An Interim Look at ADW's Impact on California Thoroughbred Purses

In January of 2002, when the CHRB first authorized Advance Deposit Wagering ("ADW") in the State, its then Chairman, Alan Landsburg, cautioned all that while ADW had the potential to help racing, it was also just as probable that it would ultimately become nothing more than another "tarnished white knight" that further fragmented and divided racing's diminishing revenues. Similarly, prominent California owner Marty Wygod publicly expressed concern that ADW could represent little more than a shift of wagering dollars from tracks and satellites, with only a minimal or possible detrimental impact on our purses.

At the time, TOC was acutely aware of these concerns and of the very real possibility that ADW could cannibalize such handle, so it devised a strategy to establish an economic model that at least returned to purses a percentage equivalent to or better than – on a blended basis – that received from an identical in-state bet placed through a California satellite wagering facility. Though we admittedly wanted a model that equated an ADW wager to one placed on track, it was simply not possible, given the costs involved.

With California's ADW law set to "sunset" at the end of 2007, this article will explore the impact such wagering has had on Thoroughbred purse revenues. Four years removed from the hype and promises made by our future ADW partners, it's a great time to ask ourselves: *What have we learned, and what changes to the law should be considered before it is renewed?*

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What is an ADW Provider?

ADW providers – such as TVG, XpressBet, and Youbet.com – are what the industry refers to as "secondary pari-mutuel operators," meaning, they are licensed to facilitate wagers on horse races even though they are not permitted to conduct a live horse racing meet.

Licensed by the State of California, ADW providers operate interstate wagering businesses, through tote hubs located outside California. ADW providers generally accept wagers by phone and/or the Internet from bettors located both in and out-of-state, on both California and out-of-state races.

The Role of TOC

In licensing California's three ADW providers, the CHRB has consistently required – in 2002, 2003, and 2004 – that as a condition of those licenses each provider have a contract with TOC. The CHRB did so not based upon any specific statute or regulation requiring it to do so, but upon well-founded beliefs and a recognition that owners, as the largest stakeholder in the industry, deserved the right and ability to influence the terms and conditions under which our race signals were sold and utilized. Its authority to impose such a requirement is derived from the specific ADW statute passed by the California legislature – Business & Professions Code section 19604 – which empowers the CHRB to impose additional qualifications and requirements as a condition of licensure.

The contracts executed between TOC and California ADW providers include both consent to the use of our race signals, as required by the Interstate Horseracing Act ("IHA"), and the economic terms under which the providers are compensated. This compensation is commonly referred to as the "Hub Fee rate," and differs for each provider based on the breadth and quality of services they offer to the industry and our patrons, and is dependent upon whether the wager is placed on a Thoroughbred race originating in California, or imported into the State. As an incentive to providers, TOC sets a higher Hub Fee rate on wagers placed on California Thoroughbred races than it does for those races imported into the State; meaning, the provider actually receives greater compensation for handling wagers on our races than they do for handling imported races.

Though the California ADW law caps the amount a provider can receive as a Hub Fee at 6.5%, TOC negotiated lower rates from the outset. By doing so, in less than three years, **TOC increased track and Thoroughbred purse revenues in the State by over $8.6 million!**

How TOC Measures the Impact and Performance of ADW

1. Handle and Revenue

Looking at ADW revenues alone does not provide a clear assessment of the impact such wagering activity has had on California's Thoroughbred racing industry. Instead, one must also consider how ADW has impacted wagering on-track and at satellite facilities. To better understand the impact, TOC compared handle and purse revenue data for 2001 – the last year before ADW was legalized in the State – and 2005, the last full year of racing for which there is such data. What we found was quite interesting, and at the same time alarming. In California, subsequent to the authorization of ADW:

- Overall HANDLE grew by 3.5%, in nominal terms;
- Adjusted for inflation, HANDLE **declined** by 7.3%;
- ON-TRACK HANDLE **declined** by 12.2%;
- SATELLITE WAGERING HANDLE **declined** by 12.8%;
- Overall PURSE REVENUE **declined** by 1.3%, in nominal terms;
- Adjusted for inflation, overall PURSE REVENUE **declined** by 11.6%;
- ON-TRACK PURSE REVENUE **declined** by 15.1%; and,
- SATELLITE WAGERING PURSE REVENUE **declined** by 14.6%.

2. Expanded Distribution of California Races Out-of-State

One of the industry's key objectives in embracing ADW was to expand the out-of-state distribution of and associated wagering on California Thoroughbred race signals. At the time, we believed this was a real possibility, particularly given the promises and predictions our ADW partners made in the months leading up to the authorization of such wagering.

So, again, at the end of last year, TOC took a closer look at how successfully each of our partners fulfilled those promises in the four years since they were first made to the industry. What we observed was that:

- Youbet accepted wagers in 39 other States;
- Xpressbet accepted wagers in 37 other States; and,
- TVG accepted wagers in 12 other States.

3. Purse Revenue Generated Out-of-State

Looking at total Thoroughbred purse revenue generated by out-of-state residents' ADW wagers on all California Thoroughbred races, we discovered that for the calendar year 2005:

- Youbet produced $1,152,735;
- Xpressbet produced $431,270; and,
- TVG produced $389,282.

Given the modest purse revenue derived from out-of-state ADW wagers on California Thoroughbred races, we thought it equally important to better understand just how much purse revenue California ADW bettors were producing for out-of-state racing interests through wagers on out-of state races. Again, what we found was surprising; namely, that California exported far more in terms of purse revenue than we were deriving from other states. For example, in 2005, out-of-state wagers placed on California Thoroughbred races through TVG produced a total of less than $390,000 in purse revenues statewide, while wagers by California ADW bettors on out-of-state races – facilitated by TVG – produced over $1.7 million for out-of-state horsemen. In other words, TVG was a *net exporter* of over $1.3 million in purse revenue in 2005.

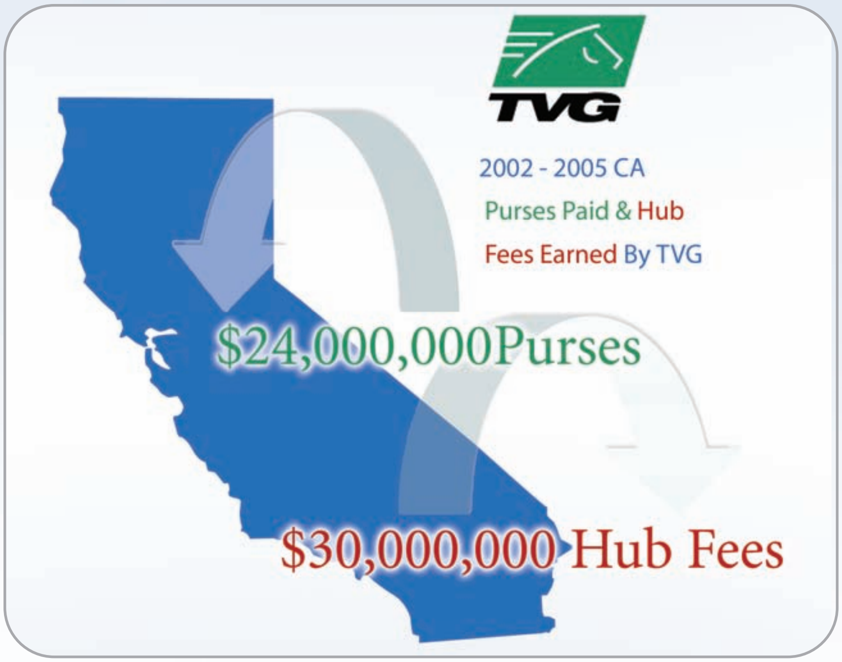
Further, we learned that over 60% of TVG's total business was derived in the California market, and when the handle it derives from California races out-of-state is included, California racing and its bettors produced nearly 70% of TVG's total handle in 2005.

4. Purse Revenue Generated In-State

Since 2002, TVG has unquestionably had the most success in penetrating the California ADW market, handling more on Thoroughbred races than any other ADW provider. As a result, it has also produced the largest contribution to purses; approximately $24 million in the first four years, with well over 90% of that amount derived from wagers by Californians. While this appears to be a positive sign, it is nonetheless important to remember that handle at both California tracks and satellite facilities declined by over 12% during this same time period, and that overall purse revenue actually fell, by 1.3%.

To put this figure in perspective, we thought it useful to compare purse revenues received by California horsemen from TVG to the hub fees retained by TVG during the same period of time. What TOC learned was that, while purses received approximately $24 million over four years, TVG retained over $30 million as hub fees.

Additionally, because of its purported "exclusive rights" to handle ADW wagers on certain California tracks, TVG was paid "license fees" by other ADW providers. In the case of Youbet alone, it is our understanding that TVG received an additional $60 million, of which a substantial portion of those "license fees" were derived from ADW wagers on California Thoroughbred signals.



5. The Effect of So-called "Exclusivity" Rights

In the nomenclature of ADW, the term "exclusivity" is used to describe the contractual relationship between a track and an ADW provider whereby the track purportedly conveys, and the provider receives, exclusive rights to facilitate telephone and Internet wagers on our races. These rights are said to include the exclusive ability to televise or stream our races live.

The purported transfer of exclusive rights has been troubling to TOC since ADW was authorized in 2002, particularly given that they were arguably conveyed without horsemen's consent or approval, in contracts to which TOC is not a party. As a consequence, TOC has consistently asserted that to actually enjoy such rights, licensed ADW providers must have a valid, separate contract with the organization implicitly or expressly acknowledging such rights.

Unfortunately, these exclusive rights arrangements present additional practical problems that TOC believes have diminished both the distribution of and return on our races. For example, preventing certain California licensed ADW providers from facilitating wagers on all California Thoroughbred races means that – at different times during the year – our race fans cannot wager through their preferred ADW provider, but must establish a second ADW account with another licensed ADW, or opt to play other race signals, likely not California signals. If they choose to open a second account, they must then establish and fund different wagering accounts, and in some instances, reconfiguring computer displays to optimize services; none of which makes it more convenient for our fans to play California races.

However, and perhaps more importantly, because of these so-called "exclusivity" rights, California's licensed ADW providers have been forced to obtain "licensing" agreements from other ADW providers purportedly holding such rights. To obtain the "license," any ADW provider wanting to facilitate wagers on California races must pay what are seemingly exorbitant license fees to the ADW provider with "exclusivity," not to California horsemen or track interests.

Because the fees are so high, several ADW operators have candidly advised that they reluctantly enter into such agreements only to be able to advertise that they offer wagering on all California Thoroughbred racing. Under the licensing arrangements, those ADW providers essentially earn nothing on a wager on a California race, so they are forced to utilize their system's technology and marketing resources to shift their patrons' play to signals other than California's, which produce a higher internal yield for that provider. In other words, if they make nothing on a patron's wager on a California race, and 2% to 10% on another, "non-exclusive" signal, prudent business practices demand that the provider do everything legally possible to switch that bettor's play from a California race to something else. In the end, California racing is the big loser!

CONCLUSION

All in all, this review logically led TOC leadership to reconsider the economic model and processes under which ADW wagering takes place in the State. Our objective in assessing the impact of ADW wagering was to identify means to improve the flow of revenue back to the industry, rather than to third-party providers, thus ensuring a more stable, profitable racing industry going forward.

While TOC fully recognizes and appreciates the investment made by ADW providers, that investment is a fraction of what California owners invest every year. TOC remains hopeful that, through well-intentioned dialogue between the industry and the providers, we can together modify the law so as to better serve the interests of all. Should we together fail to find a way to create a better process and economic model, then ADW as we know it is – as Alan Landsburg prophetically observed – destined to become tarnished as another failed effort to help racing overcome its competitive challenges.