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Alison Harvey
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1530 J Street, Suite 250
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Dear Ms. Harvey:

This responds to your request for an estimate of the revenue that the State of California could derive from a proposal¹ to license and tax intrastate, internet poker.

Short Answer

The proposal would result in an annual General Fund revenue reduction of \$365 million, partially offset by an annual increase in revenue of up to \$50 million and by an unknown, but probably not substantial increase in personal income tax collections. The \$50-million estimate assumes that all Californians currently playing on offshore sites redirect their play to a new California site and that there is a 10-percent state tax on participation fees paid by poker players to online pokers operators. In practice the market share captured by the new site is likely be substantially less than 100 percent.

Background

Federal Law

¹The Morongo Band of Mission Indians and a consortium of card clubs have proposed legislation to create a single internet poker site operated by a "single licensed entity" that would be regulated and taxed by the state.

The Unlawful Internet Gambling Enforcement Act (UIGEA) of 2006, defines unlawful internet gambling as “to place, receive, or otherwise knowingly transmit a bet or wager by any means which involves the use, at least in part, of the Internet where such bet or wager is unlawful under any applicable Federal or State law in the State or Tribal lands in which the bet or wager is initiated, received, or otherwise made².”

However, UIGEA and the implementing Regulations³, jointly issued by the Federal Reserve and the Department of the Treasury, provide for an intra-state exemption. The exemption is predicated on the premise that the bet or wager is initiated and received or otherwise made exclusively within a single State and certain other conditions are met (i.e., the bet is otherwise legal in the state).

Continuation of Internet Gambling in the US Post-UIGEA

Despite the UIGEA, internet gambling, including internet poker, continues in the US. Global Betting and Gaming Consultants (GBGC)⁴ estimate that in 2006 there were 778,900 active internet poker accounts based in

² U.S.C. § 5361 et seq.

³ 12 CFR Part 132, and 12 CFR 233.

⁴ Global Betting and Gaming Consultants is an independent, international gaming consultancy. It operates from the Isle of Mann in the UK as well as from Zagreb, Croatia. It is one of two major established consultancies of its type in the world (the other being H2 Gaming Consultants, also of the UK). It provides market research and assessments to governments and businesses throughout the world. Its estimates are based on data published by government regulators worldwide, publicly available information on active customers, yields and win margins in company reports and data obtained through consultancy work with clients. This is combined with economic and cultural information that GBGC has determined is related to the Internet gambling sector such as GDP, gambling tax rates, internet and broadband usage and growth, regulations and the ability for operators to advertise freely in the market and the number of websites targeting specific markets.

California⁵. With the enactment of the UIGEA the number of active accounts fell to 567,900 in 2007, but by 2009 had rebounded to 778,000. Many online poker players have more than one account; a survey conducted by GBGC found that only 44 percent of players use only one account.

US-facing offshore sites operate beyond the reach of US law. In fact, the European Union and the World Trade Commission have both determined that UIGEA is a violation of free trade agreements⁶. While UIGEA has resulted in the elimination of some money transfer agents (payment processors) and outlaws domestic credit card use for internet gambling, the federal government, for practical reasons, has not been able to eliminate all forms of money transfer in and out of the country for purposes of internet gambling. Indeed, some offshore sites still offer Americans the option of using a credit card. Alternative methods of money transfer such as debit cards, wire transfers and checks issued on US banks are more time-consuming and difficult to use than credit cards, but they provide mechanisms for the continuation of internet gambling in the US. Moreover, in December 2009, the US Treasury and Federal Reserve postponed for six months the implementation of the regulations implementing UIGEA⁷ and with bills to legalize and regulate internet gambling pending in Congress⁸, there is speculation that the UIGEA will never be enforced.

It remains illegal in California for anyone to use the internet for gambling, including playing poker. However, to our knowledge, there has never been

⁵ See attachment no. 1, GBGC Estimate of California Internet Poker Market. Since many poker players have more than one active account, this figure significantly overstates the number of individual Californians who played poker over the internet.

⁶World Trade Organization report WT/DS285/RW, 30 March 2007, "United States Measures Affecting the Cross-Border Supply of Gambling and Betting Services; recourse to Article 21.5 of the DSU by Antigua and Barbuda."

⁷ Poker News Daily, November 30, 2009.

⁸ Poker News Daily, May 7, 2009.

a successful enforcement action brought against any individual for using the internet to play poker in California, or in any other state.

Indian Gaming and Exclusivity in California

The Indian Gaming Regulatory Act of 1988⁹ required tribes to negotiate a compact with the state government in order to engage in casino-style gaming on Indian lands. In California, passage of the IGRA in 1988 did not end disputes between the State of California and tribes regarding the legality of various types of Indian gaming under California law, since the state constitution prohibited slot machines. Governor Wilson entered into compacts with a number of tribes that allowed some types of lottery-style machines to be used, but many tribes objected to the limitations in these compacts.

In November 1998, the voters enacted Proposition 5, which provided broad authority to Indian tribes to offer certain types of gaming, including slot machines. The California Supreme Court, however, nullified the proposition on the grounds that it violated the State Constitution. Governor Davis responded with a new round of compacts, which were contingent on the enactment of a legislative constitutional amendment. This amendment -- Proposition 1a -- was approved on the March 7, 2000 ballot.

In 2004 and 2006, Governor Schwarzenegger signed new compacts with various tribes, which required these tribes to make substantial payments to the state's General Fund. These compacts granted the tribes that signed them the exclusive right to provide play on certain gaming devices "in recognition of the Tribe's agreement to make the payments¹⁰." The exclusivity agreements specifically allow tribes to continue providing the type of gaming authorized by the compacts but to cease making the payments to the state "if any person or entity other than an Indian tribe with a feder-

⁹ 25 U.S.C. § 2701 et seq.

¹⁰ Section 3.2 of various compacts.

ally authorized compact engages in any Gaming Activities specified”¹¹, which includes the use of a “gaming device.”

The Governor’s Budget for 2010-11 projects that the General Fund will receive payments from tribes pursuant to these compacts and subject to the exclusivity clauses totaling \$365 million in 2010-11¹². The compacts will remain in effect until 2030.

The Proposal

Consistent with the UIGEA, the proposal would permit internet poker in California, provide for its regulation and impose a fee to consist of an unspecified percentage of the “commissions” to be collected from players. However, the proposal would allow only one “licensed entity” to operate and provide intrastate internet poker in California. This single licensed entity would consist of a partnership of a tribe or tribes with a licensed card room or rooms. The single licensed entity would be the sole operator of only one website. The measure provides that this site would operate as a hub and all betting would be conducted on this single hub. Using a computer terminal, players would connect via the internet, place their bets, play the game of poker, and collect their winnings.

The measure also states that a personal, networked or server computer used as described in this proposal is not an illegal slot machine as defined in the Penal Code. This provision clarifies that the proposal does not expand the limitations on gambling provided pursuant to city ordinances, which generally authorize poker-type games to be provided in licensed card rooms. However, the provision does not negate the exclusivity provisions of the 2004 and 2006 Indian gaming compacts with regard to the operation of gaming devices, nor would it be possible to do so by statute given that the compacts are valid contracts and therefore subject to the

¹¹ Section 3.2 (e) of various compacts.

¹² Schedule 8, Comparative Statement of Revenues, Governor’s Budget 2010-11.

protections of contracts clause of the US Constitution (“No State shall ... pass any ...Law impairing the Obligation of Contracts”).¹³

Analysis

Violation of Exclusivity

Poker is legal in California (under certain circumstances) and the provision of poker to the public at a physical location does not violate the exclusivity clauses of the 2004 and 2006 Indian gaming compacts. However, by authorizing the use of an electronic device for the play of virtual poker, the proposal would result in the loss of \$365 million in annual Indian gaming revenue to the state’s General Fund.

This is because the exclusivity granted by the compacts is for the use of “gaming devices.” Section 2.6 of the compacts defines a gaming device as a “slot machine, including an electronic, electromechanical, electric or video device that, for consideration, permits: individual play with or against that device or the participation in any electronic, electromechanical, electric or video system to which that device is connected; the playing of games thereon or therewith, including, but not limited to, the playing of facsimiles of games of chance or skill; the possible delivery of, or entitlement by the player to, a prize or something of value as a result of the application of an element of chance; and method for viewing the outcome, prize won, and other information regarding the playing of games thereon or therewith.” It is indisputable that this definition would encompass the use of the internet to provide poker play. In addition, the National Indian Gaming Commission has opined that the use of a device in the play of what would otherwise be a class II game (e.g., non-house banked poker) makes it a class III game¹⁴ (i.e., covered by the exclusivity clause of the compacts).

¹³ US Constitution, Article I, section 10, clause 1.

¹⁴ Letter from Penny J. Coleman, Acting General Counsel, National Indian Gaming Commission to Mr. Kent R. Hagg, Whiting Hagg and Hagg of Rapid City South Dakota on December 21, 2004.

We assume that no tribe would continue making the payments tied to the exclusivity clause in the event of its violation since the tribe's obligation to make those payments would automatically be removed by the violation under the explicit language of the compacts.

Revenues from the Proposed Fee

The fees that would be collected by the State of California under the proposal would be a percentage of the "commissions" of the single licensed entity. While the term "commission" is not defined in the measure, we assume that it means the gross gambling yield (GGY). GGY is defined as the total amount wagered by players, any participation fees paid by players, less the amount paid out to players as winnings. It gives an indication of the economic value provided by the online gambling industry. For online poker, it represents the "rake"¹⁵ and tournament fees collected.

GBGC project that total GGY attributable to internet poker played anywhere in the world from terminals located in California in 2011 will be \$536 million¹⁶. If all such players moved to the proposed new single licensed entity's site and continued to play at the same level, a 10-percent fee would generate \$53.6 million. Of course, given the access that players would continue to have to the same non-licensed, offshore sites on which they currently play, it is unlikely that a substantial percentage of them would begin playing on the proposed new single licensed entity's site or play there exclusively. There are two reasons why many players, especially the high-stakes players whom GBGC advise account for a disproportionate share of the GGY, would be unlikely to switch to the new site.

First, moving to a single licensed entity's site could entail substantial costs to the players. California card clubs typically charge players a higher rake than the offshore internet sites which, in turn, pay much lower taxes to the

¹⁵ The "rake" in poker refers to the collection by the operator of a portion of each pot, where a pot is the total amount of money bet on a given hand of poker.

¹⁶ See attachment no. 2, GBGC Estimate of California Internet Poker Market, Jan 2010.

jurisdictions in which they operate. A 5-percent tax on the rake is considered higher than most offshore operators are willing to pay. In addition, the offshore sites offer substantial bonuses and incentives to attract and keep players. California has the highest marginal income tax rate in the nation and this would be added on top of the federal tax owing by players on the licensed site.

Second, as a monopolistic, intrastate site the proposed single licensed entity would have a competitive disadvantage in attracting players away from offshore sites whose player base is international, far more numerous and thus likely to provide larger pots and more competition. Top level players seek sites with the maximum number of less experienced players, i.e., those with the best “fish-to-shark” ratios. They also seek high stakes play with international peers, who would not be admitted to a California-only site. In addition, it is unlikely that a monopolistic, regulated site would be as nimble in its player acquisition and retention tactics as are the current, very competitive, very experienced sites.

While the percentage of players who would move to the single licensed entity is unknown, the Swedish experience may be instructive. Sweden’s government monopoly poker site has been in operation for several years and has managed to achieve only a 30-percent share of the total Swedish internet poker market.¹⁷ A similar share in the California operation would drop state revenues to less than \$17 million if the rake is taxed at 10 percent.

We also asked GBGC what effect legalization would have on total state revenues if licensing was also opened to offshore operators, all were deemed suitable by the state, all chose to participate, and all paid a state tax. They believe that legalization could expand the market substantially, but only if (a) the fee is kept quite low, probably no more than 5 percent, and (b) the legalization allows for competition. Under these conditions, GBGC projects that the total GGY for a California site and the numerous offshore sites could rise to \$1.2 billion in the first year and to \$3.7 billion by the fifth year of legalization, with revenues from a five-percent fee esti-

¹⁷ Deutsche Bank, Company Alert, Party Gaming PLC, January 11, 2010.

mated at \$61.1 million in year one and \$183.4 million by year five¹⁸. Competition is important because this is a sophisticated and competitive market, and successful companies devote substantial resources to player acquisition and retention. The importance of competition may best be illustrated by the statistic, cited above, that fewer than half of current players maintain only a single account.

Of course, the current proposal does not allow for in-state competition and it is our understanding that the proponents are suggesting a fee of at least 10 percent, double what GBGC believes to be feasible without substantially degrading participation. As a result, we believe that the appropriate estimate of fee revenues, assuming a 10 percent fee and a non-competitive licensing environment, to be substantially less than \$50 million annually.

Additional Personal Income Tax Revenues

To the extent that California-based internet poker players do not currently report their winnings for tax purposes, the inception of a legal site could be expected to generate increased personal income tax revenues. In the absence of aggressive enforcement by the federal government, however, players will continue to have access to unregulated, off-shore sites. Moreover, we do not believe that there is any data available that could be used to estimate the amount of internet poker winnings that currently goes unreported to the Franchise Tax Board nor any data on which to base an estimate of how much would be reported through the proposed single licensed entity.

It should also be noted that the proposal requires the Governor of California to opt out of any subsequent federal scheme to legalize, regulate and tax internet gambling, including casino-style games. Since regulation of US access to the world wide web can only be optimally achieved by the federal government, the proposal may result in a loss of an opportunity to increase personal income tax revenues from gamblers in the future, to the

¹⁸ See attachment no. 2, GBGC forecast of legalized internet poker in California.

extent it prevents the federal government from authorizing and regulating California-based internet gambling.

Local Government Revenues

Various local governments in California collect revenues from licensed card rooms. We have not analyzed in detail the probable effects of the proposal on local revenues, in part because there is no reliable source of comprehensive, statewide data on how much revenue is currently collected attributable to poker. However, it is clear that to the extent that the proposal attracts players away from card rooms, there could be a loss of local revenues. Since players in card rooms already have access to off-shore poker sites, albeit with some difficulty due to the limited impacts of UIGEA, we see no reason to believe that a significant number of them would give up play in card rooms in favor of the proposed single licensed entity's site. Therefore we do not believe that the proposal would result in a significant loss of revenues to local governments in California.

Other Issues

We have limited our analysis to revenue effects and have not rendered an opinion on the efficacy of existing technology to (a) block advertising from unlicensed sites, (b) prevent or limit underage gambling, or (c) contain users to the geographic boundaries of the State of California. These are significant practical issues that need to be addressed should the proposal move forward.

We also have not rendered an opinion as to the legality under federal or international law of the proposed state action to block access to non-licensed sites.

In addition, we are concerned that the proposal does not clearly and unequivocally require that a competitive process be followed for issuing any future licenses to provide internet poker in California. Indeed, the proposal before us seems to imply that its proponents would have, at minimum, the inside track to become a monopolistic provider. As noted above, this has significant implications for the potential to generate fee revenues, but perhaps more importantly, it raises serious ethical and legal concerns.

Alison Harvey, Executive Director
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Sincerely,

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Attachments