

Research Report: Online Poker

Introduction

Online gaming, particularly poker, is a multi-billion dollar a year industry. The market's financial boom allowed many of the more successful companies to become publicly traded, and with increased profits comes increased scrutiny. Many consider online poker to be illegal and various laws have been passed to curb or kill the industry. Large amounts of money also attract the corrupted segments of the population, in this case hackers, cheaters, and phishers. The technology behind online gaming has been forced to advance to protect not only against these attacks, both for itself and its players, but also from the U.S. Government.

The goal of this report is to examine the factors that made online gaming successful and secure and to forecast the long-term possibilities for the market and the steps necessary for new companies to enter it. The focus will be primarily on online poker as that comprises the majority of revenue made by online gaming companies. The report will cover four sections: the availability to new companies, the long-term viability, the potential dangers, and the legality. It will begin with a definition of relevant terms followed by a short background on the history of the game and industry. The report will then examine the aforementioned topics and conclude with a summary and forecast of the market. The attached slides and website will focus on the technology that allows the market to exist.

Definition of Terms

- # *Rake*: One of the main methods used by casinos, both online and in the real world, to make a profit. The group running the gaming table takes a portion of the final value of every pot. The average online rake is 5-10% with average maximums of \$1-\$5.
- # *Freeroll tournament*: In regards to online poker, a freeroll tournament is typically funded from the company sponsoring the event. Entrance is either free or costs points that have been earned through playing real money tables and tournaments.
- # *Sit and Go*: Can be thought of as a mini-tournament. Typically they are between nine players where the top three finishers share the total entrance fees paid by all nine players. The winner usually gets 50% of the total funds collected. The gaming company makes a profit by usually charging a 10% fee on top of the entrance fee. For example, a \$10 tournament would cost the player \$11 and the winner typically receives \$45. Other forms of sit and go tournaments include six player tables, multi tables, and winner takes all.
- # *Referral Program*: Online poker companies often have affiliate programs that allow members to refer others to the site for monetary compensation.
- # *Deposit Bonuses*: Many online poker companies will match a percentage of a player's deposit. This bonus does not automatically go into the player's account, but is awarded in increments as the player sends more money into the rake and other tournament fees.
- # *Play Money Tables*: These are tables that are played with virtual chips. The chips have no real world value. Play money tables are an excellent place for novices to learn more about the game without risking any of their own money.

Background

The exact origin of poker is debatable, but most agree that the game has been played in some form resembling the modern version for nearly 200 years. The online world of poker is a recent phenomenon spurred on by the success of network broadcasts and the victory of Chris Moneymaker in the main event of the 2003 World Series of Poker. Moneymaker's Cinderella story inspired many amateurs and novices. Since his victory the number of entrants to the main event has increased nearly ten fold, from 839 in 2003 to 8,773 in 2006. This growth is not limited to the United States. Russia recently declared poker a sport. The declaration could remove expensive taxes placed on casinos and create a Russian poker boom. The global renewal of interest in poker spread to the Internet where revenues grew from \$82.7 million dollars for 2001 to \$2.4 billion dollars for 2005.

Availability

Online poker is still a relatively young market and has great potential for new companies to enter. However, it would take excellent planning and marketing to take customers away from the well-established companies. Initial investments would be in the millions if the company plans to have any chance at succeeding. The most likely way for a new company to succeed in the market would be to emulate the successful methods other companies have employed. These include incentive-driven offerings and poker celebrity endorsements.

Incentives for joining the new company's site could include offering freeroll tournaments, deposit bonuses, referral programs, and play money tables. These incentives are appealing to both new and veteran players as they provide training grounds for novices and money back rewards for real money players. Celebrity endorsements could involve having well-known poker

stars play at the company's site, appear on advertisements, and wear the company's logos on clothing at live events.

Online gaming sites can also host live real world tournaments to increase their revenue and more importantly their image. Live tournaments, especially if televised, provide additional marketing and help create a sense of legitimacy in the minds of players.

If a new company is successful in marketing its product and is able to provide a secure and attractive interface for users then there is an excellent chance for the fledgling company to succeed. However, if these tasks are not completed effectively the result could be devastating. Full Tilt is an example of a company that was created well after some of the more established companies and successfully asserted itself in the market through similar techniques.

Viability

The long-term viability of online gaming is difficult to forecast. Recent laws, which are to be addressed in the legality section of this report, have hampered the growth of the market and crippled several established companies. However, recent indications show the stock values of publicly traded online gaming sites to be increasing again. Several companies have also managed to keep their American clientele through the use of foreign online banking systems.

The main source of income for online poker sites comes in three forms: the rake, sit and go entrance fees, and tournament entrance fees. The revenue generated by the three forms is tied directly to the number of players on the company's site and the size of the pots and tournament

prizes. Quite simply, more players and larger stakes return larger rakes and entrance fee revenues.

Potential Dangers

The main realistic bane to online gaming companies, besides its own legality, is the use of bots. Several botting programs are available to purchase and download online. These bots can sit at multiple tables and track the history and style of opponents at the table to know when and how to bet. They are not influenced by emotions and are capable of running millions of calculations to determine their best course of action. Many tests have been run by independent sources to test the value of well designed bots and most have shown that they make a profit for the person running them. While the company still extracts the rake and entrance fees from bots, the fear is that if the use of bots becomes a widespread issue it will turn players off to the game. If a site were to become known as a common spot for bots it could be devastating on the company's bottom line.

The second concern to online gaming companies is the threat of hackers and crackers. Companies protect themselves from this threat in a variety of ways. Many online gaming sites use advanced encryption to secure their data, run various auditing programs to detect unusual activity on their networks, and secure their servers behind locked cages in monitored buildings. To date, there have been no publicly reported incidents of hackers gaining access to any online gaming companies' servers or databases. For a new company to become successful it would need to be able to protect itself from such intruders. Any reported successful attack could destroy the site's reputation and thus its revenue.

Another nuisance to the online poker sites is collusion. This is when two or more people share information with one another over the phone, through instant messages, or other communication methods. The sharing of information can influence what hands are played and how they bet. This can put the other players at the table at a distinct disadvantage. Online gaming companies counter this threat by running analyses on hand histories to determine when collusion may have happened. They also rely on player-submitted reports of suspected collusion.

Legality

Online gaming and poker often fall into a legal grey area in the United States. The Federal Wire Act does not allow for sports betting across state lines, but it does not clearly address the legality of online poker and other “games of skill.” Some states have laws that make online gambling of any kind illegal. Louisiana is an example of a state that prohibits any sort of online gambling and in 2005 the chairman of SportingBet PLC was detained in New York because of a warrant issued in Louisiana. The warrant was later dismissed. While this was not a case over online poker it does indicate certain states desire to prosecute.

Not all politicians are against the legalization of online poker. Rep. Jim Kasper of North Dakota succeeded in passing a bill in the North Dakota House of Representatives to legalize and regulate the industry in the state. His belief is that the Government is missing out on the significant revenue that would be generated from the industry via regulation and taxation. The CEO of Paradise Poker, one of the largest online poker companies, testified that he would move the

company's operations to North Dakota if the bill was passed into law. However, the bill was defeated in the State Senate. Rep. Kasper has since pledged to introduce a similar bill in 2007.

The largest blow to the legality and general progress of online poker in the United States came when President Bush signed the Safe Port Act into law in late 2006. Attached to the bill was the Unlawful Internet Gambling Enforcement Act which prohibits online gaming sites from making transactions with American based financial institutions. This act severely crippled the stock value of all online gaming companies. PartyGaming, the operators of PartyPoker.com and traded on the London Stock Exchange as PRTY, saw a 60% drop overnight. The stock has since rebounded, but remains well short of its previous highs.

The fight over the legality of online gaming and poker is not over. It is regulated and legal in over 80 countries. The U.K. passed laws to regulate and tax online gaming in 2005 and many feel that similar laws will pass in the United States down the line. The Poker Players Alliance boasts over 350,000 members dedicated to protecting the rights of poker players and their ability to play online. If their mission succeeds then it can be expected that online gaming revenues will continue to increase at high rates.

Conclusion

The possibility of entry into the online gaming market is difficult to make and contains several logistical issues, from finding online banking sources to the development of a secure network. However, the potential return on investment is extremely high. If the logistical issues are too much to overcome for a new company, the investment into other successful companies is worth

considering. After the Safe Ports Act passed the stock values dropped tremendously, but have since rebounded nicely. They still remain well below their highs but if bills like Rep. Kasper's pass the stock values and revenues of online gaming sites would see a considerable increase.

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