

# Analysis: Pennsylvania Moves To Regulate Online Gambling

Inside the key facets of Pennsylvania's online gambling bill, what it means for the market, and how other states will respond



# On October 26, the Pennsylvania House passed H 271, a sweeping gambling expansion bill that included authorization of online casino and poker games.

Pennsylvania's approach to online gambling is unique on many fronts, and those differences will play a key role in determining the size and success of the market for online gambling in the Keystone State.

This white paper identifies the key elements of H 271 and offers answers to some of the critical questions stemming from Pennsylvania's move toward regulation, including:

- How much revenue is Pennsylvania likely to realize in terms of tax and license fees?
- What is the impact of Pennsylvania's tax rate on the market's potential?
- Will regulated sites in Pennsylvania be able to capture black market activity?
- How will Pennsylvania's decision influence other states considering online gambling?



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# Key points of the bill

## Unique license structure

**H 271 SETS A WHOLLY UNIQUE LICENSE STRUCTURE** for online gambling. Instead of issuing blanket licenses, the bill divides licenses (called “Interactive Gaming Certificates” in the bill) into three categories - essentially poker, table games, and slots - and creates a structure that could conceivably allow license holders to choose between offering one, two, or all three categories.

In addition, the bill also opens the door for gaming entities from outside of the Pennsylvania market to hold

Interactive Gaming Certificates (IGCs). The number of IGCs is capped at 36 (12 per category). Current land-based license holders get first crack at purchasing the IGCs, but if any remain 120 days after licensing opens, then licensed gaming operators from other jurisdictions are able to apply for the remaining IGCs.

The cost per IGC is \$4 million. Land-based license holders have the option to purchase all three categories for \$10 million within the first 90 days of the license process opening.

## How many sites allowed?

**THE BILL ISN'T CLEAR ON THAT POINT.** While the number of IGCs is limited, the bill doesn't articulate how many “skins” (unique brands or websites) can operate under a single license. Consider New Jersey's online casino market: There, the number of Internet Gaming Permits (similar to PA's IGCs) is limited to Atlantic City casinos. But licensees are able to partner with multiple brands under their license. For example, the Golden Nugget has the Golden Nugget online casino, Betfair's NJ online casino, and the

SugarHouse online casino operating under the Golden Nugget's Internet Gaming Permit. Other casinos have similar arrangements.

There's definitely no hard cap described on skins described in Pennsylvania's bill. Skins would need to be partnered with an IGC holder, so there's definitely a practical cap in terms of what the casinos will feel comfortable with. Ultimately, it's likely that regulators will wield discretion on this particular question.

## High taxes and fees

**PENNSYLVANIA HAS SOME OF THE HIGHEST TAXES** on land-based casinos in the world, and policymakers have elected to take a similar approach with online gambling. There is a unique tax rate set for each category (16% for poker, 16% for table games, and 54% for slots), creating a blended tax rate that is easily over two times the tax rate employed by New Jersey.

Additionally, Pennsylvania's upfront license fees are substantially higher than we've seen in any U.S. state-regulated market to date. The combination

of high taxes and high fees may suppress operator interest in the market, and will certainly curtail the ability of operators both to market aggressively and to offer players games and promotions that create a compelling value proposition. Given the unprecedented nature of Pennsylvania's approach, it's difficult to precisely predict what the impact will be, but the performance to date in Delaware, where online gambling has struggled to generate any meaningful revenue, may be the most useful point of comparison.

## Speed to market

**MUCH OF PENNSYLVANIA'S BILL** suggests an approach built to facilitate a rapid path to market. While regulators will have a substantial amount of work prior to launch, the legislation provides them with tools - including conditional approvals and waivers based on approvals in other U.S. jurisdictions - that will help move the process along.

This is likely by design, given the need on the commonwealth's part to realize as much revenue as possible prior to the end of the current fiscal

year in June. But it also reflects a simple reality: Pennsylvania's neighbor New Jersey now has nearly four years of online gambling experience under its belt, as does Nevada, and both states are well-positioned to supply Pennsylvania with much of the template and expertise necessary to craft effective regulations. That advantage, combined with the fact that Pennsylvania regulators have been preparing for online gambling for several years, augurs well for a quick pace to a live market.

## Built for interstate agreements

**DELAWARE AND NEVADA** have shared online poker player pools for over two years. The duo recently reached an agreement with New Jersey that will facilitate the creation of a shared player pool between all three markets.

Pennsylvania is likely to become the fourth state in the pool with relatively minimal delay. H 271 expressly contemplates and enables Pennsylvania's participation in interstate online gambling agreements. New Jersey regulators have confirmed

that they are already in talks with their Pennsylvania counterparts. Operators, having learned the hard lessons of an isolated player pool in New Jersey, will certainly push for quick action. While player pooling won't be at the top of a long to-do list facing regulators in the wake of the bill becoming law, it won't be at the bottom either. The market probably won't share player pools at launch, but it will likely be a matter of months and not years before Pennsylvania joins the larger shared state player pool.

# Revenue analysis

## License fees

# \$120,000,000

Pennsylvania will likely collect \$120 million in upfront license fees from regulated online gambling

The license fee picture in Pennsylvania is complicated by the state's tiered and phased approach to licensing. But it's relatively easy to assign an upper bound to license fees the state could collect. With a total of 36 Internet Gaming Certificates (three per category) available at a maximum price of \$4mm each, the hard cap from IGC fees is \$144mm. Pennsylvania also looks to charge Internet Gambling Operators (e.g., software platform providers) a \$1mm fee. It's harder to establish a hard cap here, but we have difficulty imagining a scenario where more than \$20mm comes in via this route.

With \$164mm as the top, how do we arrive at \$120mm? First, not all licenses will be sold for \$4mm. Land-based operators have the option to purchase all three categories within the first 90 days at a discounted price of \$10mm total. Second, there's a realistic chance that not all licenses will be sold. For example, it's hard to appreciate how 12 online poker IGCs will be sold. There's a less-realistic chance that not all slot licenses will be sold. Finally, while \$20mm is a reasonable upper bound for IGO license fees, it's not an especially realistic number.

License Price		\$3.33mm	\$4mm		
Total Sold	Slot	5	7		
	Table	5	7		
	Poker	5	1		
		\$49.95mm	\$60mm	IGO license fees	<b>Total</b>
				\$10mm	<b>\$120mm</b>

## Impact of tax rate on revenue

Online gambling operates on far thinner margins than land-based gambling. Below we first identify what the blended tax rate is likely to be in Pennsylvania based on the current distribution of revenue by product in New Jersey. Next we compare how a dollar of revenue is broken down in terms of cost and profit in New Jersey and how that same dollar is likely to be broken down in Pennsylvania.

The upshot is clear: Pennsylvania operators will have significantly fewer resources for advertising, player promotions, and staff than their New Jersey counterparts.

In fact, Pennsylvania operators will need to reduce marketing and promotions by roughly half, a cut that is certain to have a negative impact on consumer experience and therefore market performance.

### Online gambling revenue distribution by product in New Jersey

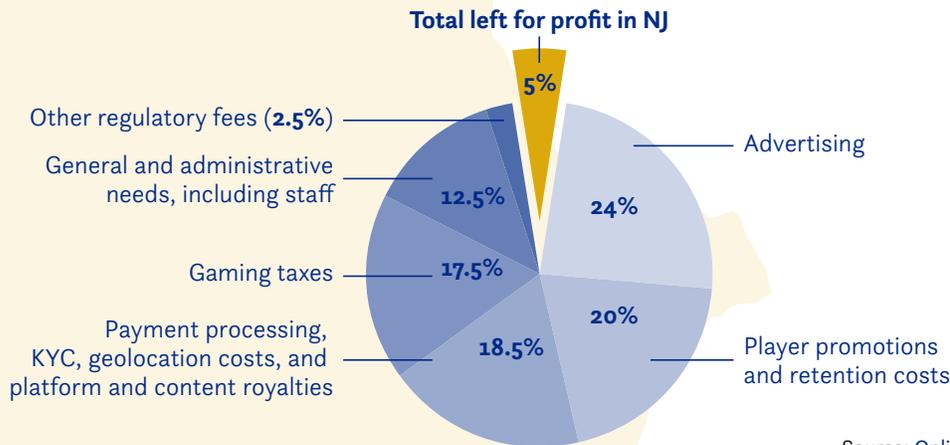
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# 42%

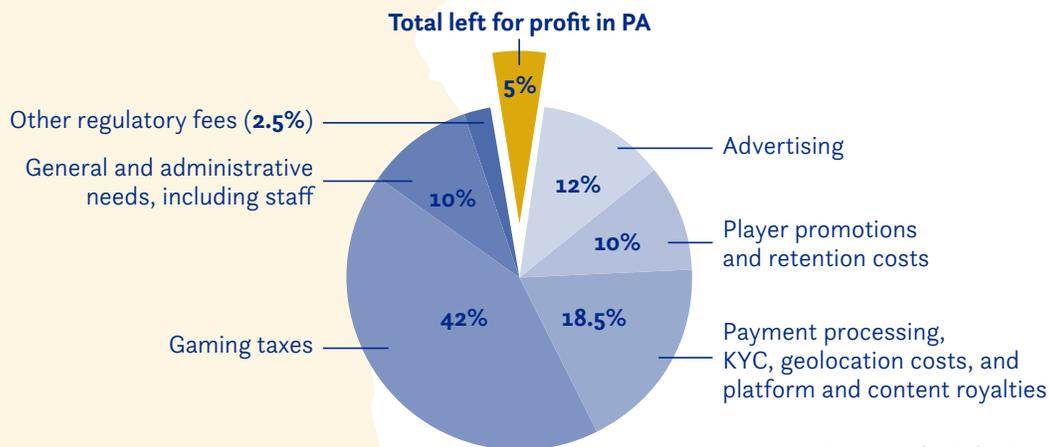
The effective tax rate in Pennsylvania will be 42% if those distributions hold

## Breakdown of \$1 in New Jersey online gambling revenue



Source: [OnlinePokerReport.com](http://OnlinePokerReport.com)

## Breakdown of \$1 in Pennsylvania online gambling revenue



Source: [OnlinePokerReport.com](http://OnlinePokerReport.com)

## Research from international markets

The table to the right summarizes research into optimal tax rates for online gambling. The conclusion is clear: Experts consistently settle on a rate under 20% as the optimal rate for regulated markets. A link to the full text of each study is also provided.

Source	Optimal tax rate	Link to study
Deloitte	10%	<a href="#">Link</a>
Copenhagen Economics	15-20%	<a href="#">Link</a>
PwC	10%	<a href="#">Link</a>

## Lessons from existing state-regulated online gambling markets

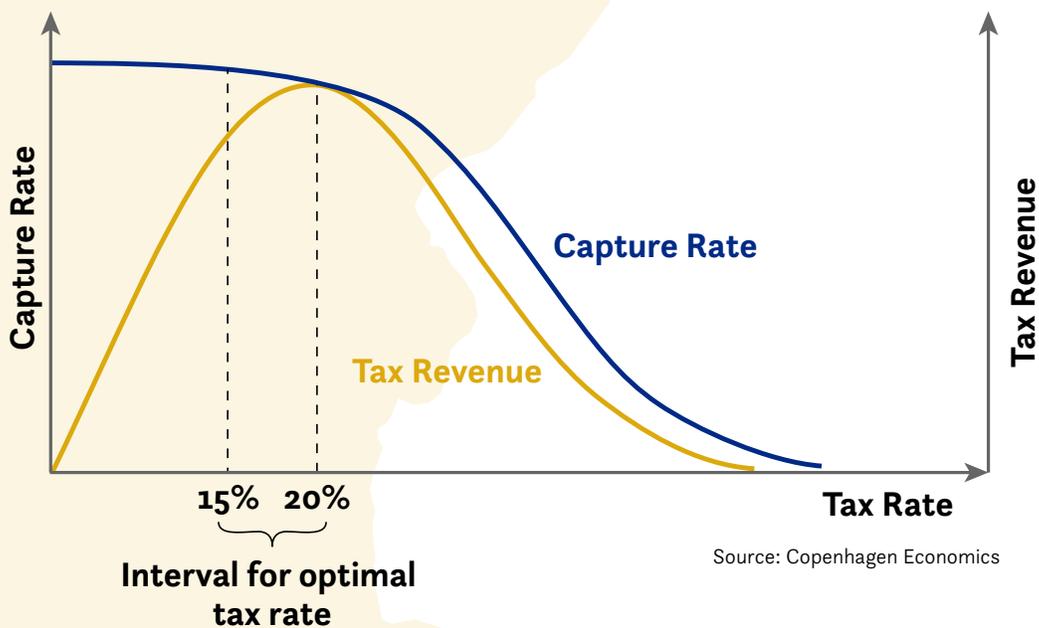
What can we learn from the performance of other states that have regulated online gambling? Below we've assembled a table breaking down the tax rates in Delaware, Nevada, and New Jersey along with some commentary regarding the performance of each state to date.

	<b>Poker tax rate</b>	<b>Table game tax rate</b>	<b>Slot tax rate</b>	<b>Takeaway</b>
Delaware	29.40%	29.40%	43.5%	Delaware's crippling tax rate has ensured that operators spend little to nothing on marketing and product. The result is a market that is on pace to generate a mere \$2.4mm in revenue in 2017. New Jersey will generate roughly 100x more revenue despite being only 10x the size of Delaware.
Nevada	6.75%	—	—	Nevada only offers online poker, but enjoys an online poker market that easily outperforms New Jersey on a per-capita basis. The lower tax rate has allowed WSOP.com (the state's sole operator) to deploy generous promotions that have helped drive growth at the land-based World Series of Poker.
New Jersey	17.50%	17.50%	17.50%	New Jersey's online gambling market is an unqualified success for both the state and operators alike. The state has realized over \$100mm in tax revenue thanks in part to a dynamic, competitive market that has generated significant customer interest and extremely attractive customer values. That environment wouldn't be possible with a materially higher tax rate.
Pennsylvania	16%	16%	54%	The tax rates adopted by Pennsylvania put it close to the Delaware side of the spectrum, suggesting that Pennsylvania will see a market that is artificially depressed. Consumer adoption will likely be suppressed due to low marketing spend and poor promotional / game value.

## Capturing black market demand

One of the primary arguments for a conservative tax rate is that regulated sites must compete with black market sites for customer dollars. The higher the tax rate, the less attractive the regulated product becomes, lowering the overall revenue the market can produce, and therefore the revenue that governments can capture. Below we've included research from Copenhagen Economics that articulates the specific impact of tax rates on "capture rate" (the rate at which black market demand transfers to regulated markets).

**A tax rate of 10% to 15% gives a high capture rate and favorable tax revenues**



Country	Tax rate	Capture rate
United Kingdom	15%	95%
Denmark	20%	88%
Italy	20%	80%
Spain	25%	70%
Portugal	41%	52%
France	45%	52%

Source: Copenhagen Economics

The Copenhagen research paints a clear picture of the relationship between tax rate and capture rate based on data from regulated markets. As the tax rate goes up, the capture rate drops dramatically.

## Forecasting Pennsylvania online gambling market size

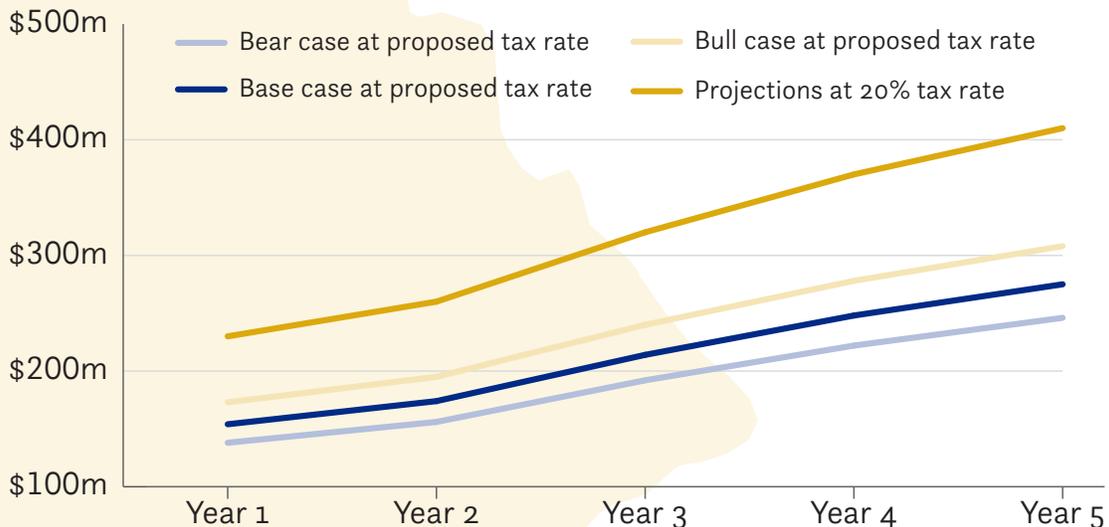
Forecasting revenue from Pennsylvania’s online gambling market is a highly speculative exercise given the unprecedented nature of the tax and fee structure. Utilizing a model that considers performance of other state markets, the impact of the reduction in marketing and promotions, and the likely reduction in captured black market player activity, we have generated the following outlook for Pennsylvania’s market.

### Base case forecast at proposed tax rate



\* Poker projections for years 2 through 5 assume PA joins shared player pool with DE, NJ, and NV

### Projected impact of proposed tax rate on market revenue



# Implications for other states

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## Neighboring states

### New York

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New York is likely to be the state where the impact of Pennsylvania is most pronounced. Not only do the two states share a significant border, but New York has also come quite close to regulating online poker in the last two sessions.

In both 2016 and 2017, the New York State Senate approved a bill to regulate online poker. In both sessions, the bill failed to advance through the Assembly. Bill supporters have indicated that the push for online poker will resume early in the 2018 session (New York lawmakers return to work in January).

The pressure to act based on increased competition from Pennsylvania will be a meaningful political force. The opportunity to share player pools with a combined population roughly equivalent to New York's will help to bolster the online poker opportunity for New York. And Pennsylvania's short-term financial windfall from regulated online gambling could prompt New York lawmakers to look beyond poker and to possibly include online casinos in the legislative approach.

Pennsylvania moving forward doesn't guarantee that New York will pass a bill in 2018, but it certainly adds to already-existing momentum in the Empire State.



## Ohio

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Ohio has yet to formally consider regulated online gambling, but movement in Pennsylvania – along with pending legislation in Michigan – will almost certainly ensure that the topic is raised by lawmakers in the state.

It is unlikely that we'll see legislation proposed and passed in a single session, but we do believe that legalization in Pennsylvania will serve as a catalyst for beginning the legislative process of regulating online poker and / or casino games in Ohio.

## West Virginia

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Online gambling is a live political issue in West Virginia, where we've seen both proposed bills and meaningful commentary regarding regulation from key stakeholders over the last two sessions.

However, the topic remains a politically contentious one. While Pennsylvania moving forward will certainly provide fodder for supporters in West Virginia, it's unclear if the momentum generated will be sufficient to overcome entrenched political opposition to online expansion.

West Virginia is also considering sports betting regulation; it's possible that the sports issue could provide a legislative avenue for regulated online poker and / or casino games in the state.



## Other states

State	Status	Impact of Pennsylvania
California	Bill failed in 2017	<b>Minimal.</b> California's lack of progress is more a function of internal dissension among industry stakeholders, and Pennsylvania moving forward is unlikely to change that dynamic.
Illinois	Bill live until mid-Nov 2017	<b>Moderate.</b> Illinois is in a similar financial predicament to Pennsylvania, and the example of the financial potential from regulated online gambling could provide additional momentum.
Massachusetts	Bill failed in 2017	<b>Minimal.</b> Massachusetts' progress is tied more to the rollout of the state's land-based casino industry than any other issue.
Michigan	Bill still live for 2017 session	<b>Moderate.</b> Pennsylvania moving forward may provide both a normative effect and an example of the financial opportunity online gambling represents, helping to reduce political opposition to online expansion.
New Hampshire	Bill still live for 2017 session	<b>Unclear.</b> New Hampshire's effort is somewhat opaque relative to other states. While Pennsylvania is unlikely to have a negative impact on New Hampshire, the extent of any positive impact is difficult to gauge.



**PlayPennsylvania.com** is an independent source for news and analysis related to the Pennsylvania regulated gambling market. The site is part of the PlayUSA.com network, which also includes sites such as PlayNJ.com and PlayNevada.com.

## ***ONLINE POKER REPORT***

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