

250 West 57th Street, Suite 432
New York, New York 10107
Phone: 207.688.4500
Email: cca-ny@verizon.net

170 Sawyer Road
New Gloucester, ME 04260
Phone: 207.688.4500
Email: stsinc@ghi.net

An Evaluation of the Effects of Online Poker on State Lotteries

Prepared by: Christiansen Capital Advisors, LLC
Prepared for: FairPlayUSA

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Executive Summary

Internet poker and lottery games are fundamentally different products. Playing lotteries and playing poker are fundamentally different consumer activities.

The available evidence suggests that the growth of Internet poker prior to the Unlawful Internet Gambling Enforcement Act of 2006 did not adversely impact State lotteries or reduce State lottery revenues.

Enforcement actions after UIGEA became law reduced U.S. spending on Internet poker by an estimated \$600 million but were not accompanied by an upward spike in U.S. lottery sales.

A recent report by Public Gaming Research Institute (“PGRI”), a group “dedicated to the support and growth of lottery organizations”, suggesting that lotteries would be adversely affected by the legalization of online poker, is not supported by the historic economic data we reviewed. Nothing in the PGRI report constitutes a factual basis for its assertion that Federal legalization of Internet poker would adversely impact U.S. lottery sales or State lottery revenues.

The PGRI report should not be used as the basis for any public policy decisions, particularly those related to the legalization of online poker.

Christiansen Capital Advisors, LLC (“CCA”) has been retained by FairPlayUSA to evaluate a report prepared by Public Gaming Research Institute (“PGRI”), “Quantifying the Impact of Federalization of Internet Gaming on Lotteries”.¹ While the PGRI report assumes a broad introduction of legal Internet gambling games, our evaluation focuses on the impact, if any, of online poker legalization on State lotteries, consistent with the current debate about pending Federal legislation that would regulate online poker only and otherwise strengthen the enforcement tools needed to remove illegal Internet gambling sites from the United States.

The PGRI report asserts that Federal legalization of Internet gambling would reduce State lottery revenues. Our understanding of consumer behavior and the economics of the gambling industry leads to a conclusion that this assertion has no basis in fact and is unwarranted, for the reasons stated below.

1. Poker and Lotteries Are Fundamentally Different Products

Lotteries are games of chance. Skill has nothing to do with whether a lottery player wins or loses.

Poker, on the other hand, is a game of mixed chance and skill. The order of cards as they are dealt is chance. The player's ability to remember the order of cards, “read” other players, bluff, manipulate other players psychologically, and know and remember odds or probabilities are skills. At expert levels skill is the dominant factor in determining the outcome of poker games. Moreover, lotteries are banked by the operator. Casinos and card rooms don’t bank poker because they would lose to expert poker players. Instead, California card rooms charge seat rentals, while casinos in Nevada and elsewhere that offer poker “rake” or deduct a percentage of the pot.

These differences are important. Arguing that legalizing Internet poker will reduce lottery sales is like arguing that because introducing nonfat milk into the beverage market is observed to reduce consumption of whole milk, introducing wine into the beverage market will likewise reduce consumption of milk. Milk and wine are both beverages but they satisfy different consumer appetites. Wine is not a good substitute for milk and *vice versa*. Similarly, in our extensive professional experience with researching economic data and consumer behavior pertaining to lotteries, poker, and other forms of gambling, playing poker and buying lottery tickets are fundamentally different forms of consumption, which have nothing in common other than their legal status as “gambling”.

2. U.S. Lottery Sales Data Contradict an Alleged Substitution Effect

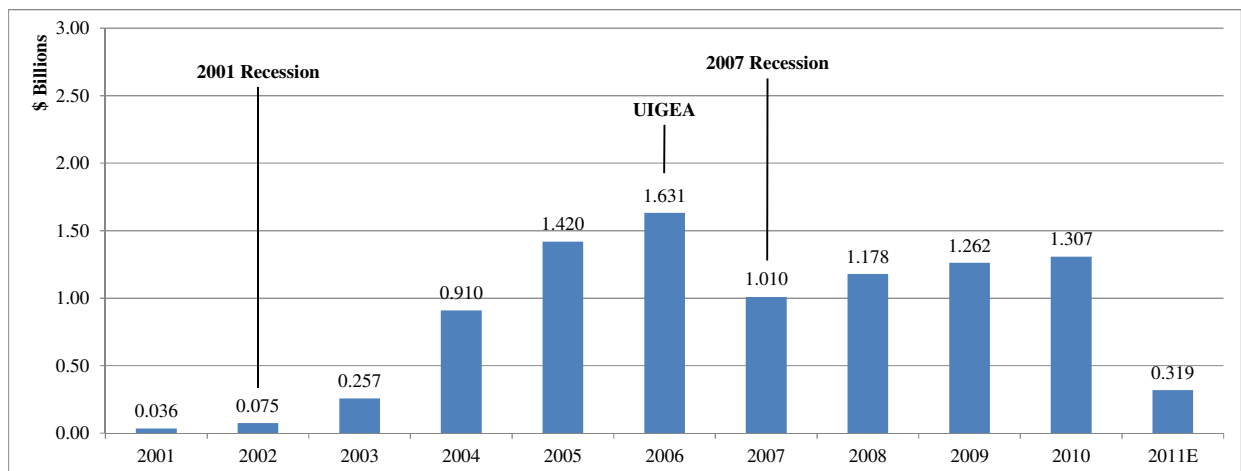
Were online poker a substitute for State lottery games, reductions in Internet poker playing by Americans related to changes in law and/or enforcement actions should have been accompanied by demonstrable increases in State lottery sales. The data do not indicate such substitution. In fact, the data suggest that there is no linkage between Internet poker and lotteries.

¹ Public Gaming Research Institute, “Quantifying the Impact of Federalization of Internet Gaming on Lotteries”. October 2011. 5 pages.

This was demonstrated in 2006, when the Unlawful Internet Enforcement Act (UIGEA) was enacted. Prior to UIGEA, the U.S. online poker market was supplied and substantially dominated by PartyPoker, a subsidiary of PartyGaming plc, a publicly traded company that was then the largest Internet poker business in the world. The UIGEA became law on Friday, October 13, 2006. PartyGaming immediately exited the U.S. market, an action that may have cost the company 90% of its Internet poker business.² Other offshore companies supplying the U.S. online poker market exited the U.S. following enactment of the UIGEA.

U.S. poker players spent an estimated \$1.6 billion in Internet poker rooms in 2006 (Exhibit 1). UIGEA reduced spending by U.S. players on Internet poker by an estimated \$600 million, to \$1 billion in 2007, a void which has subsequently been filled by illegal online poker operators.

Exhibit 1: U. S. Player Internet Poker Gambling Gross Win (2001-2011E)



Note: On July 17, 2003, the National Bureau of Economic Research (NBER) determined that the 2001 recession lasted eight months, beginning in March 2001 and ending in November 2001 (<http://www.nber.org/cycles/july2003/recessions.html>). The NBER announced on September 20, 2010 that the U.S. recession that began in December 2007 ended in June 2009 (<http://www.nber.org/cycles/sept2010.html>).

Source: H2 Gambling Capital Consultants October 2011.

If lotteries are substitutes for poker, some of the money U.S. players had been spending on Internet poker should have flowed into lotteries. We therefore examined U.S. lottery ticket sales before and after UIGEA's enactment, to see if the disruption of the U.S. Internet poker market caused by UIGEA was accompanied by an upward spike in U.S. lottery sales.

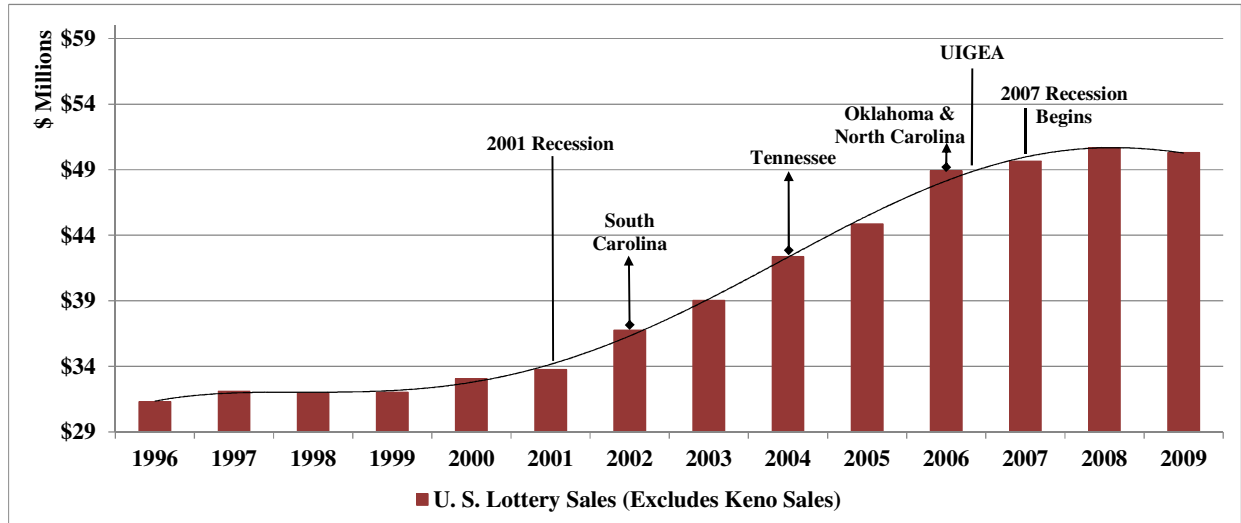
Exhibit 2 presents nominal (current) dollar U.S. lottery ticket game sales for the years 1996 through 2009.³ The recessions in 2001 and 2007 are indicated, as are the initial years of

² Simon Bowers, "Players walk away as US law wipes out 90% of PartyGaming's poker revenue", *The Guardian*, October 16, 2006. See also Fiona Walsh, "Last chance saloon for online gaming firms", *The Guardian*, October 13, 2006; "Online gambling. Poker face off. A crackdown on internet poker may be a prelude to legalization". *The Economist*, April 20, 2011.

³ "Ticket game sales" in these exhibits and elsewhere in this report excludes keno and video lottery terminal (VLT) sales.

operation of the South Carolina, Tennessee, Oklahoma and North Carolina lotteries, which began operation during this period and contributed to overall increases in U.S. ticket lottery sales. The date of UIGEA's enactment is also indicated in this exhibit.

Exhibit 2: U. S. Lottery Ticket Game Sales (1996-2009)



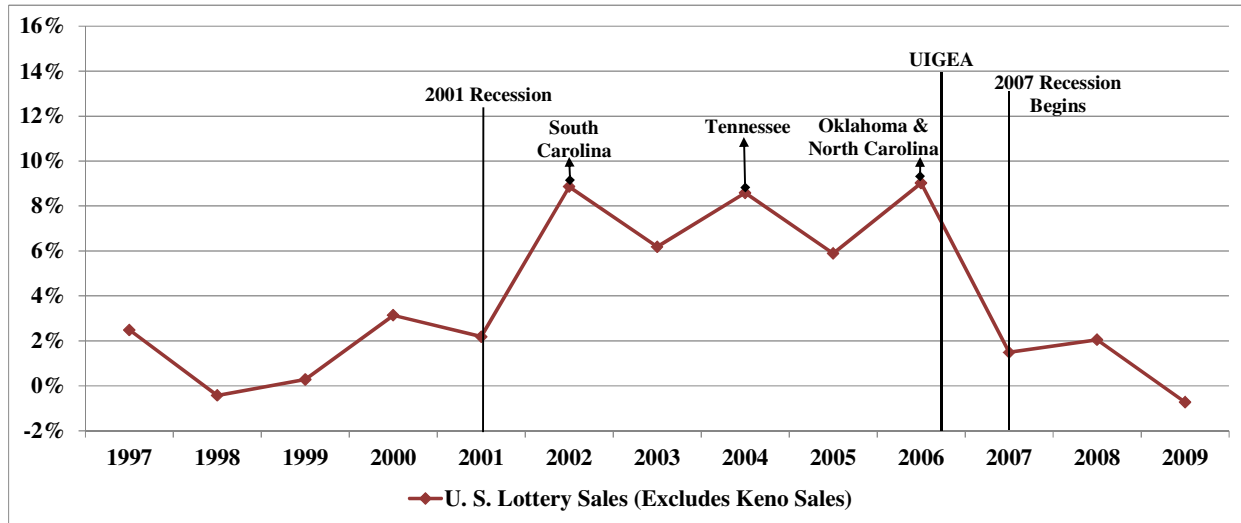
Note: On July 17, 2003, the National Bureau of Economic Research (NBER) determined that the 2001 recession lasted eight months, beginning in March 2001 and ending in November 2001 (<http://www.nber.org/cycles/july2003/recessions.html>). The NBER announced on September 20, 2010 that the U.S. recession that began in December 2007 ended in June 2009 (<http://www.nber.org/cycles/sept2010.html>). New State lotteries with contributions of \$200M or more to total U. S. lottery ticket game sales are South Carolina (2002), Tennessee (2004), Oklahoma (2006) and North Carolina (2006).

Source: *La Fleur's 2010 World Lottery Almanac – The 18th Edition*; page 355 Table "U. S. lotteries' keno sales history: FY1996-2009"; page 368 Table "U. S. lotteries' ticket sales history: FY1994-2009 (excludes VLT revenue)". Statistics are from *La Fleur's 2010 World Lottery Almanac*. Annual lottery ticket game sales are calculated by subtracting keno from U. S. lottery ticket sales (excluding VLT revenue). ((let's put all these extensive notes at the end of the paper so the body of the paper is shorter))

Between 1996 and 1999 U.S. ticket lottery sales stabilized at about \$32 billion. Sales then increased steadily through the first decade of the 21st century, partly due to the start of the South Carolina, Tennessee, Oklahoma and North Carolina lotteries during this period. We note that this growth in U.S. lottery sales coincided with the growth in Internet poker and other forms of Internet gambling in the United States, and that UIGEA did not affect this steady upward trend. (In 2008/2009 U.S. ticket lottery sales turned downward, due to the severe recession that began in December 2007 which adversely affected domestic consumer spending on all forms of gambling.)

This conclusion is reinforced by Exhibit 3, which presents nominal (current) dollar U.S. lottery ticket game sales for the years 1996 through 2009 and calculates year-over-year percentage change in this metric.

Exhibit 3: Year-over-Year Change in U. S. Lottery Ticket Game Sales (1997-2009)



Note: On July 17, 2003, the National Bureau of Economic Research (NBER) determined that the 2001 recession lasted eight months, beginning in March 2001 and ending in November 2001 (<http://www.nber.org/cycles/july2003/recessions.html>). The NBER announced on September 20, 2010 that the U.S. recession that began in December 2007 ended in June 2009 (<http://www.nber.org/cycles/sept2010.html>). New State lotteries with contributions of \$200M or more to total U. S. lottery ticket game sales are South Carolina (2002), Tennessee (2004), Oklahoma (2006) and North Carolina (2006).

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Exhibit 3 shows that U.S. lottery ticket sales were slightly impacted by the 2001 recession and much more severely impacted by the recession that began in the latter half of 2007. The enactment of UIGEA, however, did not reverse the sharp decline in U.S. lottery ticket sales precipitated by the onset of severe recession in late 2007.

The data presented in these exhibits show that reduction in spending on Internet poker caused by the UIGEA was not accompanied by an increase in U.S. lottery ticket sales.

3. Lottery Players and Online Poker Players Differ

While online poker is a new phenomenon that has not been studied as thoroughly as have lotteries, the available demographic data clearly show that online poker players are demographically different from U.S. lottery players. Online poker players are younger and are much more likely to be male.

Lottery officials acknowledge that the lottery customer and the online poker player are different. The executive director of the New Hampshire Lottery, Charles McIntyre, stated during the House of Representatives Subcommittee on Commerce, Manufacturing, and Trade during the Subcommittee's November 18, 2011 hearing on Internet poker that "I don't think [Internet poker] would have an impact directly, immediately ... it's a younger player. Lottery lives and breathes the demographic of 35 to 60 years old and that's not where the internet poker player is now."

We reviewed recent demographic data for California lottery players generated from survey research conducted by the National Opinion Research Center at the University of Chicago and several recent surveys of State lottery players commissioned by State lotteries, including the Texas Lottery. We also reviewed demographic data for online poker players published in an academic journal and on the Poker Players Alliance (PPA) Web site. Our review of these data confirms the statement of New Hampshire's lottery director.

While there is some State to State variation in lottery player demographics, the lottery player data we reviewed are broadly similar in terms of age and gender. A majority of lottery players are 35 years of age or older; in Texas 73% are 45 years of age or older. In sharp contrast, the average online poker player is 28 years of age. Online poker players are overwhelmingly male—about 95% according to the data we reviewed. Lottery players are almost evenly divided between male and female: 53.3% male vs. 46.7% female in California, for example. Clearly, online poker players and lottery players are two, demographically distinct, consumer groups.

4. The PGRI Report

The PGRI report is fundamentally flawed. The report's method, and its explanation of its method, does not support the report's conclusions.

The PGRI report states that introducing successful new products into a market cannibalizes consumer spending on existing products. This is not always or even usually true. Markets are not zero sum games, where demand for a new product comes solely from demand for existing products. A successful new product may (and indeed very often does) stimulate new demand, and may not affect demand for existing products at all, even when the products supply the same sector of the economy. Successful new products are engines of economic growth; through product innovation economies grow.

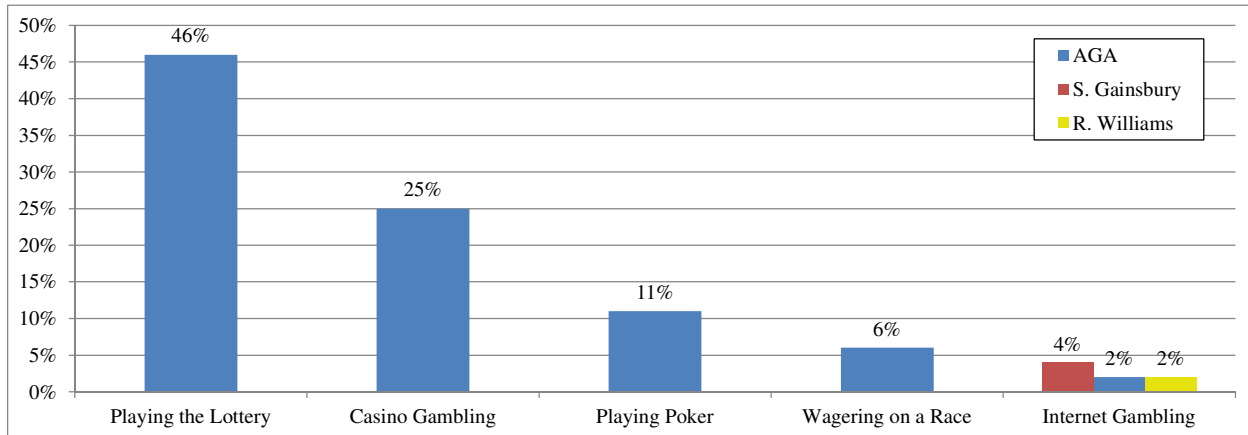
The PGRI report argues that because introducing a popular new lottery game may cannibalize sales of similar existing lottery games legalizing a completely different game (poker) will likewise reduce lottery sales. This is a logic error. In-State lotto games and multi-State lotto games (like Powerball) are essentially similar products: both offer the player the chance to win enormous prizes at very long odds. We would expect the introduction of a multi-State lotto game to adversely impact sales of in-State lotto games. We would not expect the introduction of a fundamentally different game, such as poker, to adversely impact lottery sales.

The PGRI report appears to discount 28% of estimated 2011 U.S. lottery sales and State lottery revenues by the 30% reduction in in-State lotto games it says it has observed when multi-State lotto games are introduced to arrive at a projected \$1.4 billion reduction in State lottery revenue resulting from Federal legalization of Internet poker. The PGRI report appears to state that its analysis of Claritas data⁴ led it to conclude that approximately 28% of the total U.S. population

⁴ According to the PGRI report it cross tabulated two Claritas groups, "households that play lottery 1yr(A)" (meaning, according to PGRI, households playing the lottery 1 to 5 times a month over the course of a year), and "households that have a propensity to use the Internet to play on-line games" (meaning, apparently, on-line video games, not online gambling games, in the past month) and on the basis of its "examination" of the result concluded

of lottery players would “migrate” a portion of the money they spend on lotteries to “i-gaming”, by which Internet poker is apparently meant, if the Federal government legalizes Internet poker. This level of substitution must represent an order of magnitude exaggeration, as survey data show that only 2% to 4% of the U.S. population participates in Internet gambling (Exhibit 7).

Exhibit 7: U. S. Forms of Gambling Participated in During the Last 12 Months (2008)



Source:

American Gaming Association "State of the States 2009", Page 33 VP Communications, Inc. and Peter D. Hart.
<http://www.americangaming.org/files/aga/uploads/docs/sos/aga-sos-2009.pdf>

Sally Gainsbury, "Is Legalized Online Gambling in North America Inevitable? An Australian Perspective," Slide 6. Discovery 2010 Conference, Responsible Gambling Council (RGC). Toronto, Ontario Canada April 14th, 2010.
http://www.responsiblegambling.org/articles/Sally_Gainsbury.pdf

Dr. Robert Williams, "Internet Gambling: Past, Present and Future," Slide 15. International Gambling Conference, Problem Gambling Foundation of New Zealand. Auckland, New Zealand February 24th, 2010.
http://www.pgfnz.org.nz/Uploads/Conference/Presentations/Robert_Williams_2010_Internet_Gambling_NZ.pdf

Furthermore, we would point out both that the purported level of substitution ignores the fact that Internet gambling games of all kinds are readily available today, and that consequently substitution effects (if any) have already been experienced by State lotteries; that proposed Federal legislation would regulate online poker and establish new methods and tools to enforce Federal laws against Internet casino-style games and Internet sports wagering, that proposed Federal legislation would allow States to “opt out” of regulated online poker; and that if substitution has indeed already occurred, lotteries would benefit from the removal of sites offering these games in the U.S. marketplace.

that “... the lottery player who would migrate a portion of spend over to i-gaming comprises approximately 28 percent of the total population of lottery players.” PGRI report, p. 2..

5. Conclusions

In summary, Federal legalization of online poker is unlikely to have materially deleterious effects on State lotteries because lotteries and poker are fundamentally different activities or products; because lotteries and poker serve different consumer groups; and because actual lottery sales data do not indicate the existence of substitution effects related to Internet gambling (including online poker). Moreover, the methodology PGRI apparently used to arrive at its contrary result is flawed, and does not demonstrate anything. It should not be used as the basis for any public policy decisions, particularly those related to the legalization of online poker.