

PADDY POWER PLC.
PRESENTATION TO
CALIFORNIA SENATE
COMMITTEE ON GOVERNMENTAL ORGANIZATION

I. INTRODUCTION

A. Paddy Power plc

Paddy Power plc is a 21 year-old Irish business, listed on the Dublin and London stock exchanges. We offer multi-channel gambling through shops, telephones and the Internet. Our market capitalization is approx US\$1.5bn and we had revenues of approx. US\$3bn in 2009. We have operated online poker since 2005.

The Internet channel now contributes over 70% of our operating profit and we operate market leading, licensed businesses online in Ireland, the UK and Australia. As a prudently managed public company, operating in licensed markets is very important to us. We hold (or have held) licenses in Ireland, the United Kingdom, Isle of Man, Alderney, Malta, Northern Territory Australia and Kahnawake Mohawk Indian Territory.

Paddy Power was recently chosen by PMU, the French state licensed betting monopoly, to assist in offering online sports betting in France over the next 5 years. The Irish Taoiseach (Prime Minister) Brian Cowen launched the partnership, and said: "*Paddy Power is a prime example of a company with a talent for innovation that keeps on searching for new opportunities. The decision of a world-class organisation like PMU to team up with Paddy Power is testament to Paddy Power's own world-class expertise in e-commerce, product development and risk management. I want to pay tribute to the ambition, energy and professionalism of the Paddy Power management team and staff*"

We are one of the very few online operators to have NOT taken wagers from customers in USA.

B. The Goals of Our Presentation

We appreciate the opportunity to present our views to the Committee. We are delighted, both on February 9, 2010 and at later stages, to share our experiences as a well-managed, legal online operator. We are particularly interested in sharing our views on the attractiveness of a licensed California online market for poker and other games, and the features that a regulated California system should, from the point of view of a private operator, maintain to attract investment into the state.

We believe that for player protection, mitigation of money laundering and terrorism financing risk, in addition to the revenue and employment generation opportunity, the State of California should introduce a licensing regime to allow well-capitalized, well-managed businesses with established track records to operate online gambling, which may be peer-to-peer poker rooms, casino-style games, or any other games which the State decides ought to be offered to its citizens.

C. Executive Summary

1. Citizens of California are currently playing online poker. The demand for this product is not likely to diminish.
2. This demand is being met by operators who are based offshore and not subject to state or federal licensing or regulation. They are not paying tax, not forwarding tax information as required under federal law, and are not creating any employment in the United States. They also typically have less player protection policies than the “legal operators”.
3. An open, fair licensing regime for the State of California could attract world-class operators to California to offer online players an experience that is fun, fair and safe.
4. We believe, based on our understanding of relevant federal law, that an intrastate California regulatory regime will require operators to base their operations entirely within California.

5. The system should be amenable to cross-state operations for those other states that would elect to follow California and allow Internet gambling.
6. Any regime must create effective civil remedies through which licensed operators may sue unlicensed operators and their aiders and abettors for substantial, i.e. triple damages, over and above any criminal penalties.
7. We believe that a successful licensing regime will require numerous licensees competing with each other on an equal commercial footing, as this will lead to better product and value for the consumer which in the final analysis will lead to the maximum tax take for the state. Equally importantly, a competitive regime will maximize employment in the state and allow California-based Internet gambling companies to leverage the human resources of this state in the same manner as Google, Ebay and Apple for national and perhaps international expansion.
8. If the state government chooses to permit private operators, then in addition to corporate income tax it may decide to capture additional revenues via a sur-tax, entry fee, or auction. It is our view that a substantial set entry fee (perhaps in combination with a reasonable sur-tax) will, overall, benefit California the most, in that it is the most compatible with expansion of the business on a state-by-state, reciprocal basis.
9. Should the State of California allow private operations, we would be excited to set up operations within California. We would expect to be employing several hundred people within a 2-3 year period based on a reasonable market share of a competitive market.

II. DISCUSSION

A. The Demand

Prior to the October, 2006 effectiveness of the Unlawful Internet Gaming Enforcement Act, the United States was the primary market for a large number of foreign operators who offered both casino and peer to peer gaming. We were not one of the companies offering such services. However, from what we understand, California was consistently among the top three states in terms of players seeking out Internet gambling. In particular, California players were extremely heavily represented in Internet peer to peer poker, which may be due to the long tradition of physical cardrooms in the state.

Since October 2005, such demand has been met by operators who are now acting in clear defiance of federal law. These operators pay no US taxes, do not forward tax information in respect of major winners as required of land-based US gambling establishments, and provide little if any employment in the United States. They also typically have less player protection policies than the “legal operators”.

All federal laws applicable to gambling allows states to create or expand intrastate gaming regimes, with the exception of expanding betting on sports events.¹ This creates the obvious opportunities for states such as California to create Internet gaming that will divert the demand into taxable economic activity, with greater customer care, within the state.

¹ The statute which bars states from relaxing existing bans on sports betting, the *Professional and Amateur Sports Protection Act*, is being challenged by the State of Delaware in a petition for certiorari after the Third Circuit Court of Appeal ruled that Delaware’s expansion of sports betting violated the act. *See Office of the Comm’ner of Baseball v. Markell*, Docket No. 09-3297, 3rd Cir. Aug. 24, 2009.

B. Potential Licensing Regime

1. Exclusion of unlicensed operators

Whatever form of legalization California may decide, there is one overwhelming requirement for the regime to be effective: unlicensed operators must, to the extent possible, be barred from serving Californians.

The online gaming markets are very competitive and the tax rate payable by operators has a direct and easily discernable effect on the value which an operator can offer consumers². It is therefore critical if a regulatory system is to work that a level-playing field exist, i.e. those operators who invest in brands, technology and people to build a business and who pay tax, are not at a structural disadvantage to operators who don't pay tax or abide by regulation. The maintenance of a level playing field for licensed operators will require effective mechanisms to both penalize offenders and mitigate against any commercial advantages offenders have over licensed operators. In addition any regime needs take account of the large brands and databases that have been developed by operators while flouting the law, and must ensure that those assets cannot be used to subsequently gain an advantage over players who commence their business after time of the introduction of a licensing regime.

The best way to accomplish this is to utilize existing models of unfair competition law in the US and allow licensed operators to mount civil lawsuits against unlicensed competitors, their owners, abettors, and financial intermediaries for triple the revenue obtained from California players, and to further allow as a remedy confiscation and re-assignment of URLs used by such unlicensed operators to the extent managed by entities subject to US jurisdiction.

² It should be noted that operators as established as William Hill and Ladbrokes in the UK have been compelled to move their businesses to a lower tax regime of Gibraltar to remain competitive. <http://www.guardian.co.uk/sport/2009/aug/07/ladbrokes-internet-betting-william-hill>

2. Value of private market operators vs. public monopoly

There is much experience in Europe of the trade-offs between monopolies and competitive markets in gaming. We believe that the critical trade-off to California in deciding which of the three regimes described below is between short-term tax revenue vs. fostering a world-class industry.

California is known world-wide as the center of the Internet economy. Its depth of technical expertise, free market policies and receptiveness to innovation have led to the success of companies from Apple to Ebay to Google, each of which dominates its own areas of Internet commerce (Internet music distribution, Internet auctions and Internet search and advertising, respectively). If California wants to create a new center of national and international excellence, it will allow private operators to enter the market, compete and innovate. In the long term this will create more jobs, more tax revenue and a stronger economy.

However, to the extent that California wants to maximize short-term tax revenues over job creations and economic growth, it would limit competition to a few or perhaps single license.

The European experience shows these various models.

- Monopoly License to one room/network operator (aka the Swedish model).
All players from multiple front ends (for instance each card room and Indian Tribe could have their own interface) are pooled into one network. This model has shared liquidity as a benefit but we strongly believe that it has many limitations, including but not limited to:
 - Choosing the wrong network operator for the system will bring down the whole industry;
 - The legal relationships needed between different front end operators is difficult to establish and operate;
 - Limited need to compete in terms of value or product;
 - Very difficult to equitably award this license for a new market as those with most right to compete have not operated in this market before.

- In order to raise a high sum in an auction for a single license the terms of the license would need to be relatively tightly defined (to allow for certainty of valuation by the bidders) and the term reasonably long. Once the license is then issued, should changes to the regime be deemed appropriate, as is likely in the early stages of a regulated market, it may be difficult to agree such changes with the licensee.
 - An uncompetitive model will encourage players to seek value and product in the black market as has happened in Sweden.
 - Perhaps most important, a California state monopoly operator will be highly unlikely to be allowed to operate in other states and will neither innovate nor maximize the amount of jobs created.
- A fixed number of Licenses with multiple network operators – probably auctioned to highest bidders.

The consumer has more choice but not all operators will thrive. If the licenses are auctioned those able to pay the most may not be those who have the necessary capabilities to manage and grow a network. This in turn hinders the growth of the network and in turn the tax generation capability of the model. Other risks include:

- Innovation stifled as there is limited competition,
- An uncompetitive model will encourage players to seek value and product in the black market.
- Auctions go awry when a winner bids too high then goes bankrupt. We are advised that FCC licenses of broadcast spectrum were a fiasco in the 1990's due to the bankruptcy of a leading bidder.
- Auctions are subject to collusion that is very difficult to police.
- Auctions must proceed by a modified Dutch auction or “lowest qualifying bid” system to avoid imposing a “winner’s curse” on every bidder who bids above the lowest winning bid. This leads to numerous possible cases where the auction may lead to less revenue than unlimited number of licenses with a substantial up-front fee.
- In order to make the licences attractive to licensees in an auction the terms of the licenses would need to be relatively tightly defined (to allow for certainty of valuation by the bidders) and the term reasonably long. Subsequent to the licenses being issued, should changes to the regime be deemed

appropriate, as is likely in the early stages of a regulated market, it may be difficult to agree such changes with the licensees.

- Perhaps most important, like a state-run monopoly, auctions will make negotiated cross-state operations virtually impossible because reciprocity among operators who qualify initially in other states will be irreconcilable with a limited number of auctioned licenses.
- An open market where pre-approved operators can launch their own room.
 - There will be winners and losers but market forces will lead to innovation and the best value and product for consumers. This vibrancy will maximise the tax take for the Californian government for the following reasons:
 - This is the only regime where interstate reciprocity and competition would be viable.
 - An initial auction freezes the entry payments to a limited number of winners, while an open system collects such payments on an ongoing basis as new entrants test the market.
 - International reciprocity might eventually be obtained, further expanding the market.

3. Awarding of licenses from the perspective of tax generation (auctions vs. sur-tax vs. set entry fee).

Assuming that private operation is seen as the best path, there is a choice to be made as to supplemental tax revenue generation over and above the income taxes that would be due under existing law.

Most jurisdictions which permit gaming impose special taxes on the activity. We are well familiar with such levies and provided they are set within reasonable bounds, they will not deter a vibrant business climate.

The key consideration in setting the amounts is the ongoing risk of tax competition among states. We believe that if California legalizes internet gaming, a number of other states will follow suit. Indeed, we

are aware that Nevada has a licensing regime that has never been put into effect but could be activated at any time. As federal law permits states to agree to interstate conduct of Internet gaming among themselves, the logical and reasonable pathway is to allow cross-border activities by companies which obtain reciprocal licenses.

This means that in setting the sur-tax rates, California should stay within the limits that already exist for sur-taxes on gambling activity for land-based casinos in other states, as these will be the likely guideposts for Internet based gambling.

In addition to a sur-tax, California may also consider imposing an entry fee. We believe that an entry fee should be substantial enough to exclude fly-by-night operators but not so high as to make viability of medium sized operators impossible. To put it in rough terms, a fee in the hundreds of thousands is too low, but a fee of several tens of millions of dollars is too high. The extent to which a fee is too high is dependent upon a host of factors, including:

- Is there a sur-tax and if so how much?
- Are the permitted kinds of games expansive or limited?
- What is the length of the license?
- Will the market be protected effectively from unlicensed operators who do not pay tax?

An additional possibility is setting different fees dependent upon the kinds of games offered, with a lower fee for say, sites offering low-stakes poker, with higher fees to a company that desires to have a broader selection of games.

In our view, the best long-term solution for California is a combination of an entry fee in the single digit millions plus a sur-tax on betting income in the single digit percentages, over and above California's normal income tax rate.

To the extent that slot-machine style Internet gaming is allowed, the overall tax burden on such income should be set as closely as possible to match the effective tax burden on Indian casino games so that such gaming is neither less heavily nor more heavily taxed than Internet gaming. Similarly the sur-taxes on peer-to-peer card games should be similar to the effective burden on land-based cardrooms. This may lead to different sur-tax rates on different kinds of gambling offerings, but

there is nothing inherently problematic with different tax rates on different games so long as they are similar to those imposed on California land-based competitors and, eventually, Internet-based competitors in other states.

4. Key Features of Effective Private Operator Regulation

We believe that there are a number of key features for a properly functioning regulatory regime. These are as follows:

- Websites should be operated by only experienced and responsible operators
 - The social success or failure of online gambling in California will be enormously influenced by the organisations which operate them. The state should seek to ensure that each operator is of the highest quality.
 - California must bar from obtaining a license those operators which have in the past offered or are currently offering Internet gambling to US players, and should also bar the shareholders or principals of such ventures from being associated with licensees. If this were not to occur, California players would have their funds at risk to asset forfeiture by law-enforcement in other states or at the federal level seeking to punish past or ongoing violations.
- Websites should be strictly licensed and regulated

The licensing and regulation of operators should accord with best international practice and, in particular, there should be strict enforcement. Although a detailed review of the specifics of the regulations is beyond the scope of this submission, we believe that they should include at least the following basic principles:

- a. Licences should be granted for a significant period (e.g. in the range of 10 years) to encourage real investment and development of experience;
- b. Licensing and regulation may be conducted by either a new regulator or by expanding the scope of the jurisdiction of the California Gaming Commission. however if the latter, various

- other changes may be necessary to ensure it has the resources to manage the expanded remit;
- c. Deterrence of money laundering and combating the financing of terrorism should be central obligations of the operator;
 - d. Operational issues such as age policy, game limits, game types, provision of credit to players, power of entry/inspection for the regulator, etc. should be fully regulated;
 - e. Penalties and the grounds for licence termination or suspension for regulatory breach should be clearly provided for.
 - f. operators should put up a substantial 'good conduct bond' (in the range of many millions of dollars);
 - g. Licensee should be required to establish all operations in California, but the law should contemplate reciprocity with licensed operators in other states to allow inter-state competition and expand the reach of operators who choose to set up in California.

III. CONCLUSION

California is the leader jurisdiction for businesses which focus on the Internet and entertainment. Its cardrooms created the model for peer-to-peer poker that predominates on the Internet. It has the market size, demand and human capital to create a self-sustaining market for Internet gambling that could spread to much of the nation and quite possibly compete with the licensed operators in Europe and eventually other parts of the world. At Paddy Power, we would be very excited to have the opportunity to play a part in the development of a new American industry.

PADDY POWER PLC

BIOGRAPHY OF PANELIST

Cormac Barry, Commercial Director, 35

Qualifications- BA Economics and Politics
(Trinity College Dublin, Ireland)

Experience- Cormac Barry has been involved in the online betting industry for over 10 years and is currently Commercial Director with Sportsbet, the Australian subsidiary of Paddy Power PLC, a role he took up in the summer of 2009. Cormac joined Paddy Power Plc in 2000 and was part of the team that set up www.paddypower.com and made it one of the most successful online betting operations in the UK and Ireland. From 2004 onwards Cormac managed Paddy Power's online poker business and was responsible for this business until moving to Sportsbet. Prior to moving to Melbourne to join Sportsbet, Cormac was employed as the Head of Online at Paddy Power PLC. Previous experience includes working in the software industry for IONA Technologies, an Irish middleware technology company which was quoted on NASDAQ.