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Alison Harvey
Executive Director
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1530 J Street, Suite 250
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Dear Alison:

I have reviewed the report, "Fiscal and Economic Implications of Internet Poker in California" by Jose Alberro, Ph.D. and Ronald H. Schmidt, Ph.D. The report concludes that legalization of internet poker in California would result in increased state revenues ranging from $164 million to $284 million in 2010-11, growing to between $612 million and $354 million in 2015-16.

The report does not address the loss of $365 million in annual revenue that would result from the fact that legalization of internet poker would violate the exclusivity provisions of the amendments to the tribal compacts of 2004 and 2006, which I noted in my previous letter to you. In fact, it makes no mention whatsoever of the impact on revenues from tribal compacts. Thus, my first observation regarding the report is that, even at the high end of its projected range of revenue, the state would suffer a net loss of revenue in 2010-11, and at the low end the state would incur net losses in the first three years of legalization.

I would also note that their projections of Gross Gaming Revenue (GGR) are actually somewhat lower than the estimates I provided you. Specifically, they indicate that H2Gaming Consultants project a low case of just over $400 million in 2010-11 and a "base case" of about $800 million that year. In my letter to you, I relied on forecasts provided by Global Betting and Gaming Consultants (GBGC), which ranged from $491 million to $1.2 billion in 2010. The GBGC projections are also substantially higher in the later years, e.g., $589 million to $2.8 billion for GBGC in 2012 as compared to about $700 million to $1.2 billion for H2 in 2012-13. Given the inherently speculative nature of such forecasts, these differences should not be regarded as material. Thus, the substantially higher state revenue projected by Alberro and Schmidt is not due to any material difference between our estimates of the volume of internet poker play.

Instead, the difference in our revenue estimates is due to five major factors:

1. As noted above, Alberro and Schmidt did not address the loss of $365 million in annual revenue from the 2004 and 2006 tribal gaming compacts;

2. They assume a 20-percent tax rate while I assumed a 10-percent rate;

3. They appear to assume that nearly all of the GGR/GGY would be subjected to the tax, while I note that it is unlikely that a state operated monopoly would achieve a nearly 100-percent market share;

4. They provide estimates for increased personal income taxes on winnings, which for reasons explained in my letter to you I did not think it prudent to reflect; and,

5. They provide a "base case" scenario, which I regard as an optimistic, high-end estimate.

I discuss the last four of these differences in detail below.

Tax Rate

We analyzed different proposals. Alberro and Schmidt analyzed a proposal that specified a 20-percent rate, whereas the proposal I analyzed did not specify the rate. I assumed the rate would be 10 percent because we had been told that the proponents were planning to specify that rate in a later iteration of their legislation. I also assumed 10 percent based on the following advice from GBGC (which was appended to my original letter to you):

> "As the tax rate increases the value that California-licensed websites can offer customers is lessened by comparison to those operators located offshore with low or no gaming tax to pay.
>
> High tax rates limit the amount that operators can give to players in bonuses and rakeback. Offshore operators will be able to entice players with a more compelling sign-up offer, with more marketing funds at their disposal."

Thus, I am skeptical of the 20-percent rate in the proposal analyzed by Alberro and Schmidt. I cannot discern from their written report whether they or H2 took the deterrent effects of a higher rate into account. I think it is obvious that such a high rate would tend to depress the volume

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going through the state-authorized monopoly site and encourage players to continue using untaxed offshore sites.

The Base Subject to Tax

I assume that H2 and GBGC both recognize that some Californians would continue to play on offshore sites after legalization; however, I do not find any reference to that reality in the Alberro/Schmidt report. I believe the apparent failure to account for such leakage of revenue is a major oversight.

As I indicated in my first letter to you, the UIGEA regulations only apply to credit cards (and they have effectively ended the use of those cards for internet gaming, even with the moratorium the Treasury Department has placed on their enforcement). The UIGEA regulations do not prevent the use of debit cards, wire transfers and checks. Obviously, any estimate of direct revenues to be garnered from licensing internet poker should be discounted by some amount to reflect the probability of leakage of players to offshore sites.

In my estimate, I also provided a figure that represents a 100-percent shift of existing players to the new, legal site. However, as I stated in my letter, I think that in reality it is extremely unlikely that a such a site would actually achieve anything close to a 100-percent market share. That is why I stated that the revenue to be garnered from the proposal I analyzed would be "something less than" the amount stated. I think common sense alone justifies my skepticism, but it is also based on the following advice from GBGC:

> "No state or country has achieved 100% blocking of "illegal" sites. If the state set an Internet poker tax rate that was too high, then the offshore market would still be attractive for both players and operators.
>
> The higher the tax rate, the more revenues we believe the state will lose to offshore websites."

Personal Income Tax Revenue

The major indirect revenue projected by Alberro and Schmidt is from a projected increase in the state's receipts from the personal income tax due to the assumption that winnings on a state-licensed site would be reported to state and federal tax officials. (While they provide detailed analysis of the potential economic effects such as additional employment due to moving jobs from offshore to within the state, the revenue gains from these calculations are minor compared to the gains they foresee from increased taxation of winnings.)

I acknowledged the possibility of an increase in personal income tax collections in my letter to you as follows:

> "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. "

Alberro and Schmidt provide a credible estimate of the amount of net income to internet gaming winners that goes unreported to tax authorities. While there are no data on the portion of that unreported income that is associated with internet poker (recall that poker accounts for only about 20 percent of internet gaming GGY), I do not have any significant dispute with their estimates of unreported income attributable to internet poker. I also concur with their assessment that the licensed site would result in effectively complete reporting of the net winnings of the players on that site.

The problem is that offshore sites will continue to be accessible. Alberro and Schmidt note that net winners constitute a minority of all internet poker players. The larger the winnings, the larger the attraction of playing on offshore sites where winnings would not be reported. I do not dispute that some players would play on the licensed site, even knowing that their potential winnings would be reported to the tax authorities (although such scrupulously honest players may already be reporting their net winnings). However, given the lack of federal enforcement, it seems indisputable to me that a substantial portion would be attracted to the offshore sites where winnings are not reported to tax authorities. Therefore, I continue to believe that it would not be prudent to rely on an expectation of major personal income tax gains.

"Base-Case" versus "Low Case"

My estimate assumed the GBGC estimate of the current level of GGY projected forward without any assumption of legalization. It appears that the "low-case" provided by Alberro and Schmidt was based on a similar approach, but using H2's somewhat lower projections.

As I explained in my previous letter to you, GBGC also provided a forecast for the impact of legalization, and it was substantially higher than their forecast of the status quo. It appears that H2's legalization forecast, which is the basis for the Alberro/Scmidt estimates of their "base case" is similar to GBGC's, albeit somewhat lower, especially in the out years.

GBGC's forecast for a legalization scenario made two hugely important assumptions: a low tax rate and an open market that would allow any company to secure a license in California. It is not evident from the Alberro/Schmidt report whether they had any such cautions from H2. Since neither the proposal I analyzed nor the proposal analyzed by Alberro and Schmidt allowed for a tax rate as low as prescribed in the GBGC model, and since both require a single-licensed operator, I did not think it prudent to rely on GBGC's legalization scenario projection and I know of no reason to assume that H2's projection is any less subject to those two key constraints. Not addressed by the Alberro/Schmidt report, nor by the GBGC projections, is the deterrent inherent in restricting participation to players located in a single state, even one as large as California. In practice, it seems very likely that many customers will continue to prefer playing against a broader, international and interstate market. Moreover, in a purely intrastate model, the costs of customer acquisition and retention are likely to be quite substantial and can thus be expected to erode the GGY over time. The meager 30-percent market share of Sweden's monopolistic site demonstrates not only the improbability of the near complete market domination envisioned by Alberro and Schmidt, but also the likelihood that a monopolistic, geographically limited model will require high levels of investment in customer acquisition and retention. Of course, money spent on customer acquisition and retention does not contribute to the GGY and would thus not be taxed.
In conclusion:

- The fundamental estimates of the size of the internet poker market provided by Alberro and Schmidt are actually somewhat lower than the estimates I provided you.

- Their assumption of a higher tax rate accounts for much of the difference between our estimates of direct revenues from licensing a monopolistic, intrastate poker site.

- Their estimate appears to assume near total market domination by the new, licensed site. This seems highly implausible given that offshore sites will remain available in the absence of increased federal regulation of the offshore market (not a likely prospect given the current moratorium on enforcing the UIGEA and the exemption from the UIGEA altogether of debit cards, wire transfers and checks).

- Another major difference in our revenue estimates is their willingness to count on more winnings being reported to the FTB. My reluctance to do so is based on the fact that offshore sites will continue to be accessible and especially attractive to players who expect to have significant net winnings. I am willing to acknowledge that there would be some increase in personal income tax collections, but I think it is speculative to assume a specific amount, especially an amount as large as projected by Alberro and Schmidt.

- The major difference in our bottom line forecast of state revenue is the loss of $365 million in annual tribal gaming revenues that would result from the violation of the exclusivity clauses of the 2004 and 2006 tribal gaming compacts. The Alberro/Schmidt report does not address this at all.

While I respect the professionalism and technical expertise that went into the Alberro/Schmidt report, I respectfully disagree with its findings that intrastate, internet poker would be a net revenue gain to California's General Fund, at least in the first years.

Sincerely,

GENEST CONSULTING

Michael Genest