

Indian Gaming Special Distribution Fund:

Local Governments Do Not Always Use It to Mitigate the
Impacts of Casinos, and Its Viability Will Be Adversely Affected
by Compact Amendments

July 2007 Report 2006-036



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Elaine M. Howle
State Auditor
Doug Cordiner
Chief Deputy

CALIFORNIA STATE AUDITOR

Bureau of State Audits

555 Capitol Mall, Suite 300

Sacramento, CA 95814

916.445.0255

916.327.0019 fax

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July 12, 2007

2006-036

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As required by Chapter 858, Statutes of 2003, the Bureau of State Audits presents its audit report concerning the allocation and use of moneys from the Indian Gaming Special Distribution Fund (distribution fund).

This report concludes that money provided to local governments was used for the statutorily mandated purposes. However, not every project we reviewed was related to an impact from a casino. Although it appears that the intent of the law is that projects are to mitigate the impacts of tribal gaming, there is no specific requirement that they do so. Prior to this year, the Legislature ratified five new compacts and eight amended compacts since the original compacts were ratified in 1999. These post-1999 compacts require tribes to negotiate directly with local governments to mitigate the impacts of casinos, and eliminate the requirement that these tribes contribute to the distribution fund. However, some counties where these casinos are located continue to receive mitigation grant money from the distribution fund for the casinos operated by these tribes as well as from direct negotiations with the tribes. We also noted several instances when local governments did not use the interest earned on unspent grant funds to pay for expenses related to casino mitigation projects. Rather, the interest was deposited into the local government's general fund or other operational accounts.

Finally, amended compacts that were ratified by the Legislature in June 2007 and are pending approval by the federal Secretary of the Interior, along with one other amended compact that has yet to be ratified, may threaten the future viability of the distribution fund. However, we estimate that this same group of compacts will also provide substantial revenues to the Indian Gaming Revenue Sharing Trust Fund (trust fund) and the State's General Fund. Specifically, our estimates indicate the compacts will eliminate \$92 million in contributions to the distribution fund, increase contributions to the trust fund by \$6.9 million, and increase contributions to the General Fund by between \$174.3 million and \$175.1 million for fiscal year 2007-08. However, if required to fund the shortfalls in the trust fund, within four years the distribution fund would be unable to support the programs that depend on it.

Respectfully submitted,



ELAINE M. HOWLE
State Auditor

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Summary

Results in Brief

The federal Indian Gaming Regulatory Act authorizes the State to enter tribal-state gaming compacts (compacts) that allow California Indian tribes to operate gaming devices on tribal lands. In anticipation of the passage of Proposition 1A, which was approved by voters in March 2000, amending the California Constitution to permit Indian gaming, 60 tribes agreed to the model compacts ratified in September 1999 (1999 compacts), which were materially indistinguishable from each other. Among the gambling devices allowed under the compacts are those designated as class III, which include off-track wagering, lotteries, certain card games, and slot machines. Only after a tribe and the State have negotiated a compact, which governs the conduct of the gaming activity, can the tribe operate class III gaming devices.

As required by the compacts, in fiscal year 2005–06, 37 of the tribes with compacts deposited money into the Indian Gaming Special Distribution Fund (distribution fund), the Revenue Sharing Trust Fund (trust fund), or both. These funds are administered by the California Gambling Control Commission (gambling commission). State law establishes criteria for disbursing money from both funds. Distribution fund deposits are based on the gross revenues tribes earn from operating class III gaming devices in use before the ratification of the 1999 compacts. Gross revenues, also called net wins, are the amounts players put in the devices less the amounts paid out to winners. Deposits into the trust fund are based on the number of class III gaming device licenses each tribe has acquired since the ratification of the 1999 compacts.

As shown in the text box on the following page, one designated use of the deposits made to the distribution fund is to provide grants for local governments—cities, counties, and special districts—adversely impacted by tribal gaming. State law created an Indian Gaming Local Community Benefit Committee (benefit committee) in each county in which Indian gaming is conducted. The benefit committees award distribution fund grants to local governments according to specified criteria. For instance, state law requires that the distribution fund be used for certain purposes, such as law enforcement, emergency medical services, environmental impacts, and water supplies.

The grants we reviewed were used for the statutorily mandated purposes. However, not every project funded under one of those purposes was linked to an impact from a casino. Specifically, we reviewed 30 grants totaling \$12.1 million made to local governments in six counties and found five instances totaling \$505,000 when the

Audit Highlights . . .

Our review of the allocation and uses of the Indian Gaming Special Distribution Fund (distribution fund) money revealed the following:

- » *Local governments did not always use distribution fund money to mitigate casino impacts.*
- » *The allocation of distribution fund money in some counties is based, in part, on the number of devices operated by tribes that did not pay into the fund because their compacts require them to negotiate directly with the county to pay for the mitigation of casino impacts. However, these counties continue to receive distribution fund dollars from the State.*
- » *In many instances local governments do not use interest earned on unspent distribution fund money for projects related to casino impacts.*
- » *Although all benefit committee members are required to file statements of economic interests, in our sample counties, 11 of the 13 tribal members that were required to file failed to do so.*
- » *The ratification of compacts in June 2007, along with one that is awaiting ratification, may threaten the future viability of the distribution fund and the programs that depend on it, as they eliminate \$92 million in payments to the fund beginning in fiscal year 2007–08. While we estimate that contributions to the State's General Fund would also total at least \$174 million, almost \$40 million per year could be required to pay for the estimated shortfall in the Revenue Sharing Trust Fund.*

Allowed Uses for the Funds Administered by the Gambling Commission

Distribution Fund

- Makes up for any shortfall in the trust fund.
- Funds gambling addiction and awareness programs.
- Pays for the regulatory activities of the gambling commission and the Department of Justice.
- Allocations to support local governments impacted by tribal gaming.

Trust Fund

Funds are allocated to non-gaming tribes.
Each non-gaming tribes receives \$1.1 million per year.

Sources: California Government Code, sections 12012.75, 12012.85 and 12012.90.

money was not used to offset the adverse effects of casinos. For example, Healdsburg District Hospital in Sonoma County received more than \$52,000 for surveillance cameras. Although the hospital claimed it experienced several acts of vandalism in its parking areas and other disturbances, it could not provide evidence showing that those incidents were related to the casino or that the number of criminal incidents on its property had increased since the casino was built.

We also identified 10 instances totaling \$2.3 million when the purposes of the grants as stated in the applications might have been somewhat relevant to the effects of the casinos but appeared primarily to address needs that were unrelated. For instance, the sheriff's department in San Diego County received over \$149,000 to purchase a device to analyze chemicals from arson and other crime scenes and suggested that in the future some of these investigations may occur in the area around the casino. Use of this device is not intended to be limited to casino-related incidents; it will be used for cases throughout the county.

The intent of the law establishing the uses of distribution fund money allocated to local governments is to support those impacted by the operation of casinos within their jurisdictions. The law declares that the intent of the Legislature is that tribal governments participate in the process of identifying and funding mitigation of the impacts of tribal gaming and the funding for local governments is for the purpose of mitigating impacts from tribal casinos. However, there are no specific requirements that local governments must ensure that the funds are used for projects that directly address an impact from the casinos. As a result, local benefit committees have allocated funds to projects that have no direct relationship to casinos. Even though the money was not used to mitigate the impact of casinos, the grants appear to adhere to the explicit requirements of the law.

Prior to 2007 the Legislature ratified five new compacts and amendments to eight others (post-1999 compacts) with various terms or requirements different from those in the original compacts. The post-1999 compacts require tribes to negotiate directly with local governments to mitigate the impacts of casinos rather than requiring them to contribute to the distribution fund. However, although the post-1999 compacts bypass the distribution fund when negotiating for mitigation projects, some counties with tribal casinos and amended compacts continue to receive money from the distribution fund. For example, in fiscal year 2005-06 two

counties received roughly \$850,000 from the distribution fund in addition to the funding they received directly from the tribes. As a result, that money was unavailable for other local governments that do not negotiate directly with tribes for funds to offset the effects of casinos in their counties. Existing law allows these counties to receive funding for mitigation projects from both the tribes and the distribution fund.

Counties generally awarded all the funding they were allocated each year. However, in some cases, such as large capital improvement projects, it can take months or even years before spending on a casino mitigation project begins, leaving a significant amount of distribution fund money deposited in local government accounts that may earn interest for many years. We noted several instances when local governments did not use the interest earned on grants to pay expenses related to the projects for which the grants were intended, or for other casino mitigation projects.

Several local governments asserted that state law authorizes the use of interest earned on the grants for general purposes. However, our legal counsel advised us that given the nature of the grant funds, the interest on those grant funds must be used for the purposes established in the compacts and state law. We identified interest totaling \$175,000 that local governments generated from two capital improvement projects and used to pay general county operational costs rather than applying it to mitigation projects or returning it to the benefit committee for allocation to other projects intended to offset the impacts of Indian gaming. We also identified numerous instances in which local governments placed funds in accounts earning no interest.

Allocations from the distribution fund follow a formula intended to establish a fair and proportionate system to award grants to local governments impacted by casino operations. We found that a sample of counties generally identified all eligible governments and granted amounts as required. However, although state law limits the types of local governments eligible to receive funding to counties, cities, and special districts, the benefit committees in two counties provided a total of \$325,000 to school districts, which are ineligible entities because they are specifically excluded from the statutory definition of *special districts*.

Further, members of benefit committees do not always make the financial disclosures required by state law. The Political Reform Act of 1974 (political reform act) requires state officials and employees with decision-making authority to file statements of economic interests. These statements are intended to identify conflicts of interest that an individual might have. Counties were unable to provide 11 of the 13 statements we requested for benefit committee tribal representatives

active in fiscal year 2005–06. The California Fair Political Practices Commission has advised that members of benefit committees are subject to the political reform act. When designated individuals do not file statements of economic interests, benefit committees may be unaware of conflicts of interest and cannot ensure that members are aware when they should remove themselves from making decisions that could pose conflicts of interest.

We also found that some counties lacked transparency and accountability in their distribution fund spending. Counties are required to report to the Legislature and the gambling commission annually on the projects they financed through the distribution fund. However, according to information provided by the gambling commission and various legislative committees, for the most recent fiscal year, nine counties failed to submit their reports to all the committees and agencies required and six counties failed to submit their reports at all. Our audit also revealed that one county submitted incomplete information for one of the fiscal years required. Failure to complete or submit the required reports makes it difficult for legislators and other decision makers to determine whether local governments are using the funds as intended.

In June 2007 the Legislature ratified one new compact and four of five amendments to existing compacts. To take effect, the newly ratified compact and four amendments still require approval by the federal Secretary of the Interior. Therefore, we refer to the compact and amendments (including the one amendment that has yet to be ratified) as “pending compacts” throughout our report. These pending compacts may threaten the future viability of the distribution fund. The pending compacts will change the method of calculating contributions to the trust fund and require tribes to begin contributing to the General Fund instead of the distribution fund. It is difficult to determine the precise impact these pending compacts might have because the contribution formulas largely depend on the tribes’ future economic conditions and expansion decisions. We conservatively estimate that annual contributions to the trust fund from these compacts will increase by about \$6.9 million, while annual contributions to the distribution fund will decrease by \$92 million. Further, we estimate that contributions to the State’s General Fund from these compacts will total between \$174.3 million and \$175.1 million for fiscal year 2007–08. Further, as casino operations expand, General Fund revenues will increase.

Despite the significant decrease in contributions to the distribution fund, the Government Code currently requires its continued use to pay for any shortfall in the trust fund—which we estimate will total \$39.6 million per year—enabling the gambling commission to continue paying each noncompact tribe \$1.1 million per year, as required by law. We anticipate that if these payments continue

at their current level, by fiscal year 2010–11 the distribution fund will be unable to support the current level of expenditures for its other obligations. However, because of differences in existing law, a provision in the pending compacts, and language in pending legislation, it is unclear whether the distribution fund or the General Fund would be the source first required to pay for future trust fund shortfalls.

Recommendations

To ensure that local governments receive maximum benefit from the distribution fund and comply with applicable provisions of state law, the gambling commission should seek the following legislative changes:

- Amend the California Government Code (Government Code) to provide direction to local governments to ensure that they use distribution fund grants only to purchase goods and services that directly mitigate the adverse impacts of casinos on local governments and their citizens.
- Revise the allocation methodology outlined in the Government Code so that the allocation to counties is based only on the number of devices operated by tribes that do not negotiate directly with local governments to mitigate casino impacts.
- Amend the Government Code to require that all funds be deposited into interest-bearing accounts and that any interest earned is used on projects to mitigate casino impacts.
- Amend the Government Code to allocate distribution fund money only to counties that submit annual reports as required.

To ensure that local governments comply with state laws related to the distribution fund, benefit committees should do the following:

- Require local governments to submit supporting documentation that clearly demonstrates how proposed projects will mitigate the effects of casinos.
- Ensure that local governments spend the interest earned on project funds only on mitigation projects, or return the money to the county for allocation to future mitigation projects.
- Grant distribution fund money only to eligible entities.
- Ensure that all benefit committee members follow the political reform act and file the required statements of economic interests, and inform the appropriate agency if they fail to do so.

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- Submit annual reports to all required legislative committees and the gambling commission.

Agency Comments

Four of the six counties we visited—Riverside, San Bernardino, San Diego, and Sonoma—disagreed with our conclusion that the Legislature intended that distribution fund grants be used to mitigate the impacts of Indian casinos in their respective counties. Additionally, Riverside and San Diego counties disagreed with our conclusion that interest earned on unspent grant money should be used for casino mitigation projects.

Finally, the gambling commission suggested that we add language to the report to provide more technical details about certain aspects of Indian gaming.

Introduction

Background

Indian gaming on tribal lands within California has experienced extensive growth over the past eight years. As of March 2006, Indian tribes operated more than 58,000 electronic gaming devices such as slot machines and other electronic games of chance. According to the National Indian Gaming Commission, revenues from Indian gaming in California have grown from \$2.9 billion in fiscal year 2001–02 to \$7 billion in fiscal year 2005–06. Recognizing the significant impact casinos can have on the areas in which they are located, the tribal-state gaming compacts (compacts) ratified in 1999 include language that provides funding to support local government jurisdictions—cities, counties, and special districts—that are impacted by tribal gaming. For example, the presence of a casino can increase the level of traffic, pollution, and crime as patrons are drawn to the area.

Because of the sovereignty of tribal lands, the operation of casinos on those lands does not fall under the normal jurisdiction of the State. Therefore, relationships between the State and tribal casinos are regulated through the provisions of the compacts authorized by the federal Indian Gaming Regulatory Act (IGRA). The compacts ratified in 1999 establish license and operation fees that provide money for two funds: the Revenue Sharing Trust Fund (trust fund), which is used to fund distributions to tribes that do not have compacts or operate fewer than 350 gaming devices, and the Indian Gaming Special Distribution Fund (distribution fund), which is used to finance various state and local government activities.

The doctrine of Indian sovereignty is central to the debate and controversy surrounding Indian gaming. Indian sovereignty is based on well-established principles of law that protect sovereignty by limiting the jurisdiction of state governments over Indian affairs taking place on Indian lands. As one court stated, “In modern times, even when Congress has enacted laws to allow a limited application of [state] law on Indian lands, the Congress has required the consent of tribal governments before [state] jurisdiction can be extended to tribal . . . lands.” The doctrine of Indian sovereignty plays an important role in defining the relationship between tribes and states and limits the extent to which California can regulate tribal gaming.

Federal Indian Gaming Regulatory Act

Partly in response to the U.S. Supreme Court’s decision in *California vs. Cabazon*, which held that California did not have the authority to enforce its “bingo statute” or prohibit gaming on tribal lands when gambling activities were allowed in other parts

of the State, Congress enacted the IGRA in 1988. Congress stated that the purpose of the IGRA was to provide “a statutory basis for the operation of gaming by Indian tribes as a means of promoting tribal economic development, self-sufficiency, and strong tribal governments” and “to shield [tribal gaming] from organized crime and other corrupting influences, to ensure that the Indian tribe is the primary beneficiary of the gaming operation.” A federal court described the IGRA as an example of “cooperative federalism” in that it seeks to balance the competing sovereign interests of the federal government, state governments, and Indian tribes by giving each a role in the regulation of gaming by Indian tribes.

Classes of Gaming

Class I—social games played solely for prizes of minimal value or gaming connected to traditional tribal ceremonies or celebrations.

Class II—certain games of chance in which wagers and winnings are limited, such as bingo.

Class III—all other forms of gaming that are not class I and II, such as high-stakes gaming, including off-track wagering, lotteries, certain card games, and slot machines.

Source: United States Code, Title 25, Section 2703.

The IGRA establishes three classes of gaming activity, as described in the text box, each subject to differing jurisdiction: the tribe, the State, or the federal government. The tribes themselves generally have regulatory authority over class I and class II gaming. Our audit is limited to class III gaming devices. As a California appellate court noted, class III Indian gaming is considered the most important part of the regulatory scheme imposed by the IGRA because it includes high-stakes casino-type games that may be a substantial source of revenue for the Indian tribes. The regulation of class III gaming has been the most controversial aspect of the IGRA and has been the subject of numerous lawsuits. For class III gaming to be permissible on federally approved tribal lands, those lands must be located in a state that permits that form of gaming. In addition, under the IGRA,

class III gaming can be conducted only after a tribe negotiates a compact with the state governing the conduct of gaming activities, the federal secretary of the interior approves the compact, and the tribe adopts an ordinance or resolution approved by the chair of the National Indian Gaming Commission.

The compact is the key to class III gaming under the IGRA. In approving a compact, federal law permits states and Indian tribes to develop joint regulatory schemes through the compact process. In this way a state gains the civil regulatory authority it might otherwise lack, and a tribe gains the ability to offer class III gaming. The IGRA permits the compact to include provisions relating to several issues that arise once class III gaming begins, including the assessment of fees by the State in amounts necessary to defray the costs of regulating gaming activities. It is important to note, however, that the extent of a state’s regulation over class III gaming on tribal lands is limited to the authority granted by the IGRA and by the federally approved tribal-state gaming compact.

Tribal-State Gaming Compacts in California

At the March 2000 primary election, Proposition 1A received voter approval. Proposition 1A amended the California Constitution to give the governor the authority to negotiate and enter into compacts, subject to ratification by the Legislature, and to give federally recognized Indian tribes the authority to operate slot machines, lottery games, and certain types of card games on Indian lands in California consistent with the IGRA. In 1999, anticipating voter approval of Proposition 1A, the State entered into 61 compacts (1999 compacts) with 60¹ of the 106 federally recognized Indian tribes in California at that time. The 1999 compacts later received final federal approval, as required by the IGRA. These compacts are effective until December 31, 2020, and are generally identical. Between 2003 and 2006 the governor negotiated and the Legislature ratified five additional compacts and amendments to eight of the original compacts (post-1999 compacts), with federal approval.

In June 2007 the Legislature ratified one new compact and four of five amendments to existing compacts. To take effect, the newly ratified compact and four amendments still require approval by the federal Secretary of the Interior. Therefore, we refer to the compact and amendments (including the one amendment that has yet to be ratified) as “pending compacts” throughout our report. As shown in Table 1 on the following page, the provisions in the 1999 compacts related to contributions to state-administered funds are significantly different from those in the post-1999 and pending compacts.

Subsequent to the ratification of the 1999 compacts, the governor directed the California Gambling Control Commission (gambling commission) to allocate gaming licenses to Indian tribes for the number of devices allowed in the original compacts, as described in the textbox. The gambling commission is also responsible for ensuring that the number of licenses issued statewide for certain compacts does not exceed the total number authorized by the compacts. In consideration for the State’s willingness to enter into these compacts, the tribes have agreed to provide to the State, on a sovereign-to-sovereign basis, a portion of their revenues from gaming devices. The terms of the compacts also recognize that the State has a “legitimate interest in promoting the purposes of the IGRA for all federally recognized Indian tribes in California, whether

Gaming Devices Allowed by the 1999 Compacts

Authorized Gaming Devices (no licenses required)

A tribe may operate the larger of the following without a gaming device license:

1. Grandfathered gaming devices, which are the devices a tribe had in operation on September 1, 1999.
2. Entitlement gaming devices, which are the first 350 gaming devices operated by the tribe.

Licensed Gaming Devices

A tribe may acquire licenses to use gaming devices in excess of the number the compact authorizes it to use, but cannot operate more than 2,000 gaming devices.

Source: 1999 Tribal-state gaming compacts.

¹ The Capitan Grande Band of Diegueno Mission Indians is a federally recognized tribe consisting of the Barona and Viejas groups, each of which signed a compact with the State.

Table 1
Summary of Revenue Provisions for Ratified and New Tribal-State Gaming Compacts

| | ORIGINAL COMPACTS | POST-1999 COMPACTS | | | PENDING COMPACTS* | |
|--|---|-----------------------------------|---|--|--|--|
| | 1999 COMPACT | 2003 COMPACT | 2004 COMPACT | 2004 AMENDMENT | RATIFIED COMPACT† | RATIFIED 2006 AMENDMENT‡ |
| NUMBER OF CLASS III DEVICES ALLOWED PER COMPACT | Up to 2,000 devices | From 350-2,000 devices per tribe | From 1,500-2,000 devices per tribe | Unlimited number of devices | Up to 39 devices | From 5,000-7,500 devices per tribe |
| CONTRIBUTIONS TO THE REVENUE SHARING TRUST FUND | Payments on a per-device basis | None | Payments on a per-device basis and contingent upon net wins | Payments of \$2 million annually per tribe; payment based on a per-device fee or flat fee based on the year of operation | None | Payments of \$2 million to \$3 million annually per tribe |
| CONTRIBUTIONS TO THE INDIAN GAMING SPECIAL DISTRIBUTION FUND | Payments based on percentage of net wins from devices operated as of September 1999 | None | None | None | None | None |
| CONTRIBUTIONS TO THE GENERAL FUND | None | Payments of 5 percent of net wins | Payment based on total number of devices in operation at the percentage of net wins | Payments based on total number of devices in operation or percentage of net wins Payments of \$5.75 million to \$33.8 million for certain tribes§ | Payments based on percentage of net wins | Payments of 15 percent to 25 percent of net wins from devices in excess of 2,000 Payment of \$20 million to \$45 million annually |

Sources: 1999 compacts, post-1999 compacts, and pending compacts.

* Though ratified, until approved by the federal Secretary of the Interior, the one new compact and four amended compacts cannot take effect and are therefore considered pending.

† This is a new compact with the Yurok Tribe.

‡ One amendment remains unratified by the Assembly.

§ A portion is designated for annual transportation bond payments made by five tribes totalling \$100.8 million per year.

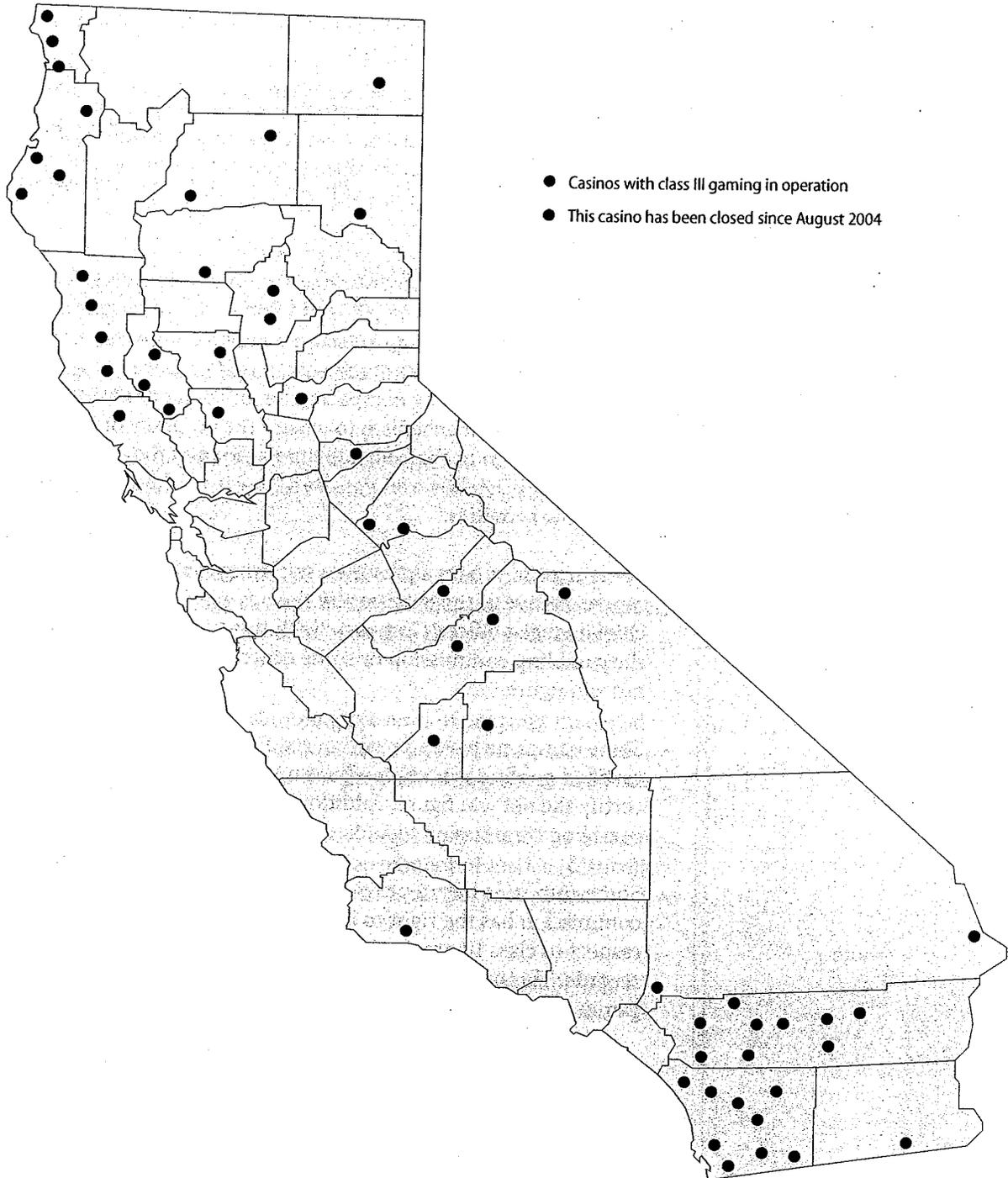
gaming or non-gaming.” To accomplish this goal, the compacts indicate that each of the State’s tribes without compacts or operating fewer than 350 devices (noncompact tribes) may receive distributions of \$1.1 million each year from the trust fund.

As of February 2007 California had ratified compacts with 66 of the federally recognized tribes in California, 56 of which operate a total of 57 tribal casinos. Figure 1 shows the casinos operating class III gaming devices by federally recognized Indian tribes in California. Appendix A lists the tribes with compacts and indicates the number of gaming devices each is currently allowed to operate.

California Gambling Control Commission

The gambling commission was created by the 1997 Gambling Control Act to serve as the regulatory body over gambling activities in the State, including Indian gaming. It has jurisdiction over the operation, concentration, and supervision of gambling establishments. A commission consisting of five appointed

Figure 1
Location of Indian Casinos Operating Class III Gaming Devices in California



Source: California Gambling Control Commission, December 2006.

Note: Map is an approximation and not drawn to scale. Icons are representative of approximate locations.

commissioners oversees and makes policy decisions for the gambling commission. The gambling commission performs audits and collects trust fund deposits based on quarterly license fees. The gambling commission also acts as the trustee of the trust fund and administers the distribution fund.

The gambling commission's regulatory authority includes auditing the books and records related to class III gaming operations of the Indian casinos that pay into the distribution fund and the State's General Fund to ensure, among other things, that their net win calculations are accurate. As described in more detail in Chapter 2, net wins, which are the amounts players put in the devices less the amounts paid out, are critical in determining the amount Indian casinos will contribute to the General Fund under the terms of new and amended post-1999 compacts and pending compacts. Although the specific provisions differ somewhat, based on our review of the post-1999 and pending compacts, the following provisions appear to provide a mechanism to ensure the accuracy of the tribes' contribution to the General Fund as long as the gambling commission consistently exercises its authority to complete any of the following activities:

- Some compacts have a provision requiring that an appointed representative of the tribe certify the net win figure, usually the chief financial officer. Compacts with this provision also allow for the gambling commission or some other state agency to audit the net win figure.
- Some compacts have a provision requiring that an independent certified public accountant who is not an employee of the tribe certify the net win figure. Additionally, the provision allows the gambling commission to audit the net win figure.
- Some compacts have a provision stating that the gambling commission has the right to inspect the gaming facility with respect to class III gaming and all related gaming operation records. This includes inspection and copying of the class III gaming operation papers, books, and records.

Indian Gaming Special Distribution Fund

The 1999 compacts call for each tribe that operates more than 200 grandfathered devices—those in operation as of September 1, 1999, before the compacts were ratified—to deposit a percentage of its average net wins into the distribution fund. The net win of a device is its gross revenue, or the amount players put in the device, less the amount paid out to winners. As shown

in Table 2, the percentage of average net wins for grandfathered devices deposited into the distribution fund ranges from 7 percent to 13 percent, depending on how many devices the tribe operates.

Table 2
Distribution Fund Tiered Payment Schedule for 1999 Tribal-State Gaming Compacts

| NUMBER OF DEVICES IN OPERATION AS OF SEPTEMBER 1, 1999 | PERCENTAGE OF AVERAGE GAMING DEVICE NET WIN |
|--|---|
| 201-500 | 7 |
| 500-1,000 | 10 |
| 1,000+ | 13 |

Source: Tribal-state gaming compacts ratified in 1999.

Note: Tribes with 200 or fewer devices in operation as of September 1, 1999 do not pay into the distribution fund.

The California Government Code (Government Code) reserves the money deposited into the distribution fund to address four needs prioritized as follows:

1. Supporting the trust fund to ensure that it can distribute \$1.1 million annually to each tribe that does not have a compact; a total of \$50.5 million was allocated to this purpose in fiscal year 2005-06.
2. Funding the problem-gambling prevention program managed by the Department of Alcohol and Drug Programs; a total of \$3 million was allocated to this purpose in fiscal year 2005-06.
3. Paying the operating costs for the regulatory functions of the gambling commission and the Department of Justice (Justice); a total of \$16 million was allocated to this purpose in fiscal year 2005-06.
4. Supporting local governments impacted by tribal gambling; a total of \$50 million was allocated to this purpose in fiscal year 2005-06.

Indian Gaming Revenue Sharing Trust Fund

As part of their agreement to the 1999 compacts, tribes that purchase licenses for gaming devices must contribute to the trust fund. For each license it purchases, a tribe under a compact must pay into the trust fund a nonrefundable one-time prepayment fee of \$1,250. The compact also requires tribes to pay license fees each quarter. It uses a graduated rate schedule, based on the number of licensed gaming

devices a tribe has, to determine the amount of the quarterly license fee a tribe pays, as shown in Table 3. The gambling commission made its first distribution to the noncompact tribes—tribes without compacts or operating fewer than 350 gaming devices—in May 2001 and has attempted to make distributions of \$1.1 million annually to each noncompact tribe since that time. However, trust fund revenues have never provided sufficient money to make the full annual distribution to the noncompact tribes. Therefore, since fiscal year 2002–03, transfers from the Indian Gaming Special Distribution Fund of \$45.3 million to \$50.6 million per year have been made to supplement those distributions.

Table 3
Revenue Sharing Trust Fund Tiered Payment Schedule for 1999 Tribal-State Gaming Compacts

| NUMBER OF LICENSED DEVICES | FEE PER DEVICE PER YEAR |
|----------------------------|-------------------------|
| 350-750 | |
| 751-1,250 | |
| 1,251-2,000 | |

Source: Tribal-state gaming compacts ratified in 1999.

Note: Tribes with fewer than 350 licensed devices do not contribute to the Revenue Sharing Trust Fund.

Problem-Gambling Prevention Program

Administered by the Department of Alcohol and Drug Programs, the Office of Problem Gambling is the second priority for the use of distribution fund money and received \$3 million in fiscal year 2005–06. According to a deputy director, the Department of Alcohol and Drug Programs used roughly \$1.6 million of this allocation for conducting public awareness campaigns and operating toll-free crisis management telephone lines; slightly more than \$800,000 to perform various research and needs assessments; and the remainder to survey the gambling industry, develop publications, convene an advisory group, and administer and monitor the program.

Regulatory Activities of the Gambling Commission and Justice

The gambling commission received \$6.2 million and Justice received \$9.8 million in fiscal year 2005–06 for regulatory activities related to Indian gaming. The gambling commission states that it used the funds to administer the process of drawing gaming device licenses; account for all gaming device license fees; ensure that the

allocations of gaming devices among California Indian tribes do not exceed the allowable numbers provided in the compacts; and perform various auditing functions, including conducting audits of quarterly contributions, performing quarterly desk reviews, certain licensing functions, and handling net win reporting issues.

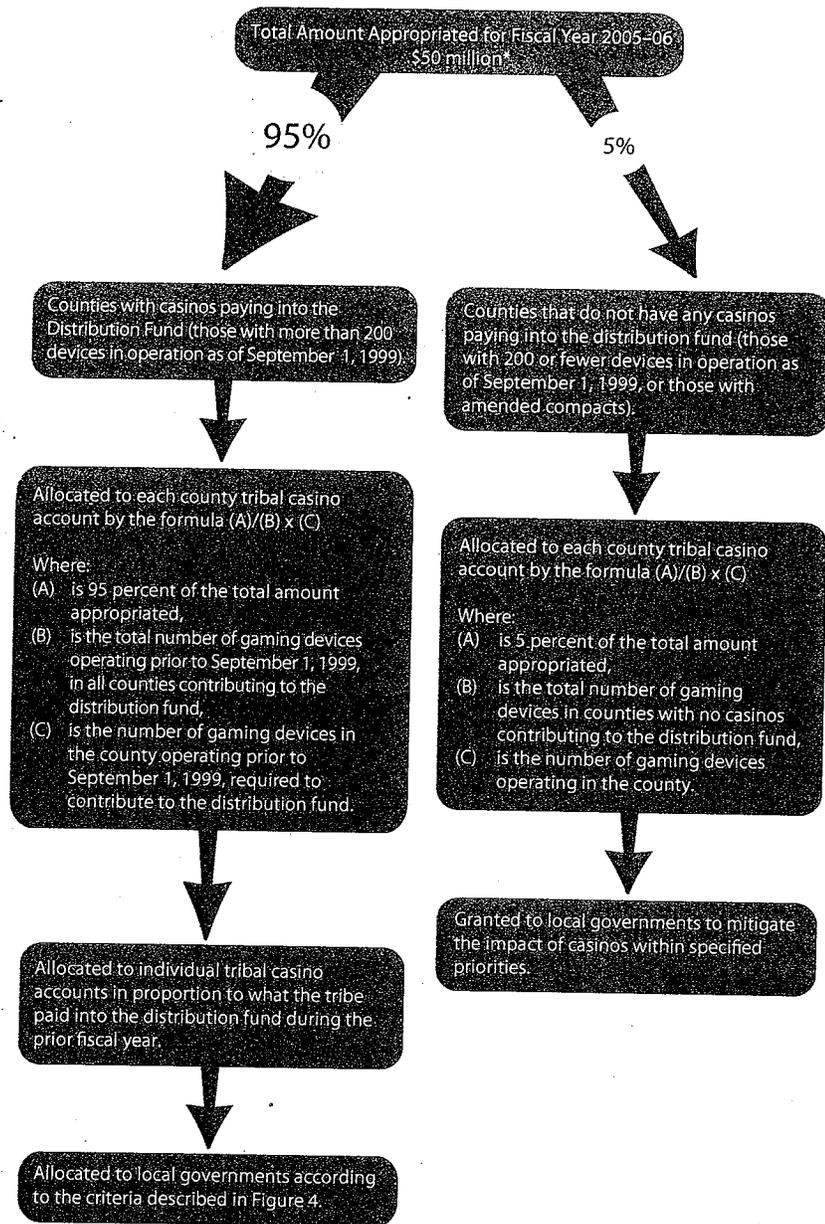
Justice states that it uses its distribution fund allocation to support the Indian gaming-related regulatory activities of its four divisions: Division of Gambling Control, Division of Public Rights, Executive Division, and Hawkins Data Center. For example, the Indian Gaming Law Section of the Division of Public Rights monitors Indian gaming practices and consults and advises the governor on compact negotiations and Indian law issues, and the Division of Gambling Control works with other state gaming agencies and tribal governments to regulate class III gaming on tribal lands.

Local Governments Affected by Tribal Gambling

Each year the Department of Finance (Finance), in consultation with the gambling commission, is required to calculate the total revenue in the distribution fund available to grant to local governments for projects intended to mitigate the adverse effects of casinos. Finance includes that information in the May budget revision. The State Controller's Office (Controller), in consultation with the gambling commission, then determines the allocation from the budget act for eligible counties to use for mitigation projects. As shown in Figure 2 on the following page, the funds allocated for mitigating casinos' impacts are further divided between counties with casinos that contribute to the fund because they operate more than 200 grandfathered devices and counties with casinos operating 200 or fewer devices on September 1, 1999, or some of those with tribes that have post-1999 compacts. The funds are then allocated to the county tribal casino account in each county. In each county where tribes have been operating devices since September 1, 1999, and pay into the distribution fund, the money is further allocated into a tribal casino account for each tribe based on the amount it paid into the distribution fund in the previous fiscal year.

In fiscal year 2005-06 the governor decreased the amount of funding available for mitigation grants in the budget act by \$20 million because some counties were not providing Finance with the required annual reports on the use of distribution fund spending. However, in March 2006, the Legislature passed Senate Bill 288, which immediately reinstated the \$20 million in funding and required counties to submit their annual reports by October 1 to the chair of the Joint Legislative Budget Committee, the chairs of the Senate and Assembly committees on governmental

Figure 2
Allocation of Funding From the Distribution Fund to Local Governments

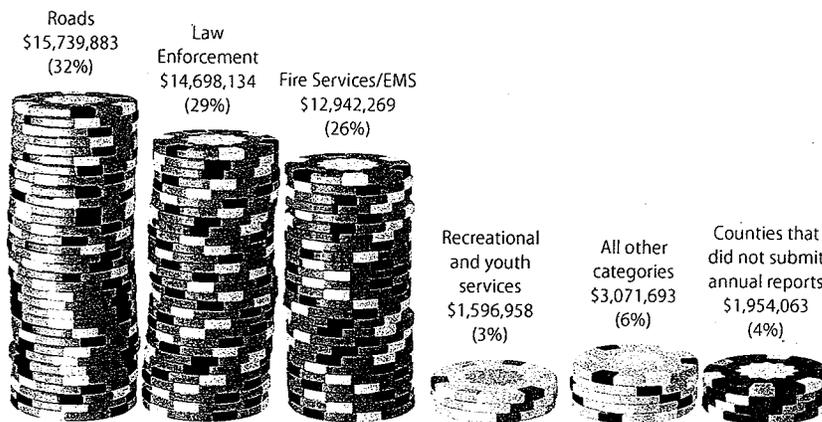


Source: California Government Code, sections 12714 and 12715.

* \$30 million appropriated from the budget act and an additional \$20 million pursuant to Senate Bill 288, Chapter 13, Statutes of 2006.

organization, and the gambling commission. Counties administering grants from the distribution fund are now required to include detailed information on the mitigation projects they fund in their annual reports. Figure 3 shows a summary of the purposes that counties reported spending their distribution fund allocations on for fiscal year 2005–06.

Figure 3
Total Mitigation Expenditures From the Distribution Fund by Category, as Described in County Annual Reports



Source: Fiscal year 2005–06 annual reports submitted by counties.

The \$50 million allocated to local governments in fiscal year 2005–06 was divided among 25 counties that issued 200 grants. The amount received by each county varied considerably. As shown in Appendix B, Modoc County received the least of any county and elected not to spend the funds it was allocated, so the funds were returned to the distribution fund for reallocation during the next fiscal year. Riverside County received the most—almost 43 percent of the \$50 million—and distributed it in 79 grants averaging over \$260,000 each.

To award grants from the distribution fund, each county is required to form an Indian Gaming Local Community Benefit Committee (benefit committee). The benefit committee is composed of two county representatives selected by the county board of supervisors, three elected representatives selected by the county board of supervisors from cities located within 4 miles of a tribal casino, and two representatives selected on the recommendation of a majority of the county’s tribes paying into the distribution fund. San Diego County’s representation differs slightly because only one city is located within 4 miles of a casino. Its benefit committee consists of two representatives of the county selected by the county board

of supervisors, one elected representative selected by the board of supervisors from the city located within 4 miles of a tribal casino, three representatives selected on the recommendation of a majority of the county's tribes paying into the distribution fund, and the sheriff of San Diego County.

Responsibilities of Indian Gaming Local Community Benefit Committees

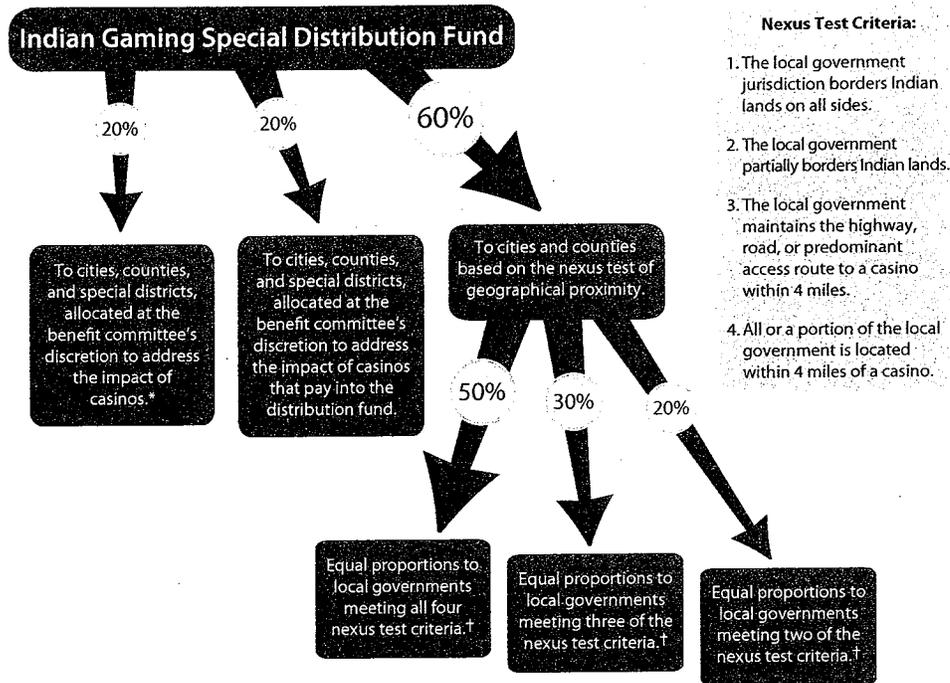
- Awarding grants.
- Ensuring funds are allocated according to priorities established by law.
- Establishing all application policies and procedures for grants from the Individual Tribal Casino Account or County Tribal Casino Account.
- Assessing the eligibility of applications for grants from local jurisdictions impacted by tribal gaming operations.
- Determining the appropriate amount for reimbursement from the aggregate county tribal account of the demonstrated costs incurred by the county for administering the grant program (not to exceed 2 percent of the total county allocation).

Source: California Government Code, Section 12715.

As described in the text box, the benefit committee is responsible for establishing procedures for allocating funds to local governments within the county and for selecting eligible applications for the distribution of funds. To correctly allocate funds to local governments, benefit committees must follow a set of criteria established in the Government Code, as shown in Figure 4. These criteria are intended to provide a fair and proportionate system to award grants to local governments impacted by tribal gaming.

After the benefit committees award grants and receive affirmative sponsorship of the tribes from whose individual tribal casino accounts the funds are being distributed, the Controller releases the funds directly to the selected local government entities. Although multiyear grants are allowed, any money that counties do not grant by the end of the fiscal year reverts to the distribution fund. Grants are administered by the county, which can be reimbursed up to 2 percent of the funds for demonstrated administrative expenses.

Figure 4
Allocation of Funds From County Tribal Casino Accounts and Individual Tribal Casino Accounts



Source: California Government Code, Section 12715.

* Grants awarded are limited to service-oriented and one-time large capital projects subject to the sponsorship of tribes paying into the fund.

† These funds may be reallocated to local governments meeting a different number of nexus test criteria if no local governments meet the required number of criteria.

Scope and Methodology

Government Code, Section 12717, requires the Bureau of State Audits to conduct an audit every three years regarding the allocation and uses of moneys from the distribution fund by the recipients of the grant money and report its findings to the Legislature and all other appropriate entities.

To determine if distribution fund money is allocated appropriately to each county, we verified the Controller's calculation of the amounts deposited in each county's account for the same period. Using factors including the amount of funding received and geographic location, we evaluated the use of distribution fund grants at six counties: Fresno, Placer, Riverside, San Bernardino, San Diego, and Sonoma. We reviewed the composition of the benefit committees to ensure their membership met the requirements of state law, and we requested copies of members' conflict-of-interest filings. We also reviewed the Controller's claim

schedules to ensure that county claims for administrative costs did not exceed 2 percent of the annual allocation, and we ensured that counties allocated distribution fund money by the end of the fiscal year or that it reverted back to the distribution fund.

To determine if grant funds are being appropriately awarded at the county level, we reviewed county and benefit committee policies and procedures and interviewed county staff regarding the awarding of distribution fund grants. We reviewed the eligibility of local governments in each sample county and assessed whether the county allocated funds appropriately according to the criteria in state law.

To determine if each grant awarded at the counties we sampled had a reasonable relationship to a casino's impact and satisfied one of the purposes required in state law, we obtained annual reports for fiscal year 2005-06 grants, which were the most recent available at the time of our audit, and selected a sample of five grants at each county using criteria such as the amount of the grant, the amount of funds remaining, and the type of project. We then reviewed grant applications describing the selected projects and their relationships to casinos' impacts, interviewed grantee staff, and obtained supporting documentation of those impacts. In addition, for large capital projects or those with significant amounts of funding not spent, we determined if interest earned on unspent funds was used for projects intended to offset the effects of casinos.

To verify that counties submit required annual reports, we requested the fiscal year 2005-06 reports from the gambling commission and all required legislative committees for each county that receives money from the distribution fund.

Finally, to determine the ability of the distribution fund to continue to fund the programs that depend on it, we compared fiscal year 2005-06 distribution fund contributions to estimated future contributions based on changes in compact provisions in new and amended pending compacts. We then compared these to current-year expenditures from the distribution fund. Because we are unable to project how fast casinos will expand or forecast the changes to their profitability, we made a conservative estimate based on fiscal year 2005-06 gaming device counts and net win figures.

Chapter 1

CURRENT PROVISIONS IN THE LAW LED TO QUESTIONABLE USES AND AN INEQUITABLE DISTRIBUTION OF FUNDS

Chapter Summary

Our review indicates that local governments—cities, counties, and special districts—have not always used grants allocated from the Indian Gaming Special Distribution Fund (distribution fund) to finance projects that directly mitigate the adverse impact Indian gaming has on communities. Of the 30 grants we reviewed in six counties, 10 were used for projects benefiting the entire county and were only partially related to the effects of casinos, and five were not related to casinos' impacts. Although counties might find it reasonable to use distribution fund grants to help finance a project that benefits the entire county, as a best practice a local government should only use distribution fund money to cover the portion of the project related to the impact of a casino and use other sources for the portion of the project that benefits the entire county. The legislation creating the grant program declares as its intent that tribal governments participate in the process of identifying and funding the mitigation of impacts from casinos. However, the law does not specifically require that all projects funded by the grants be directly related to offsetting the adverse impacts of casinos. When a distribution fund grant is used for purposes that have little or no relationship to a casino's impacts, the influence of the casino may not be adequately addressed.

Tribes with new and amended tribal-state gaming compacts (post-1999 compacts) are not required to contribute to the distribution fund but must negotiate directly with local governments for mitigation projects. However, two counties with tribes that have post-1999 compacts received roughly \$850,000 in distribution fund money in fiscal year 2005–06. Although this distribution fund money may benefit the citizens of those counties receiving mitigation funding from two sources, it leaves less of the distribution fund available to other local governments that have only one source of funding to offset the negative impacts of casinos.

Local governments have not always begun using distribution fund grants immediately after receiving them. In fact, some local governments we reviewed had not expended their grants several years after receiving the money. Consequently, these local governments have earned interest on their unspent grant funds, but they have not always spent the interest on projects that relate to the effects of casinos. Although the law does not provide guidance on what to do with interest earned on unspent grant funds, our

legal counsel advised us that, as a general rule, the interest must be used for the same purpose as the principal project. Nonetheless, we found that interest was not always used for the project for which the funds were awarded or for future mitigation projects.

Counties could improve their administration of the distribution of grant funds and their disclosure of information. Some counties awarded distribution fund grants to ineligible applicants, leaving fewer funds for distribution to eligible entities. Further, some tribal representatives on the Indian Gaming Local Community Benefit Committee (benefit committee) in each county we reviewed failed to file required statements of economic interests. When designated individuals do not file statements of economic interests, benefit committees may be unaware of conflicts of interest and cannot ensure that members are aware that they should remove themselves from making decisions that may pose conflicts of interest. Finally, according to documentation provided by the gambling commission and various legislative committees, only nine of the 24 counties receiving distribution funds in fiscal year 2005–06 submitted all the required annual reports to the California Gambling Control Commission (gambling commission) and the Legislature detailing the use of current- and prior-year distribution fund grants. When local governments fail to submit the required annual reports, it is difficult for the public and the Legislature to determine if funds are being spent as intended.

Local Governments Did Not Always Use the Distribution Fund to Pay for Mitigation Projects

The legislation establishing the distribution fund declares the intent of the Legislature that tribal governments participate in identifying and funding the mitigation of the impacts of tribal gaming through the grant process. The legislation also states that the grants are for distribution to local governments impacted by casinos. Finally, the senate floor analysis describes the legislation creating the distribution fund and grant process as establishing “priorities and procedures. . . for the purpose of mitigating impacts from tribal casinos.” However, the legislation does not establish a clear requirement that the grants be used only for projects that actually mitigate the impacts from tribal casinos in all instances. As a result, distribution fund grants are not always being used to address the adverse consequences to local governments of the location and operation of Indian casinos in their communities.

Based on our review of 30 grants, we determined that often a distribution fund grant financed a project that had the potential of offsetting the repercussions of a casino but was mainly used for

None of the six counties we visited consistently used grant funds for projects that solely address the impacts of casinos.

We found that local governments are not always using grant funds to mitigate the impacts of casinos on communities most directly affected. We reviewed 30 distribution fund grants awarded by six counties—five grants in each county—and found that none of the six counties consistently used the grant funds solely for projects that mitigate the impact of casinos. As shown in Table 4, the number of instances when grant funds were not used solely to reduce adverse consequences of casinos ranged from one of the five grants we tested in San Bernardino County to all five of the grants we tested in Sonoma County. In 10 instances the goods and services purchased with grant money had the potential for use in mitigating casinos' impacts, should the needs arise. However, the main beneficiaries were the counties as a whole because the projects had little connection to casinos. For example, the Fresno County Sheriff's Department received a distribution fund grant totaling \$658,000 of which \$515,000 was to purchase 650 handguns and other weapon-related equipment. However, only four deputies are assigned to work the area where the casino is located. Although other deputies might be called on to respond to a situation involving the casino, it is apparent that the purchase benefits all Fresno County residents and not just those affected by the casino.

Table 4
Uses of Distribution Fund Grant Money by Local Governments

| COUNTY | NUMBER OF GRANTS (FUNDS GRANTED) | | |
|----------------|--|--|---|
| | 17 PERCENT OF PROJECTS REVIEWED DO NOT ADDRESS A CASINO IMPACT | 33 PERCENT OF PROJECTS REVIEWED ARE PRIMARILY NON-CASINO RELATED | 50 PERCENT OF PROJECTS REVIEWED ADDRESS A CASINO'S IMPACT |
| Placer | 2 (\$127,885) | — | 3 (\$324,738) |
| Fresno | 1 (\$68,120) | 1 (\$658,486) | 3 (\$1,211,555) |
| Sonoma | 1 (\$52,247) | 4 (\$334,852) | — |
| Riverside | 1 (\$257,000) | 2 (\$771,300) | 2 (\$289,224) |
| San Diego | — | 2 (\$366,884) | 3 (\$4,660,000) |
| San Bernardino | — | 1 (\$170,000) | 4 (\$2,825,741) |
| Totals | 5 (\$505,223) | 10 (\$2,301,522) | 15 (\$9,311,258) |

Source: Bureau of State Audits' review of fiscal year 2005-06 Indian Gaming Special Distribution Fund grants.

In another instance, the San Bernardino County Consolidated Fire District (fire district) was awarded a \$170,000 distribution fund grant. The fire district intends to use the money to purchase a rescue/ambulance boat and hire additional staff for holiday weekends. In its grant application, San Bernardino County officials stated that the influx of holiday visitors and recreational vehicles result in accidents on or near Lake Havasu. According to an analyst with the fire district, the Lake Havasu area's population of 50,000 triples on holiday weekends because of visitors, but the fire district does not know how many visitors come to use the casino. The casino is relatively small—6,900 square feet, with 220 slot machines and five table games—and the fire district's application does not mention the other recreational activities that draw visitors to the 25,000-acre lake. However, the Web site of the chamber of commerce of Lake Havasu City, Arizona, which is located directly across the lake from the casino, states that the major attractions to the area are the recreational activities offered by the lake, including boating, fishing, camping, and annual festivals, as well as the London Bridge, which was relocated to Lake Havasu City in 1971 and draws more than 500,000 visitors to the area each year. Therefore, it appears likely that the rescue/ambulance boat and additional staff will be used mainly for purposes other than those related to the casino.

We acknowledge that these and other purchases are beneficial to the counties. However, it is unclear whether the Legislature intended for distribution fund grants to be used to pay for goods and services that would be used mainly for incidents unrelated to a casino. Although counties might find it reasonable to use distribution fund grants to purchase goods or services that benefit the entire county, we believe that the intent of the law is to offset the adverse effects of casinos and that local governments should use other sources of money to pay for the portion of the acquisition expected to be used for activities unrelated to a casino. For example, the San Diego County Sheriff's Department requested a distribution fund grant totaling \$750,000 to partially fund the purchase of a new \$6 million sheriff's station intended to meet the public safety needs of the surrounding communities and tribal lands. The sheriff's department provided us with data indicating the percentage of adult arrests that were casino-related, which was actually greater than the proportion of distribution fund money used for the new station. The remaining project costs will be paid for with funds from other sources.

In other cases grants were used for projects with no apparent direct relationship to casinos' impacts. For example, a distribution fund grant totaling more than \$52,000 was awarded to the Healdsburg District Hospital (hospital) in Sonoma County to purchase and install surveillance cameras at strategic locations on the roof of

Although Healdsburg District Hospital was awarded \$52,000 to purchase and install surveillance cameras because of vandalism and other disturbances at the hospital, it did not provide any evidence of the connection between these acts and the casino.

the hospital. The cameras monitor the hospital's parking areas and building entryways. In its grant application the hospital claimed that it experienced several acts of vandalism in the parking areas and disturbances in the patient waiting area of the emergency department. However, the hospital did not provide evidence of any connection between the vandalism or disturbances and the casino, which is located 10 miles away. Nor did the hospital's application include data showing that the number of criminal incidents at the hospital had increased since the casino was built. Furthermore, the hospital only used \$18,900 of the grant award on the surveillance cameras. The remaining money was used to purchase a defibrillator and to purchase and install a pharmacy climate control system. These purchases occurred even though the Sonoma County benefit committee approved only the hospital's request to purchase and install surveillance cameras in its application and did not authorize and was not informed by the hospital of the decision to spend grant funds on other items.

When a distribution fund grant is used for purposes that have little or no relationship to a casino impact, the problems the community experiences because of a casino will not be adequately addressed. Ultimately, it is the citizens living and doing business in the areas surrounding the casino who will suffer the consequences.

Compacts Ratified Since 1999 Require Tribes to Directly Fund Efforts to Mitigate Casinos' Impacts, but Local Governments Continue to Receive Distribution Fund Money

Post-1999 compacts require tribes to negotiate directly with local governments to pay for local mitigation projects in lieu of paying into the distribution fund. However, based on the allocation methodology established in state law in 2004, two counties where casinos under post-1999 compacts are located received roughly \$850,000 in distribution fund money in fiscal year 2005-06. Local governments in those counties received money for projects that, in accordance with the post-1999 compacts, should have been funded directly by the tribes. Consequently, less distribution fund grant money is available to other counties where tribes are not required to provide funding directly to local governments.

As described in the Introduction, 60 of California's Indian tribes entered into the 61 compacts signed in 1999.² All the 1999 compacts contained materially identical terms, including a provision requiring tribes operating casinos to make annual contributions

Although two tribes negotiated directly with local governments to pay for mitigation projects and did not pay into the distribution fund, based on the allocation methodology established in state law, the two counties where these tribes are located still received \$850,000 from the distribution fund in fiscal year 2005-06.

² The Capitan Grande Band of Diegueno Mission Indians is a federally recognized tribe consisting of the Barona and Viejas groups, each of which signed a compact.

to the distribution fund based on the net wins of gaming devices in operation on September 1, 1999. Since the ratification of the 1999 compacts, five new and eight amended compacts have been ratified. However, the post-1999 compacts do not include provisions requiring tribes to make annual contributions to the distribution fund. Instead, they require the tribes to negotiate directly with local governments to pay for mitigation projects.

An allocation method was established in state law in 2004 to equitably distribute grant money from the distribution fund to counties affected by Indian gaming. As explained in the Introduction, counties where tribes are not obligated to make contributions to the distribution fund receive 5 percent of the total amount the Legislature appropriates for grants to local governments, and counties where tribes must make contributions to the distribution fund receive 95 percent of the total appropriation. However, the California Government Code (Government Code) has not been amended to address the changes to mitigation funding caused by the post-1999 compacts.

As shown in Figure 5 on the following page, when a tribe that currently contributes to the distribution fund agrees to an amended compact that replaces provisions for contributing to the distribution fund with requirements to negotiate directly with local governments, one of two situations occurs. If another casino in the county is contributing to the distribution fund, the total allocation to the county is reduced because it is based in part on the number of grandfathered devices operating in the county by casinos contributing to the distribution fund. Because one casino is no longer contributing to the distribution fund, its grandfathered devices are not included when calculating that county's allocation. Alternatively, if no other casinos in the county are contributing to the distribution fund, the county becomes one of those receiving 5 percent of the Legislature's appropriation; however, the county continues to receive money from the distribution fund because that allocation is based in part on the total number of gaming devices in the county. Thus, if no other casino is contributing to the distribution fund, the county continues to receive an allocation for the casino's gaming devices, although the casino is required to negotiate with the county directly to mitigate any impact the operation of the casinos housing those machines may be causing. The county then has an advantage over other counties because it receives mitigation funding from two sources: the distribution fund and the tribes. At the same time, the amount of distribution fund money available to the remaining counties affected by casinos is reduced.

One amendment to an existing compact that has not yet been ratified by the Assembly also requires the tribe to negotiate directly with local governments and will further exacerbate the problem just

The California Government Code has not been amended to address the changes to mitigation funding caused by the post-1999 compacts.

Figure 5
Illustration of How Amended Compacts Can Affect Distribution Fund Allocations

| \$30,000,000 TOTAL ALLOCATED | | | | | | | |
|--|---|--------------------|---|------------|--------------------|------------------|---------------------------|
| Allocation to county (c or 3) = | $\frac{\text{Devices contributing to fund in county (a or 1)}}{\text{Devices contributing to fund in all counties (b or 2)}} \times \$28,500,000$ | | 95% allocated to counties paying into the fund | | | | |
| Allocation to county (f or 6) = | $\frac{\text{Total devices in county (d or 4)}}{\text{Total devices in counties not contributing (e or 5)}} \times \$1,500,000$ | | 5% allocated to counties not paying into the fund | | | | |
| PRE-AMENDMENT | | | POST-AMENDMENT | | | | |
| | DEVICES | ALLOCATION FORMULA | DOLLARS RECEIVED | DEVICES | ALLOCATION FORMULA | DOLLARS RECEIVED | |
| County A | | | | | | | |
| Grandfathered devices contributing to fund | 5,000 (a) | 95% | \$14,250,000 (c) | 2,000 (1) | 95% | \$11,400,000 (3) | Plus \$ direct from tribe |
| Grandfathered devices not contributing to fund | 0 | | | 3,000 | | | |
| Non-grandfathered devices | 3,000 | | | 3,000 | | | |
| Total devices | 8,000 | | | 8,000 | | | |
| County B | | | | | | | |
| Grandfathered devices contributing to fund | 2,000 (a) | 95% | \$5,700,000 (c) | 0 | | | |
| Grandfathered devices not contributing to fund | 0 | | | 2,000 | | | |
| Non-grandfathered devices | 1,000 | | | 1,000 | | | |
| Total devices | 3,000 | | | 3,000 (4) | 5% | \$300,000 (6) | Plus \$ direct from tribe |
| County C | | | | | | | |
| Grandfathered devices | 0 | | | 0 | | | |
| Non-grandfathered devices | 3,000 | | | 3,000 | | | |
| Total devices | 3,000 (d) | 5% | \$375,000 (f) | 3,000 (4) | 5% | \$300,000 (6) | Plus \$ direct from tribe |
| County D (No amendment negotiated) | | | | | | | |
| Grandfathered devices | 0 | | | 0 | | | |
| Non-grandfathered devices | 3,000 | | | 3,000 | | | |
| Total devices | 3,000 (d) | 5% | \$375,000 (f) | 3,000 (4) | 5% | \$300,000 (6) | (No money from tribe) |
| Other counties not presented | | | | | | | |
| Grandfathered devices contributing to fund | 3,000 | | | 3,000 | | | |
| Total devices in counties not contributing | 6,000 | | | 6,000 | | | |
| Total devices contributing | 10,000 (b) | | | 5,000 (2) | | | |
| Total devices in counties not contributing | 12,000 (e) | | | 15,000 (5) | | | |
| Grandfathered devices not contributing to fund and non-grandfathered devices in 95% counties | 4,000 | | | 6,000 | | | |
| Total devices | 26,000 | | | 26,000 | | | |

Source: Bureau of State Audits' hypothetical examples based on compact terms and California Government Code, Section 12715.

described. If the amendment with the San Manuel Band of Mission Indians (San Manuel Band) in San Bernardino County is ratified, the county will no longer have any devices requiring a contribution to the distribution fund and will therefore receive a portion of the 5 percent funding share allocated to counties that do not have devices contributing to the distribution fund. This allocation will be based on the total number of devices in the county, including those operated by the San Manuel Band. As a result, San Bernardino County will be able to negotiate directly with the San Manuel Band to fund local mitigation projects and will also receive money from the distribution fund for the same purpose.

The situation possible in San Bernardino County already exists in Placer County, which has been eligible for funding from both sources because of the compact with the United Auburn Indian Community (Auburn Indian Community) that was amended in 2004. Placer County has always been eligible for a portion of the 5 percent funding share allocated to counties that do not contribute to the distribution fund; however, the post-1999 compact with the Auburn Indian Community also requires the tribe to negotiate directly with Placer County to pay for projects intended to offset the effects of casino construction or expansion. In fiscal year 2005-06, in addition to the \$765,000 Placer County received from the distribution fund, it also receives \$2.1 million in annual funding through direct negotiations with the Auburn Indian Community, both amounts for the purpose of financing mitigation projects. Although the grant money might benefit the citizens of Placer County, by receiving funding from two sources the county decreases the grant funds available for other cities and counties that depend solely on distribution fund grants to address the impact of casino operations.

Interest That Local Governments Earned on Unspent Distribution Fund Money Has Not Always Gone Toward Mitigation Projects

Some local governments have earned interest on distribution funds until the funds are needed for the intended project. In many instances, large amounts of grant money remained unspent for more than a year, and the local governments indicated to us that the interest earned was not always allocated back to the original mitigation project or used for similar future projects. In fact, several local governments we spoke to use the interest to pay for general operational costs. In some cases local governments did not even earn interest, instead depositing the grant funds in accounts that generate no interest.

The United Auburn Indian Community provided Placer County with an annual payment of \$2.1 million to mitigate the impact of the casino through direct negotiations. In addition, although this tribe did not pay into the distribution fund, the county received \$765,000 from the distribution fund for the same purpose.

Counties that administer distribution fund grants are required to submit annual reports that describe, among other things, the amount of each grant they received, the intended use of the grant, and the amount of money spent to date. We reviewed the annual reports submitted by 17 counties for fiscal year 2005–06. In addition to information on fiscal year 2005–06 grants, the reports contained information on funds remaining from grants awarded in previous fiscal years. Our review revealed 14 instances when counties had not spent at least \$100,000 of the distribution fund grant money awarded them more than a year after receiving the funds. In fact, according to the annual reports, as of June 30, 2006, the 17 counties had not spent a total of \$1.3 million (5.5 percent) of the \$23.4 million awarded to them in fiscal year 2003–04 and \$6.3 million (23 percent) of the \$28.1 million awarded to them in fiscal year 2004–05. This is not surprising given the long-term nature of many of the capital improvement projects selected by benefit committees. For example, Yolo County received total grant awards of \$426,000 in fiscal year 2003–04 and \$511,000 in fiscal year 2004–05. However, as of June 30, 2006—the date of the most recent annual report—the county had spent only \$61,000 of its fiscal year 2003–04 grant awards and \$169,000 of its fiscal year 2004–05 grant awards. Likewise, local governments in San Diego County received \$5 million in grants for fiscal year 2004–05 but as of June 30, 2006, had spent only \$2.4 million.

Many local governments we visited used the interest earned on unspent distribution fund money for general county purposes rather than on the original mitigation projects or future projects with a similar purpose. Several local governments asserted that the Government Code grants them authority to use interest earned on that money for general purposes. Our legal counsel advised us that although the law does not specifically require a local government to allocate interest earned on unspent grant funds to original or future mitigation projects, the Government Code section cited by local governments states that earned interest may be deposited in their general funds unless otherwise specified by law. The purposes for which distribution fund money may be spent are set forth in the compacts and state law. Accordingly, our counsel advised us that the interest on distribution fund money is subject to the common law rule that unless it is separated by statute from the principal, the interest should be used for the originally intended purpose. Thus, we believe the interest should be used to support mitigation projects.

Apparently, many local governments did not consider whether other legal restrictions applied to the use of the interest earned on distribution fund money. Consequently, many local governments we visited told us that they do not have procedures in place to ensure that interest earned is allocated to the originally funded project or to another project that will alleviate a casino impact.

The purposes for which distribution fund money may be spent are set forth in the compacts and state law. Accordingly, our counsel has advised that the interest on distribution fund money should be used for mitigation projects.

For example, officials in San Bernardino County acknowledged that they have not allocated interest earned on unused distribution fund money to a casino-related purpose. From fiscal year 2003–04 through fiscal year 2005–06, the city of Highland in San Bernardino County received \$2.2 million for a road improvement project. However, as of March 2007 it had spent only about \$63,000. City officials estimate that the city has earned roughly \$133,000 in interest, all of which has been used to pay for other capital project costs rather than mitigation projects. Officials from Highland stated that beginning in July 2007 it would use interest generated from Indian gaming funds for the same purpose as the original funds.

Our review revealed similar examples in two other counties. In San Diego County, the sheriff's department received two grants totaling \$899,000, of which \$750,000 remained unspent at the time of our audit. These funds are kept in the county's general fund and, according to the county sheriff's department, approximately \$41,700 in interest earned from these funds was not allocated to mitigation projects. Similarly, officials from two local governmental entities in Riverside County stated that they do not use interest earned from distribution fund grants for casino-related projects. Rather, one local government allocates the interest to its operating fund and uses it for general purposes, and the other local government transfers the interest earned from distribution fund grants to the city's general fund but indicated to us that it will allocate interest earned to the distribution fund beginning in fiscal year 2006–07. Further, we noted two grants in San Bernardino County totaling \$879,000, two grants in Riverside County totaling \$613,000, and two grants in Placer County totaling \$187,000 that local officials indicated were maintained in accounts that earned no interest. Had these six grants totaling roughly \$1.7 million been deposited in an account that paid interest, these counties could have earned additional funds for their mitigation projects.

One county we reviewed has procedures in place to ensure that interest earned on grants from the distribution fund is used to assist local governments adversely affected by Indian casinos. Fresno County places the distribution fund money it receives in a county account and reimburses individual departments for expenses they incur for casino-related mitigation projects. This practice allows Fresno to account for any interest earned and to use the interest for future projects related to offsetting the effects of casinos.

City officials estimate that the city of Highland in San Bernardino County has earned roughly \$133,000 in interest, all of which has been used to pay for purposes other than mitigation.

Allocations to Counties Were Calculated Correctly, but Counties and Benefit Committees Need to Improve Their Administration of Distribution Fund Grants

The State Controller's Office (Controller) correctly allocated distribution fund money designated for the support of local governments affected by tribal gaming. However, local governments have failed to meet several requirements of state law and could improve other aspects of their administration of distribution fund grants. Our review revealed that one county inconsistently applied the criteria used to allocate distribution funds, and did not adhere to the amounts determined pursuant to its allocation methodology. Moreover, we noted that benefit committees awarded grant funds to ineligible entities, which reduces the amount of funding available for eligible entities. We also found that benefit committees did not require all their members to file statements of economic interests, and many counties failed to submit required annual reports to all designated entities. When committee members fail to file required statements of economic interests, local benefit committees may be unaware of conflicts of interest, and cannot ensure that the committee members are aware of their responsibility to remove themselves from making certain decisions. Further, when counties do not submit annual reports, the Legislature and the public have no assurance that funds are being spent as intended.

Grant Allocations Have Generally Been Properly Calculated, but Some Local Governments Were Not Awarded the Amounts They Were Allocated Through the Nexus Test

The Controller accurately calculated grant allocations to each county based on the budget act and information received from the gambling commission. To distribute grant funds in a fair and efficient manner while giving priority for funding to local governments affected by casinos paying into the fund, state law requires the Controller to use the allocation methodology described in the Introduction to determine the amount of money each county should receive. Additionally, state law requires a county receiving distribution fund money to allocate a portion of its funding to local governments based on the nexus test criteria listed in Figure 4 in the Introduction.

We found that counties generally conducted the nexus test using the required criteria. However, our review identified one county that inconsistently applied the nexus test criteria and did not always award the amounts local governments were allocated through the nexus test. In reviewing the application of the nexus criteria in Riverside County, we identified two instances where the criteria were not consistently applied. Specifically, the county concluded that the

city of Banning and the county itself met three of the four nexus criteria. In both cases, the county incorrectly concluded that land within each respective local government's jurisdiction bordered the tribal land where a casino was located. County officials agreed with our assessment and stated that it would revise its application of the nexus criteria. Further, Riverside County did not even adhere to its inaccurate nexus test calculation. We identified several instances where cities in Riverside County were awarded less money than they should have been allocated under the nexus test. For example, the City of Palm Desert should have received a minimum of \$131,000; however, it only received \$46,000. According to the county's principal management analyst, this occurred because the tribes may not have sponsored projects that totaled up to the maximum amount these cities should have been allocated.

Some Grantees Were Not Eligible for Funding

Although state law provides clear guidance defining the intended recipients of distribution fund money—cities, counties, and special districts—some benefit committees provided grant money to ineligible entities. Specifically, of the 30 grants we reviewed, we found two instances in which benefit committees awarded grants to school districts. State law specifically excludes school districts from the definition of *special districts*.

Nevertheless, Clovis Unified School District in Fresno County requested and was awarded a distribution fund grant from fiscal year 2005–06 funds for \$68,100 to help in purchasing books for new schools. According to the minutes of a May 12, 2006, open meeting, the county's legal counsel initially advised the benefit committee that the school district was not a special district and hence was not eligible for the grant. However, the tribal representative stated that he supported the project, and the chair of the benefit committee stated that unless someone brought legal action against the benefit committee contending the contrary, he did not believe the State would take any action. In the same meeting, Fresno County's legal counsel stated that after reviewing a letter from Clovis Unified School District, he determined that while he had initially relied on a statute that specifically excludes school districts from the statutory definition of *special districts*, he had found another section of the law that states that for the purpose of special taxes, school districts may be considered special districts. Fresno's counsel further advised that there is some provision of law that would permit the committee to define Clovis Unified School District as a special district. However, we do not agree. Our legal counsel advised us that because school districts do not fall within the definition of special districts for the purposes of distribution fund grants, they are not eligible to receive grant funds.

Although the benefit committee recognized that a school district was not eligible to apply for distribution fund money, it approved the application because it was impressed by the collaborative nature of the project and because the tribe sponsored it.

In another instance Riverside County awarded a distribution fund grant to the Banning Unified School District by having the Banning Police Department (police department) submit an application for it, in effect using the police department as its fiscal agent. According to the police department, the chairman of the Morongo Band of the Mission Indian Tribal Council requested that the police department apply for the grant on the school district's behalf. The police department requested a \$257,000 grant on behalf of the school district to fund two programs: \$125,000 for a program connecting troubled students with services that could enhance their academic achievement and \$132,000 for a full-time police officer on campus who would work with the school district, the community, and the police department to promote campus safety. Riverside County stated that the benefit committee took a supportive position on the school district project because it addressed one of the priorities, recreation and youth programs, specified in the law that defines the uses of the discretionary fund. A representative of the county also explained that although the benefit committee recognized the school district was not eligible to apply for distribution fund money, it approved the application because it was impressed by the collaborative nature of the project and because the tribe recognized the need to support it.

Despite the attributes of the projects just described, we believe that the benefit committees did not have adequate reasons to disregard the law and award funds to ineligible grantees. Because the Legislature has identified specific entities and purposes for this money, counties must ensure that they follow the statutory requirements. If other entities are affected by casino operations, local governments should consider asking the Legislature to amend the law to expand the eligibility requirements rather than disregarding the requirements by providing grants to entities they know are not eligible to receive funds.

Some Benefit Committee Members Fail to Meet Disclosure Requirements

The Political Reform Act of 1974 (political reform act) requires state and local officials and employees with decision-making authority to file statements of economic interests annually and on assuming or leaving a designated position. These statements are intended to identify conflicts of interest that an individual might have. However, the counties we visited could not provide 11 of the 13 statements of economic interests for tribal representatives on the benefit committees for fiscal year 2005-06.

The political reform act is the central conflict-of-interest law governing the conduct of public officials in California. The intent expressed in the act states that public officials, whether elected or

appointed, should perform their duties in an impartial manner, free from bias caused by their own financial interest or the financial interests of persons who have supported them. The political reform act places certain duties and responsibilities on local government agencies to ensure that their designated employees, including benefit committee members, comply with the act's reporting and disclosure requirements. The political reform act requires each designated employee to file a statement disclosing reportable investments, business positions, and interests in real property and income (statement of economic interests) on an annual basis and within 30 days of assuming or leaving office. The statements must be retained by the filing officer and made available for public inspection. Finally, the political reform act also requires local government agencies to report apparent violations to the appropriate agencies.

Despite these statutory requirements, we received only two of the 13 statements of economic interests for tribal representatives that we requested from the counties we reviewed. Although the counties requested that tribal members file statements, 11 of the 13 tribal members that were required to file failed to do so. Three of the six counties we requested statements from informed us that the tribal members of their respective benefit committees asserted that they are exempt from the requirements to submit statements. The other three counties we visited stated that they do not know the reasons tribal members did not file the required statements. However, the California Fair Political Practices Commission has issued an advice letter regarding this issue stating that any individual serving in a capacity as a member of a public agency, including tribal members of benefit committees, are subject to the provisions of the political reform act. When designated individuals do not file statements of economic interests, benefit committees may be unaware of conflicts of interest. Further, the benefit committees cannot ensure that members are aware that they should remove themselves from making decisions that may pose conflicts of interest.

Many Counties Did Not Properly Report Their Use of Distribution Fund Money

State law requires each county that receives distribution fund grants to submit an annual report by October 1 each year detailing, among other information, the specific projects funded by the grants and how current-year grant money has been or will be spent. However, counties do not always adhere to this requirement. In response to the failure of some counties to submit their annual reports in fiscal year 2004-05, the governor decreased by \$20 million the amount appropriated to local governments for mitigating casinos' impacts in the fiscal year 2005-06 budget. The Legislature subsequently

Although the counties requested that tribal members file statements of economic interests, 11 of the 13 tribal members that were required to file failed to do so.

passed legislation reinstating the \$20 million and modifying the reporting requirements. Nevertheless, many counties still fail to submit their annual reports by the October 1 deadline or do not submit them to all required entities. In fact, according to the gambling commission and various legislative committees, in 2006 only nine counties reported to all required entities, and six of the 24 counties receiving funds did not report at all.

Our review also found that at least one county did not include all required information in its most recent annual report. The law requires each county to submit an annual report on its current- and prior-year allocations and expenditures for distribution fund grants. However, in fiscal year 2005-06 Riverside County failed to report its current-year grant allocations and only provided expenditures of prior-year grants. Because no agency is responsible for overseeing distribution fund grants provided to local governments, it is critical that counties are transparent in reporting the amounts they allocate and the purpose of each grant. Unless counties adhere to reporting requirements, it is difficult for the Legislature and the public to understand the impacts casinos have on local governments, what grant funds are being spent for, and how long it is taking for projects to be completed.

Recommendations

To ensure that local governments receive maximum benefit from the distribution fund and comply with applicable provisions of state law, the gambling commission should seek the following changes to legislation:

- Amend the Government Code to provide direction to local governments to ensure that they use distribution fund grants only to purchase goods and services that directly mitigate the adverse impacts of casinos on local governments and their citizens.
- Revise the allocation methodology outlined in the Government Code so that the allocation to counties is based only on the number of devices operated by tribes that do not negotiate directly with local governments to mitigate casino impacts.
- Amend the Government Code to require that all funds be deposited into interest-bearing accounts, and that any interest earned is used on projects to mitigate casino impacts.
- Amend the Government Code to allocate distribution fund money only to counties that submit annual reports as required.

To ensure that local governments comply with state laws related to the distribution fund, benefit committees should do the following:

- Require local governments to submit supporting documentation that clearly demonstrates how proposed projects will mitigate the effects of casinos.
- Ensure that local governments spend the interest earned on project funds only on the projects for which the grants were awarded or return the money to the county for allocation to future mitigation projects.
- Correct the inconsistent application of nexus test criteria and ensure that local governments receive at least the minimum amounts they are allocated under the Government Code requirements.
- Grant distribution fund money only to eligible entities.
- Ensure that all benefit committee members follow the political reform act and file the required statements of economic interests, and inform the appropriate agency if they fail to do so.
- Submit complete annual reports to all required legislative committees and the gambling commission.

Chapter 2

PENDING NEW AND AMENDED COMPACTS MAY SIGNIFICANTLY AFFECT THE VIABILITY OF THE INDIAN GAMING SPECIAL DISTRIBUTION FUND AND PROGRAMS THAT DEPEND ON IT

Chapter Summary

Revenues to three state funds will change dramatically if one new tribal-state gaming compact (compact) and amendments to five existing compacts are approved. The pending new and amended compacts (pending compacts) would decrease annual revenues in the Indian Gaming Special Distribution Fund (distribution fund) by an estimated \$92 million. If another funding source is not used for the programs the distribution fund supports, including payments to cover shortfalls (backfill) in the Revenue Sharing Trust Fund (trust fund), the distribution fund would exhaust its current reserve within four years and be unable to support those programs. On the other hand, the revenue reduction to the distribution fund that would result from the ratification of the pending compacts would be partially offset by about \$6.9 million in additional revenue for the trust fund in fiscal year 2007–08, reducing the amount that otherwise would be required for the backfill to the trust fund.

The pending compacts also require substantial payments into the State's General Fund; we conservatively estimate these will total between \$174.3 million and \$175.1 million for fiscal year 2007–08. The increased revenues to the General Fund are based partially on profits, and as more gaming devices come into operation, the revenues will increase. Legislation under consideration would use this General Fund money to support the trust fund if the distribution fund cannot. The Department of Finance (Finance) anticipates that if the pending compacts are approved, beginning in fiscal year 2008–09 the General Fund will cover the trust fund backfill.

New Compact Provisions Will Change the Amount of Revenues in the Distribution and Trust Funds

Pending amendments to tribal compacts will significantly decrease revenues in the distribution fund and, to a lesser extent, increase trust fund revenues. In June 2007 the Legislature ratified one new compact and four of five amendments to existing compacts. To take effect, the newly ratified compact and four amendments still require approval by the federal Secretary of the Interior. Therefore, we refer to the compact and amendments (including the one amendment that has yet to be ratified) as "pending compacts" throughout our report. In fiscal year 2005–06 the five compacts with pending

amendments provided two-thirds of distribution fund revenues. However, the amendments will eliminate those payments to the distribution fund, causing a significant reduction and affecting its ability to fund the programs that depend on it. We estimate that at the casinos' current levels of operation, the amendments will reduce distribution fund revenues by \$92 million annually. In contrast, the amendments provide the trust fund with increased revenues, which we estimate will be about \$6.9 million annually, again based on current operating information.

As described in the Introduction, the compacts negotiated in 1999 had no material differences regarding contributions to the trust fund and the distribution fund. Because of the formulas used, a few tribes with class III devices in operation as of September 1, 1999, provided most of the revenue to the distribution fund. Between 2003 and 2006, the Legislature ratified five new compacts and amendments to eight others (post-1999 compacts), and the federal Secretary of the Interior approved the new and amended compacts. The post-1999 compacts differ significantly from those ratified in 1999 in that they no longer require tribes to pay into the distribution fund and change the calculations for deposits to the trust fund. They also provide for contributions directly to the General Fund, the impact of which we describe in the following section. Because the changes in operations allowed by the post-1999 compacts have not been fully implemented—the tribes have not installed all the permissible gaming devices, for example—their fiscal effects on the trust fund and General Fund have not been fully realized. The pending compacts have provisions similar to those of the post-1999 compacts.

To determine the fiscal impact on the distribution fund, we compared fiscal year 2005–06 distribution fund revenues, which would come only from tribes whose original 1999 compacts have not changed, to our estimates of revenues assuming all pending compacts were in effect—including one amended compact yet to be ratified. The pending compacts no longer require the tribes to contribute to the distribution fund and instead call for the tribes to contribute to the General Fund. Under the 1999 compacts, the five tribes with pending amendments contributed two-thirds of the total revenue in the distribution fund in fiscal year 2005–06—a total contribution of about \$92 million. A loss of that magnitude would have a significant impact on the distribution fund's ability to support program activities.

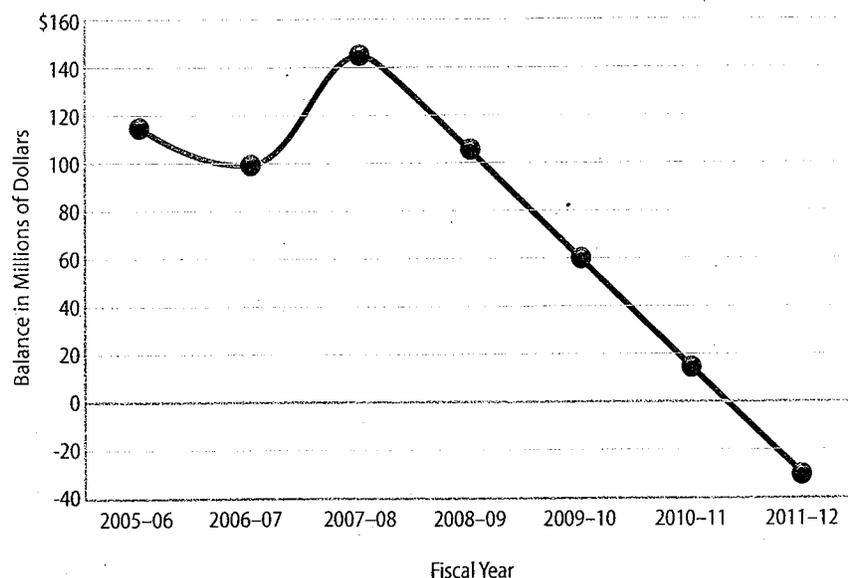
For fiscal year 2007–08, anticipated expenditures for the problem-gambling prevention program, costs of certain regulatory functions of the Department of Justice and the gambling commission, and grants to support local governments adversely affected by tribal gaming will total roughly \$55.6 million. This amount does not include the distribution fund's responsibility

The pending amendments for five compacts would eliminate approximately \$92 million in revenue to the distribution fund annually, affecting its ability to fund the programs that depend on it.

to provide backfill distributions to the trust fund, which we estimate would be \$39.6 million for fiscal year 2007–08. Therefore, the estimated fiscal year 2007–08 combined expenditures for the distribution fund total \$95.2 million. However, without the revenue from the pending compacts, we estimate that annual revenue including interest to the distribution fund will total only \$53.2 million for the 2007–08 fiscal year. Assuming trust fund revenue from the tribes and program expenditures remain static, we estimate that the distribution fund will have a deficit of more than \$42 million for the year. This deficit would increase as interest revenue on the declining fund balance decreases. As shown in Figure 6, we estimate that should the conditions assumed for fiscal year 2007–08 continue into the future, without additional resources the distribution fund will be unable to meet its obligations in approximately four years (by fiscal year 2010–11). Later in this chapter we discuss the potential use of General Fund resources to help fund current distribution fund activities.

The pending compacts partially offset the loss of distribution fund revenues by providing for increased revenues in the trust fund. As discussed in the Introduction, the first of the four priorities for the use of distribution fund resources is to backfill the trust fund. To fully understand the effect of the pending compacts and how

Figure 6
The Special Distribution Fund Balance Will Diminish Rapidly if It Continues to Fund the Shortfall in the Revenue Sharing Trust Fund



Sources: Bureau of State Audits' projection of future special distribution fund balance based on the Governor's Budget for fiscal year 2007–08, California Gambling Control Commission accounting documents, and ratified and pending compacts.

the decrease in the distribution fund revenues will affect the four priorities in total, we looked at the fiscal impact of the pending compacts on the trust fund contribution. The five tribes that have amendments to their compacts pending were contributing to the trust fund based on a formula that charges an annual fee for each gaming device put in operation after September 1, 1999. The pending amendment provisions would require each tribe to contribute a flat fee of \$2 million to \$3 million annually. By comparing fiscal year 2005-06 trust fund revenues with estimated future revenues, we calculate that the pending amended compacts will provide a net increase of about \$6.9 million in annual trust fund revenues. Finally, if the post-1999 compact tribes place additional devices in operation, as allowed in the compact provisions, additional revenue will be deposited in the trust fund. Because backfilling the trust fund is currently the first priority of the distribution fund, this increase would directly reduce the obligations of the distribution fund.

Post-1999 and Pending Compacts and Amendments Provide Revenues to the General Fund

Unlike the 1999 compacts, the pending compacts require tribes to provide revenues to the General Fund, but estimating the amount of revenue that will be raised is made difficult by uncertainties about when tribes will start or expand their gambling operations and what the impact of those changes will be. Because of differences in the assumptions we used in our calculations, our estimate of fiscal year 2007-08 revenue to the General Fund differs significantly from Finance's. The post-1999 compacts have similar provisions, but their effect on the General Fund has not yet been fully realized.

The pending compacts generally contain two types of provisions requiring contributions to the General Fund. The first is an annual flat fee requirement regardless of casino profitability or size. This provision requires the five tribes with pending amendments to make annual payments to the General Fund totaling \$167.6 million.³ A second compact provision requires annual General Fund contributions based on casino net wins and the number of gaming devices in operation in excess of the 2,000 allowed by the original 1999 compacts.

To estimate the contributions to the General Fund from the second type of provision, we had to make some assumptions to calculate future revenues. Specifically, because it is impossible

³ The one amendment yet to be ratified by the Assembly would provide \$45 million, or over 25 percent, of these payments to the General Fund.

to project how fast casinos will expand or forecast changes to their profitability due to future expansion, we based our estimate of revenue contributions to the General Fund on fiscal year 2005–06 counts of gaming devices and net wins. Using these data, we estimate that General Fund revenues from net wins and gaming devices in operation will increase total revenue by between \$6.7 million and \$7.5 million per year.

We based our estimate on two factors. First, it includes 99 anticipated devices from the pending new compact. In addition, it includes devices that, according to the gambling commission, are no longer in operation because the two casinos with pending amendments were operating more than 2,000 devices, in violation of their compact terms. However, we elected to include those additional devices in our calculation of total General Fund revenues for fiscal year 2007–08 because it is likely that the casinos can quickly put them back into operation. Overall, we estimate an increase in total General Fund contributions from the pending compacts of between \$174.3 million and \$175.1 million for fiscal year 2007–08.

Our estimates of contributions to the General Fund for fiscal year 2007–08 differ significantly from those calculated by Finance for the Governor’s Budget May Revision 2007–08 because of differing assumptions regarding casino expansion. On April 10 and 11, 2007, the tribes with pending amended compacts testified before the senate committee on governmental organization. A portion of the testimony focused on when the tribes intended to add more gaming devices and how many more they would add. Based on the tribes’ testimony, Finance has assumed for its estimate that the tribes will add 9,250 additional devices to operations by January 1, 2008, resulting in more than \$314 million in additional revenue to the General Fund for fiscal year 2007–08, in contrast to our estimate of \$174.3 million to \$175.1 million.

We believe our more conservative approach to the revenue calculation for fiscal year 2007–08 is appropriate primarily because the tribes’ testimony about how long it would take to put additional devices into operation was often not very specific. For example, one tribe indicated that it would take two to three years to install an additional 1,000 machines. Three tribes stated that they would install additional machines fairly quickly but did not expect to reach their respective compact limits of 7,500 devices each. Although it is likely that the casinos will eventually expand, our inability to determine with certainty when the tribes will install additional devices led us to use the most current numbers available to us for devices in operation and casino profitability for our estimate of contributions to the General Fund for fiscal year 2007–08. Further, given that, as of June 2007, one pending compact still needed to be ratified by the Assembly and all

We conservatively estimate an increase in total General Fund contributions from the pending compacts of between \$174.3 million and \$175.1 million for fiscal year 2007–08.

of the pending compacts require approval by the federal Secretary of the Interior, we believe it is unlikely 9,000 new gaming devices will be made operational in such a short period of time.

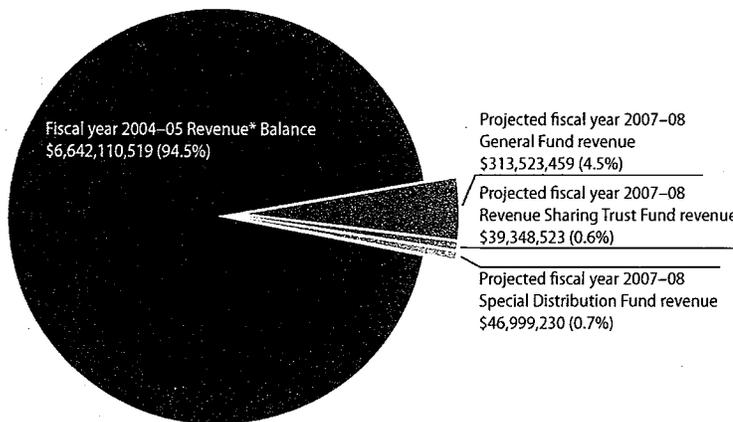
As further confirmation of the reasonableness of our estimate, we reviewed information for the eight tribes that have had amendments ratified since 1999; seven of these tribes are allowed to operate an unlimited number of gaming devices. We determined that as of March 2006, when according to the most recent statewide device count that the gambling commission has conducted, only three of the seven tribes had more than 2,200 devices in operation, with one other tribe operating 2,197 devices. None of these four tribes have ever operated more than 2,722 devices, and of the 66 tribes with compacts, only these four have legally operated more than the 2,000 devices allowed in the original 1999 compacts.⁴ Even though the four tribes could operate an unlimited number of gaming devices under their amendments ratified in June 2004, none had added more than 827 as of March 2006, indicating that tribes can take a significant amount of time to expand their operations. Although we believe that basing our estimates of future contributions on current device counts and net wins is a conservative yet reasonable approach, we also recognize that because revenues to the General Fund are based partially on net wins, those revenues will increase as more gaming devices are put into operation.

In addition to the income from the pending compacts, contributions to the General Fund will increase as tribes with post-1999 compacts choose to build or expand their casinos. These post-1999 compacts provided \$128 million in General Fund revenue in fiscal year 2005-06. However, that figure will increase because several casinos allowed under post-1999 compacts only recently began operations or will begin operations this year. Given their short or nonexistent periods of operation, these casinos have yet to submit information on their profitability or contribution levels. Therefore, to estimate their contributions to the General Fund, we made assumptions about their profitability based on minimum and maximum values for casinos of similar size provided by the gambling commission. Using these figures and the number of devices the casinos expect to operate, we estimate that General Fund revenues will increase between \$1.7 million and \$10.4 million for fiscal year 2007-08, bringing total General Fund contributions from post-1999 compacts to between \$129.7 million and \$138.4 million.

⁴ Two tribes with 1999 compacts were operating over 2,000 devices, in violation of their compact. For additional information, please see footnote 11 in Appendix A.

Overall, we estimate that General Fund revenues for fiscal year 2007–08 from the post-1999 and pending compacts will total between \$304 million and \$313.5 million. These amounts represent between 4.3 percent and 4.5 percent of the \$7 billion in revenue that Indian gaming in California generated during fiscal year 2004–05. Further, for fiscal year 2007–08, we estimate that trust fund and distribution fund revenue from tribal contributions will total \$39.4 million and \$47 million, respectively, representing 0.6 percent and 0.7 percent of total fiscal year 2004–05 gambling revenue, respectively, as shown in Figure 7.

Figure 7
Projected Fiscal Year 2007–08 Indian Gaming Contributions to the State Compared to the \$7 Billion in Total Indian Gaming Fiscal Year 2004–05 Revenue



Sources: National Indian Gaming Commission reports and Bureau of State Audits' projections of future Special Distribution Fund and Revenue Sharing Trust Fund revenues based on fiscal year 2007–08 Governor's Budget, California Gambling Control Commission accounting documents, and ratified and pending compacts.

* Fiscal Year 2004–05 is the most recent revenue figure available.

General Fund Revenues May Be Used for Many Purposes

Future General Fund revenue contributions from Indian gaming may be used to help reduce the impact of the \$92 million decrease in distribution fund revenue. Finance has indicated that, beginning in fiscal year 2008–09, the administration plans to have the shortfall in the trust fund covered from tribal contributions to the General Fund. Should such a shift in funding occur, it would significantly reduce expenditures currently paid by the distribution fund and allow it to continue to pay for its programs in the long term. However, pending legislation would require the General Fund

to pay for the shortfall in the trust fund only if the distribution fund cannot. Although we estimate the distribution fund's revenue, including interest earned on the fund balance, will be more than \$2.4 million less per year than its expenditures for these programs with the loss of revenue from the pending compacts, the distribution fund's reserve would allow it to provide the current funding level for approximately 20 years, assuming revenues and expenditures remain roughly the same and the General Fund pays for any backfill distributions required by the trust fund. Four of the pending compact amendments contain provisions that redirect a portion of their General Fund revenue contributions to the trust fund if there is an insufficient amount in the trust fund to distribute \$1.1 million to each eligible tribe. However, without further clarification in the Government Code by the Legislature, it is unclear if this compact provision to cover any shortfalls in the trust fund takes place before or after the Government Code requirement for the distribution fund to cover any shortfalls in the trust fund.

General Fund contributions required by the compacts may be used to offset the \$92 million decrease in distribution fund revenue, and may also be obligated to repay transportation fund loans made to the General Fund in prior fiscal years and therefore would not be available for other purposes.

Furthermore, the General Fund contributions required by the compacts may also be obligated to repay a California Department of Transportation fund (transportation fund) that made loans to the General Fund in prior fiscal years. For fiscal year 2005-06, \$101 million in tribal payments to the State were used to repay a loan from the transportation fund to the General Fund. State law indicates that shortfalls in the Transportation Congestion Relief Fund can be repaid from Indian gaming revenues or from other contributions to the General Fund. The California Department of Transportation estimates a \$588 million shortfall by the end of fiscal year 2007-08 in the Transportation Congestion Relief Fund, which exceeds our estimates of total tribal gaming contributions to the General Fund for the year. As such, any increase in General Fund revenue from pending compacts may be obligated to repay the Transportation Congestion Relief Fund and thus would not be available for backfill distributions required by the trust fund or for other purposes.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of the report.

Respectfully submitted,



ELAINE M. HOWLE
State Auditor

Date: July 12, 2007

Staff: Steven Cummins, CPA, Audit Principal
Jonnathon Kline
Simerdip Kaur Khangura
Rosa Reyes
Albert Sim, MPA
Katrina Williams

Appendix A

NUMBER OF GAMING DEVICES OPERATED BY FEDERALLY RECOGNIZED INDIAN TRIBES IN CALIFORNIA AS OF MARCH 2006

On September 1, 1999, California entered into 57 tribal-state gaming compacts (compacts) with federally recognized Indian tribes. Eventually, 60 tribes agreed to the terms of the 1999 compacts. From 2003 to 2006, the Legislature ratified five new compacts and eight amended compacts, bringing the total number of gaming devices operated by California Indian tribes to more than 58,000 as of March 2006. In June 2007 the Legislature ratified one new compact and four amendments (a fifth amendment has yet to be ratified). However, these compacts have not yet been approved by the federal Secretary of the Interior.

The 1999 compacts require tribes to obtain licenses for gaming devices they plan to operate in excess of the first 350 (entitlement devices) or those already in operation on September 1, 1999 (grandfathered devices). The 1999 compacts also specify 2,000 as the maximum number of devices that each tribe can operate. However, compacts ratified from 2003 to 2006 contain different provisions regarding the maximum number of devices allowed. Table A on the following pages describes the maximum number of gaming devices allowed for each compact, the number of devices each tribe operated as of March 2006, the number of grandfathered devices, and when the compact was negotiated or amended.

Table A**Number of Gaming Devices Operated by Federally Recognized Indian Tribes in California as of March 2006**

| FEDERALLY RECOGNIZED INDIAN TRIBE | YEAR OF COMPACT | CASINO IN OPERATION | GRANDFATHERED DEVICES ¹ | CURRENT NUMBER OF DEVICES [†] | MAXIMUM DEVICES ALLOWED |
|---|-----------------|---------------------|------------------------------------|--|-------------------------|
| Agua Caliente Band of Cahuilla Indians | 2006 Amendment | X | 1,153 | 2,000 | 2,000 [‡] |
| Alturas Rancheria | 1999 Compact | X | — | 148 | 2,000 |
| Augustine Band of Cahuilla Mission Indians | 1999 Compact | X | — | 751 | 2,000 |
| Barona Band of Mission Indians | 1999 Compact | X | 1,057 | 2,000 | 2,000 |
| Big Sandy Rancheria Band of Mono Indians | 1999 Compact | X | 239 | 329 | 2,000 |
| Big Valley Rancheria | 1999 Compact | X | 353 | 518 | 2,000 |
| Bishop Paiute Tribe | 1999 Compact | X | 273 | 329 | 2,000 |
| Blue Lake Rancheria | 1999 Compact | X | — | 700 | 2,000 |
| Buena Vista Rancheria of Me-wuk Indians | 2004 Amendment | — | — | — | unlimited |
| Cabazon Band of Mission Indians | 1999 Compact | X | 741 | 1,956 | 2,000 |
| Cahto Tribe of Laytonville | 1999 Compact | X | 125 | 83 | 2,000 |
| Cahuilla Band of Mission Indians | 1999 Compact | X | 207 | 302 | 2,000 |
| Campo Band of Mission Indians | 1999 Compact | X | — | 750 | 2,000 |
| Chemehuevi Indian Tribe | 1999 Compact | X | 100 | 230 | 2,000 |
| Chicken Ranch Rancheria | 1999 Compact | X | 224 | 255 | 2,000 |
| Coast Indian Community of the Resighini Rancheria | 1999 Compact | X | 135 | 350 | 2,000 |
| Colusa Indian Community | 1999 Compact | X | 523 | 846 | 2,000 |
| Coyote Valley Band of Pomo Indians | 2004 Compact | X | — | 280 | 2,000 |
| Dry Creek Rancheria Band of Pomo Indians | 1999 Compact | X | — | 1,600 | 2,000 |
| Elem Indian Colony of Pomo Indians | 1999 Compact | — | — | — | 2,000 |
| Elk Valley Rancheria | 1999 Compact | X | 167 | 342 | 2,000 |
| Ewiiapaayp Band of Kumeyaay Indians | 2004 Amendment | — | — | — | unlimited |
| Fort Mojave Indian Tribe | 2004 Compact | — | — | — | 1,500 |
| Hoopa Valley Tribe | 1999 Compact | X | 85 | 98 | 2,000 |
| Hopland Band of Pomo Indians | 1999 Compact | X | 307 | 563 | 2,000 |
| Jackson Band of Mi-wuk Indians | 1999 Compact | X | 435 | 1,500 | 2,000 |
| Jamul Indian Reservation | 1999 Compact | — | — | — | 2,000 |
| La Jolla Indian Reservation | 1999 Compact | — | — | — | 2,000 |
| La Posta Band of Mission Indians | 2003 Compact | X | — | 349 [§] | 350 |
| Manchester-Point Arena Rancheria | 1999 Compact | — | — | — | 2,000 |
| Manzanita Tribe of Kumeyaay Indians | 1999 Compact | — | — | — | 2,000 |
| Middletown Rancheria Band of Pomo Indians | 1999 Compact | X | 150 | 429 | 2,000 |
| Mooretown Rancheria Concow Maidu Tribe | 1999 Compact | X | 500 | 999 | 2,000 |
| Morongo Band of Mission Indians | 2006 Amendment | X | 1,627 | 2,045 | 2,000 [#] |
| Pala Band of Mission Indians | 2004 Amendment | X | — | 2,268 | unlimited |
| Paskenta Band of Nomlaki Indians | 1999 Compact | X | — | 773 | 2,000 |
| Pauma Band of Luiseno Mission Indians | 2004 Amendment | X | — | 1,049 | unlimited |
| Pechanga Band of Luiseno Indians | 2006 Amendment | X | 1,333 | 2,139 | 2,000 [#] |
| Picayune Rancheria of Chukchansi Indians | 1999 Compact | X | — | 1,800 | 2,000 |