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December 9, 2004

Representative Kino Flores
Chairman & Members
House Committee on Licensing & Administrative Procedures
P. O. Box 2910
Austin, TX 78768

RE: December 1, 2004, Interim Report, Texas Lottery

Dear Representative Flores:

Thank you for sharing with me the Texas Lottery's Interim Report regarding the underpayments and over payments to Lotto Texas jackpot winners. As I read their interim report, I find once again that they are telling what I term, half truths.

The issue at hand is two-fold. One, did the Texas Lottery cheat winners out of their rightful winnings between Feb 1997 thru Feb 2000 (only one rule in effect during this time frame), and two, was the Texas Lottery acting within their rights in paying jackpot winners more than the allocated percentages of sales? (3 rules in effect between Sept 1996 through May 2002)

It is my opinion, based on the rules themselves, that the Executive Director did not have the authority to underpay jackpot winners. As for the authority to pay more than the allocated amounts, I would consider the authority questionable as well. Especially in light of the Auditors remark regarding "*amount available for prizes.*"

I am going to quote four (4) key statements from the Interim Report and show you why I do not agree with the Auditors preliminary comments and findings. I firmly believe you will agree with my assessment of the situation.

The Key Statements from the Interim Report Are

1. "While the rules addressed the amount to be dedicated to the prize pool, the rules did not specify whether the entire amount available for prizes must be paid. In fact, the rules define the prize pool as the amount 'available' for prizes."
2. "As of March 6, 2002, TLC adopted rules to specifically address the determination of the amount of the Lotto Texas jackpot winner award. These rules, updated in May 2004, should provide for consistency in award determinations for jackpot prize winners."
3. "While internal policies and procedures appeared to address the calculation of the amount to be awarded to Lotto Texas jackpot prize winners, it is impossible to determine which internal policies and procedures were in effect at any point in time."
4. "Consistent with the conclusion made in a prior internal audit report dated September 2002, regarding the payment of Lotto Texas jackpot prize winners, the applicable administrative rules prior to March 6, 2002, allowed for the exercise of discretion in determining the amount of the prize award."

My Response to The Auditors Statements

Statement One (1)

“While the rules addressed the amount to be dedicated to the prize pool, the rules did not specify whether the entire amount available for prizes must be paid. In fact, the rules define the prize pool as the amount ‘available’ for prizes.”

What was **omitted** is the second portion of the sentence in the definition - 1997 Rule: 401.304 (a) Definitions (22) Prize Pool. “*The total amount of money available for prizes as a percentage of the the total sales for the current draw period.*”

Regarding the definition of “prize pool” and the overpayments issue - most of the time, the TLC paid out more than what was available to pay “**as a percentage of sales for the current draw period.**”

Regarding the definition of “prize pool” and the underpayment issue, the “*percentage of the total sales*” was NOT paid to some winners. This is a fact.

Other vital definitions and rules that are key factors in determining the Executive Directors authority include: (Copy of rules attached.)

1997 Rule: 401.304 (a) Definitions (5) **Direct prize category contribution** - A specified percentage of net sales allocated to the prize categories as described in the rules of the specified game being played.

1997 Rule: 401.304 (a) Definitions (10) **Indirect prize category contribution** - Amounts allocated from the prize reserve fund and roll-over for a specific drawing.

1997 Rule: 401.305 (e) **Prizes for Lotto Texas (1)** - The prize amounts, for each drawing, paid to each lotto player who selects a matching combination of numbers **will vary due to a “pari-mutuel” calculation**, with the exception of the fourth prize, which is a guaranteed \$3.00. The calculation of a prize shall be rounded down so that prizes can be paid in multiples of whole dollars. Each prize breakage, with the exception of the fourth prize breakage, “will” **carry forward** to the next drawing for each respective prize category. The fourth prize category breakage will be placed in the reserve fund. No prize amount shall be less than \$3.00. **The prize amounts are based on the total amount in the prize category for that Lotto Texas drawing distributed equally** over the number of matching combinations in each prize category. (*Please note: The rule says the prizes vary due to “pari-mutuel” calculations. “Pari-mutuel” means a pre-set percentage of sales is THE amount that is suppose to be divided and paid out. If the prize is not “pari-mutuel,” then the prize is described a “guaranteed prize.” Especially important, notice that the rule says, “prize amounts are based on the total amount in the prize category.”*)

1997 Rule: 401.305 (e) **Prizes for Lotto Texas (2)** The prize pool for Lotto Texas “shall” be a minimum of 50% of lotto sales.

1997 Rule: 401.305 (e) **Prizes for Lotto Texas (3)** Prize categories. (A) First prize. (iii)

(I) The direct prize category contribution “may” be 64% of the prize pool for the drawing. (II) The indirect prize category contribution, which may be “increased” by the executive director, WILL include the roll-over from the previous drawing, IF ANY. *(Please note: The rule does not say “shall” be 64%, it was changed in this rule to say, “may” be 64%.” If the rule had said “shall,” then the executive director could not have “increased” any payments as it would be conflicting language all in one sentence. Notice too, that the rule does NOT say that he “may decrease” either the direct or indirect contribution. The statement allowing the Executive Director to increase the indirect amount is very BROAD especially since the “money available” in the “prize pool” is a percentage of “total sales” for the “current draw period” as per the definitions in the rule. The TLC can NOT pay less than the set percentage allocated per prize category in a game where the rule clearly says “prizes may vary due a “pari-mutuel” calculation.” The winners overpayments between Feb 1997 through March 2002 were as low as \$24K and as high as \$2.5 million not counting the promotional draws. \$2.5 million is a lot of authority!)*

1997 Rule: 401.305 No where does the rule state that the TLC is “guaranteeing the advertised jackpot amount” nor does it say they are paying the “investment cost” to jackpot winners. With regard to how much is actually won, again, the rule says jackpot amounts are based on “pari-mutuel calculations” and the definition of “pari-mutuel” means a percentage of sales is divided among all winners. You can’t have “pari-mutuel calculations” and “guaranteed prize amounts” applied to one prize category at the same time. It’s got to be one or the other and not at the discretion of Tom, Dick or Harry.

1997 Rule: 401.304 (a) Definitions (24) **Roll-over** - The amount not won (no matching combinations) or prize breakage from the previous drawing in a prize category. The amount not won will be carried forward for the next drawing for that “specific” prize category. *(Please note: When there is a jackpot winner, the “roll” is over. This is why the “indirect contribution” (401.305(e) Prizes for Lotto Texas (3) (a) (iii)(II), includes IF ANY. This means once there is a winner, ALL that is in 1st prize prize pool is the minimum amount the player has won and IS entitled to receive. Also, notice that the roll definition clearly says “carried forward for that specific prize category.” Monies “carried forward” is suppose to pay out in the next draw for that “specific prize category.”)*

1997 Rule: 401.305 (4) **Prizes reserve fund**. (A) The prize reserve fund is 2.0% of the prize pool. (B) The Lotto Texas prize reserve fund may be increased and decreased by any amounts allocated to the prize pool and not paid to the winners. For example, rounding down, paying Lotto Texas prizes, and roll-over amounts from the fourth prize. *(Please note: If you add the percentages allocated to each prize category - 1st prize: 64% + second prize: 5% + 3rd prize: 18% + fourth prize: 11% - it only equals 98%. Again, there is conflicting language. The People were led to believe that players received 50% of total sales by way of prizes paid out in their “pari-mutuel” games. During the 2000 rule change, many press releases stated that the TLC was increasing the payouts to 55% of sales. The only monies that rightfully belonged in reserve was the excess money from the 4th prize.)*

1997 Rule: 401.304 (b) **Price of tickets and prizes** (2) The total amount of prize money allocated to the prize pool for on-line games from total of on-line sales shall be

a minimum of 50%. (*Please note: This clearly says, “the total amount of prize money.” and it says SHALL.*)

1997 Rule: 401.304 (a) Definitions (19) **Prize breakage** - The money which is left over from the rounding down of the pari-mutuel prize levels to the next lowest whole dollar amount or money which is in excess of the amount needed to pay a prize. (*Please note: “Left over from rounding down” can only apply to the 1st, 2nd and 3rd prizes as they are pari-mutuel calculated prizes. The first prize “breakage” would “carry-over” and cease to exist once there was a winner except for the cents resulting from “rounding down.” This is why the “indirect contribution” says “If Any.” The only monies that could be in “excess” would be the “guaranteed 4th prize” monies. Monies in each prize category are “specific amounts” and are independent of other funds.*)

Statement Two (2)

“As of March 6, 2002, TLC adopted rules to specifically address the determination of the amount of the Lotto Texas jackpot winner award. These rules, updated in May 2004, should provide for consistency in award determinations for jackpot prize winners.”

The rule change of 2002 required eight (8) months to complete. It was originally proposed May 11, 2001 (*See Texas Register May 11, 2001*); withdrawn June 2001 (*See Texas Register August 10, 2001*); re-proposed August 10, 2001 (*See Texas Register August 10, 2001*); withdrawn Nov. 9, 2001 (*See Texas Register Nov 23, 2001*); re-proposed Dec. 21, 2001 (*See Texas Register Dec 21, 2001*); revised again; then adopted 2-12-02 (*See Texas Register March 1, 2002*).

You also need to understand WHY the TLC decided to propose the 2001/2002 rule at the time that they did. After all, they had just changed the Lotto Texas rule in July of 2000.

First, the reason for all the different proposals and withdraws was because the TLC was “trying” to write into the rule that they were going to pay just the “advertised amount” - **irregardless of what sales justified** - and they were refusing to make it clear in the rule that a jackpot winner was guaranteed to receive at least the amount allocated to the 1st prize category via the word “may” and “shall.” Public outcry was enormous.

In the end, the TLC foolishly decided to state in the rule that they would pay the **greater of either** the amount in the prize pool OR the investment cost. I told them this was stupid as it was entirely too risky for the state. Lotto Texas is a “pari-mutuel” game, therefore, they should only commit to paying the percentages allocated for each prize category - this protects **both** the State and the People. (*See the Commission Meeting transcripts for my many testimonials*)

As a result of writing this into the 2002 rule, the TLC paid \$9 million more than was allocated to lotto winners between March 6, 2002 through May 3, 2003. Ironically, the 2% of sales held in reserve was only \$7.5 million and \$146K was needed from reserve to fund the 4th prizes during this same time frame. So, do you think the money was

“available?” Or maybe they used unclaimed prize monies to overpay jackpot winners.

In the 2002 rule, the TLC did replace the word “may” with “shall” guaranteeing the jackpot winner’s prize amount was - at least - a set percentage of roll sales. The original 1992 Lotto Texas rule also used the word “shall” in this sentence. The sentence regarding the executive director’s authority to “increase” prize amounts, remained in the rule.

Ironically, the definition of ‘prize pool’ remained as is in the new 2002 rule too. It says, “the total amount of money available for prizes as a percentage of the total sales for the current draw period” - Therefore, we still have the question of, did the TLC pay more than what was ‘available’ between March 2002 through May 2003? (*Please note: The Interim Report states that there was a new rule in effect as of May 2004 - this is incorrect. The last time the Lotto Texas rule was changed was May 2003, not 2004*)

The reason they “finally” decided to write it into the rule that they were going to “begin” paying the “amount advertised” was because the TLC “felt” they’d lost money when they HAD to pay the Austin couple the full amount in the prize pool for the March 7, 2001 \$85 million jackpot. There was \$51.2 million in the prize pool but the cost to fund \$85 million was just \$48.7. Keep in mind, I began posting the exact amount due a winner in March of 2000 and from that date forward, the TLC paid winners according to the written rule. The March 7th win, where they HAD to pay the correct amount or risk being caught, was the straw that broke the camels back. They were determined to write it into the rule that they could “legally” pay the amount advertised and not the amount allocated to the prize category. Again, this proves to me that staff was well aware that the allocated amount was the true amount won.

The rule change that took effect in May 2003 still guaranteed the greater of the either the allocated amount or the advertised amount but only for the first four draws in a roll. However, sales still do NOT justify the advertised jackpot amounts for the 1st four draws in a roll. So if and when someone should win, the state is going to pay out more than what they have from sales to pay. However, as a result of over-allocating the three guaranteed prizes plus the 2% that is held in reserve, there is plenty of excess funds to pay a jackpot winner. This also means that the People are NOT receiving 52% of sales that was promised to the People - again - the People are being misled.

Since the May 7, 2003 rule became effective and as of the date of this letter, the TLC has shorted players (from receiving 52% of sales) by \$7.0 million. Just the current roll - 10/20/04 thru 12/9/04 - players have been shorted by <\$354K>.

Statement Three (3)

“ While internal policies and procedures appeared to address the calculation of the amount to be awarded to Lotto Texas jackpot prize winners, it is impossible to determine which internal policies and procedures were in effect at any point in time.”

The underlined comment is a totally unacceptable excuse and I would think unacceptable for any Texas lawmaker. Just how many policies did they have? There was only

ONE rule.

IF the independent auditor had fully “investigated/audited” payment calculations, she would have contacted ex-staff members who were present during the many staff meetings to determine the “intent” and the “motives” at the time the 1997 Lotto Texas rule was proposed and adopted. The Auditor would have learned that staff recommended to legal to write it into the rule that the TLC was going to start “paying the investment cost or the advertised amount.” The Auditor would have learned that Ms. Kiplin did not want to write this in the rule - rather - Ms. Kiplin wanted the TLC to have an “option” of what to pay jackpot winners - she purposely did not want to have “specific” language in the rules pertaining to paying jackpot winners.

As a result, the TLC has calculated jackpot prize amounts in 5 different ways and the calculations varied from win to win, not time frame to time frame. This is why the Auditor “can’t determine which internal policy and procedure was in effect at any point in time.” But she fails to admit this in her very carefully worded sentence.

The Auditor would also have learned that staff’s discussions for months centered around the fear that sales were not going to warrant advertising \$4 & \$6 million jackpots. This is why they upped the annual pay to 25 years from 20 years in the 1997 rule change. Then, the plan was to under-estimate larger jackpots to offset the losses at the low end hoping all would balance out and no one would ever know.

Now, as you have seen, the TLC is taking one very broad statement in the rule (“*which may be increased by the executive director*”), discarding all other rules and definitions and are trying to convince the Legislature that they the rules allowed for “*discretion in determine the amount of the prize awarded.*” No one should have the authority to increase or decrease any prize payment for a pari-mutuel payout game.

Besides Kim Kiplin who is still the TLC’s General Council, ex-staff members that can verify these things may include Lawrence Littwin, Linda Cloud, Bart Sanchez, Pam Udall, Toni Smith, Karen Porter and Steve Levine. Though I’m not certain that Ms. Kiplin would be able to recall these events. If I were an investigator, I would contact the ex-staff members if I wanted to know the truth. Current staff members are too afraid of retribution so I’d leave them alone. And this is really sad.

Remember when Director Littwin was terminated? After his termination, headlines of the *Dallas Morning News* read, “*Lottery Commission fires executive director. He says panel is playing politics, ‘ripping off’ Texans.*” Director Littwin had compiled a report listing all of the TLC’s budget shortfalls and contract compliance issues but when the press tried to obtain this report, the TLC filed for an AG Opinion. Needless to say, the AG ruled in favor of the TLC so its contents were never known by the press or the public. However, Director Littwin did give some interviews prior to being paid off by G-Tech.

Rep. Frank Corte filed HR No 153, 76R9480 MDR-F to allow Mr. Littwin to sue the Texas Lottery Commission. Mr. Corte said, “*There are some things that need to be brought out, and he can’t unless he goes to court.*” One of the things that would have sur-

faced in court was the fact that Lotto Texas was a “pari-mutuel payout game” yet the TLC had already short-changed winners and was overpaying winners needlessly.

During Littwin’s short tenure, no winner received less than the percentage allocated for the jackpot winner (June 1997 - Oct 1997), they all received the investment cost even though it was not written in the rule. Yet before and after his short his tenure, some winners were cheated. I believe Ms. Kiplin was one of the acting directors during this time frame. Ms. Kiplin was the acting director when the TLC was caught falsely advertising average jackpots for the Cash5 game.

After Linda Cloud gained control, the “verbal” Lotto Texas payment plan, that ex-staff members can confirm, began with the FIRST large jackpot which occurred on Feb 4, 1998. They continued underpaying larger jackpot winners until I began posting exactly how much a winner was entitled to receive in March of 2000. From March 2000 forward, no winner ever received less than the percentage allocated to the jackpot win. This action shows that the TLC knew that the jackpot winner was entitled to receive at least the allocated amount. So why won’t the TLC just pay the cheated winners what they rightfully won and get on down the road?

Statement Four (4)

“Consistent with the conclusion made in a prior internal audit report dated September 2002, regarding the payment of Lotto Texas jackpot prize winners, the applicable administrative rules prior to March 6, 2002, allowed for the exercise of discretion in determining the amount of the prize award.”

Because ... the 1997 rule said all prizes EXCEPT the 4th prize were based on “pari-mutuel calculations” ... because the rule did not say that the executive Director could “decrease” any allocated percentages ... because the rule did not say anything about paying the investment cost or guaranteeing the advertised amount ... because the “Prizes for Lotto Texas” rule says “prize amounts are based on the total amount in the prize category” ... and because the Auditor failed to review the definitions for roll-over, direct and indirect prize category contributions, prize pool including “prizes as a percentage of total sales,” prize breakage, and pari-mutuel in her assessments - I totally disagree with the auditors concluding statement in her Interim Report.

Rules are rules and they should be abided.

Providing the final analysis and conclusions are on course with writings in the Interim Report, I feel the Auditor has failed to provide a “comprehensive audit,” otherwise, she would have revealed and considered factors shown in my comments. I firmly believe the Texas Lottery has no business investigating itself either. The “independent auditor” is not really “independent” as she goes to the very person whose job it is to protect the agency for legal advice - Ms. Kim Kiplin.

We need legislation, rules and physical actions to GUARANTEE Texans that our lottery is beyond reproach, especially considering it handles billions of dollars annually in

a state that has become dependent on lottery proceeds for budget considerations. A state that counts on gambling revenue as much as Texas should make certain that its lottery games are operated openly, fairly and above board. The state should give the public no reason to believe otherwise.

I pray that the Legislature will hold the TLC accountable now and in the future. The TLC cheated some winners and they need to ante up. As for the overpayments, the rule did say that the executive director could "increase prize amounts" but as to whether or not the money was "available" and by how much they could increase, is questionable. I'd have to calculate those wins to see if the money was "available" which I have not done yet.

The Commission Meeting is Monday, Dec 13, 2004. I can only hope that the Commissioners will finally do the right thing regarding the cheated winners.

Sincerely,

Dawn Nettles
Publisher
The Lotto Report

cc: Members, House Committee on Licensing and Administrative Procedures
Honorable Governor Rick Perry
Senator Jeff Wentworth
Senator John Carona
Senator Jane Nelson
Senator Bob Deuell
Senator Judith Zaffirini
Senator Juan Hinojosa
Representative Bill Keffer
Representative Steve Wollens
Mr. C. Thomas Clowe, Commissioner
James A Cox, Commissioner
J. Roland Olvera, Commissioner
Reagan E. Greer, Executive Director

Attachments: 3 applicable pages from the 1997 Lotto Texas Rule
Copy of the Auditors Interim Report