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BY ELECTRONIC MAIL

March 4, 2019

Carla Campos Vidal
Executive Director
Puerto Rico Tourism Company

Dear Executive Director Campos Vidal:

On December 27, 2018, the Oversight Board concluded that the compliance certification for Act 257-2018 (the “New Tax Law”) failed to provide the formal estimate of the New Tax’s Law fiscal impact because it self-evidently did not address Articles 132 through 163, which concern video lottery terminals (“VLTs”) that operate outside of casinos. As the compliance certification acknowledged, the fiscal impact of Articles 132 through 163 cannot be ascertained until certain regulations have been promulgated by the Puerto Rico Tourism Company (the “Required Regulations”).

The New Tax Law requires the process for granting licenses be drafted within 60 days of the law’s enactment. It also establishes a period of 120 days to draft the regulations and/or processes necessary to regulate the process of requesting proposals and the connection of VLT machines. The Oversight Board’s policy on rules, regulations, and executive orders mandates that the Required Regulations be submitted to and approved by the Oversight Board prior to their issuance.

I write to explain which revenues are potentially at risk in the Certified Fiscal Plan (the “Fiscal Plan”) from the legalization of VLTs and to highlight certain provisions that must be incorporated into the Required Regulations to minimize revenue cannibalization risks, which were not included in the draft regulations that were submitted to the Legislature on February 1, 2019.

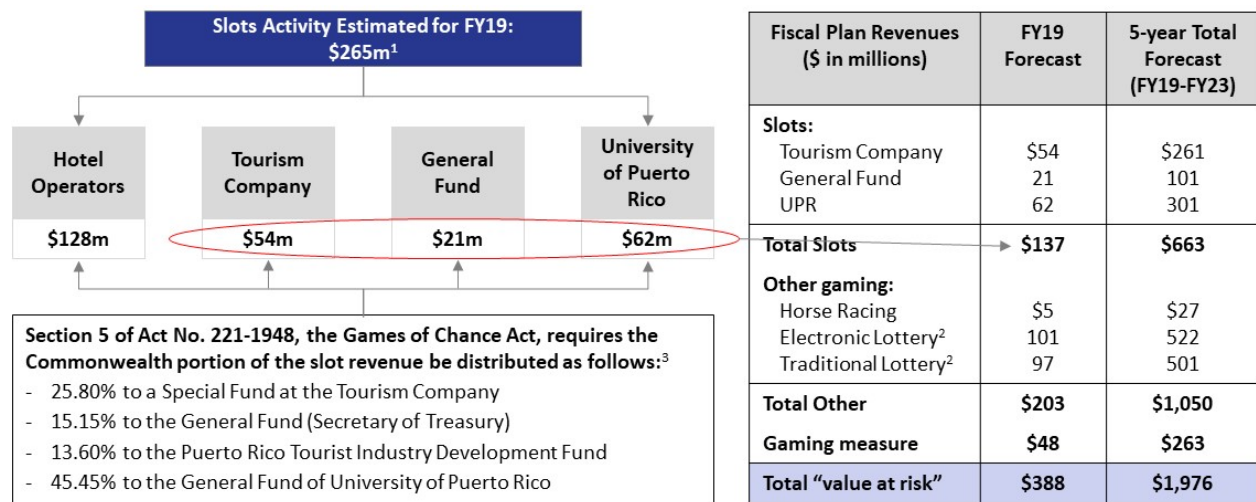
Fiscal Plan Revenue at Risk

The Oversight Board has expressed concern about revenue cannibalization risk since the introduction of VLT gaming legalization last fall because the Fiscal Plan incorporates significant revenues from gaming-related activities. This includes revenues from casino gaming, horse racing, off track betting, the electronic and traditional lottery as well as skills-based games and games of chance. In total, the Fiscal Plan estimates gaming activities will contribute nearly \$2

billion in revenue over the next five years. A breakdown of each gaming activity’s contribution to the Fiscal Plan is provided as Exhibit A in the Appendix.

Of all the revenue categories, casino slot machine revenue appears to be most at risk of cannibalization from VLT legalization. As shown in Table 1, each year a portion of casino slot machine gaming revenue is distributed to the General Fund, the Tourism Company, and the University of Puerto Rico. Combined, this revenue totals an estimated \$137 million in FY2019 and \$663 million over the next five years.

Table 1: Value at risk for all gaming activities included in the Fiscal Plan



¹ Based on Fiscal Plan estimates. This forecasted FY2019 amount is net of operating expenses and other costs; gross receipts are \$283m.

² Based on Fiscal Plan estimates. Net inflows to the Government calculated based on inflows from draw games, instant games and traditional lottery sales and other less prize and other expenses. Total inflows in FY2019 is \$931m.

³ Under the Games of Chance Act, slot machine revenue is split between operators and the Government in varying proportions depending on the total revenue collected.

In addition to the gaming-related revenues included in the baseline financial projections, the Fiscal Plan includes a revenue measure that, at the Government’s recommendation, increased license fees on skills-based games and certain games of chance. The measure was to be achieved largely by increasing and properly taxing Adult Entertainment Machines, many of which incorrectly paid license fees for coin-operated electronic video games in the past. Table 2 on the next page – which is based on information provided by the Government to the Oversight Board – shows the increase in fees. In FY2019, the Fiscal Plan forecasts the measure will generate ~\$48 million.¹

To enforce the measure, the Government passed Act 108-2017, which, in part, canceled all existing licenses for coin-operated machines and required their renewal under the terms of Act 108-2017. The Fiscal Plan requires that this revenue be incremental to the revenues in the baseline financial forecast (including all the gaming-related revenues referenced above).

¹ Based on an assumption of 23,000 gaming machines on which Hacienda is able to collect fees (<http://www.oslpr.org/2017-2020/leyes/pdf/ley-108-23-Ago-2017.pdf>). The measure proposed by the Government was originally estimated to generate ~\$71 mm, however, when factoring in the potential that a 2,900% increase in taxes on the machines could decrease total revenues from gaming—a change from 2017 forecasting—run-rate incremental revenue from the gaming tax was reduced in the Fiscal Plan to ~\$48 mm in FY2019 increasing to ~\$56 million per year by FY2023.

Table 2: Projected Fiscal Plan revenues from increase in gaming machines licensing fees

Gaming License Fee Collections **Before** Passage of Act 108-2017					Government Forecast Fee Collections **After** Passage of Act 108-2017				
License Type	Description	Fee Per Machine	Number Machine	Collections (\$ in 000)	License Type	Description	Fee Per Machine	Number Machine	Collections (\$ in 000)
720	Maquina Juegos Mecanicos	\$100	560	\$56	720	Maquina Juegos Mecanicos	\$3,000	560	\$1,680
730	Maquina De Juegos Electronicos	100	23,574	2,357	730	Maquina De Juegos Electronicos	3,000	23,574	70,722
740	Maq Juego Video Para Ninos Y Jov	100	959	96	740	Maq Juego Video Para Ninos Y Jov	300	959	288
745	Maq Video Mat Violento O Ind Sex	400	161	64	745	Maq Video Mat Violento O Ind Sex	3,000	161	483
Total			25,254	\$2,574	Total			25,254	\$73,173

Gov't. Forecast Collections Above Current Collections	\$70,599
Fiscal Plan Risk Adjustment (34% reduction, FY18 base)	\$46,595
Fiscal Plan Inflation Adjusted FY19 Revenue Estimate	\$47,594

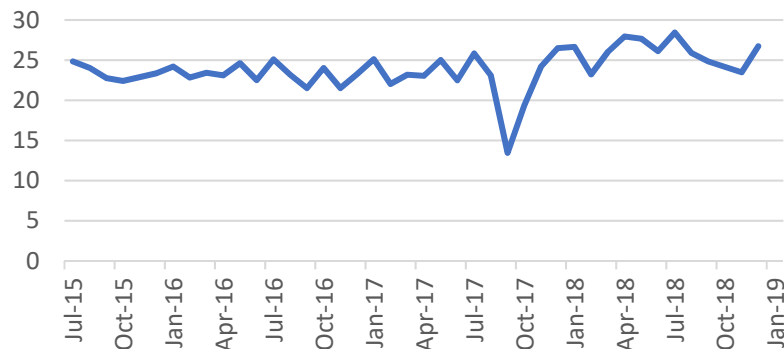
Examples of Revenue Cannibalization

At multiple stages in the legislative drafting process, the Oversight Board raised concerns over revenue cannibalization and asked the executive and legislative branches of government for information and research to inform its analysis. A summary of the inputs received, as well as the Oversight Board’s own research efforts, follows.

Even though VLT machines already operate illegally in Puerto Rico, without proper regulations and controls, research from other jurisdiction indicates that legalizing VLTs may negatively impact existing gaming revenues in Puerto Rico. This is possible because of the overlap in the local population that plays at both casino slot machines and at adult entertainment machines and the likely increase in marketing and promotion activity for VLTs.

As examples, one study indicated that 85 percent to 95 percent of gaming revenues are attributable to the local Puerto Rican population.² This is further supported by the monthly adjusted gross win slot machines data shown in Table 3. The data below shows, except for the period immediately following Hurricane Maria, slot machine winnings have been stable throughout the fiscal year and do not vary with the tourist season. This further implies slot revenues are generated from the local population, not tourists.

Table 3: monthly slot machine gross winnings (\$ in millions)



² Gaming Feasibility Analysis and Recommended Scope: Roosevelt Roads Development. Prepared for: Department of Economic Development and Commerce. January 2012. Located at: http://www.rooseveltroads.pr.gov/rfq/Documents/Exhibit%20K_TIGanalysisRR.pdf

Third-party studies also indicate existing gaming revenues could be cannibalized. One such study evaluated the fiscal impact to gaming revenue in Illinois, Louisiana, and West Virginia, following the introduction of VLTs in those markets. The analysis was commissioned by the Commonwealth of Pennsylvania to help the state assess the impact from the introduction of Video Gaming Terminals on state casino revenues, fiscal contributions, and employment.³

A key section of the report contains analysis on VLT operations in Illinois, which currently has more than 30,000 video lottery and poker machines operating in 6,800 locations, more than any other state. Following the introduction of VLTs in that state, slot machine revenue eroded affected casinos by an average of 18 percent over the course of three years. In markets where VLT development was extensive, slot revenues at casinos declined by as much as 25 percent.

The Illinois example is also relevant to Puerto Rico because, prior to legalizing VLTs, many bars, restaurants, bowling alleys and fraternal organizations in Illinois already operated video slot and poker machines called “simulated gambling devices.” Most had amusement tax stamps from the state revenue department and did not directly pay out prizes. Instead, like in Puerto Rico, the machines produced printed slips or tickets showing how much was “won” or “lost.” These machines, however, were known to illegally offer cash payouts to players.⁴

The same report indicated casino revenues in Louisiana declined by 13.5 percent once video poker machines were introduced. The Louisiana example also demonstrates what might happen to casino revenues when a competitor video based product is removed from the market. After a referendum was passed banning video poker from certain parishes in Louisiana, revenues at Baton Rouge casinos increased dramatically, and at higher rates than in some of the surrounding parishes.

A second report prepared for the State of Maryland concluded the substitution effect to VLTs was expected to cause a decline in existing casino revenue streams, including a 10 percent permanent decline based on applicable cases.⁵ This concern led policy makers to limit the number of VLT licenses to 15,000 for Maryland’s 6.0 million residents (nearly half the number of machines Puerto Rico legalized with twice the population.) The Maryland report also discussed how there could also be significant social costs from the introduction of VLTs, particularly from increased costs of addiction treatment and increases in individuals’ debt.

Several Puerto Rico specific reports also concluded that existing revenues could be eroded from the legalization of VLTs. One study produced by the Spectrum Gaming Group calculated the legalization of 30,000 VLT machines in Puerto Rico would cause casino slot revenue to decline between 45.8 percent and 59.8 percent and disbursements to the General Fund, UPR, and Tourism

³ Pennsylvania Video Gaming Terminal (VGT) Impact Analysis. Report prepared by The Innovation Group. May 2016. Located at: <http://msgaming.org/wp-content/uploads/2018/09/PA-VGT-Impact-Analysis-FINAL.pdf>

⁴ How Illinois Bet on Video Gambling and Lost. ProPublica. January 16, 2019. Located at: <https://features.propublica.org/the-bad-bet/how-illinois-bet-on-video-gambling-and-lost/>

⁵ An Analysis of the Impact of Introducing Video Lottery Terminals in Maryland. Report prepared by the Maryland Institute for Policy Analysis and Research. October 14, 2008. Located at: <https://mipar.umbc.edu/files/2015/01/Impact-of-Introducing-Video-Lottery-Terminals-FINAL.pdf>

Company to decline between 38.2 percent and 49.9 percent.⁶ Another study by Consltec estimated the introduction of VLTs, based on various assumptions, could lead to the closure of the Camarero Hippodrome as well as a significant number of hotels with casinos.⁷ At least one current Government official also warned the legalization of VLTs “would be disastrous for the revenues received by the Government of Puerto Rico for gambling and casinos.”⁸

The Legislature did provide the Oversight Board with some materials, particularly a study published by the Asociación de Operadores de Máquinas de Entretenimiento (ADOME) concluding that legalizing the existing, but illegal 25,000 machines, would add revenues for the Government. This was supplemented with additional analysis from the Legislature contending the Spectrum study had shortcomings with its assumptions because it failed to draw distinction between the different machine types and corresponding consumer preference. While appreciated, the Legislature’s analysis mostly relies on the premise that since VLT machines exist today, they will not cannibalize casino revenues.

In addition, the Government does not adequately explain how the current VLT flow of funds will minimize revenue shortfall risks. Estimates provided by the Legislature imply that, net of technological costs, the General Fund will, at most, receive \$36 million annually from VLT licensing and taxes on gaming activity.⁹ Since the Fiscal Plan gaming measure estimates \$48 million will be collected, it is not clear how the Government expects to collect the remaining revenue. This could lead to a shortfall up to \$12 million a year. License fees from other gaming activity may help offset that gap, but the Government’s data in Table 2 above implies projected inflows from those other sources will likely be insufficient.

Required Components to Include in Regulations

As stated above, the Required Regulations must be submitted to, and approved by, the Oversight Board prior to their issuance. Accordingly, to minimize fiscal cannibalization risks, these considerations must be incorporated as part of the Required Regulations.

First, the Required Regulations must clarify how the full regulatory costs for oversight and compliance will be incorporated into the gaming flow of funds. While the New Tax Law requires Wholesale Owners to pay for initial implementation costs, it does not clearly define which entity is responsible for paying ongoing compliance and oversight costs or the sequence in which those costs are paid. The Government projects it will receive significant revenue from the \$1,500 annual license fee per machine payable by Wholesale Owners, the \$3,000 biennial license fee payable by Distributors, Goods and Services Providers, and Manufacturers, and the estimated \$115 million in

⁶ Market analysis: projected impacts of adding 30,000 slot machines in Puerto Rico, prepared for Puerto Rico Tourism Company. Report prepared by Spectrum Gaming Group. April 16, 2013.

⁷ La Industria del Turismo y su Relación con los Juegos de Azar en Puerto Rico

⁸ “Dire” slot machine legalization. El Nuevo Dia. November 1, 2018. Located at:

<https://www.elnuevodia.com/english/english/nota/direslotmachineslegalization-2456740/>

⁹ The New Tax Law caps the revenue flows from VLTs to the General Fund at \$40 million annually but the Government estimates at least \$4 million of that amount is required to implement the technology requirement for monitoring and enforcement activity.

annual holdback revenue from play activity.¹⁰ From those amounts, \$300 per license and 5 percent of the holdback revenue are transferred to the Tourism Company for implementation activities. This fee allocation is much smaller than comparable jurisdictions with VLT machines. Pennsylvania, for instance, charges \$25,000 to apply for a terminal operator's license. The New York State Gaming Commission mandates 10 percent of VLT revenues go to fund operations. At 5.6 percent, Puerto Rico's effective tax on VLT gaming activity is also very low compared to other jurisdictions. The Illinois tax rate on VLTs is 30 percent. West Virginia and South Dakota tax VLT activity at 50 percent. In Oregon, where the state owns and operates video gambling machines through the state lottery, the tax rate is 73 percent. The draft regulations submitted to the legislature also indicate there will be no taxation on winnings smaller than \$500 and only 2 percent on winnings greater than that amount. And, while the New Tax Law requires some gaming revenue to go to municipalities, the police, and the General Fund, those entities only start receiving funds after 7,000 VLT licenses are issued.

Second, the Required Regulations must define how all ongoing regulatory costs, including GPS monitoring of the proposed RFID stickers and enforcement activities, will be assessed such that the Government does not fund unforeseen costs. The regulations must clarify that equipment and system costs, as well as installation costs required to connect VLT machines to the audit system, will all be paid by the Wholesale Owner. A process must also be established for Wholesale Owners to follow to complete their payments. The Required Regulations must also make clear that under no circumstances will the Government invest funds in the implementation or operation of the VLT technology established in the New Tax Law. Similarly, the regulations must more clearly define who pays for the marketing and promotion of VLTs. In New York, for instance, a portion of the net win paid to the operator finances advertising, marketing, and promoting costs.

Third, the Required Regulations must require wholesale operators that apply for a license go through a strict licensing process similar to the requirements for casino operators. Historically, the only requirements to operate adult entertainment machines are license application Form SC 2309,¹¹ the same form used for other coin-operated devices such as billiards, arcade, jukeboxes, among others, and Form SC 2353,¹² titled "commitment of responsibility for the purposes of the internal revenue licenses for adult entertainment machines." The VLT licensing process must include comprehensive financial and criminal background checks with a clear funding source.

Fourth, the Required Regulations must include strict parameters for operators on the game mix, promotions, hours of locations, operations, the electronic monitoring systems to be used, and social responsibility requirements. Tight restrictions will help limit the possibility VLTs will attract gaming activity away from existing alternatives.

Fifth, the Required Regulations must define the technology provisions for machines that will be required and the funding source to implement that technology platform. The New Tax Law

¹⁰ There is a requirement VLTs must offer players at least an 83 percent payback on play activity. The remaining 17 percent is holdback revenue that gets split between the operator of the machine (67 percent) and the Government (33 percent). The net revenue to the Government assumed per machine is \$37.50, which implies more than \$2.0 billion of game play annually. If revenue targets are met on the first 25,000 machines, the Government expects to collect ~\$115 million a year.

¹¹ Hacienda Form SC 2309 located at: http://www.hacienda.gobierno.pr/sites/default/files/documentos/sc_2309_0.pdf

¹² Hacienda Form SC 2353 located at: <http://www.hacienda.gobierno.pr/sites/default/files/documentos/sc2353.pdf>

requires that VLT machines be connected to a centralized electronic monitoring system at Hacienda, but Article 155 only provides a list of general terms for the technology requirements. And, while Article 153 provides that the Wholesale Owner must pay for the equipment and system, it does not say how or when those payments must be made. Clarity on the financial costs for both provisions must be provided.

Lastly, current law, including Act 77-2014 and Regulation 8603-2015, describe how to compensate and remove illegal adult entertainment machines on the Island. However, the provisions in existing law regarding confiscation and removal of illegal adult entertainment machines are quite cumbersome and require significant time before the machines can be confiscated and destroyed. To the extent possible under constitutional due process requirements, the provisions under the Required Regulations regarding the seizure and removal of illegal VLT machines should be simplified. Section 3.4 of the draft regulations provided to the Legislature only addresses this topic superficially by referencing the existing, cumbersome regulations on seizures for games of chance machines.

The Required Regulations should also clarify how the Government intends to address existing illegal VLT machines that do not receive a license and how the Government plans to manage the process for operators who have machines and purchase a license but lack the technical capacity to connect to the centralized system mandated by the New Tax Law. Articles 160 - 162 provide for administrative and criminal fines from this process, but additional clarification on who pays for this enforcement activity is critical.

Other Implementation Considerations

In addition to the financial issues that must be addressed, the Oversight Board has several considerations for the Tourism Company as it drafts the Required Regulations.

First, the Government's implementation approach should ensure the regulation of VLTs is effective, and that those who circumvent the New Tax Law face appropriate consequences. In this context, the Tourism Company's should pursue ways to supplement its role as regulator for this new industry. Given current staffing levels, the agency may find it challenging to oversee a disparate set of machines managed by hundreds of owners located in thousands of locations throughout the Island. The New Tax Law provides only 60 days to approve regulations regarding the issuance of licenses and 120 days to establish the regulation or process necessary to regulate the request for proposals and the connection. This is a significant challenge. For example, when Illinois legalized VLTs, it took the state close to three years to promulgate effective regulations.¹³

Second, the Tourism Company should give special consideration to the pace at which licenses are distributed because the initial number of licenses being legalized is much larger than other jurisdictions. Under the New Tax Law, 25,000 machines are legalized over the first two years. An additional 10,000 machines are authorized in each of years three and four if the Tourism Company's Games of Chance Division concludes, based on a study, that the market for VLTs is

¹³ <https://www.cdcgamingreports.com/commentaries/illinois-vlts-now-exceed-casinos-in-taxes-generated/>

not saturated. As shown in Table 4 on the next page, even at 25,000 machines, Puerto Rico would have one of the greatest concentrations of VLT machines per population of any jurisdiction in the United States. This becomes even more pronounced if 45,000 machines are ultimately approved, which would result in the second highest VLT per Capita of all jurisdictions surveyed, with only Montana being higher.

Table 4: People per VLT machine. (Lower number implies higher saturation rate.)

State	2017 Population	VLT Machines	Population per VLT	State	2017 Population	VLT Machines	Population per VLT
Ohio	11,660,000	11,267	1,035	West Virginia	1,816,000	6,913	263
New Mexico	2,088,000	3,568	585	Rhode Island	1,060,000	5,633	188
Pennsylvania	12,810,000	25,442	503	Nevada	2,998,000	18,996	158
New York	8,623,000	18,494	466	Delaware	961,939	6,900	139
Illinois	12,800,000	30,735	416	South Dakota	869,666	9,109	95
Maryland	6,052,000	15,000	403	Montana	1,050,000	19,003	55
Louisiana	4,684,000	13,091	358	Puerto Rico	3,337,000	25,000	133
Oregon	4,143,000	11,742	353	Puerto Rico (max)	3,337,000	45,000	74

Source: La Fleur’s Fiscal 2017 VLT Special Report, North American Association Of State and Provincial Lotteries, state lottery annual financial reports, census bureau

Third, numerous studies have found that access and density of gambling operations drive gambling addiction. Consequently, the regulations should consider whether there are alternatives to minimize negative social consequences that may emerge from the legalization of VLTs. The New Tax Law does not include self-exclusion or treatment protocols that would proactively prevent vulnerable people from gambling at VLTs. In fact, Puerto Rico is one of only three jurisdictions that has not conducted research to measure the prevalence of gambling addiction prior to legalizing VLTs.¹⁴ A strategy to assist and treat gamblers addicted to VLTs under the Mental Health and Anti-Addiction Services Administration’s (ASSMCA) Compulsive Gamblers Assistance Program could be considered. This might become even more necessarily as VLT operators likely expand VLTs from being adjunct sources of income in bars and restaurants to “café” type mini-casinos. The proposed regulations to the Legislature only provide that a VLT license not represent the sole, or the highest income of the establishment’s commercial activity.

The Required Regulations should also consider establishing strict anti-money laundering and anti-terrorism provisions. Under the law, the income limits from prizes are \$1,000 per play but ambiguity in the definition of income could make play activity vulnerable to money laundering. If, for instance, \$700 is inserted in a machine, and \$300 is played and lost, the player can cash out \$400 (tax free), which, because the proposed regulations to the Legislature does not define the term income, may not be treated as such, and, depending on the technology systems and controls in place, may not be flagged as a suspicious transaction. Additionally, while the proposed regulations to the Legislature do indicate the Tourism Company may deny or revoke a license to an operator if they are identified as a habitual criminal or a member of a criminal organization, those people are not prohibited from playing at VLTs.

¹⁴ Illinois and West Virginia are the other two locations. Source: How Illinois Bet on Video Gambling and Lost. ProPublica. January 16, 2019. Located at: <https://features.propublica.org/the-bad-bet/how-illinois-bet-on-video-gambling-and-lost/>

Ms. Campos Vidal

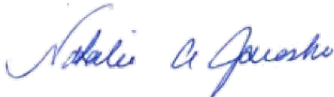
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Finally, the Required Regulations could better define certain parameters. The proposed regulations to the Legislature indicate VLTs must include certain components like a knock off switch, bill validator, and a mechanism that allows the machine to operate without interaction from the player to ensure it is determined by chance. The Required Regulations could also, however, seek to set forth the required minimum internal controls standards which will be used for safeguarding and accounting for all cash associated with the operation of VLTs.

We hope these insights and guidance are helpful to the Tourism Company as the agency drafts the Required Regulations. To the extent you would like to further discuss any of the material in this letter, please let us know. Otherwise, we look forward to reviewing the final version of the Required Regulations prior to their issuance.

Sincerely,



Natalie A. Jaresko

CC: Christian Sobrino Vega
Raúl Maldonado Gautier
Honorable Thomas Rivera Schatz
Honorable Carlos J. Méndez Núñez

Exhibit A: The Fiscal Plan projections include revenues from several gaming activities

Gaming Activity	Description	Fiscal Plan 5 yr. Revenue (19-23)
Casino Gaming	<ul style="list-style-type: none"> As of March 2018, there were 16 casinos operating 189 gaming tables and 4,875 slot machines in Puerto Rico. The casinos employ 1,832 people.¹⁵ Casino Operations are regulated by the Tourism Company. 	\$663m From slot machines
Horse Racing	<ul style="list-style-type: none"> Hipódromo Camarero in San Juan offers live thoroughbred horse racing. Horse racing and off-track betting operations are regulated by the Puerto Rico Horse Racing Administration (AIDH). 	\$27m General Fund portion
Off Track Betting	<ul style="list-style-type: none"> There are ~700 Off Track Betting (OTB) locations in Puerto Rico. OTBs range from small, rooms where players review the race sheets for the day, make a bet and then leave, to larger, more diversified outlets that offer a bar, food service, and other activities. 	N/A Embedded in horse racing collections
Electronic and Traditional Lottery	<ul style="list-style-type: none"> The Electronic Lottery was founded in 1989 and offers various lottery games at retail locations across the Island. The Traditional Lottery has a variety of weekly draw games as well as instant scratch tickets that are sold at retail locations across the Island. 	\$1,023m Net of Expenses & Winnings
Skills Based Games and Games of Chance	<ul style="list-style-type: none"> Retail outlets pay license fees for adult entertainment electronic skill based gaming machines, some of which have violent and/or sexual content. Other outlets have Game of Chance Adult Entertainment Machines (AEMs) that reward patrons with non-cash prizes. Legally, these games are for amusement purposes only, providing no payout on wins. Some games, however, have been illegally modified to allow for jackpots and bonus awards. Prior to the New Tax Law, Hacienda regulated skill based games & AEMs. The Tourism Company will regulate the newly legalized VLTs. 	\$263m After Fiscal Plan Measure

¹⁵ Puerto Rico Casinos Gaming Offer. As of March 1, 2018. Located at:
https://www.prtourism.com/dnn/Portals/0/PDF_Statistics/PR%20Casinos%20Gaming%20Offer.pdf?ver=2018-03-16-110130-163