The Corporation’s handle decreased by 2.9 percent in fiscal year 2006-07, and 4.1 percent in fiscal year 2007-08. Moreover, the Corporation projects a further 10 percent reduction in its handle for the 2008-09 fiscal year.

It should be noted that, consistent with industry trends, off-track betting handle has been declining throughout New York State due to a number of factors. These factors include waning interest in horse racing (as reflected by the declines in attendance at most State race tracks) and competition from other gaming industries, such as casinos and government-sponsored lotteries. For example, Corporation officials believe their operations have been hurt by competition from the new video lottery terminals at the race track in Yonkers and a recently-opened OTB location in New Jersey. They further note that the closure of four of their branch offices in 2008 has contributed to the Corporation’s reduction in handle.

The Corporation’s operating expenses increased by 2.1 percent in the 2005-06 fiscal year, then increased by 1.7 and 2.7 percent respectively in the next two years. Most of the Corporation’s operating expenses are payroll-related (employee salaries and fringe benefits), which for unionized employees was set by contract negotiations with New York City prior to the State takeover. For example, salaries and fringe benefits accounted for $86.4 million (67 percent) of the Corporation’s operating expenses in the 2007-08 fiscal year. Salary expenses ($65.3 million in 2007-08) have remained fairly constant since the 2000-01 fiscal year ($65.4 million), as the total number of staff on the payroll has been reduced. However, the cost of fringe benefits has increased from $15.6 million in 2000-01 to $21.1 million in 2007-08, an increase of 35.3 percent.

The Corporation also incurs significant costs for the rental of buildings and office space ($21.7 million in the 2007-08 fiscal year), mostly for its branch locations. These costs increased by 12.4 percent in 2007-08, rising from $19.3 million in 2006-07, because of escalation clauses in the lease agreements.

The Corporation’s statutory distributions, although not considered an operating expense, and not under the direct control of Corporation management, represent a significant financial outlay for the Corporation. As such, they are relevant to its financial condition. By far the most significant of these distributions are those to the horse racing industry. During the four years ended June 30, 2008, these distributions totaled $386 million and accounted for more than 72 percent of the Corporation’s total $533.5 million in statutory distributions. The distributions to the horse racing industry, which have been critical to the industry, are made to the following entities:

- the New York Racing Association (NYRA), a specially created not-for-profit organization that operates the State's three largest thoroughbred race tracks (Aqueduct Racetrack, Belmont Park, and Saratoga Race Course),

- Finger Lakes Race Track, a privately-owned thoroughbred race track in central New York,

- the State's seven privately-owned harness race tracks and certain other associations that support horse racing in New York,

- out-of-state race tracks with contracts to simulcast their races at Corporation sites,

- certain designated horse breeding funds that were created to support and promote in-State activities related to horse breeding and racing.

The following table shows the amounts distributed to each of these entities during the three years ended June 30, 2008:

Racing Industry Entity	(in Thousands)			
	2005-06	2006-07	2007-08	Total
NYRA	$ 55,938	$ 53,361	$ 51,690	$ 160,989
Finger Lakes Race Track	6,098	6,058	5,801	17,957
State Harness Tracks	15,384	14,609	13,522	43,515
Out-of-State Race Tracks	15,249	14,872	14,901	45,022
Horse Breeding Funds	8,235	8,438	7,297	23,970
Totals	$ 100,904	$ 97,338	$ 93,211	$ 291,453

As is shown in the table, payments to out-of-state race tracks account for a significant portion of the Corporation's annual distributions to the horse racing industry (15 to 16 percent a year). However, the in-State entities also benefit from these out-of-state simulcast arrangements, as the Corporation is required by the State Racing Law to pay the in-State entities a certain portion of the total amounts wagered by its customers on these out-of-state races. For example, when the Corporation accepts wagers on simulcast races at places such as Churchill Downs or Philadelphia Park, it must pay a percentage of this handle to NYRA, the Finger Lakes Race Track, the State harness tracks, and the other in-State entities. Thus, nearly $24 million of the $51.7 million received by NYRA in 2007-08, and $4.9 million of the $5.8 million received by the Finger Lakes Race Track in that year, came from wagers on out-of-state races.

The Corporation also makes statutory distributions to local governments and to New York State. Most of the Corporation's distributions to local governments have been paid to New York City. For example, $15.5 million of the $20.2 million distributed in 2007-08, and $16.8 million of the $21.6 million distributed in 2006-07, went to New York City. Most of the distributions to New York State go to the State Treasury, but some also go to the State Racing and Wagering Board to help fund its regulatory oversight responsibilities.

It should be noted that distributions to local governments (and New York City in particular) were initially the largest of the Corporation's statutory distributions. However, due to reduced handle and legislative changes in the statutory formulas governing the distributions, the distributions to New York City have steadily decreased from more than $60 million a year in the 1970s to less than $20 million in recent years; while the distributions to the horse racing industry have steadily increased from about $30 million a year in the 1970s to nearly $100 million in recent years. The distributions to New York State have remained fairly level, declining from about $20 million a year in the 1970s to about $15 million annually in recent years.

In an effort to address the Corporation's deteriorating financial condition, certain changes were made in the Corporation's statutory distribution requirements when the State Racing Law was amended in June 2008. Specifically, the Corporation was allowed to retain some of the revenue that was formerly distributed to New York City and was temporarily (for two years) allowed to also retain a larger portion (1 percent) of the amounts wagered on most thoroughbred races.

According to an analysis prepared by the Corporation, if these changes had been in effect in the 2007-08 fiscal year, they would have provided the Corporation with an additional $16.2 million in net revenue, to help offset its $17.8 million operating deficit for that year. However, the Corporation's projections for fiscal year 2008-09 show that an operating deficit of more than $17 million is again likely for the Corporation, despite the additional revenue from the legislative changes, because this additional revenue will be offset by a further decline in total betting handle and the rescinding of the 1 percent increase. As of September 17, 2008, the Corporation's reported handle was down by more than 10 percent from the prior year and is expected to remain at this lower level for the remainder of the fiscal year due to economic conditions.

It thus appears that the Corporation's financial condition is unlikely to improve unless (a) its total betting handle increases, (b) its operating expenses decrease, and/or (c) further changes are made in its statutory distributions. In this audit, we focus on the opportunities for reduced costs in the Corporation's operations and examine whether Corporation management has taken steps to realize these potential cost savings.

Corporation Management-Opportunities for Cost Savings

We assessed the actions taken by Corporation management to address the operating deficits threatening the Corporation's financial viability. We found that management has taken a number of actions to address these operating deficits. In particular, it has identified possible ways of increasing the Corporation's total betting handle and it has sought legislative changes in the statutory distributions required of the Corporation. In addition, management has also taken some actions to reduce the Corporation's operating expenses by closing 12 branch offices between 2005 and 2008, and allowing the size of its workforce to be reduced through attrition.

However, management has not performed a comprehensive assessment of the Corporation's operating expenses as one would expect from an entity in its unsound financial situation. For example, its internal audit department has not systematically examined operating expenses to identify opportunities for cost savings, nor performed vulnerability assessments to identify areas of control risk.

According to the Corporation's financial records its operating expenses for the 2007-08 fiscal year can be categorized as follows:

Operating Expenses	Amount (in Millions)
Salaries	$ 65.3
Fringe Benefits *	21.1
Rents	21.7
Heat, Light, Utilities	2.3
Security Services	1.1
Repair and Maintenance	1.7
Telephone and Data Lines	2.6
Computer Services	2.5
Insurance	1.4
Other	9.3
Total	$129.0

* Not including the non-cash expense for the unfunded portion of certain post-employment benefits.

While management has taken some actions to contain these expenses, the expenses have not declined to match the Corporation's decline in revenue. Therefore, it is thus incumbent upon management to explore additional cost-saving and revenue enhancement opportunities.

We note that two such opportunities were identified by a consultant that was hired by New York City in April 2007 to develop a strategy for improving the financial viability of the Corporation. While the consultant focused primarily on the need for major structural changes in the State's off-track betting operations - and its horse racing industry as a whole, it also noted that costs at the Corporation's Telephone Betting Center could be significantly reduced through additional automation; and the cost of servicing its automated betting terminals could potentially be reduced by making use of contractor service agreements.

In addition, when asking Corporation management about their governance initiatives, we identified opportunities for potential cost savings in the areas of executive staffing, branch office staffing, consultant contracts and simulcast contracts, and we questioned whether the Corporation needed all 87 of its motor vehicles for business purposes.

We recommend Corporation management pursue these opportunities for cost savings; perform a comprehensive assessment of their operations to identify further such opportunities; develop a detailed plan for achieving certain reductions in its operating expenses by specified dates; and incorporate this comprehensive cost-reduction plan into an overall plan for avoiding insolvency.

(In response to our draft report, Corporation officials informed us that they have already begun to explore the additional cost savings opportunities detailed in our report.)

<u>Executive and Management Staff</u>

The Corporation has 274 staff located at its administrative headquarters in Manhattan. According to the Corporation's organization chart, 55 of these staff are executive and management level staff (i.e., Executive Vice Presidents, Senior Vice Presidents, Vice Presidents, Executive Directors, Senior Directors, Directors, and comparable titles), with salaries ranging from $60,000 to $189,677 (25 salaries exceed $100,000). All 55 are appointed positions.

We asked Corporation officials whether they had evaluated their executive and management staffing levels to determine opportunities for cost savings in this area. The officials said that they have periodically performed such evaluations, and, as a result, several management level positions have been eliminated. Although we have confirmed that many Corporation positions have been eliminated over the years through attrition, we have not seen a formal evaluation. We encourage Corporation management to perform such an evaluation and determine whether certain management functions could be consolidated or executive and management level staffing costs reduced in other ways.

<u>Branch Operations</u>

The Corporation accepts wagers at a total of 68 sites (57 branch offices, 8 privately-owned restaurants that accept wagers and receive commissions, and 3 teletheaters). It also accepts wagers over the telephone and on the internet (online wagering was initiated in August 2007). According to Corporation's records, during the 2007-08 fiscal year, 79 percent of its wagers ($791.5 million) were placed at its branch sites and 21 percent ($206.7 million) were placed by telephone or internet.

At the branch sites, wagers may be accepted by betting clerks or automated betting terminals. As of December 2008, the branch sites employed a total of 460 betting clerks: 210 on a full-time basis, 156 on a part-time basis, and 94 on a per diem basis. The sites also employed 346 supervisory, administrative and support personnel, and were equipped with a total of 409 automated betting terminals. About 45 percent of the wagers at the branch sites are placed through the automated betting terminals.

Telephone wagers are accepted by telephone agents at a central Telephone Betting Center. As of December 2008, the Center employed a total of 225 agents and about 11 supervisory, administrative and support personnel. Internet wagers are processed online.

The Corporation's records show that, during the 2007-08 fiscal year, the cost of operating the telephone and internet betting operations was less than $13.2 million, or 6.4 percent of the related handle. In comparison, the cost of operating the branch sites was $76.8 million, or 9.7 percent of the related handle. It is thus clear that the Corporation's telephone and internet operations are far less costly to operate than the branch operations. As such, Corporation officials told us that they are taking steps to increase online betting because of its low-cost features.

Branch staffing levels are set by the Corporation's Vice President of Branch Operations on the basis of his determination of individual branch needs. However, there are no written standards to guide this determination, and no documentation showing that staffing levels are compared to business volume or any other indicators to ensure that they are justified. Although Corporation officials periodically redeploy branch staff in relationship to wagering, they have not evaluated the appropriateness of the current staffing levels at the branch sites. In fact, the Corporation has not completed an official staffing study since 1981, prior to its installation of automated betting terminals at the branches and the initiation of telephone betting.

We also analyzed Corporation records for fiscal year 2007-08 and identified wide variations between branches when comparing operating expenses as a percentage of handle ranging from 6 percent to 27 percent. It thus appears that there is need for management to review branch operations and determine whether actions can be taken to reduce associated costs.

We also noted that, while three of the branch locations in Brooklyn are in close proximity to one another (at 1367 Rockaway Parkway, 2112 Rockaway Parkway, and 111-14 Flatlands Avenue), Corporation officials have not reviewed the potential benefits and/or feasibility of consolidating these operations. In addition, 28 of the Corporation's branch leases have either expired, or are due to expire by the end of 2010. A review of the locations with expiring leases could identify other possible opportunities for cost-saving consolidations.

(In response to our draft report, Corporation officials assert that since there is no "surcharge" collected on telephone wagers, most of its branch operations are more profitable to the Corporation. They also note that the independent consultant's report we cite, concludes only "low-impact" savings opportunities are available at branches.)

Auditor's Comments: Considering the Corporation's tenuous financial condition, we recommend any and all potential cost savings be pursued.

Consultant Contracts

In the 2007-08 fiscal year, the Corporation had 14 active consultant contracts for personal services. During that year, a total of $285,000 was paid to eight of these consultants (no payments were made on the other six contracts). Three of these eight contracts required specific monthly payments to the consultants. We reviewed these three contracts, which accounted for $250,936 of the total $285,000 in consultant contract payments for the year.

The three contracts were for services such as strategic business planning and industry positioning; the development and execution of digital media and marketing plans; and the development and execution of strategies for promoting online (account deposit) wagering. We found no written justification showing the need for the contracts and no indication Corporation officials had determined whether in-house staff could provide the services instead of consultants. Rather, we were told that a decision was made by the Corporation's Board and executive staff that these contracts were essential for the Corporation's existence and hence necessary.

There was also no written justification explaining why those particular consultants were selected (none of the three was selected through a competitive process). In the absence of documentation showing that the services were necessary and could not be obtained in-house, there is no assurance the contracts were necessary. In the absence of documentation explaining why those particular consultants were selected, there is no assurance the consultants were qualified to provide the services and no assurance their prices were reasonable.

It thus appears that there may be an opportunity for cost savings in the area of consultant contracts. Some of the contracts may be unnecessary, more costly than necessary, or ineffective. We recommend Corporation management determine whether any cost savings can be realized in this area.

(In response to our draft report, Corporation officials note that each of the above-noted consultant contracts has ended and not renewed.)

Simulcast Contracts

At its branch locations, the Corporation simulcasts races held at certain race tracks, both in and out-of-state, and accepts wagers on those races. These simulcast arrangements are governed by contracts between the Corporation and the race tracks, and the contracts specify how much the Corporation pays the race tracks for the simulcast rights (generally, the Corporation pays fees ranging between 1 percent and 4.55 percent of the total wagers received on the races, depending on the type of wager). The fees are negotiated by the Corporation and the race tracks, and vary from contract to contract. According to Corporation officials, they believe that their negotiated fees are industry-competitive.

We note that, for financial reporting purposes, these fees are traditionally lumped together with the Corporation's statutory distributions to the race tracks. However, except for certain simulcast payments made to NYRA pursuant to legislative requirements they are not, in fact, "statutory" payments because they are not required by law. Rather, they are a controllable operating expense. In fiscal year 2007-08, these fees totaled about $15 million.

It is possible that there are opportunities for cost savings (i.e., lower simulcast fees) in these contracts. We recommend the Corporation actively pursue such negotiations.

(In response to our draft report, Corporation officials note that they have been, are, and will continue to be, extremely aggressive in the noted negotiations.)

Corporation Vehicles

As of August 2008, the Corporation had an inventory of 87 motor vehicles (sedans, vans and sport utility vehicles). According to the Corporation's 2007-08 audited financial statements, the cost of operating and maintaining the vehicles that year (i.e., fuel, tolls, insurance and maintenance) was $585,000, an average of more than $6,700 per vehicle. In addition, while most of the vehicles were purchased in prior years, four of them (all sport utility vehicles) were purchased for $80,831 during the fall of 2007.

We question whether all 87 vehicles are needed by the Corporation. According to the Corporation's Executive Director of Administration, the vehicles are assigned to various departments and individuals on the basis of travel needs and business needs. However, there was no written justification governing the assignment of Corporation vehicles. Also, vehicle usage logs are not properly maintained, and thus, do not provide adequate accountability for vehicle use. As a result, it cannot readily be determined whether the vehicles are, in fact, necessary for Corporation business.

We note that 22 of the vehicles are assigned to executive and management staff based at the Corporation's administrative headquarters in Manhattan (including the four sport utility vehicles noted above). We also note that, while there is no written policy authorizing the practice, employees are allowed to take the vehicles home and use them to commute to and from work (these vehicles are properly reported as an employee fringe benefit for income tax purposes). Corporation officials note that 41 of the vehicles are equipped with global positioning systems (GPS tracking devices) that supervisors use to monitor vehicle usage.

If the Corporation could reduce its inventory of vehicles, it could realize certain cost savings. We recommend Corporation management determine whether its vehicle inventory could, in fact, be reduced without adversely affecting the Corporation's business operations.

(In response to our draft report, Corporation officials note that they have since reduced the vehicle fleet from 87 to 75, have created a vehicle "pool" for executive and management staff, and are more closely scrutinizing vehicle usage logs.)

Telephone Betting Center

The Telephone Betting Center employs a total of about 236 individuals, 225 of whom are responsible for answering the phones and accepting wagers. The consultant that was hired by New York City noted that costs at the Center, which total about $13 million annually, could be significantly reduced if more of the calls were answered by an automated system.

However, we found no indication the Corporation has pursued this option. Corporation officials provided us with no formal assessments of the consultant's recommendations and no documentation that any action has been taken to increase the Corporation's automated answering capability at the Telephone Betting Center.

When we discussed this issue with Corporation officials, they stated that they had put this issue on the back burner while they were developing their closure plan.

Maintenance of Automated Betting Terminals

The automated betting terminals at the branch sites are maintained and repaired by Corporation technicians who work out of the Corporation's warehouse in Queens. During the 2007-08 fiscal year, this staff of 21 was paid a total of $1.8 million to perform this work. The consultant suggests it would be more cost-effective for the Corporation to lease these machines from a company that provides maintenance and repair services. In fact, we determined that this is the arrangement for at least three of the other regional OTB corporations in New York State.

Recommendations

1. Develop a comprehensive, detailed management plan to avoid insolvency.

2. Follow up on the potential opportunities for cost savings identified in this report, and perform a comprehensive assessment of all Corporation operating areas to identify further opportunities.

Agency Comments

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May 26, 2009

Frank Patone, CPA
Audit Director
Office of the State Comptroller
Division of State Government Accountability
123 William Street, 21st Floor
New York, NY 10038

Re: The Final Draft of the Comptroller's Audit Report

Dear Mr. Patone:

Enclosed please find a copy of the Statement and Specific Responses of the New York City Off-Track Betting Corporation in Response to the Comptroller's Final Draft Audit Report.

Thank you for your attention in this matter.

Very truly yours,

Raymond V. Casey

Enc.
Cc: David Cornstein, Chairman

PART I: SUMMARY STATEMENT OF THE NEW YORK CITY OFF-TRACK BETTING CORPORATION IN RESPONSE TO THE COMPTROLLER'S FINAL DRAFT AUDIT REPORT

NYCOTB appreciates the opportunity to submit a response to the final draft of the Comptroller's Audit Report. Given that the document to which the New York City Off-Track Betting Corporation ("NYCOTB" or "Corporation") is responding is a draft (albeit a *final* one), it is understood that the ultimate audit report may differ in some ways from the draft document, and that parts of the Corporation's response may be directed to language that has either changed or been eliminated since the final draft. Likewise, the Corporation understands that the ultimate audit report may contain language that the Corporation has neither seen nor to which it has been afforded an opportunity to respond. In Part II NYCOTB responds to specific language in the final draft audit report. The Corporation submits *this* statement to explain the methodology of its response, as well as to summarize its salient points. The detailed response, however, is left to the "Specific Responses" submission that is Part II.

While the Corporation believes that the Comptroller's Office has made a significant effort to present a balanced report and has done an admirable job in learning, in a relatively short time-frame, the often daunting and complex workings of the horse-race wagering business, the Corporation, likewise, believes that a few of the findings and conclusions in the final draft audit report call for a response that takes a view different from that of the Comptroller's Office. In other areas, however, the Corporation accepts the Comptroller's Office's findings and recommendations and has either acted upon them or will endeavor to do so.

The Corporation's response can be summarized by the following points:

- The Comptroller's Office appears to be of the view that the financial problems of NYCOTB can be substantially, if not completely, addressed by making internal changes to the way the Corporation is managed and by taking certain initiatives to increase revenue while cutting expenses. However the Comptroller's Office has not quantified what it believes would be the amount of savings realized from any recommendation or suggestion it has made, nor quantified the expenses associated with any initiatives it believes the Corporation should undertake to increase revenues so that it can be determined whether the Corporation is in a position to incur such expenses. On the other hand, the Corporation has had the benefit of a nine-month study done by the highly-regarded outside business consulting firm – the Boston Consulting Group (BCG) – whose 2007 report concluded that although there are some relatively minor steps that the Corporation can take to improve operating efficiencies somewhat, those efficiencies would not create nearly enough savings to offset the Corporations yearly deficits created by the flawed legislative distribution system under which it has to operate, and allow it to avoid insolvency. For the Corporation to avoid insolvency, BCG concluded that two, overriding, changes had to take place. First, the New York State legislature must change the racing law so that the Corporation (as well as each other regional OTB) is not compelled to distribute all (and more) of

* Comment 1

*See State Comptroller's Comments, page 41.

the substantial operating profit it makes each year, thereby leaving the Corporation with no funds to re-invest in its business and thus assuring its financial failure. Second, to increase overall revenue, a certain set of initiatives must be undertaken both by the Corporation, as well as by the racing industry as a whole, to widen the demographics to which horse racing appeals so as to include a younger adult (male and female) customer base and to align the business interests of the various sectors of the industry. But, once again, BCG concluded that NYCOTB will never have sufficient money to invest in the revenue-enhancing initiatives recommended (nor even for ordinary re-investment in its business) unless and until the legislature first changes the mandatory distribution scheme which currently requires the Corporation to make distributions to the State and to the in-state tracks calculated as a percentage of the dollar amount of its ***gross*** transactions (i.e., handle), instead of as a percentage of its ***net*** revenues after accounting for operating expenses.[1] Finally, the view of BCG is shared by the outside independent auditors who annually report on the Corporation's finances.

- The management of the Corporation has consistently taken steps to minimize the operating costs over which it has control. Unfortunately, much of the increase in operating expenses, such as salaries and fringe benefits for the overwhelming majority of its employees were not directly under the Corporation's control, but were dictated by outside entities, such as the City of New York, NYCERS and the healthcare industry. (It should also be noted that, unlike a regular retail business, NYCOTB does not have the power to raise the retail price of its product (e.g., the takeout amount on a $2 wager) to cover increased costs. Its only remedy is to try to increase handle, so that its aggregate "take-out" revenue increases. However, when that happens, the Corporation's obligations under the mandatory distribution scheme also increase, because those obligations come in the form of a percentage of handle).

- Notwithstanding all of the above factors, the Corporation's newly-constituted Board of Directors, working in concert with corporate management, is taking a fresh and bold look at cutting costs. It is hoped that such cuts will enable NYCOTB to continue long enough for legislative and/or other relief to be forth-coming, which will in turn permit investment in new initiatives currently being considered that would likely bring about significantly increased revenue in the future.

* Comment 2

5/26/09

[1] It is important to note that of the gross dollar transactions amount (handle), approximately 80% is immediately returned to the winning bettors and the Corporation only retains approximately 20% as its "takeout" commission, which is really its gross revenue, from which it has to pay all of its obligations, including its statutory and contractual ones, as well as all other operating expenses, such as salaries and fringe benefits. Not even corporate or personal income taxes are collected as a percentage of gross income, let alone of a number 4 to 5 time higher than gross income.

*See State Comptroller's Comments, page 41.

PART II: SPECIFIC RESPONSES AND COMMENTS BY THE NEW YORK CITY OFF-TRACK BETTING CORPORATION (NYCOTB) TO LANGUAGE IN THE FINAL DRAFT AUDIT REPORT OF THE NEW YORK STATE COMPTROLLER'S OFFICE

For clarity, NYCOTB believes that it is important to respond *with specificity* to what the Comptroller's Office has written. However, as we noted in our Statement in Response to the Comptroller's Final Draft Audit Report, we have not been provided the opportunity to respond to the Audit Report as it is ultimately issued, but only to the final *draft* of the Audit Report. Therefore it should be kept in mind that the Comptroller's Office language that we quote below, and to which we respond, comes from the Final Draft Audit Report, and, therefore, such language may or may not be found in the final Audit Report at the page numbers we refer to below (and, for that matter, might not be found in the final Audit Report at all).

On page 5 of the Final Draft the Comptroller's Office wrote:

Our objectives were to assess the financial condition of the New York City Off-Track Betting Corporation (Corporation) upon its acquisition by the State, and the actions taken by Corporation management to address the operating deficits threatening the Corporation's financial viability.

The Corporation's response is:

In fairness, this report should acknowledge at the outset the perspective that is set forth much deeper in the document, *i.e.*, that the Comptroller's Office has chosen to focus on "reduction of operating costs" as the exclusive means to solve OTB's financial problems, rather than fixing the State's "flawed" mandatory distribution system that compels OTB to distribute significantly more money than is available after allowance for its necessary operating expenses.[1] Moreover, nowhere in the audit report does the Comptroller's Office quantify what it believes would be either the savings realized or new revenues gained were its recommended actions undertaken by the Corporation. Without such quantification there is no way to know whether taking such actions would in any material way solve the Corporation's dire financial problems. On the other hand, a nine-month study completed in 2007 by a highly regarded outside business consulting group concluded that taking the actions now being recommended by the Comptroller's Office would not, by themselves, stave off the ultimate insolvency of the Corporation, and that only the taking of more global actions, such as changing the flawed mandatory distribution system, and aligning the business interests of the State's various racing entities, could do that.

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On page 5 of the Final Draft the Comptroller's Office wrote:

We found that the Corporation is unlikely to avoid financial insolvency if its current financial trends continue. We further found that, while management has made attempts to improve the Corporation's financial viability, it has not undertaken the kind of comprehensive cost-reduction necessary to address its unsound financial condition. We recommend such efforts be undertaken, and we identify

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[1] The system of legislatively mandated distributions requires the Corporation to make distributions to the State and to the in-State tracks calculated as a percentage of the dollar amount of its gross transactions (i.e., handle), instead of as a percentage of its *net* revenues after accounting for operating expenses. It is important to note that of the gross transactions dollar amount (handle), approximately 80% is immediately returned to the winning bettors and the Corporation only receives approximately 20% as its "takeout" commission, which is really its gross revenue, from which it has to pay all of its obligations, including its statutory and contractual ones, as well as all other operating expenses, such as salaries and fringe benefits. Even corporate or personal income taxes are collected as a percentage net income, not of gross revenue, let alone of a number 4 to 5 times higher than gross revenue.

*See State Comptroller's Comments, page 41.

potential cost-saving opportunities for management's consideration.

The Corporation's response is:

In fact, as was demonstrated to the Comptroller's Office, and as will be demonstrated below, substantial and comprehensive cost-reductions have been undertaken by management and the Corporation has identified the steps and furnished the documentation relating to those efforts. However, the opportunities identified by the Comptroller's Office will be explored further in an attempt to lower costs.

On page 5 of the Final Draft the Comptroller's Office wrote:

The New York City Off-Track Betting Corporation is a public benefit corporation that was created in 1970 pursuant to State legislation allowing local governments to operate systems of off-track pari-mutuel betting. Under the enabling legislation, the Corporation is required to distribute certain percentages of its betting revenue to New York City and other local governments, to the State's horse racing industry, and to New York State. The remaining revenue is to be used to cover the Corporation's operating expenses, and any surplus would be remitted to New York City.

The Corporation's response is:

In actuality, the Corporation's operating expenses are paid concurrently with the afore-mentioned distributions throughout the fiscal year; the remittance to New York City only came from a year-end surplus, when there was one. Subdivision 6 of Section 527 of the Racing, Pari-Mutuel Wagering and Breeding Law spells this out.

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On page 5 of the Final Draft the Comptroller's Office wrote:

However, in recent years, the Corporation has been unable to cover all of its operating expenses without depleting its surplus funds and delaying payments to vendors.

The Corporation's response is:

We believe it would be more accurate to say: "However, in recent years, the net revenue available for distribution after meeting the Corporation's operating expenses has been insufficient to satisfy the mandated statutory distributions, since all trade vendors have been paid in a timely manner.

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On page 6 of the Final Draft the Comptroller's Office wrote:

We recommend Corporation management perform a comprehensive assessment of the Corporation's operations, develop a detailed plan for achieving certain specified reductions in its operating expenses by certain specified dates, and incorporate this cost-reduction plan into an overall plan for avoiding insolvency.

The Corporation's response is:

Management's pursuit of cost-cutting opportunities has been diligent and comprehensive and that, with the exception of certain *de minimis* cost-cutting opportunities, cuts were made up to the point that further cuts, in management's view, would have adversely impacted the Corporation's handle levels, thereby reducing the revenue received by the racing industry and government from the Corporation. However, management, in concert with committees of the Corporation's recently re-

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*See State Comptroller's Comments, page 41.

constituted Board of Directors, has undertaken a fresh comprehensive assessment of the Corporation's operations with an eye toward just such a cost-reduction and insolvency-avoidance plan.

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<u>On page 6 of the Final Draft the Comptroller's Office wrote:</u>

For example, the Corporation has not conducted a staffing study since 1981, prior to its initiation of telephone and internet betting and prior to the installation of automated betting terminals at its branch locations. We believe such a study should be conducted and staffing levels adjusted accordingly.

<u>The Corporation's response is:</u>

In fact, a comprehensive "outside" study was performed as recently as 2007 by the well-respected Boston Consulting Group (BCG). Indeed, the BCG Report, which was previously furnished to the Comptroller's Office, concludes on its page 46 that: "Detailed examination of the branch network revealed a generally efficient branch operation, with few low impact opportunities [for improved operational efficiency]". In truth, the Corporation performs branch location staffing analyses on a daily, as well as a monthly basis, as reflected in the following types of documents that were furnished to the staff of Comptroller's Office: Daily Branch Staffing Reports; Monthly Branch Staffing Reports. The Vice President of Branch Operations reviews these reports and makes adjustments as needed, whether that is on a daily, weekly or monthly basis. Copies of examples of Memoranda to Branch Managers Re Staffing Adjustments were also furnished to the Comptroller's Office. As part of the above noted "operations assessment" management will be evaluating management staff levels too.

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<u>On page 8 of the Final Draft the Comptroller's Office wrote:</u>

[The Corporation] has been able to meet its operating costs by spending its cash reserves and deferring payments on certain of its obligations (mainly amounts owed to New York City and amounts owed to certain race tracks pursuant to its simulcast contracts).

<u>The Corporation's response is:</u>

There were never deferrals of amounts owed to NYC. All amounts owed to NYC were paid in the year they were due. Likewise, the Corporation did not defer payments owed on simulcast contracts either. Only certain "statutory payments" without specific due dates were deferred.

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<u>On page 11 of the Final Draft the Comptroller's Office wrote:</u>

The Corporation's financial statements must be audited annually by an independent auditor. Because of the Corporation's deteriorating financial condition, beginning with the fiscal year ended June 30, 2004; this auditor (a private CPA firm) has questioned the Corporation's ability to continue to operate as a going concern.

<u>The Corporation's response is:</u>

Since this Report by the Comptroller's Office is focused entirely on cost-cutting as the way to address the Corporation's financial deterioration, it should be made clear that the Corporation's auditor was NOT saying that unless there were changes made in the Corporation's 'internal' operations, such as reducing expenses, it is likely to go out of

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*See State Comptroller's Comments, page 41.

business. The auditor's actual language regarding the Corporation's not being able to continue in business reads: "The Corporation has experienced continuing mandated increases in personnel and other costs and increases in the statutory distribution requirements of New York State laws, including a regulatory fee of .50% of the Corporation's gross handle payable to the New York State Racing and Wagering Board. These factors have resulted in the Corporation being required to make distributions in excess of its operating income before statutory distributions. Management has instituted a number of initiatives to reduce its expenses, including a reduction in its workforce and a focus on maximization of branch profitability. These operating initiatives, however, have not been sufficient to offset the increases in expenses and distributions. Management has continued to seek legislative relief from the statutory distribution requirements of New York State laws. There is no assurance that the New York State legislature will adopt the necessary changes to the New York State laws to provide relief to the Corporation." In fact, by October, 2008, the auditor was writing in the introduction to its audit report: "Without legislative adjustment to the statutory scheme of distribution of retained commissions from handle, the Corporation will continue to be required to make statutory distributions in aggregate amount exceeding operating income before statutory distributions. This gives rise to additional uncertainties that raise substantial doubt about its ability to continue as a going concern." Thus, the auditor was placing the problem of the Corporation's continuing financial viability squarely on the shoulders of one major 'external' factor, *i.e.*, the flawed distribution scheme, and not on the Corporation's 'internal' operations, such as its operating expenses. We believe, as a matter of fairness and accuracy, that distinction should be clearly reflected in this report.

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On page 11 of the Final Draft the Comptroller's Office included a Table with certain Notes, below is the Table along with the Corporation's comment on the first Note:

The following table summarizes certain key financial information from the independent audit reports covering the four fiscal years ended June 30, 2008:

	(in Thousands)			
	2004-05	2005-06	2006-07	2007-08
Operating Revenues	$ 251,266	$ 261,325	$ 255,883	$ 244,696
Statutory Distributions *				
Local Governments	22,095	22,405	21,574	20,167
Racing Industry	94,511	100,904	97,338	93,211
New York State	14,925	15,962	15,251	15,167
Total Statutory Distributions	$ 131,531	$ 139,271	$ 134,163	$ 128,545
Revenue After Distributions	$ 119,735	$ 122,054	$ 121,720	$ 116,151
Operating expenses **	$ 125,510	$ 128,177	$ 130,352	$ 133,931
Net loss **	$ (5,775)	$ (6,123)	$ (8,632)	$ (17,780)

Notes - * **The Corporation's payments to various race tracks under its simulcast contracts are regularly included with its statutory distributions to the racing industry, even though these contract payments are not "statutory" (i.e., they are not required by law). In the four years shown, these contract payments totaled between $23.5 and $24.2 million a year**

The Corporation's comment to the above Note is:

It is important to note, however, that of those contract payments, 32% of them are

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*See State Comptroller's Comments, page 41.

attributable to the NYRA simulcast contract, which the Corporation does NOT get to negotiate on an "arms-length" basis due to certain statutory constraints imposed upon it. Thus, those payments are more akin to statutory payments than they are to contractual payments.

On page 12 of the Final Draft the Comptroller's Office wrote:

The Corporation's operating expenses decreased by 1.6 percent in the 2005-06 fiscal year, then increased by 1.7 and 2.7 percent respectively in the next two years. Most of the Corporation's operating expenses are payroll-related (employee salaries and fringe benefits), which for unionized employees was set by contract prior to the State takeover. For example, salaries and fringe benefits accounted for $86.4 million (67 percent) of the Corporation's operating expenses in the 2007-08 fiscal year. Salary expenses ($65.3 million in 2007-08) have remained fairly constant since the 2000-01 fiscal year ($65.4 million), as the total number of staff on the payroll has been reduced. However, the cost of fringe benefits has increased from $15.6 million in 2000-01 to $21.1 million in 2007-08, an increase of 35.3 percent.

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The Corporation's response is:

For the most part, increases in salary and fringe benefits have not been costs which the Corporation has been in a position to control. Up until the recent takeover by the State, the salaries and fringe benefits of the Corporation's union employees (which constitute most of the Corporation's payroll) have been set by the City of New York as part of its city-wide collective bargaining with the applicable unions.

On page 12 of the Final Draft the Comptroller's Office wrote:

The Corporation also incurs significant costs for the rental of buildings and office space ($21.7 million in the 2007-08 fiscal year), mostly for its branch locations. These costs increased by 12.4 percent in 2007-08, rising from $19.3 million in 2006-07, because of escalation clauses in the lease agreements.

The Corporation's response is:

In an effort to contain such costs, the Corporation retains outside professional real estate brokers (currently GMAC International Real Estate) to negotiate the Corporation's leases at no expense to the Corporation since broker's commissions are paid by the landlords. In addition, at the beginning of Calendar Year 2007, the Corporation consolidated its headquarters space by surrendering one entire floor (out of three-and-half-floors) to its landlord, thereby saving more than $1 million per year -- for calendar years 2007 and 2008 the aggregate savings totaled $2,216,000. The Corporation continues to look for opportunities to lower its rental costs by reviewing its inventory to take advantage of the changing commercial real estate market.

It should also be noted that, since FY 2004, management has succeeded in putting into effect cost savings initiatives that have aggregated to $44,670,000. For FY 2008 alone these initiatives have resulted in a cost savings of $ 13,349,000. A breakdown of those cost saving initiatives showing the savings from each category was provided to the Comptroller's Office.

On page 15 of the Final Draft the Comptroller's Office wrote:

...[M]anagement has not performed a comprehensive assessment of the Corporation's operating expenses as one would be [sic] expect from an entity in its unsound financial situation. For example,

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*See State Comptroller's Comments, page 41.

its internal audit department has not systematically examined operating expenses to identify opportunities for cost savings, nor performed vulnerability assessments to identify areas of control risk.

The Corporation's response is:

In fact, as noted earlier, a comprehensive assessment of the Corporation's operations, including its operating expenses, was conducted by BCG over a nine-month period during 2006-2007 to determine the most effective means to increase the Corporation's asset value to the City of New York. (See BCG Report at pp. 4 and 5). Management played an integral role in that process. In addition, systematic and continual reviews of operations are done regularly under the Corporation's Bet Stat program. Under the direction of the Corporation's Chief of Staff, presentations by the Bet Stat staff are held every 4-6 weeks with representatives of the Operations, Facilities, Purchasing, Human Resources, Real Estate, Branch Operations, Telephone Betting Center, Customer Service, Marketing, Discipline, IT, Custodial Services and Security Departments, where the most recent findings of the Bet Stat staff are reviewed in order to implement any necessary changes. (Samples of Bet Stat Documents were provided to the Comptroller's Office). With respect specifically to cost controls and cost savings opportunities, the Finance Department requires each corporate department head to review and respond to Budget Variance Reports on a monthly and quarterly basis to identify and justify variations in actual expenses from the then current budget for the department. (Examples of Budget Variance Reports and Responses were also provided to the Comptroller's Office). For FY 2009, Department heads were required to identify and implement a 5% cut in their department's budgets. This year's budget process requires each Department head to justify the need for every single line item cost for his/her Department or face the cutting of those costs.

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On page 16 of the Final Draft the Comptroller's Office wrote:

While management has taken some actions to contain [operating] expenses, the expenses have not declined to match the Corporation's decline in revenue. Therefore, it is thus incumbent upon management to explore additional cost-saving and revenue enhancement opportunities.

The Corporation's response is:

Once again, this paragraph makes it appear that the reason the Corporation cannot meet all of its financial obligations is solely the result of its not having cut sufficient costs, when in truth, cost-cutting alone will never solve the Corporation's financial predicament so long as the flawed mandatory distribution scheme is not fixed through appropriate legislation. Indeed, relying solely on cost-cutting to eliminate the deficit insures that handle will be negatively impacted, thus diminishing the Corporation's financial support of the racing industry and government. See, *e.g.*, BCG Report at p. 46.

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On page 16 of the Final Draft the Comptroller's Office wrote:

We asked Corporation officials whether they had evaluated their executive and management staffing levels to determine opportunities for cost savings in this area. The officials said that, although periodically discussed, no formal evaluations had been performed.

The Corporation's response is:

First, it should be noted that in 2004 management positions were cut by 17%. The beneficial financial effects from the savings from those lost positions are realized in each subsequent year

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*See State Comptroller's Comments, page 41.

because those positions have not been re-filled. Moreover, the savings actually increase each year, because the Corporation does not incur the costs attributable to the increased costs of fringe benefits in connection with each of those positions. On the downside, the Corporation – *which last year handled more than 1.5 million transections per day!* -- has had to operate with an extremely lean management staff, where executives and managers have had to assume extra burdens due to the consolidation of duties and responsibilities. Secondly, contrary to the Comptroller's Office's assertion, such evaluations have, indeed, been done, as was spelled out to the Comptroller's staff. In September 2005, a year after the loss of the 22 managerial positions referred to above, another evaluation was done which resulted in even more managerial lines being expunged from the budget. Then, as recently as September 2008, after the complete closure of the Corporation was narrowly averted, another evaluation was done. Indeed, from January 1, 2004 to January 1, 2009, the Corporation reduced managerial staffing by 40 positions, or an average of 8 management positions per year.

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<u>On page 17 of the Final Draft the Comptroller's Office wrote:</u>

The Corporation's records show that, during the 2007-08 fiscal year, the cost of operating the telephone and internet betting operations was less than $13.2 million, or 6.4 percent of the related handle. In comparison, the cost of operating the branch sites was $76.8 million, or 9.7 percent of the related handle. It is thus clear that the Corporation's telephone and internet operations are far less costly to operate than the branch operations.

<u>The Corporation's response is:</u>

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While it may be true that telephone operations are less costly, they, in fact, currently throw off less profit because there is no "surcharge" collected on those wagers. With recent legislation that allows the Corporation to retain most of the surcharge that would have in the past gone to New York City, branch operations are now significantly more profitable to the Corporation. This is borne out by Revenue Schedules for FY 2008 and for July to October 2008, respectively, that show that in the latter period, after the Corporation was allowed to retain the surcharge on bets at its Branches, most branches became significantly more profitable than telephone operations.

<u>On page 17 of the Final Draft the Comptroller's Office wrote:</u>

Although Corporation officials periodically redeploy branch staff in relationship to wagering, they have not evaluated the appropriateness of the current staffing levels at the branch sites. In fact, the Corporation has not completed an official staffing study since 1981, prior to its installation of automated betting terminals at the branches and the initiation of telephone betting.

<u>The Corporation's response is:</u>

As stated earlier, in fact, a comprehensive "outside" study was performed as recently as 2007 by the highly regarded Boston Consulting Group (BCG) Once again the BCG Report, which was previously furnished to the Comptroller's Office, concludes at page 46 that: "Detailed examination of the branch network revealed a generally efficient branch operation, with few low impact opportunities [for improved cperational efficiency]". In truth, the Corporation performs branch location staffing analyses on a daily, as well as a monthly basis, as reflected in the following types of documents that were furnished to the staff of Comptroller's Office: Daily Branch Staffing Reports; Monthly Branch Staffing Reports. The Vice President of Branch Operations reviews these reports and makes adjustments as needed, whether that is on a daily, weekly or monthly basis. Copies of examples of Memoranda to Branch Managers Re Staffing Adjustments were

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*See State Comptroller's Comments, page 41.

also furnished to the Comptroller's Office.

On page 17 of the Final Draft the Comptroller's Office wrote:

We also analyzed Corporation records for fiscal year 2007-08 and identified wide variations when comparing operating expenses as a percentage of handle ranging from 6 percent to 27 percent. It thus appears that there is need for management to review branch operations and determine whether actions can be taken to reduce associated costs.

The Corporation's response is:

Branch operations are reviewed constantly, not just, as stated above, for staffing purposes, but also for comparative profitability, so that ways might be found for less profitable branches to increase their profitability.

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On page 18 of the Final Draft the Comptroller's Office wrote:

We also noted that, while three of the branch locations in Brooklyn are in close proximity to one another (at 1367 Rockaway Parkway, 2112 Rockaway Parkway, and 111-14 Flatlands Avenue), Corporation officials have not reviewed the potential benefits and/or feasibility of consolidating these operations. In addition, 28 of the Corporation's branch leases have either expired, or are due to expire by the end of 2010. A review of the locations with expiring leases could identify other possible opportunities for cost-saving consolidations.

The Corporation's response is:

The BCG Report. at pp. 46-47, concluded that, even with some branches close together, branch consolidation is likely to produce only limited gains and therefore recommended against closing branches because of the prospect of decreasing handle. With respect to reviews of expired and expiring leases, such reviews are done on an ongoing basis, and will continue to be done. However, once again, in doing so, the Corporation is mindful that under the current distribution scheme where distributions to stakeholders (such as the State, in-State tracks and breeders) are based on a percentage of gross handle instead of operating profit, a reduction in the number of branches could easily have a negative impact on what these stakeholders receive.

On page 18 of the Final Draft the Comptroller's Office wrote:

The three [consultant's] contracts were for services such as strategic business planning and industry positioning; the development and execution of digital media and marketing plans; and the development and execution of strategies for promoting online (account deposit) wagering. We found no written justification showing the need for the contracts and no indication Corporation officials had determined whether in-house staff could provide the services instead of consultants.

The Corporation's response is:

In each of the three instances, Corporation management concluded that the appropriate expertise and resources to perform the Consultant's assignments was not available internally. Presentations were made to the Board of Directors giving appropriate justification for the retention of the consultants as part of the mandatory approval by the Board of all consulting contracts. In

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*See State Comptroller's Comments, page 41.

fact, as to one of the assignments, it was a specific requirement that the task be performed by an outsider who was not an employee of the Corporation.

On page 18 of the Final Draft the Comptroller's Office wrote:

There was also no written justification explaining why those particular consultants were selected (none of the three was selected through a competitive process). In the absence of documentation showing that the services were necessary and could not be obtained in-house, there is no assurance the contracts were necessary. In the absence of documentation explaining why those particular consultants were selected, there is no assurance the consultants were qualified to provide the services and no assurance their prices were reasonable.

The Corporation's response is:

See response above. Moreover, when the Consultant's billings were approved, ample documentation of performance of each Consultant's assignment was available to the end user of each Consultant's services, as well as personal familiarity with the Consultant's activities as a result of direct supervision of the assigned tasks. Documentation containing the respective consultant's contracts and examples of work product and invoices were provided to the Comptroller's Office.

On page 18 of the Final Draft the Comptroller's Office wrote:

It thus appears that there may be an opportunity for cost savings in the area of consultant contracts. Some of the contracts may be unnecessary, more costly than necessary, or ineffective. We recommend Corporation management determine whether any cost savings can be realized in this area.

The Corporation's response is:

As the Comptroller's Office has been made aware, each of the consultant contracts has ended, and none has been renewed.

On page 19 of the Final Draft the Comptroller's Office wrote:

We note that, for financial reporting purposes, [simulcast fees paid to tracks to enable the Corporation to show their live broadcasts of races] are traditionally lumped together with the Corporation's statutory distributions to the race tracks. However, they are not, in fact, "statutory" payments because they are not required by law. Rather, they are a controllable operating expense. In fiscal year 2007-08, these fees totaled $23.5 million.

The Corporation's response is:

Only $14.9 million in simulcast fees was paid to out-of-state tracks, with most of the remainder attributable to simulcast payments to NYRA, which, as stated previously in connection with the Note to the Table of Key Financial Information, cannot be negotiated at arms-length due to restrictions placed upon the Corporation by certain legislative requirements, thereby making these payments virtually required by law and therefore much more akin to "statutory" payments than to operating expenses.

* Comment 12

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*See State Comptroller's Comments, page 41.

On page 19 of the Final Draft the Comptroller's Office wrote:

It is possible that there are opportunities for cost savings (i.e., lower simulcast fees) in these contracts. The Corporation has been delaying its fee payments on some of these contracts because of its deteriorating financial condition, but this is not the same as negotiating lower fee payments. We recommend the Corporation actively pursue such negotiation.

The Corporation's response is:

First, as the Comptroller's Office has been advised, there have been no deferrals of payments of simulcast fees. Secondly, the Corporation has been, is and will continue to be, extremely aggressive in its negotiations for wagering and simulcast rights with out-of-state racetracks. Historically, the Corporation has been quite successful in these efforts, and the Corporation is confident that the rates it pays for such rights are, on average, considerably below both current industry standard rates, as well as the rates paid for these same racing products by other New York licensed pari-mutuel operators. In fact, for FY2007-2008, the overall blended effective rate paid to the out-of-state racetracks under the simulcast contracts was only 2.25%.

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Comment
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On page 19 of the Final Draft the Comptroller's Office wrote:

We question whether all 87 vehicles [in the Corporation's fleet] are needed by the Corporation.

The Corporation's response is:

The Corporation agreed with this statement (which was also contained in an earlier draft of the Comptroller's Office audit report) and had the fleet re-evaluated. As a result, the vehicle fleet has since been reduced by 15% to 75. In the future NYCOTB will re-evaluate assignments and fleet size when we adopt our budget.

On page 19 of the Final Draft the Comptroller's Office wrote:

According to the Corporation's Executive Director of Administration, the vehicles are assigned to various departments and individuals on the basis of travel needs and business needs. However, there are no written procedures governing the assignment of the vehicles and no written explanations for the existing assignments. Also, vehicle usage logs are not properly maintained, and thus, do not provide adequate accountability for vehicle use. As a result, it cannot readily be determined whether the vehicles are, in fact, necessary for Corporation business.

The Corporation's response is:

Corporate Policy GL105-1F "Auto Usage Guideline," in fact, sets out the procedures governing the assignment of vehicles. To the extent that such guidelines were not followed as carefully as they might have been, that has now been rectified. Likewise, the maintenance of vehicle usage logs is now reviewed on a regular basis to assure compliance.

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Comment
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On page 20 of the Final Draft the Comptroller's Office wrote:

We note that 22 of the vehicles are assigned to executive and management staff based at the Corporation's administrative headquarters in Manhattan (including the four sport utility vehicles

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*See State Comptroller's Comments, page 41.

noted above). We also note that, while there is no written policy authorizing the practice, employees are allowed to take the vehicles home and use them to commute to and from work (these vehicles are properly reported as an employee fringe benefit for income tax purposes).

The Corporation's response is:

Only 18 vehicles are now assigned to executives and management staff, with all such vehicles operating out of a pool system, and none of the SUVs are assigned to executives.

On page 20 of the Final Draft the Comptroller's Office wrote:

Corporation officials note that 41 of the vehicles are equipped with global positioning systems (GPS tracking devices) that supervisors use to monitor vehicle usage, but we saw no evidence of such monitoring during the audit period.

The Corporation's response is:

Such evidence was provided to the Comptroller's Office. In fact, among the evidence provided was written documentation of at least one occasion where an employee was deprived of future use of a vehicle because of misuse detected through the ongoing monitoring of the GPS tracking devices by management. Indeed, the ongoing monitoring of the system has proven to be a particularly successful tool in assuring the proper use of Corporation vehicles. Although formal written procedures for such monitoring had not been promulgated at the time of the audit that is now being done.

* Comment 4

On page 20 of the Final Draft the Comptroller's Office wrote:

The Telephone Betting Center employs a total of about 236 individuals, 225 of whom are responsible for answering the phones and accepting wagers. The consultant that was hired by New York City noted that costs at the Center, which total about $13 million annually, could be significantly reduced if more of the calls were answered by an automated system. However, we found no indication the Corporation has pursued this option.

The Corporation's response is:

The consultant, BCG, however, also suggested that the investment in any initiative to expand the automation system should await the Corporation's institution of internet betting, which did not begin until September 2007, at which point management was turning its attention to the development of a close-down plan, which would have made investment in the Corporation's automated systems a back-burner issue even if there was money to be invested, which there was not. The consultant also acknowledged that initiatives for cost-saving through a transfer of transactions from live operators to automated systems could be problematic due to "current labor constraints." BCG Report, at p.49. In addition, it should be noted that the Comptroller's Office was provided with documentation showing that the percentage of automated handle for the Corporation's account wagering, *i.e.*, all wagering done by means of telephone and internet, has increased from 16.30% in FY 2005 to 25.25% in FY 2009. Likewise, the Comptroller's Office was also provided with documentation showing that the percentage of automated handle in branches has gone from 35.51% to 45.92% during the same period. All of which is clear evidence that management has pursued initiatives to increase the use of automation by the Corporation's

* Comment 14

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*See State Comptroller's Comments, page 41.

customers, albeit without being able to invest significant funds toward new equipment and software.

On page 20 of the Final Draft the Comptroller's Office wrote:

The automated betting terminals at the branch sites are maintained and repaired by Corporation technicians who work out of the Corporation's warehouse in Queens. During the 2007-08 fiscal year, this staff of 21 was paid a total of $1.8 million to perform this work. The consultant suggests it would *be more cost-effective for the Corporation to lease these machines from a company that provides* maintenance and repair services. In fact, we determined that this is the arrangement for at least three of the other regional OTB corporations in New York State.

The Corporation's response is:

An earlier draft of this document contained an explanation from the Corporation as to why the machines continue to be maintained by in-house unionized employees. That paragraph read as follows:

"Corporation officials told us that they tried to pursue this option in the past, but were opposed by the union representing the Corporation's technicians and had to drop the idea when the union's challenge was upheld during arbitration. The officials said that, with the State now operating the Corporation, the collective bargaining agreement may change and the maintenance option could be revived. We recommend the Corporation actively pursue this matter."

Dated: May 26, 2009.

12

State Comptroller's Comments

1. We have revised our report to clarify our position on the solvency of the Corporation and the impact of declining revenues and statutory distribution.

2. We acknowledge the Corporation's new emphasis on cutting costs and have revised our report to reflect this effort.

3. Our focus was on the Corporation's efforts to reduce operating costs. However, we have revised our Audit Results Summary to clarify that declining revenues and statutory distributions are impacting solvency.

4. We have revised our report to reflect the Corporation's comments.

5. Considering the Corporation's financial condition even low impact opportunities require follow-up. As explained in the body of our report, the daily staffing analysis does not compare staffing levels to set standards of need.

6. Report pages 10 and 22 were revised to note that only certain statutory payments were deferred.

7. Our final report was revised to indicate that the Corporation's operating expenses increased by 2.1 percent in the 2005-06 fiscal year.

8. We found the consultant's report focused on global issues affecting the Corporation such as industry trends and potential marketing strategies rather than day to day fiscal and administrative issues. Our assessment was that the Bet Stat Program was primarily for management decision-making and not for comprehensive assessment and operating expenses that could be reduced.

9. Corporation officials note that as a result of staffing evaluations, a number of managerial positions were eliminated. We note on page 19 of our report that many of the Corporation's managerial positions have been eliminated over the last few years through attrition. We have not been supplied with any formal Corporation analysis establishing the optimal management staffing levels.

10. In response to our draft report, Corporation officials agree that telephone betting operations are less costly than its branch operations. However, they also note that branch profitability has recently increased now that the Corporation is able to retain the surcharge formerly payable to New York City. Their comments have been included on page 21 of our report.

11. Corporation officials assert that presentations were made to their Board of Directors giving appropriate justification for the retention of the noted consultants. However, they did not provide us with documentation to support their assertion.

12. Page 22 of our final report was revised to acknowledge the Corporation's unique relationship with NYRA regarding simulcast fees.

13. Page 23 of our report was revised to acknowledge the absence of written justification for vehicle assignments as opposed to the absence of governing procedures.

14. The increase in automated wagering cited by the Corporation may be valid, but there is no indication that this growth is attributable to specific Corporation initiatives. Our point, as well as the consultant's point, is that this option needs to be actively pursued.