

Equilibrium Bids in Sponsored Search Auctions: Theory and Evidence*

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Abstract

This paper presents a game theoretic analysis of the generalized second price auction that Yahoo operates to sell sponsored search listings on its search engine. We present results that indicate that this auction has a multiplicity of Nash equilibria. We also show that weak dominance arguments do not in general select a unique Nash equilibrium. We then analyze bid data assuming that advertisers choose Nash equilibrium bids. We offer some preliminary conclusions about advertisers' true willingness to bid for sponsored search listings. We find that advertisers' true willingness to bid is multi-dimensional and decreasing in listing position. We illustrate revenue and efficiency gains of alternative auction rules. Our estimates indicate that Broadband revenues could increase by at least 49 percent if an alternative auction rule were used.

1 Introduction

Internet search engines such as Google or Yahoo provide a service where users enter search terms and receive in response lists of links to pages on the World Wide Web. Search engines use sophisticated algorithms to determine which pages will be of most interest to their users. But they also offer to advertisers against payment the opportunity to advertise their pages to all users who entered specific terms. These advertisements are called “sponsored links.” Sponsored links are displayed on the same page as the links determined by the search engine’s own algorithm, but separately from these.

Sponsored links are an important new marketing instrument. Sponsored links offer advertisers a more targeted method of advertising than traditional forms of advertising such as television or radio commercials, because sponsored links are only shown to users who have expressed an interest in a search term that is related to the product that the advertiser seeks to sell. For companies that run search engines advertising revenue constitutes a major component of their total revenue. Google reported for the first six months of 2006 a total revenue of \$4.71 billion of which \$4.65 billion originated in sponsored search incomes.¹ For the same period, Yahoo reported a total revenue of \$3.14 billion, of which \$2.77 billion were attributed to “marketing services.”²

The major search engines use auctions to sell spaces for sponsored links. A separate auctions is run for each search term. Advertisers’ bids determine which advertisers’ sponsored links are listed and in which order. The subject of this paper is an early version of an auction of sponsored link spaces that was operated until 2005 by a company called *Overture*. At the time, in 2004, at which we observed Overture’s auction, advertisers bid in Overture’s auction for sponsored search listings on Yahoo’s search pages. Indeed, Overture, which had started as an independent company, had been acquired at this

¹These figures are taken from the quarterly report filed by Google Inc. to the United States Securities and Exchange Commission on August 9, 2006. The figures are not audited. The report was accessed by the authors at: http://investor.google.com/pdf/20060630_10-Q.pdf on August 13, 2006.

²These figures are taken from the quarterly report filed by Yahoo Inc. to the United States Securities and Exchange Commission on August 4, 2006. The figures are not audited. The report was accessed by the authors at: <http://www.shareholder.com/Common/Edgar/1011006/1104659-06-51598/06-00.pdf> on August 13, 2006.

point by Yahoo, and it was later to be renamed to *Yahoo Search Marketing*.

We examine a theoretical model, and bidding data, for Overture's auction. We seek to extract information about bidders' valuation of sponsored search advertisements, and we seek to understand how bidders responded to the incentives created by the auction rules. Bidders in Overture's sponsored search auction, and also in the current sponsored search auctions run by Yahoo Search Marketing and by Google, bid a payment *per click*. Whenever a search engine user clicks on an advertiser's sponsored link that advertiser has to make a payment to the search engine. The auction format that Overture used, and that is also currently used by Yahoo Search Marketing and by Google, is a "generalized second price auction:"³ The highest bidder is listed first and pays per click the second highest bid; the second highest bidder is listed second and pays per click the third highest bid; etc.⁴

The generalized second price auction is a method for allocating heterogeneous objects, such as positions on a page of search results, to bidders. It is based on the assumption that bidders agree which object has the highest value, which one has the second highest value, etc. The generalized second price auction is a somewhat surprising choice of auction format in the light of the recent auction literature. An example of a modern auction format that is used to allocate multiple, heterogeneous goods to bidders each of whom acquires at most one unit the simultaneous ascending auction described in Milgrom (2000). In this auction, bidders can specify in each round which object that they are bidding for. Bids are raised in multiple rounds. Within the limits of the auction rules, they can switch from bidding for one object to bidding for another object. The auction closes when no further bids are raised. By contrast, in the generalized second price auction, bidders submit a single-dimensional bid without specifying what they are bidding for. It seems worthwhile to investigate the properties of this new auction format.

Edelman et. al. (forthcoming) and Varian (forthcoming) have recently offered theoretical analyses of the generalized second price auction that suggest that the auction may yield an efficient allocation of positions to bidders. The first part of this paper reinvestigates the theory of the generalized second price auction. We come to somewhat different conclusions than Edelman et.

³This expression was introduced by Edelman et. al. (forthcoming).

⁴Google also uses a generalized second price format, but, when ranking advertisers and determining their payments, Google incorporates the likelihood that a user will actually click on the advertisers' link.

al. and Varian. These authors' work relies on a relatively narrow specification of bidders' payoff functions, and it relies on a selection from the set of Nash equilibria of the generalized second price auction. Preferences are assumed to be such that the bidders' values per click do not depend on the position in which their advertisement is placed. Moreover, the click rates are assumed to grow at the same rate for all advertisers as one moves up in sponsored link position. Finally, the selection among Nash equilibria of the second price auction in these papers focuses on equilibria that are very similar to Walrasian equilibria.

We propose a more flexible specification of bidders' preferences than is used by Edelman et. al. and Varian. We undertake a more exhaustive analysis of the set of Nash equilibria. We find that existence of pure strategy Nash equilibrium can be proved quite generally. In fact, the generalized second price auction typically has many Nash equilibria. Moreover, we suggest that there are no strong theoretical reasons to expect the equilibria of the generalized price auction to be efficient.

We then proceed to an analysis of bidding data for selected search terms. We have collected our data from Overture's website in the Spring of 2004. We use a revealed preference approach and maximum likelihood estimates to infer the structure of bidders' valuations. The more restrictive specifications of preferences used by previous authors are nested by our model, and therefore correspond to parameter restrictions within our model.

The evidence suggests that the properties of valuations that previous authors have postulated do not hold in practice. Our non-parametric revealed preference approach suggests the conclusion that valuations are multi-dimensional and declining in listing position. Moreover, even with our flexible specification of payoffs we find that we can rationalize most bidders' behavior only over relatively short time periods, after which we have to postulate an unexplained structural break in preferences. Thus we find that it is not easy to rationalize bidding behavior as equilibrium behavior.

We then incorporate random components to valuations which are known to bidders but not observed by the econometrician. Random components rationalize bidding behavior as stemming from equilibrium and allow us to take a parametric valuation model to the data. We find little evidence that valuations are a function of listing positions held in the recent past suggesting that our static modelling approach is not unreasonable. Based on our

parametric estimates, we quantify the slope coefficient, and undertake a preliminary assessment of the efficiency of equilibria. We do not find evidence that equilibria are efficient. We illustrate possible revenue and efficiency gains of alternative auction rules.

Bidding in sponsored search auctions has been examined empirically by Edelman and Ostrovsky (forthcoming) and by Varian (forthcoming). Edelman and Ostrovsky's data concern an even earlier version of the Overture auction than we consider. At the time for which Edelman and Ostrovsky have data, Overture used a generalized first price format rather than a generalized second price format. This differentiates their paper from ours. Moreover, unlike us, Edelman and Ostrovsky do not use a structural model of equilibrium bidding, and they do not present valuation estimates in any detail.

Varian (forthcoming) uses bidding data for Google's sponsored search auction on one particular day. He finds evidence that supports a model of equilibrium bidding in which bidders' valuations are not rank dependent. By contrast, we use data that have been collected over a period of several months. To interpret observed bids as equilibrium bids over extended time periods, we need to allow valuations to depend on rank, and we need to allow for structural breaks. Varian's model is based on an equilibrium selection that implies efficiency of equilibria. Our analysis, using a data set that extends over time, and using a more general structural model, does not find evidence of efficiency of equilibria.

While it is a strength of our analysis in comparison to Varian's that our bidding data cover several months, a strength of Varian's analysis is that he has (proprietary) click rates available to him. When interpreting our results it must be kept in mind that our findings may be distorted by the lack of precise click rates.

This paper is organized as follows. Sections 2-6 describe our theoretical analysis. Section 2 presents the model. Section 3 discusses a type of Nash equilibria that Varian (forthcoming) has called "symmetric." Section 4 analyzes "asymmetric" Nash equilibria. Section 5 discusses refinements of Nash equilibria. Sections 6-9 constitute the empirical analysis. Section 6 describes the data. Section 7 reports the results of revealed preference tests. Section 8 describes valuation estimates. Section 9 discusses ex post revenue and efficiency losses in the auction. Section 10 concludes. Some proofs are in an Appendix.

2 Model

There are K positions $k = 1, 2, \dots, K$ for sale, and there are N potential advertisers $i = 1, 2, \dots, N$. We shall refer to the potential advertisers as “bidders.” We assume $K \geq 2$ and $N \geq K$. Bidders $i = 1, 2, \dots, N$ simultaneously submit one-dimensional non-negative bids $b_i \in \mathfrak{R}_+$. Bids are interpreted as payments *per click*. The highest bidder wins position 1, the second highest bidder wins position 2, etc. The bidder with the K -th highest bid wins position K . All remaining bidders win no position. The highest bidder pays per click the second highest bid, the second highest bidder pays per click the third highest bid, etc. The K -th highest bidder pays per click the $K + 1$ -th highest bid if there is such a bid. Otherwise, if $N = K$, the K -th highest bidder pays nothing. We will explain later how we deal with identical bids, i.e. ties. We follow Edelman et. al. (forthcoming) and refer to this auction as a “generalized second price auction.”

The payoff to bidder i of being in position k if he has to pay b per click is:

$$c_i^k(\gamma_i^k - b) + \omega_i^k \tag{1}$$

Here, $c_i^k > 0$ is the *click rate* that bidder i anticipates if he is in position k , that is, the total number of clicks that bidder i will receive in the time period for which the positioning resulting from the auction is valid. Next, $\gamma_i^k > 0$ is the *value per click* for bidder i if he is in position k . This is the profit that bidder i will make from each click on his advertisement. Finally, $\omega_i^k \geq 0$ is the *impression value* of being in position k for bidder i . The impression value describes the value that bidder i derives from merely being seen in position k , independent of whether a search engine user clicks on bidder i 's link.⁵

The impression value component that we include in bidder i 's payoff might need further motivation. We have in mind that companies derive value from the fact that a sponsored search link reminds customers of the existence of their company, and that it makes users more likely to buy in the future, even if those users do not click on the link and make a purchase at the time of their search. The impression value is thus similar to the value that advertisers derive from other forms of advertising, such as television advertising, that

⁵Click rate, value per click, and impression value may be random variables. Equation (1) is the expected value of the payoff, assuming that value per click and click rate are stochastically independent, and that the same is true for impression value and click rate.

are less targeted than sponsored search advertising.⁶

We shall refer to the value of the price b which makes the payoff in expression (1) zero as *bidder i 's willingness to bid for position k* . We denote it by v_i^k :

$$v_i^k = \gamma_i^k + \frac{1}{c_i^k} \omega_i^k \quad (2)$$

We can now equivalently write bidder i 's payoff as:

$$c_i^k (v_i^k - b) \quad (3)$$

This expression makes clear that our model is equivalent to one in which there is no impression value, and the value per click is v_i^k rather than γ_i^k . We shall conduct our analysis using the notation introduced in expression (3), but it will be useful to keep in mind that the model admits the alternative interpretation given in expression (1).

Our model nests as special cases those of Edelman et. al (forthcoming), Lahaie (2006) and Varian (forthcoming). Edelman et. al. and Varian assume that the values per click are independent of the position, that is, for every $i = 1, 2, \dots, N$ there is some constant v_i such that:

$$v_i^k = v_i \text{ for all } k = 1, 2, \dots, K \quad (4)$$

Edelman et. al. and Varian also assume that the click rate is independent of the identity of the advertiser, that is, for every position $k = 1, 2, \dots, K$ there is some constant c^k such that:

$$c_i^k = c^k \text{ for all } i = 1, 2, \dots, N \quad (5)$$

As bids are payments per click, any bidder i 's incentives in the auction depend only on the *ratios* of bidder i 's click rates in different positions, and not on the absolute values of these click rates. Lahaie (2006) therefore replaces equation (5) by the assumption that for every bidder $i = 1, 2, \dots, N$ and every position $k = 1, 2, \dots, K$ there are numbers a_i and c^k such that:

$$c_i^k = a_i c^k \quad (6)$$

This obviously implies that the ratio of the click rates is independent of the identity of the advertiser. Our analysis is more general than the analysis in

⁶Note that we have not ruled out that the impression value is zero.

the papers cited above, although in Section 3 (Proposition 2) we shall focus on the specification in equation (6).

We shall study pure strategy Nash equilibria of the auction game. A pure strategy Nash equilibrium is a vector of bids (b_1, b_2, \dots, b_N) such that each bid maximizes the bidder's payoffs when the bids of the other bidders are taken as given. Note that we view the auction as a game of *complete information*. The idea behind this is *not* that all bidders' valuations of positions are common knowledge among the bidders, but rather that the continuous possibility of adjusting bids that Overture's auction offered to bidders allowed bidders to find a Nash equilibrium of the complete information auction game without knowing other bidders' payoffs.

To give a formal definition, we need to deal with ties. A *ranking* of bidders is a bijection $\phi : \{1, 2, \dots, N\} \rightarrow \{1, 2, \dots, N\}$ that assigns to each rank ℓ the bidder $\phi(\ell)$ who is in that rank. A ranking of bidders is compatible with a given bid vector (b_1, b_2, \dots, b_N) if $\ell \leq \ell' \Rightarrow b_{\phi(\ell)} \geq b_{\phi(\ell')}$, that is, higher ranks are assigned to bidders with higher bids, where ties can be resolved arbitrarily. A ranking of bidders that is compatible with a given bid vector thus represents one admissible way of resolving ties in this bid vector. We now define a Nash equilibrium to be a bid vector for which there is some compatible ranking of bidders so that no bidder has an incentive to unilaterally change their bid.

Definition 1. *A vector of bids (b_1, b_2, \dots, b_N) is a Nash equilibrium if there is a compatible ranking ϕ of bidders such that:*

- *For all positions k with $1 \leq k \leq K$ and all alternative positions k' with $k < k' \leq K$:*

$$c_{\phi(k)}^k (v_{\phi(k)}^k - b_{\phi(k+1)}) \geq c_{\phi(k)}^{k'} (v_{\phi(k)}^{k'} - b_{\phi(k'+1)})$$

- *For all positions k with $1 \leq k \leq K$ and all alternative positions k' with $1 \leq k' < k$:*

$$c_{\phi(k)}^k (v_{\phi(k)}^k - b_{\phi(k+1)}) \geq c_{\phi(k)}^{k'} (v_{\phi(k)}^{k'} - b_{\phi(k')})$$

- *For all positions k with $k \leq K$:*

$$c_{\phi(k)}^k (v_{\phi(k)}^k - b_{\phi(k+1)}) \geq 0$$

- For all ranks ℓ with $\ell \geq K + 1$ and all positions k with $1 \leq k \leq K$:

$$c_{\phi(\ell)}^k (v_{\phi(\ell)}^k - b_{\phi(k)}) \leq 0$$

Here, if $K = N$, we define $b_{N+1} = 0$.

The first two conditions say that no bidder who wins a position has an incentive to deviate and bid for a lower or for a higher position. Note the following asymmetry. A bidder who bids for a lower position k has to pay b_{k+1} to win that position, but a bidder who bids for a higher position k has to pay b_k to win that position. The last two conditions say that no bidder who wins a position has an incentive to deviate so that he wins no position, and no bidder who wins no position has an incentive to deviate so that he wins some position.

3 Symmetric Nash Equilibria

We shall initially focus on a particular type of Nash equilibrium, namely equilibria in which bidders don't even have an incentive to win a higher position k if they have to pay b_{k+1} rather than b_k . Varian (forthcoming) has called such a Nash equilibrium a "symmetric Nash equilibrium."

Definition 2. A vector of bids (b_1, b_2, \dots, b_N) is a symmetric Nash equilibrium if there is a compatible ranking ϕ of bidders so that the bid vector satisfies the conditions of Definition 1, and:

- For all positions k with $1 \leq k \leq K$ and all alternative positions k' with $1 \leq k' < k$:

$$c_{\phi(k)}^k (v_{\phi(k)}^k - b_{\phi(k+1)}) \geq c_{\phi(k)}^{k'} (v_{\phi(k)}^{k'} - b_{\phi(k'+1)})$$

- For all ranks ℓ with $\ell \geq K + 1$ and all positions k with $1 \leq k \leq K$:

$$c_{\phi(\ell)}^k (v_{\phi(\ell)}^k - b_{\phi(k+1)}) \leq 0$$

The sense in which Nash equilibria that satisfy the conditions of Definition 2 are "symmetric" is that all bidders, when contemplating to bid for position

k , expect to pay the same price for this position, namely $b_{\phi(k+1)}$. Thus, the vector $(b_{\phi(2)}, b_{\phi(3)}, \dots, b_{\phi(K+1)})$ can be interpreted as a vector of Walrasian equilibrium prices. If each bidder takes these prices as given and fixed, and picks the position that generates for him the largest surplus at these prices, then for each position there will be exactly one bidder who wants to acquire that position, provided that indifferences are resolved correctly. Thus the market for each position “clears”: demand and supply are both equal to 1.

We now introduce an assumption that guarantees the existence of a symmetric Nash equilibrium.

Assumption 1. *For every bidder $i = 1, 2, \dots, N$ and for every position $k = 2, 3, \dots, K$ the following two inequalities hold:*

$$c_i^{k-1} v_i^{k-1} > c_i^k v_i^k \quad \text{and} \quad v_i^{k-1} \geq v_i^k$$

The first inequality says that the expected value of a higher position for bidder i is at least as large as the expected value of a lower position. The second inequality says that the same monotonicity is true for bidder i 's willingness to bid. Even if the value per click and the impression value are larger for larger positions, the second inequality in Assumption 1 may be violated if the click rates increases too fast in comparison to the impression value. This can be seen from equation (2). Thus, the second part of Assumption 1 is somewhat restrictive.

Proposition 1. *Under Assumption 1 the game has at least one symmetric Nash equilibrium in pure strategies.*

Proof. STEP 1: We show the existence of Walrasian equilibrium prices for the K positions. This is essentially an implication of Theorem 3 in Milgrom (2000). Milgrom proves existence of competitive equilibrium indirectly. He postulates that K objects are sold through a *simultaneous ascending auction*, and that bidders bid *straightforwardly*. He then proves that the auction will end after a finite number of rounds, and that the final prices paid for the K objects converge to Walrasian equilibrium prices as the increment in the simultaneous ascending auction tends to zero. This implies that Walrasian equilibrium prices exist. To apply Milgrom's argument to our context, we need to modify his construction, and assume that bids in the simultaneous ascending auction are payments per click, rather than total payments. With this modification, Milgrom's argument goes through without change. Milgrom's result assumes that objects are substitutes: each bidder's demand

for an object does not decrease as the prices of the other objects increase. This assumption is obviously satisfied in our setting. Denote by ϕ a ranking of the bidders that is compatible with the Walrasian equilibrium, that is, in the Walrasian equilibrium position k is obtained by agent $\phi(k)$. Denote by (p_1, p_2, \dots, p_K) some vector of Walrasian equilibrium prices that has been constructed by Milgrom's method. Observe that, as one can easily show, $N = K$ implies $p_K = 0$. STEP 2: We show that $p_1 \geq p_2 \geq \dots p_K$. Indeed, suppose that for some k we had $p_{k-1} < p_k$, and consider the bidder i who acquires position k . Because position k is the optimal choice for bidder i at the given prices:

$$c_i^k (v_i^k - p_k) \geq c_i^{k-1} (v_i^{k-1} - p_{k-1}) \quad (7)$$

Because $p_{k-1} < p_k$ this implies:

$$c_i^k (v_i^k - p_k) > c_i^{k-1} (v_i^{k-1} - p_k) \Leftrightarrow \quad (8)$$

$$(c_i^{k-1} - c_i^k) p_k > c_i^{k-1} v_i^{k-1} - c_i^k v_i^k \quad (9)$$

The expression on the right hand side of (9) is by Assumption 1 positive. The expression on the left hand side is linear in p_k . For $p_k = 0$ it equals zero and is thus smaller than the right hand side. The largest possible value of p_k is v_i^k . We now show that even for this largest value of p_k the expression on the left hand side is smaller than the expression on the right hand side:

$$(c_i^{k-1} - c_i^k) v_i^k \leq c_i^{k-1} v_i^{k-1} - c_i^k v_i^k \Leftrightarrow \quad (10)$$

$$v_i^k \leq v_i^{k-1} \quad (11)$$

which holds by Assumption 1. Thus, there is no value of p_k for which (9) could be true, and the assumption $p_{k-1} < p_k$ leads to a contradiction. STEP 3: We now construct a symmetric Nash equilibrium. For each k with $2 \leq k \leq K$ we set the bid of the bidder who wins position k in the Walrasian equilibrium equal to the price that position $k - 1$ has in that equilibrium:

$$b_{\phi(k)} = p_{k-1} \quad (12)$$

For bidder $\phi(1)$ who wins position 1 we can choose any bid $b_{\phi(1)}$ that is larger than p_1 . Finally, if there are bidders i who don't obtain a position in the Walrasian equilibrium, we set their bids equal to p_K . Because the Walrasian prices are ordered as described in STEP 2 these bids imply that

every bidder who wins a position in the Walrasian equilibrium wins the same position in the auction, and pays in the auction the price that he pays in the Walrasian equilibrium. Moreover, because we have implemented a Walrasian equilibrium, no bidder prefers to acquire some other position at the price that the winner of that position pays over the outcome that he obtains in the proposed bid vector, and hence we have a symmetric Nash equilibrium. \square

Two remarks are in order. First, as the second part of Assumption 1 is somewhat restrictive, one might wonder whether it can be relaxed. We have not pursued this question. Second, the simultaneous ascending auction to which we refer in STEP 1 of the above proof may be regarded as an alternative to the generalized second price auction used by Overture. We have not attempted to evaluate the relative merits of this alternative auction format for sponsored search positions.

If we knew bidders' valuations v_i^k , could we predict who will win which position in a Nash equilibrium? In the current section, we shall answer this question only for symmetric Nash equilibria. We shall start by considering the question under the following simplifying assumption.

Assumption 2. *For every bidder $i = 1, 2, \dots, N$ and for every position $k = 1, 2, \dots, K$ there are numbers $a_i > 0$ and $c^k > 0$ such that*

$$c_i^k = a_i c^k$$

for all i and all k .

Proposition 2. *Under Assumption 2 a ranking ϕ of bidders that is compatible with a symmetric Nash equilibrium maximizes*

$$\sum_{k=1}^K c^k v_{\phi(k)}^k$$

among all possible rankings ϕ .

For generic parameters, there will be a unique allocation of positions to bidders that maximizes the sum in Proposition 2. In this sense, Proposition 2 provides conditions under which we can unambiguously predict which bidder will win which position in a symmetric equilibrium.

The function that according to Proposition 2 symmetric Nash equilibrium rankings maximize is similar to a utilitarian welfare function. However, a utilitarian welfare function would assign to each ranking the sum of all bidders' valuations of positions, that is:

$$\sum_{k=1}^K a_i c^k v_{\phi(k)}^k$$

In the expression in Proposition 2 the bidder specific factors a_i are omitted. It is intuitively plausible that the Overture auction cannot lead to an allocation which takes these factors into account. These factors only affect the absolute level of click rates, but not their ratio. Incentives in the auction only depend on the ratio of click rates.

Proof. Let ϕ be a ranking of bidders that is compatible with a symmetric Nash equilibrium, and let $\hat{\phi}$ be an alternative ranking. Without loss of generality assume that ϕ is the identity mapping. Let p^k (for $k = 1, 2, \dots, K$) be the Walrasian prices associated with the symmetric equilibrium. By definition of the Walrasian equilibrium we have for all positions k that are won under $\hat{\phi}$ by bidders $\hat{\phi}(k)$ that would also win a position under ϕ , i.e. for whom $\hat{\phi}(k) \leq K$:

$$a_{\hat{\phi}(k)} c^k \left(v_{\hat{\phi}(k)}^k - p^k \right) \leq a_{\hat{\phi}(k)} c^{\hat{\phi}(k)} \left(v_{\hat{\phi}(k)}^{\hat{\phi}(k)} - p^{\hat{\phi}(k)} \right) \Leftrightarrow \quad (13)$$

$$c^k \left(v_{\hat{\phi}(k)}^k - p^k \right) \leq c^{\hat{\phi}(k)} \left(v_{\hat{\phi}(k)}^{\hat{\phi}(k)} - p^{\hat{\phi}(k)} \right) \quad (14)$$

For all positions k that are won under $\hat{\phi}$ by bidders $\hat{\phi}(k)$ that would not win a position under ϕ , i.e. for whom $\hat{\phi}(k) > K$:

$$a_{\hat{\phi}(k)} c^k \left(v_{\hat{\phi}(k)}^k - p^k \right) \leq 0 \Leftrightarrow \quad (15)$$

$$c^k \left(v_{\hat{\phi}(k)}^k - p^k \right) \leq 0 \quad (16)$$

Summing (14) and (16) over all $k = 1, 2, \dots, K$ we obtain:

$$\sum_{k=1}^K c^k \left(v_{\hat{\phi}(k)}^k - p^k \right) \leq \sum_{k \in \{1, \dots, K \mid \hat{\phi}(k) \leq K\}} c^{\hat{\phi}(k)} \left(v_{\hat{\phi}(k)}^{\hat{\phi}(k)} - p^{\hat{\phi}(k)} \right) \quad (17)$$

which implies:

$$\sum_{k=1}^K c^k \left(v_{\hat{\phi}(k)}^k - p^k \right) \leq \sum_{k=1}^K c^k \left(v_k^k - p^k \right) \Leftrightarrow \quad (18)$$

$$\sum_{k=1}^K c^k v_{\hat{\phi}(k)}^k \leq \sum_{k=1}^K c^k v_k^k \quad (19)$$

Thus, the value of the function in Proposition 2 under $\hat{\phi}$ is not larger than it is under ϕ . \square

While Proposition 2 provides a characterization of the rankings of bidders that can arise in *any* symmetric Nash equilibrium, the next Proposition gives conditions that guarantee that a ranking ϕ can arise in *some* symmetric Nash equilibrium. It is without loss of generality to focus on the case that ϕ is the identity. For all other functions ϕ we only need to re-order bidders, and can then apply Proposition 3.

To begin, we introduce an assumption that implies, but is stronger than Assumption 1.

Assumption 3. *For every bidder $i = 1, 2, \dots, N$ and for every position $k = 2, 3, \dots, K$ the following two inequalities hold, and at least one of them is strict:*

$$c_i^{k-1} \geq c_i^k \quad \text{and} \quad v_i^{k-1} \geq v_i^k$$

The main assumption that we use for Proposition 3, Assumption 4, compares different bidders' marginal willingness to pay for higher positions. Roughly speaking the assumption says that this marginal willingness to pay is larger for bidders with a lower index than for bidders with a higher index.

Assumption 4. *For all bidders $i, j = 1, 2, \dots, N$ with $i < j$ the following inequality holds, and it is strict when $i = K$ and $j = K + 1$:*

$$v_i^K \geq v_j^K$$

Moreover, for all bidders $i, j = 1, 2, \dots, N$ with $i < j$ and all positions $k = 2, 3, \dots, K$ the following two inequalities hold:

$$\frac{c_i^{k-1}}{c_i^k} \geq \frac{c_j^{k-1}}{c_j^k} \quad \text{and} \quad v_i^{k-1} - v_i^k \geq v_j^{k-1} - v_j^k$$

The first half of the assumption says that the willingness to bid for the lowest position is at least as large for bidders with a lower index as it is for bidders with a higher index. In the second half of the assumption the first inequality says that the percentage increase in click rates as a bidder moves up one position is at least as large for a bidder with a lower index as it is for a bidder with a higher index. The second inequality in the second half of Assumption 4 says that the willingness to bid for a one step increase in position is at least as large for a bidder with a lower index as it is for a bidder with a higher index.

Note that Assumption 4 implies, through an induction argument:

$$v_i^k \geq v_j^k \quad \text{for all } k$$

whenever $i < j$. That is, for any given position, the willingness to bid of bidders with a lower index is at least as large as the willingness to bid of bidders with a higher index. Thus, bidders are ordered in terms of their absolute willingness to bid as well as their marginal willingness to bid.

It is important to keep in mind that Assumption 4 refers to the willingness to bid rather than the value per click. The two are the same if the impression value is zero for all bidders and all positions. If the impression value is positive, then it may be the case that the inequalities in Assumption 4 hold for the value per click as well as the impression value, but that they don't hold for the willingness to bid. Recalling the definition of the willingness to bid, one can see that this may occur if the bidder with the lower index has the larger absolute number of clicks, and if the value per click is small relative to the impression value.

Assumption 4 is clearly a strong assumption. We note, however, that the models used by Varian (forthcoming), Edelman et. al. (forthcoming) and Lahaie (2006) are special cases of our model in which Assumptions 3 and 4 are automatically satisfied.

Proposition 3. *Under Assumptions 3 and 4 there is a symmetric Nash equilibrium in which bidder i wins position i for all $i = 1, 2, \dots, K$.*

The proof of this result is similar to proofs in Edelman et. al. (forthcoming) and Varian (forthcoming), and is provided in the Appendix. Note that we leave the question open whether under Assumptions 3 and 4 *all* Nash equilibria have to have the property that bidder i wins position i for all $i = 1, 2, \dots, K$.

4 Asymmetric Nash Equilibria

The game defined in Section 2 has further Nash equilibria if we allow for equilibria that are not symmetric, that is, asymmetric equilibria. It is hard to give a complete description of *all* Nash equilibria. We provide two partial results. The first result concerns the same case as Proposition 3 in the previous section.

Proposition 4. *Under Assumptions 3 and 4 there is an asymmetric Nash equilibrium in which bidder 1 wins position 2, bidder 2 wins position 1, and bidder i wins position i for all $i = 1, 2, \dots, K$.*

Proof. Suppose that b_1, b_2, \dots, b_N is a Nash equilibrium as described in Proposition 3. Define a new vector of bids, $\tilde{b}_1, \tilde{b}_2, \dots, \tilde{b}_N$ as follows: $\tilde{b}_i = b_i$ for $i = 3, \dots, N$, $\tilde{b}_1 = b_3 + \varepsilon$ where $\varepsilon > 0$ is very close to zero, and \tilde{b}_2 is arbitrary but very large, and, in particular, larger than \tilde{b}_1 . We now show that we can choose ε so small that no bidder has an incentive to deviate and bid for a different position. We ignore the possibility of deviating and bidding for position 1, because by choosing \tilde{b}_2 sufficiently large we can eliminate all incentives to bid for position 1. We first consider the incentives of bidder 2.

Bidder 2 wins position 1 at a price that is ε larger than the price that he paid in the original equilibrium for position 2. If bidder 2 were to deviate and bid for position 2, the price that he pays would go down by only ε but by Assumption 3 position 2 is worth strictly less than position 1. Thus, for sufficiently small ε , this is not a profitable deviation. Bidding for an even lower position is not a profitable deviation because such a deviation wasn't profitable in the original equilibrium, and in the new equilibrium bidder 2 obtains a higher profit than in the original equilibrium, provided that ε is sufficiently small. We next consider the incentives of bidder 1. Bidder 1 obtains position 2 at the same price at which originally bidder 2 obtained position 2. The argument that bidder 1 does not wish to bid for a lower position relies on an argument in the proof of Proposition 3 in the Appendix. That argument shows that, under Assumption 4, if a bidder has no incentive to bid for a lower position, then no higher ranked bidder has an incentive to bid for those lower positions either. Therefore, we can conclude that bidder 1 does not have an incentive to bid for a lower position. Finally, we have to argue that bidders $i = 3, 4, \dots, N$ have no incentive to bid for a different position. Recall that we started with a symmetric equilibrium. Thus, these bidders

have no incentive to deviate in the original equilibrium if they assume that all positions are available to them at the prices which the current winners of those positions pay. Because the price of none of the positions $2, 3, \dots, K$ have changed, these bidders continue to have no incentives to bid for any of those positions. As noted, an incentive to bid for position 1 can be ruled out by making bidder 2's bid \tilde{b}_2 arbitrarily high. Finally, observe that the equilibrium that we have described is not symmetric. If bidder 1 could obtain position 1 at the same price as bidder 2 obtains it, then for sufficiently small ε he would want to deviate. \square

For a further illustration of the multiplicity of Nash equilibria in our model we now take a closer look at the case that $N = K = 3$. For this case explicit calculations that we provide in the Appendix prove the following result.⁷ Note that this result relies on none of the assumptions used earlier.

Proposition 5. *Suppose $K = N = 3$. An equilibrium in which bidder i wins position i for $i = 1, 2, 3$ exists if and only if either $c_3^2 v_3^2 \leq c_3^3 v_3^3$ and*

$$\begin{aligned} c_1^1 v_1^1 &\geq c_1^3 v_1^3 \\ c_2^2 v_2^2 &\geq c_2^3 v_2^3 \end{aligned}$$

or, alternatively, $c_3^2 v_3^2 > c_3^3 v_3^3$ and in addition to the two conditions above also the following two conditions hold:

$$\begin{aligned} (c_1^1 v_1^1 - c_1^3 v_1^3) &\geq \frac{c_1^1}{c_3^2} (c_3^2 v_3^2 - c_3^3 v_3^3) \\ (c_1^1 v_1^1 - c_1^2 v_1^2) + \frac{c_1^1}{c_2^2} (c_2^2 v_2^2 - c_2^3 v_2^3) &\geq \frac{c_1^1}{c_3^2} (c_3^2 v_3^2 - c_3^3 v_3^3) \end{aligned}$$

The conditions in Proposition 5 are very weak. The second to last inequality in Proposition 5, for example, requires that the marginal value to bidder 1 of being in position 1 rather than position 3 (the left hand side of the inequality) is at least as large as a variable that is proportional to the marginal value to bidder 3 of being in position 2 rather than position 3,

⁷Lahaie (2006, Lemma 3) provides a necessary condition for the existence of a Nash equilibrium that assigns position i to bidder i for all $i = 1, 2, \dots, K$. He asserts that this condition is also sufficient, but after publication of his paper he found this part of the claim to be incorrect. We are grateful to Sebastián Lahaie for helpful discussions regarding his result. Our Proposition 3 corrects Lahaie's work for the special case that $N = K = 3$.

where the proportionality factor is some ratio of click rates. The last inequality is a similarly weak inequality relating the marginal value that bidder 1 derives from being in position 1 rather than position 2, the marginal value that bidder 2 derives from being in position 2 rather than position 3, and the marginal value that bidder 3 would have if he were in position 2 rather than position 3.

We now give an example in which Proposition 5 implies that every allocation of positions to bidders can be an equilibrium allocation. We describe corresponding bid vectors.

Example 1. *There are 3 bidders and 3 positions. Click rates are bidder independent: $c_i^1 = 3, c_i^2 = 2, c_i^3 = 1$ for all bidders $i = 1, 2, 3$. The willingness to bid per click is independent of a bidder's position: $v_1^k = 16, v_2^k = 15, v_3^k = 14$ for all positions $k = 1, 2, 3$. Whenever one bidder bids 11, another bids 9, and another bidder bids 7, then this will be a Nash equilibrium. Thus, all allocations of positions to bidders are possible equilibrium allocations.*

5 Refinements of Nash Equilibrium

In this section we ask whether there are good reasons to expect only some of the Nash equilibria described in the previous section to be played and not others. In other words, we ask whether there are plausible ways of refining the set of Nash equilibria in the auction game that we are studying. Edelman et. al. (forthcoming) and Varian (forthcoming) advocate symmetric Nash equilibria. We comment on these authors' approaches towards the end of this section. The purpose of this section is to examine the equilibrium selection issue from a different angle than these authors have.

The classic way of selecting among equilibria in second price auctions is to rule out Nash equilibria in weakly dominated strategies. Weak dominance arguments are powerful in our model only if the number of bidder is $N = 2$. In that case each bidder knows that even a bid of zero guarantees at least the second position. Bidders essentially bid for the marginal benefit of being in the first rather than the second position. The auction is strategically equivalent to a single unit, second price auction. It is well-known that the single unit Vickrey auction has multiple Nash equilibria,⁸ but that the only strat-

⁸See, for example, Blume and Heidhues (2004) for the case of incomplete information.

egy that is not weakly dominated is to bid one's true value. This observation extends to our setting. Although the multiplicity of equilibria described in the previous section also prevails in the case of $N = 2$, it is easily seen that each bidder i has a weakly dominant strategy, namely to place the bid b_i that makes bidder i indifferent between obtaining the first position with bid b_i , and obtaining the second position for free. This bid thus solves the following equation:

$$c_i^1(v_i^1 - b_i) = c_i^2 v_i^2 \quad \Leftrightarrow \quad (20)$$

$$b_i = v_i^1 - \frac{c_i^2}{c_i^1} v_i^2 \quad (21)$$

Unfortunately, the situation changes quite dramatically when $N \geq 3$. This is shown in the following result that provides a range of not weakly dominated bids. Intuitively, the reason why in the case $N \geq 3$ we obtain a range of not weakly dominated bids rather than a single such bids is that for $N \geq 3$ the marginal gain of a bidder who raises his bid is no longer clear unambiguously defined. Raising one's bid may, in the best case, move a bidder up from no listing to top position, but it may also, for example, move a bidder up by only one position, from position k to $k+1$. The range of bids is the range of marginal utilities derived from any such marginal improvement in a bidder's position, modified by a correction factor that takes into account how positions affect click rates.

Proposition 6. *Suppose $N \geq 3$, and Assumption 1 holds. Consider any bidder i . If $N = K$, a bid b_i is not weakly dominated if and only if:*

$$\min\{v_i^k - \frac{c_i^{k'}}{c_i^k} v_i^{k'} \mid k' > k\} \leq b_i \leq v_i^1$$

If $N > K$, a bid b_i is not weakly dominated if and only if:

$$\min(\{v_i^k - \frac{c_i^{k'}}{c_i^k} v_i^{k'} \mid k' > k\} \cup \{v_i^K\}) \leq b_i \leq v_i^1$$

Proof. We give the proof in the case $N = K$. The proof in the case $N > K$ is analogous. We first show that any bid outside the range described in Proposition 6 is weakly dominated. First, obviously any bid $b_i > v_i^1$ is weakly dominated by bid v_i^1 . It remains to show that any bid below the boundary

described in Proposition 6 is weakly dominated. Let b_i be any such bid, and let $\hat{b}_i > b_i$ be another such bid that is also lower than the lower boundary in Proposition 6. We shall show that \hat{b}_i weakly dominates b_i . For some bid vectors of the other bidders it will not make a difference whether bidder i bids \hat{b}_i or whether he bids b_i . Suppose it does make a difference, and that bidder i , by bidding \hat{b}_i acquires position k whereas bidding b_i yields position $k' > k$. We shall show that it is better to bid \hat{b}_i than b_i . The worst case is that bidding b_i acquires position k' at price 0, whereas bidding \hat{b}_i acquires position k at price \hat{b}_i . We shall show that in even this case it is better to bid \hat{b}_i rather than b_i :

$$c_i^k(v_i^k - \hat{b}_i) > c_i^{k'}v_i^{k'} \Leftrightarrow \quad (22)$$

$$\hat{b}_i < v_i^k - \frac{c_i^{k'}}{c_i^k}v_i^{k'} \quad (23)$$

This holds by construction. We now show that no bid that satisfies the inequality in Proposition 6 is weakly dominated. Consider any bid $b_i \leq v_i$, and consider any other bid $\hat{b}_i \neq b_i$. We shall construct a vector of bids of the other bidders such that b_i achieves a higher payoff than \hat{b}_i . Suppose first $\hat{b}_i < b_i$. Consider a vector of bids of all other bidders such that no two bids are equal to each other, the highest bid of the other bidders is $\hat{b}_i + \varepsilon$ and the second highest of the other bidders bid is $\hat{b}_i - \varepsilon$. Here, ε is a positive number. Suppose that it is sufficiently small so that bidder i , if he bids b_i , wins position 1 and has to pay for it $\hat{b}_i + \varepsilon$, but if he bids \hat{b}_i he wins position 2 and has to pay $\hat{b}_i - \varepsilon$. By Assumption 1 bidder 1 strictly prefers position 1 to position 2 if he has to pay the same price for both positions. Therefore, for ε sufficiently close to zero, he also prefers bidding b_i to bidding \hat{b}_i . Now consider the case that $\hat{b}_i > b_i$. Assume that k, k' are the indices for which the minimum in Proposition 6 is attained. Let b_i be a bid that is equal or greater than this minimum. Let $\hat{b}_i > b_i$ be an alternative bid. Suppose that $N - k'$ bidders bid 0. Suppose that $k' - k$ of the remaining bidders bid $\hat{b}_i - \varepsilon > b_i$, and that all other bidders bid above \hat{b}_i . Here, $\varepsilon > 0$. Then bidding b_i wins position k' at price 0, whereas bidding \hat{b}_i wins position k at price $\hat{b}_i - \varepsilon$. It is better to bid b_i if:

$$c_i^{k'}v_i^{k'} > c_i^k(v_i^k - \hat{b}_i - \varepsilon) \Leftrightarrow \quad (24)$$

$$\hat{b}_i - \varepsilon > v_i^k - \frac{c_i^{k'}}{c_i^k}v_i^{k'} \quad (25)$$

By construction

$$\hat{b}_i > v_i^k - \frac{c_i^{k'}}{c_i^k} v_i^{k'} \quad (26)$$

and hence for sufficiently small ε also (25) will be true. \square

Observe that Proposition 6 examines only weak dominance when the dominating strategy is a pure strategy. In principle, it may be that more strategies can be ruled out when mixed strategies are considered. We conjecture that this is not the case. A formal examination of this issue would require us to specify bidders' risk attitudes. We have not pursued this issue.

Proposition 6 indicates that there is little chance of obtaining a substantial refinement of the set of Nash equilibria by appealing to weak dominance. In Example 1 neither of the equilibria displayed is ruled out by weak dominance, as the intervals of undominated bids are in that example $[\frac{16}{3}, 16]$, $[\frac{15}{3}, 15]$ and $[\frac{14}{3}, 14]$ for bidders 1, 2, and 3 respectively. Also, it is straightforward to verify that the equilibria that are constructed in the proof of Proposition 3 in the Appendix do not involve weakly dominated strategies.

Edelman et. al. (forthcoming) and Varian (forthcoming) in more special models than ours select among all Nash equilibria the symmetric Nash equilibria. Varian offers no game theoretic motivation for this. Edelman et. al. argue that the selection can be derived from the assumption that bidders raise their bids to induce a higher payment for the next highest bidder, but that they do so only up to the point \bar{b} at which they would not regret having raised their bid if the next highest bidder were to lower his bid slightly below \bar{b} . Edelman et. al. refer to the selected equilibria as "locally envy-free." Their construction thus includes a spite motive for bidders as well as a conjectured response function for other bidders. This may have some plausibility, but is hardly compelling. If bidders' preferences include an arbitrarily small weight on reducing other bidders' profits, but one considered Nash equilibria instead of the conjectured response equilibria Edelman et. al. propose, then each bidder would want to raise his bid to just below the next highest bidder's bid, and no pure strategy equilibrium would exist.

6 Data

We have collected bid data for 5 search terms over a period from February 3rd 2004 to May 31, 2004. The search terms are *Broadband*, *Flower*, *Loan*, *Outsourcing* and *Refinance*.⁹ For each search term, the data describe the current bid levels every 15 minutes¹⁰ yielding 96 bid observations per bidder for every day.¹¹ We include a bid observation (and time period) for bidder i in the final data only when the bidder places a new bid or alters the bid level of an existing bid. The data selection avoids a set of issue related to delays in bidders' response times.

We augmented the bid data with weekly click-through data for 46 weeks in 2004.¹² Based on the click through data we calculate that the ratio c_i^{k-1}/c_i^k equals about 1.5 for top positions on average across our search terms. We use this number in the subsequent analysis.

The price paid reflects a lower bound on an advertiser's willingness to pay for a click. The lower bound varies substantially across categories. The price for the top *Broadband* position equals \$2.05 on average. The average top position price equals \$2.44, \$4.62, \$2.54, \$6.92 for the search term *Flower*, *Loan*, *Outsourcing*, and *Refinance* respectively.

There is substantial dispersion in bids over time suggesting that revealed preference arguments may achieve tight bounds on advertisers' willingness to pay. The bid dispersion varies in magnitude across categories. The low standard deviation occurs for *Outsourcing* with a standard deviation of the top position price equalling 0.27. On the other extreme is the category *Broadband* with a standard deviation of 0.81. The empirical distribution reveals

⁹Initially, search words were chosen at random by using an english dictionary, and we collected one sample of bid prices for each search word. We then selected the search words that achieve high bid prices. The motivation for our selection was that bidders may be more likely to behave optimally when more money is at stake.

¹⁰The data were collected using the publicly accessible bidtool on the webpage <http://uv.bidtool.overture.com/d/search/tools/bidtool>. The data retrieval time interval ranges between 10 and 20 minutes.

¹¹Bidders revise their bids frequently and the 15 minute sampling frequency was chosen to capture bid changes accurately. On average across search terms a new bid is chosen, or an existing bid is revised every 43 minutes across search terms, yielding an average of 63 changes per day. There is variation across search terms with the average number of bid revisions ranging from five per day for *Outsourcing* to 63 per day for *Flower*.

¹²The data were kindly provided to us by Yahoo.

that ninety percent of high *Outsourcing* position price observations fall into the interval \$2.00 to \$3.00. Ninety percent of *Broadband* price observations fall into the interval \$1.32 to \$3.25.

The price difference between two adjacent positions is 20 cents on average across search terms for top ten positions. The price difference between two adjacent positions varies across search terms and ranges from 14 cents for *Outsourcing* to 31 cents for *Refinance*.

In the data we see that some bidders achieve a premium position on occasions only, or vanish after a short time, while other bidders are regular bidders for premium positions. These two types of bidders may exhibit distinct valuation processes and we wish to distinguish them in the subsequent analysis.

We classify bidders as one of two types of bidders, *premium* and *fringe bidders*. The definition is based on the following classification. For each bidder we determine the average position in the bid ranking during our sample period. We classify premium bidders as bidders with average ranking of one to ten. Fringe bidders are the remaining bidders which have average rank higher than ten. Our classification yields 167 premium bidders and 1,227 fringe bidders. Premium bidders win 85 percent of the top five positions.

7 Revealed Preferences

This section explores a non-parametric revealed-preference approach to infer bounds on advertisers' willingness to pay. We assume that the submitted bid maximizes the bidder's payoff. We use the bid data in conjunction with the optimality condition to deduce bounds on the willingness to pay. We illustrate when the bounds imply a non-empty set of valuations and examine the non-emptiness hypothesis empirically. We discuss the shape of the valuation profiles consistent with the bounds. Section 7.1 illustrates when a set of bid observations yields a non-empty set of valuations. Section 7.2 describes our empirical test results.

7.1 Test of the Revealed Preference Hypothesis

It is instructive to distinguish two types of bid submissions depending on whether the submitted bid wins an item or not. First, suppose the chosen bid

of bidder i does not win a position which we call a *type one* bid submission. If we denote by $b_{\phi(k)}$ the k -th highest bid, then, it must be that the bid prices exceed the valuation of the position:

$$v_i^k \leq b_{\phi(k)} \quad \text{for all } k \leq K \quad (27)$$

Thus, we obtain an upper bound on the valuation vector.

Second, suppose the bid by bidder i wins position $k \leq K$. We call this a *type two* submission. Optimality of the bid choice implies the following three inequalities:

$$-v_i^k \leq -b_{\phi(k+1)} \quad (28)$$

$$v_i^{k'} \leq \frac{c_i^k}{c_i^{k'}} v_i^k + \left[b_{\phi(k')} - \frac{c_i^k}{c_i^{k'}} b_{\phi(k+1)} \right] \quad \text{for } k' < k \quad (29)$$

$$v_i^{k'} \leq \frac{c_i^k}{c_i^{k'}} v_i^k + \left[b_{\phi(k'+1)} - \frac{c_i^k}{c_i^{k'}} b_{\phi(k+1)} \right] \quad \text{for } K \geq k' > k \quad (30)$$

The first inequality says that the valuation of position k is at least as large as the winning price which places a lower bound on the valuation v_i^k . The second and third inequalities say that the valuation for a position that is not won, $v_i^{k'}$ with $k' \neq k$, is bounded from above by a line with slope $\frac{c_i^k}{c_i^{k'}}$ and an intercept equal to $b_{\phi(k')} - \frac{c_i^k}{c_i^{k'}} b_{\phi(k+1)}$ for $k' < k$ and an intercept equal to $b_{\phi(k'+1)} - \frac{c_i^k}{c_i^{k'}} b_{\phi(k+1)}$ for $k' > k$, respectively.

We can write the above inequalities compactly in matrix notation as

$$\mathbf{A}_t \mathbf{v}_i \leq \alpha_t \quad (31)$$

where $\mathbf{v}_i = (v_i^1, v_i^2, \dots, v_i^K)$ is a $K \times 1$ dimensional valuation vector; \mathbf{A}_t is a $K \times K$ dimensional matrix and α_t is a $K \times 1$ dimensional vector. In type one submissions \mathbf{A}_t equals the identity matrix and α_t is equal to $(b_{\phi(1)}, b_{\phi(2)}, \dots, b_{\phi(K)})$. In type two submissions, when position k is won, \mathbf{A}_t is equal to a matrix with entry k, k equal to -1, entry k, k' equal to 0, entry (k', k') for $k' \neq k$ equal to 1, entry (k', k) equal to $-(c_i^k/c_i^{k'})$ and all other entries equal to zero;¹³ and vector α_t has entry k equal to $-b_{\phi(k+1)}$,

¹³Here, $k' \neq k$.

entries k' where $k' < k$ equal to $b_{\phi(k')} - \frac{c_i^{k'}}{c_i^k} b_{\phi(k+1)}$, and entries $k' > k$ equal to $b_{\phi(k'+1)} - \frac{c_i^k}{c_i^{k'}} b_{\phi(k+1)}$.

Given a set of observations T , we denote the set of valuations that satisfy restriction (31) as \mathbf{V}_i^T ,

$$\mathbf{V}_i^T = \{\mathbf{v}_i \in \mathfrak{R}_+^K \mid \mathbf{A}_t \mathbf{v}_i \leq \alpha_t \text{ for all } t \in T\}$$

Revealed preference predicts that the set \mathbf{V}_i^T is non-empty. The revealed preference hypothesis can be tested empirically. Observe though that the computational complexity of the empirical test can be high even for moderately sized K , due to the curse of dimensionality.

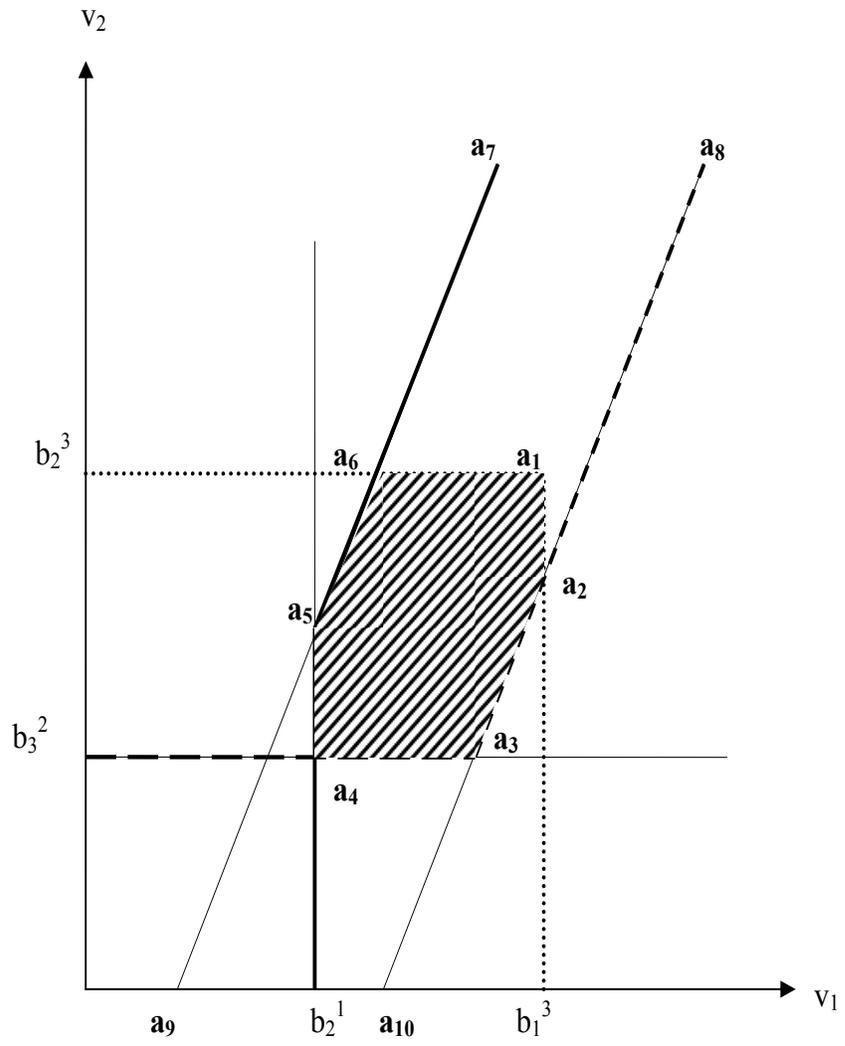


Figure 1

Figure 1 illustrates the set \mathbf{V}_i^T graphically in the case of two positions, $K = 2$.¹⁴ The dark shaded area with boundary points $a_1, a_2, a_3, a_4, a_5,$ and a_6 is consistent with three hypothetical bid vectors b^1, b^2, b^3 where the superscript in the bid vector indicates that bidder i wins item 1, item 2, or no item, respectively. Item 1 is won in the area south-east of the solid line segments $b_{\phi(2)}^1, a_5$ and a_7 .¹⁵ Item 2 is won in the area north-west of the dashed line segments $b_{\phi(3)}^2, a_3$ and a_8 .¹⁶ No position is won in the area south-west of the dotted line-segments going through the points $b_{\phi(3)}^3, a_1,$ and $b_{\phi(1)}^3$.

Figure 1 can be easily extended to an arbitrary set of bids. To see that, partition the set of observations T into three sets T^1, T^2, T^3 , so that T^1, T^2 denote the sets of bids in which position 1, 2 is won and T^3 denotes the set of bids in which no position is won. The dotted line is defined by the minimum bids for positions 1 and 2, $b_{\phi(2)}^3 = \min_{t \in T^3}(b_{\phi(2)}^t)$, and $b_{\phi(1)}^3 = \min_{t \in T^3}(b_{\phi(1)}^t)$, the dashed line segments are defined by $b_{\phi(3)}^2 = \max_{t \in T^2}(b_{\phi(3)}^t)$ and $a_{10} = \min_{t \in T^2}(b_{\phi(1)}^t - (c_i^2/c_i^1)b_{\phi(3)}^t)$, and the solid line segments are defined by $b_{\phi(1)}^1 = \max_{t \in T^1}(b_{\phi(2)}^t)$ and $a_9 = \max_{t \in T^1}(b_{\phi(2)}^t - (c_i^2/c_i^1)b_{\phi(3)}^t)$. Hence, the bid vectors b^1, b^2, b^3 in Figure 1 denote the corresponding minima and maxima. If some set T^i is empty, then the corresponding boundary will not bind and the shaded area in the figure will be enlarged.¹⁷

With multiple positions, $K > 2$, the set \mathbf{V}_i^T is contained in \mathfrak{R}^K . The boundary of the set \mathbf{V}_i^T along dimension $(v_i^k, v_i^{k'})$ shares the features as in Figure 1 for any pair $(v_i^k, v_i^{k'})$.

Next, we state that a pairwise non-empty boundary is a necessary condition for the revealed preference hypothesis. We denote the set of bid observations in which the submitted bid wins position k by $T^k \subset \mathfrak{R}^N$, and the

¹⁴In Figure 1, we write “ b_2^1 ” for $b_{\phi(2)}^1$ etc.

¹⁵The line going through the points a_5 and a_7 has slope c_i^1/c_i^2 and intercept $b_{\phi(3)}^1 - (c_i^1/c_i^2)b_{\phi(2)}^1$.

¹⁶Here the line going through the points a_3 and a_8 has slope c_i^1/c_i^2 and intercept $b_{\phi(3)}^2 - (c_i^1/c_i^2)b_{\phi(1)}^2$.

¹⁷If T^1 is empty, then the left boundary of the shaded area will equal the vertical line $(0, v_i^2)$ as by assumption $v_i^1 > 0$. If T^2 is empty, then the bottom boundary of the shaded area will equal the horizontal line $(v_i^1, 0)$. If T^3 is empty, then the shaded area is unbounded to the north-east.

set of bid observations in which the submitted bid does not win an position by $T^{K+1} \subset \mathfrak{R}^N$. We adopt the convention that the maximum and minimum over an empty set equals $-\infty$ and $+\infty$, respectively.

Condition 1 (Non-empty Pairwise Boundaries). *Given a set of observations T , a necessary condition for the valuation range \mathbf{V}_i^T to be non-empty is that*

$$\begin{aligned} \max_{t \in T^k} (b_{\phi(k+1)}^t) &\leq \min_{t \in T^{K+1}} (b_{\phi(k)}^t) \text{ for all } k \leq K; \\ \max_{t \in T^k} \left(b_{\phi(k+1)}^t - \frac{c_i^{k'}}{c_i^k} b_{\phi(k'+1)}^t \right) &\leq \min_{t \in T^{k'}} \left(b_{\phi(k)}^t - \frac{c_i^{k'}}{c_i^k} b_{\phi(k'+1)}^t \right) \\ &\text{for all } k, k' \leq K \text{ with } k < k'. \end{aligned}$$

The non-empty pairwise boundary condition is a necessary condition for a non-emptiness of the set \mathbf{V}_i^T . The first necessary condition states that the position price paid during some period cannot exceed the price of the same position during another period when the bidder doesn't win a position. The second necessary condition says that when position k is won the valuation difference, $v_i^k - (c_i^{k'}/c_i^k) v_i^{k'}$, is bounded from below by the price differences $b_{\phi(k+1)}^t - (c_i^{k'}/c_i^k) b_{\phi(k'+1)}^t$, and, when position k' is won it is bounded from above by the price differences $b_{\phi(k)}^t - (c_i^{k'}/c_i^k) b_{\phi(k'+1)}^t$, respectively. Observe that condition 1 is not a sufficient condition as two two-dimensional areas that share one dimension need not overlap in the common dimension.

Examining empirically whether the set $\mathbf{V}_i^T \subset \mathfrak{R}^K$ is non-empty can be computationally complex for moderately sized K . Yet, the necessary pairwise boundary condition can be examined at relatively small computational costs for all K . For computational reasons we proceed with a two step test approach of the revealed preference hypothesis: In the first step, we examine whether there is a violation of the necessary pairwise boundary condition. In the second step, we examine whether there is a non-empty set for those observations with a non-empty pairwise boundary.

A violation of the revealed preference hypothesis may be indicative of behavior inconsistent with rationality. Alternatively, it may suggest taste changes across subsets of the observations. For instance, preferences may be different during day-time than during night-time. The revealed preference hypothesis may be satisfied during day-time periods and during night-time periods, but not for both periods jointly.

7.2 Revealed Preference Test Results

This section examines the revealed preference hypothesis for our data. We also comment on the shape of the valuation profile for observations that satisfy the revealed preference hypothesis.

The non-empty pairwise boundary hypothesis is examined for a subset of our data consisting of bidders that submit a bid for a top five position on average.¹⁸ In total there are 67 such bidders. We find no violation of the non-empty pairwise boundary condition for 21 of 67 bidders, or 31 percent.¹⁹ Violations arise for bidders submitting numerous bids. On average, a bidder with a violation submits 137 bids. In contrast, a bidder without a violation submits 2.71 bids.

A violation may be attributable to a discrete change in an observable characteristic, such as a change from day-time to night-time. Alternatively, a violation may be attributable to a gradual change in observable characteristics, for instance when there is a time trend. Violations may also arise, if bidders are inexperienced and make periodic mistakes in assessing their willingness to pay or in submitting erroneous bids.

To examine whether violations arise suddenly or gradually, we select all bidders with a violation for the entire sample period. We determine the (maximal) length of sub-periods on which the non-empty boundary hypothesis holds. The algorithm is simple. For each bidder, we start with the first observation and then add on additional consecutive observations as long as no violation of the non-empty boundary hypothesis occurs. When a violation arises, we start a new set of observations. The algorithm partitions the set of observations into consecutive sub-period T_{i1}, \dots, T_{it_i} with the property that the non-empty boundary hypothesis is satisfied on each sub-period.

The length of the sub-periods without a violation amounts to 12.5 days on average. During the 12.5 days the bidder submits a total of 7 bids on

¹⁸An examination of all bidders shows that a violation of the non-empty boundary condition occurs for 20 percent of bidders only. The low violation rate may appear surprising initially. However, the bidders without a violation win position 70 or higher on average. For these bidders, the upper valuation bound is binding most of the time, and there are hardly any observations that provide a lower bound on the valuation range.

¹⁹A similar conclusion emerges when we consider bidders that submit a bid for a top ten but not top five position on average. There are in total 100 bidders in this category and no violation arises for 42 percent of bidders.

average. The multiple bids suggest that the valuations may change gradually over time, or that bidders may make mistakes on occasions only. In the next section, we will explore the later interpretation.

Next, we describe our test results of the revealed preference hypothesis. We examine whether the hypothesis holds for observations without a violation of the non-empty pairwise boundary condition.

The non-empty \mathbf{V}_i^T hypothesis. In total we include 1191 observations. These include all observations of bidders with a non-empty pairwise boundary during the entire period and all observations with a non-empty pairwise boundary for sub-periods. To limit the computational complexity of the exercise, we examine the non-emptiness hypothesis for a five dimensional valuation profile consisting of the top five valuations $(v_i^1, v_i^2, \dots, v_i^5)$. We do not examine the restrictions placed by the hypothesis for higher position valuations, $(v_i^6, v_i^7, \dots, v_i^{10})$. For each test candidate, we take one million independently and identically distributed multi-variate random draws from a uniform distribution.²⁰

The results are the following: For 55 percent of observations the set \mathbf{V}_i^T is non-empty. We can conclude that for the majority of observations the revealed preference hypothesis is satisfied.

Next, we explore the shape of the valuation profiles that are consistent with revealed preference.

Shape of the Valuation Profile. We consider two alternative hypothesis: (i) constant valuations, $v_i^1 = v_i^2 = \dots = v_i^5$; and (ii) monotone decreasing valuations, $v_i^1 > v_i^2 > \dots > v_i^5$. The data include all observations that pass the revealed preference test.

The hypothesis of a constant valuation profile is tested in the following way. We fix a grid with 0.5 cent increment and determine whether there exists a constant valuation profile $\tilde{v}_i \in \{0.005, 0.01, \dots, 15\}$ such that $\tilde{v}_i \in \mathbf{V}_i^T$. The hypothesis of monotone decreasing valuations is tested by using a sample of

²⁰The support of the uniform distribution is defined by the position price when no item is won, and the price paid when the item is won. Specifically, we take as the upper bound for valuation v_i^k the low bid observation that does not win a top ten position, $\min_{t \in T^{11}} b_{(i)}^t$, and we take as the lower bound the price paid when position k is won, $\max_{t \in T^k} b_{\phi(k+1)}^t$. When the upper bound does not exist, we replace it with 15. When the lower bound does not exist, we set it to 0.

randomly drawn monotone valuation profiles. We select one million draws from a multi-variate uniform distribution and we check whether $\tilde{v}_i \in \mathbf{V}_i^T$.

We find that 13 percent of observations pass the constant valuation test. We interpret the test result as a rejection of the null hypothesis of constant valuations. We find that 99 percent of observations pass the monotone decreasing valuation test. We cannot reject the monotonicity of valuation profiles.

To examine whether the decrease amounts to at least five percent for all consecutive pairs of valuations we consider the hypothesis that $v_i^k > 1.05 \cdot v_i^{k+1}$ for $k = 1, \dots, 4$. We cannot reject the null hypothesis of a five percent decline for all consecutive pairs for 98 percent of observations.

The test results indicate that the willingness to pay decreases with the position. We conclude this section with a caveat of the revealed preference approach as the chosen data partition may influence the interpretation of the test results. For example, it may be of interest to partition the data into day-time and night-time observations, and to examine whether the revealed preference hypothesis holds for the respective sub-samples. Yet, it is difficult to determine whether the newly created partition improves the fit simply due to the increased fineness of the partition, or indeed reflects a structural break.

To avoid this conceptual difficulty, we consider a statistical approach in the next section. We assume that valuations consist of a (parametric) deterministic component plus a random error. We find the set of covariates that best describes the bidders valuations in the sense that the probability of mistakes are minimized.

8 Willingness to Pay Estimates

This section describes willingness to pay estimates. We assume that valuations consists of a parametric component plus an error. The error can be interpreted as optimization error, as in McKelvey and Palfrey (1995), or may reflect random components in valuations which are known to bidders but not observed by the econometrician. Maximum likelihood is used to estimate the parameters of the parametric component.

The valuation vector is given by,

$$\mathbf{v}_i = \mathbf{X}_i^t \alpha_i + \varepsilon_i \quad (32)$$

where \mathbf{X}_i^t is a deterministic set of covariates, α_i is a parameter vector, and ε_i is a $K \times 1$ dimensional vector of standard normally distributed errors, with $\varepsilon_i^k \sim \Phi$. We sometimes use the notation $\mathbf{X}_i^{\mathbf{k},t} \alpha_i$ to denote the deterministic component of valuation k .

We can combine the parametric assumption with the bounds on the valuations described in Section 7 to obtain a set of inequalities for any bid observation b^t . For a type one submissions, when the bid does not win a top position and $t \in T_{K+1}$, the inequality is,

$$\mathbf{X}_i^{\mathbf{k},t} \alpha_i + \varepsilon_i^k \leq b_{\phi(k)}^t \quad \text{for all } k \leq K \quad \text{for } k \leq K. \quad (33)$$

For type two submissions, when the submitted bid wins position $k \leq K$ and $t \in T^k$, the inequalities are

$$\mathbf{X}_i^{\mathbf{k},t} \alpha_i + \varepsilon_i^k \geq b_{\phi(k+1)}^t \quad (34)$$

$$\begin{aligned} \mathbf{X}_i^{\mathbf{k}',t} \alpha_i + \varepsilon_i^{k'} &\leq \frac{c_i^k}{c_i^{k'}} \mathbf{X}_i^{\mathbf{k},t} \alpha_i + \frac{c_i^k}{c_i^{k'}} \varepsilon_i^k + b_{\phi(k')}^t - \frac{c_i^k}{c_i^{k'}} b_{\phi(k+1)}^t \\ &\quad \text{for } k' < k \end{aligned} \quad (35)$$

$$\begin{aligned} \mathbf{X}_i^{\mathbf{k},t} \alpha_i + \varepsilon_i^{k'} &\leq \frac{c_i^k}{c_i^{k'}} \mathbf{X}_i^{\mathbf{k},t} \alpha_i + \frac{c_i^k}{c_i^{k'}} \varepsilon_i^k + b_{\phi(k'+1)}^t - \frac{c_i^k}{c_i^{k'}} b_{\phi(k+1)}^t \\ &\quad \text{for } K \geq k' > k \end{aligned} \quad (36)$$

The standard normal assumptions on the error ε allows us to derive the likelihood. The log-likelihood is given by

$$\begin{aligned} \ell = & \sum_{t \in T^{K+1}} \sum_{k=1}^K \ln \left(\Phi \left(b_{\phi(k)}^t - \mathbf{X}_i^{\mathbf{k},t} \alpha_i \right) \right) + \\ & \sum_{k=1}^K \ln \left(\int_{\mathbf{X}_i^{\mathbf{k}',t} \alpha_i + \varepsilon_i^{k'} = b_{\phi(k+1)}^t}^{\infty} \left[\prod_{k' < k} \Phi \left(\frac{c_i^k}{c_i^{k'}} \mathbf{X}_i^{\mathbf{k},t} \alpha_i + \frac{c_i^k}{c_i^{k'}} \varepsilon_i^k + b_{\phi(k')}^t - \frac{c_i^k}{c_i^{k'}} b_{\phi(k+1)}^t - \mathbf{X}_i^{\mathbf{k}',t} \alpha_i \right) \right. \right. \\ & \left. \left. \cdot \prod_{k' > k} \Phi \left(\frac{c_i^k}{c_i^{k'}} \mathbf{X}_i^{\mathbf{k},t} \alpha_i + \frac{c_i^k}{c_i^{k'}} \varepsilon_i^k + b_{\phi(k'+1)}^t - \frac{c_i^k}{c_i^{k'}} b_{\phi(k+1)}^t - \mathbf{X}_i^{\mathbf{k},t} \alpha_i \right) \phi(\varepsilon_i^k) d\varepsilon_i^k \right] \right) \end{aligned} \quad (37)$$

Table 1: Maximum Likelihood Estimates

Keyword	Broad-band	Flower	Loan	Out-sourcing	Re-finance
Obs	301	1,141	512	324	735
Log-Lik	-197.4	-1,509.9	-789.8	-451.8	-1,032.2
α^1	-0.237 (0.01)	-0.050 (0.01)	-0.086 (0.00)	-0.080 (0.01)	-0.021 (0.00)
α_1^0	5.559 (0.23)	4.063 (0.08)	4.621 (0.12)	3.429 (0.11)	7.748 (0.07)
α_2^0	5.270 (0.31)	3.574 (0.11)	5.001 (0.10)	2.554 (0.15)	6.164 (0.155)
α_3^0	2.477 (0.29)	3.424 (0.09)	4.974 (0.11)	2.631 (0.25)	7.235 (0.11)

where the first line describes the contribution to the likelihood of type one bid submissions, and lines two and three describe the likelihood contribution of type two bid submissions.

Table 1 reports estimates for a linear valuation model where we postulate: $v_i^k = \alpha_i^0 + (\alpha^1 \cdot \alpha_i^0) \cdot k + \varepsilon_i^{kt}$. The coefficients α_i^0 measure bidder fixed effects. The coefficient α^1 enters the multiplicative term ($\alpha^1 \cdot \alpha_i^0$) and measures the valuation decrease relative to the bidder specific intercept α_i^0 . The top position has index k equal to one. The data include the top three premium bidders who submit at least ten bids and who occupy a top ten position for more than two weeks during the sample period. Estimates are reported for all five search terms.

Table 1 shows that the high *Broadband* valuation equals \$5.56 and the high valuation ranges between \$3.44 and \$7.75 for other search terms. We can test whether values per click depend on the position in which their advertisement is placed. The null hypothesis of constant valuations, $\alpha^1 = 0$, is rejected for all search terms at the 99% confidence interval. The slope coefficients α^1 in Table 1 are all negative and sharply estimated. Valuations decrease as the position increases. The average *Broadband* valuation decreases by 24 percent as the position increases by one. For other search terms the decrease ranges between two percent for *Refinance* and nine percent for *Loan*. The two percent decrease for *Refinance* appears a small number but translates into 15 cents between adjacent position which is considerable. We can conclude that

Table 2: Maximum Likelihood Estimates

Keyword	Broad-band	Flower	Loan	Out-sourcing	Re-finance
Obs	301	1,141	512	324	735
Log-Lik	-191.8	-1,507.9	-736.6	-439.7	-991.8
α_1^0	5.554 (0.23)	4.050 (0.08)	5.067 (0.16)	3.496 (0.11)	7.919 (0.07)
α_2^0	5.763 (0.40)	3.643 (0.11)	4.690 (0.11)	2.257 (0.18)	5.491 (0.28)
α_3^0	2.288 (0.28)	3.390 (0.10)	5.270 (0.13)	3.016 (0.31)	7.019 (0.15)
α_1^1	-1.304 (0.13)	-0.154 (0.05)	-0.606 (0.06)	-0.341 (0.05)	-0.281 (0.03)
α_2^1	-1.728 (0.27)	-0.271 (0.06)	-0.270 (0.03)	0.000 (0.06)	-0.039 (0.05)
α_3^1	-0.340 (0.11)	-0.132 (0.05)	-0.562 (0.04)	-0.406 (0.11)	0.000 (0.07)

valuations decrease in the position.

Table 2 reports estimates for a linear valuation specification in which bidder heterogeneity is accounted for in the intercept and also in the slope coefficient. The postulated valuation model is: $v_i^k = \alpha_i^0 + \alpha_i^1 \cdot k + \varepsilon_i^{kt}$.²¹

The slope coefficients in Table 2 are less precisely estimated than in Table 1 as some bidders submit most of their bids for a specific position. This makes it more difficult to estimate both an intercept and slope coefficient. In the table all but two slope coefficients are negative and all but two are significant at the 99 percent level. Two slope coefficients are zero which is consistent with the interpretation that these two bidders have constant valuations. Table 2 also suggests that bidders with an average higher rank may have on occasions a lower valuation than bidders with a lower average rank indicating the possibility of inefficiencies. We will examine this hypothesis more closely in the next section.

²¹To ensure that the slope coefficient α_i^1 is non-positive in accordance with assumption 1 we specify $\alpha_i^1 = -\left((\alpha_i^2)^2\right)^{\frac{1}{2}}$ and maximize the likelihood with the parameter tuple $(\alpha_i^0, \alpha_i^2)_{i=1}^3$.

Table 3: Maximum Likelihood Estimates

Keyword	Broad-band	Flower	Loan	Out-sourcing	Re-finance
Obs	295	1,134	505	306	623
Log-Lik	-190.7	-1,486.7	-772.4	-426.1	-877.7
α^1	-0.237 (0.01)	-0.048 (0.01)	-0.086 (0.00)	-0.076 (0.01)	-0.028 (0.003)
α_1^0	7.483 (1.23)	5.203 (0.25)	4.170 (0.35)	2.984 (0.35)	7.956 (0.18)
α_2^0	6.727 (0.95)	4.534 (0.23)	4.693 (0.27)	2.327 (0.22)	6.560 (0.20)
α_3^0	3.956 (1.05)	4.118 (0.17)	4.748 (0.20)	2.547 (0.36)	7.353 (0.14)
α^2	-0.020 (0.012)	-0.015 (0.003)	0.005 (0.004)	0.005 (0.004)	-0.001 (0.002)

Table 3 examines the dependence of valuations on the percentage of time a bidder held a top three position in the past seven days. The postulated valuation model is: $v_i^k = \alpha_i^0 + (\alpha^1 \cdot \alpha_i^0) \cdot k + \alpha^2 \cdot Top3_i^t + \varepsilon_i^{kt}$ where $Top3_i^t$ is the percentage of time bidder i held a top three listing position during the seven days preceding day t and α_i^0 controls for bidder heterogeneity as in Table 1. The variable $Top3_i^t$ is not defined for the first seven days of the sample period and we exclude all bid observations during that period. The number of bid observations in Table 3 is thus smaller than in Table 1. The $Top3_i^t$ variable allows us to test the presence of dynamic elements in valuations. For instance, if bidders are financially constrained, then we will expect that the value of an additional customer is reduced if the bidder had held many top listing positions in the past resulting in a negative α^2 coefficient. We examine the validity of the static valuation model by testing the null of a zero α^2 coefficient.

In the table three α^2 coefficients are negative and two are positive. Four of five α^2 estimates are not significant. We cannot reject the null of a static model for four search terms which are Broadband, Loan, Outsourcing, and Refinance. For the search term Flower, the static null is rejected. But even for Flower the magnitude of the dynamic effect is not overwhelming. Note also that for all search terms the slope coefficient estimate α^1 remains similar

to the estimate in Table 1 suggesting that the slope coefficient is robust to the inclusion of the intertemporal variable. On the other hand the intercept coefficients in Table 3 are less precisely estimated than in Table 1. The inclusion of the additional variable may capture some bidder heterogeneity which may explain the increased variance. We can conclude that the percentage of time a bidder held a top three position in the past seven days does not have an overwhelming effect on valuations. We cannot reject the static valuation model.

A bidder’s rent estimate equals the difference between the predicted willingness to pay and the price paid. Our estimates in Table 1 imply an estimated rent per click equal to 55 cents for top three bidders across search terms. The estimated bidder’s rent per click equals \$1.52, \$1.05, \$-0.57, \$0.28, \$0.47 for the search term *Broadband*, *Flower*, *Loan*, *Outsourcing*, and *Refinance*, respectively.

9 Revenue and Efficiency Losses

The willingness to pay estimates allow us to illustrate possible efficiency and revenue gains of alternative auction rules. The measures are defined in the following way. We examine the occasions in our data in which two or more of the top-three-premium bidders win a position. We interchange the relative positions of the top-three-premium bidders in order to maximize the total surplus. Our measure of efficiency loss is defined as the incremental surplus that can be achieved by making this interchange. We hold the bids and position positions of all other bidders fixed in the exercise and the estimates will provide us with a lower bound on possible revenue and efficiency gains, as there could be additional revenue and efficiency gains among non-top-three-premium bidders. The efficiency measure is reported relative to the observed revenue which is the price paid weighted with the click through rate. For *Broadband* inefficiencies equal 0.6 percent of observed revenues. The inefficiency equals 0.4, 0.6, 0.6, 1.7 percent of observed revenues for the search term *Flower*, *Loan*, *Outsourcing*, and *Refinance*, respectively.

Our measure of revenue losses is based on the maximal surplus that can be extracted from premium bidders based on our willingness to pay estimates. For *Broadband*, our estimates imply that a full rent extracting auction would improve revenues by as much as 49 percent. For other search terms the

possible revenue improvements are smaller. The revenue improvement equals 5, 7, 7 and 32 percent for the search term *Flower*, *Loan*, *Outsourcing*, and *Refinance*, respectively.

10 Conclusion

We have presented a game theoretic analysis of the Yahoo sponsored search auction, and we have interpreted bidding data assuming that this theory is a correct model of bidders' behavior. Our analysis suggests that it might be interesting to consider a dynamic model of bidding behavior in the auction in which bidders pursue repeated game strategies. Another missing element in our model might be bidders' budget constraints. It seems common that bidders in sponsored search auctions have to respect budget constraints. The rich data that high frequency sponsored search auctions provide allows the examination of a variety of further issues.

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Appendix

Proof of Proposition 3

For simplicity we focus on the case that the number of bidders N is strictly larger than the number of positions K : $N > K$. The case $N = K$ is analogous. The method of proof is that we construct a Nash equilibrium in which $b_1 > b_2 > \dots > b_K \geq b_{K+1} \geq b_{K+2} \geq \dots \geq b_N$, i.e., bidder 1 wins position 1, bidder 2 wins position 2, etc., and bidders $K + 1, \dots, N$ win no position. First, for all bidders $i = K + 1, K + 2, \dots, N$, we set: $b_i = v_i^K$. Next, for all bidders $i = 2, 3, \dots, K$ (leaving out bidder 1 for the moment), we choose a bid b_i that satisfies two conditions. The first condition says that bidder $i - 1$, who will win position $i - 1$ and pay for it b_i , does not wish to bid lower, and win position i instead:

$$c_{i-1}^{i-1} (v_{i-1}^{i-1} - b_i) \geq c_{i-1}^i (v_{i-1}^i - b_{i+1}) \Leftrightarrow \quad (38)$$

$$b_i \leq v_{i-1}^{i-1} - v_{i-1}^i + \left(1 - \frac{c_{i-1}^i}{c_{i-1}^{i-1}}\right) v_{i-1}^i + \frac{c_{i-1}^i}{c_{i-1}^{i-1}} b_{i+1} \quad (39)$$

The second condition implies that bidder i , who will win position i and pay for it b_{i+1} , does not have an incentive to raise his bid to win position $i - 1$. To win position $i - 1$ bidder i would have to pay b_{i-1} . We will require that he doesn't even want to win it if he had to pay b_i for it, i.e. what the current winner of position $i - 1$, i.e. bidder $i - 1$, pays.

$$c_i^i (v_i^i - b_{i+1}) \geq c_i^{i-1} (v_i^{i-1} - b_i) \quad (40)$$

$$b_i \geq v_i^{i-1} - v_i^i + \left(1 - \frac{c_i^i}{c_i^{i-1}}\right) v_i^i + \frac{c_i^i}{c_i^{i-1}} b_{i+1} \quad (41)$$

Equations (39) and (41) give an upper and a lower bound for the bid b_i when $i = 2, 3, \dots, K$ where both bounds depend on b_{i+1} . As $b_{K+1} = v_{K+1}^K$ is given, we can start the construction with b_K and then work recursively up to b_2 at each step picking some bid that is between the two bounds. The final step of the construction is then to choose any arbitrary b_1 such that $b_1 > b_2$.

The proof now shows in a first step that this construction is well-defined, and, moreover, that we can choose the bids so that: $b_1 > b_2 > \dots > b_N$. The second step then shows that any bid vector that is constructed in this way is indeed a Nash equilibrium of the auction game.

We begin the first step by noting that $b_{K+1} \geq b_{K+2} \geq \dots \geq b_N$ follows from the first part of Assumption 4. We complete the argument of the first step by showing that for every $i = 2, 3, \dots, K$ the upper boundary in equation (39) is at least as large as the lower boundary in equation (41), and, moreover, that we can choose b_i from the interval defined by these two boundaries so that that: $b_i > b_{i+1}$ and $b_i < v_{i-1}^{i-1}$. We show this first for $i = K$, and then by induction for $i < K$.

Consider first $i = K$. The upper boundary in equation (39) as well as the lower boundary in equation (41) consist of two terms: Firstly, the increase in the willingness to pay per click (for bidder i or bidder $i - 1$) as we move up from position i to position $i - 1$, and secondly, a convex combination of the willingness to bid per click for position i (for bidder i or for bidder $i - 1$), and the bid for position $i + 1$. By Assumption 4 the first term is at least as large in the upper boundary as it is in the lower boundary. In the second term, the willingness to bid per click receives by Assumption 4 at least as large a weight in the upper boundary as in the lower boundary. It thus suffices to show that the bid b_{K+1} is not larger than the willingness to bid per click v_K^K . If we can show this, then the assertion that the upper boundary is at least as large as the lower boundary follows because in (39) the willingness to bid, that is, the larger expression, receives at least as large a weight as in (41), and moreover the willingness to bid in (39) is by Assumption 4 at least as large as the willingness to bid in (41). But for $i = K$ the inequality $b_{i+1} < v_i^i$ follows from $b_{K+1} = v_{K+1}^K$ and the first part of Assumption 2 which implies: $v_{K+1}^K < v_K^K$.

Next, we show that b_K can be picked from the interval given by (39) and (41) so that it satisfies $b_K > b_{K+1}$. Equation (39) shows the upper boundary for b_K is equal to the weighted average of b_{K+1} and an expression that is larger than b_{K+1} , namely v_K^K , plus some non-negative difference in values per click. Assumption 3 means that either the weight on v_K^K is strictly positive, or the difference in values per click is strictly positive, or both. Thus the upper boundary is strictly larger than v_K^K , and the claim follows.

Finally, we show that if b_K is picked from the interval given by (39) and (41), it will satisfy: $b_K < v_{K-1}^{K-1}$. This is obvious from equation (38), where the right hand side is strictly positive, and therefore also the left hand side needs to be strictly positive.

The induction step now assumes that we have proved our assertions for

$i + 1$. We then prove that it is also true for i . The argument proceeds in exactly the same way as in the case $i = K$. Note that in the above argument it was crucial that we knew that $v_i^i > b_{i+1}$, but that is true in the induction step by the induction assumption.

We have thus shown that our construction is feasible. It remains to show that the bid vector that we obtain is a Nash equilibrium. Observe that our construction implies that no bidder $i = 1, 2, \dots, K$ has an incentive to either deviate by bidding for a position $i - 1$ or bidding for position $i + 1$. We next show that this implies under our assumptions also that no bidder $i = 1, 2, \dots, K$ has an incentive to deviate by bidding for a position that is more than one position up or down from his own position.

Consider first deviations that involve bidding for a lower position. By equation (39) bidder $i - 1$ prefers winning position $i - 1$ over winning position i . We now show that the same is true for all bidders whose index is lower than $i - 1$ as well. For this, we have to show that equation (39) holds if we replace all bidder indices $i - 1$ by lower indices. But this is easy to see. The valuation difference on the right hand side of equation (39) does not decrease as we lower the index, according to Assumption 4. In the convex combination that follows, the weight on the willingness to pay per click does not decrease as we lower the bidder index according to Assumption 4. Finally, the willingness to pay per click does not decrease, by Assumption 4. By iterating the argument, we find that for every bidder the best downward deviation is to the position just below him, but by construction this deviation is not profitable. The argument that no deviations in which bidders bid for higher positions are profitable is similar.

It remains to consider whether bidders $i = K + 1, K + 2, \dots, N$ have an incentive to deviate to win a position. It is clear that they cannot raise their profit by bidding for position K , as they would have to pay b_K which is by construction larger than $b_{K+1} = v_{K+1}^K$, and hence, by Assumption 2 at least as large as v_i^K for all $i = K + 1, K + 2, \dots, N$. An argument similar to the arguments above then shows that the bidders $i \geq K + 1$ have no incentive to bid for a position higher than K either. \square

Proof of Proposition 5

Observe that we can choose b_1 arbitrarily high and thus ensure that no bidder has an incentive to bid for position 1. Therefore, we can find a Nash

equilibrium of the required type if and only if we can find non-negative bids b_2 and b_3 such that four incentive constraints hold. Firstly, bidder 1 does not want to bid for position 2:

$$\begin{aligned} c_1^1(v_1^1 - b_2) &\geq c_1^2(v_1^2 - b_3) \Leftrightarrow \\ b_2 - \frac{c_1^2}{c_1^1}b_3 &\leq v_1^1 - \frac{c_1^2}{c_1^1}v_1^2 \end{aligned} \quad (42)$$

Secondly, bidder 1 does not want to bid for position 3:

$$\begin{aligned} c_1^1(v_1^1 - b_2) &\geq c_1^3v_1^3 \Leftrightarrow \\ b_2 &\leq v_1^1 - \frac{c_1^3}{c_1^1}v_1^3 \end{aligned} \quad (43)$$

Next, bidder 2 does not want to bid for position 3:

$$\begin{aligned} c_2^2(v_2^2 - b_3) &\geq c_2^3v_2^3 \Leftrightarrow \\ b_3 &\leq v_2^2 - \frac{c_2^3}{c_2^2}v_2^3 \end{aligned} \quad (44)$$

Finally, bidder 3 does not want to bid for position 2:

$$\begin{aligned} c_3^3v_3^3 &\geq c_3^2(v_3^2 - b_2) \Leftrightarrow \\ b_2 &\geq v_3^2 - \frac{c_3^3}{c_3^2}v_3^3 \end{aligned} \quad (45)$$

We now distinguish two cases. The first case is that the lower bound in (45) is not-positive.

$$\begin{aligned} v_3^2 - \frac{c_3^3}{c_3^2}v_3^3 &\leq 0 \Leftrightarrow \\ c_3^2v_3^2 &\leq c_3^3v_3^3 \end{aligned} \quad (46)$$

In this case, a necessary and sufficient condition for the existence of a non-negative solution to (42)-(44) is that the right hand sides of (43) and (44) are non-negative. The necessity is obvious. To see sufficiency note that

$b_2 = b_3 = 0$ will solve (42)-(44) in this case. The upper boundary in (43) is non-negative if:

$$\begin{aligned} v_1^1 - \frac{c_1^3}{c_1^1} v_1^3 &\geq 0 \Leftrightarrow \\ c_1^1 v_1^1 &\geq c_1^3 v_1^3 \end{aligned} \quad (47)$$

The upper boundary in (44) is non-negative if:

$$\begin{aligned} v_2^2 - \frac{c_2^3}{c_2^2} v_2^3 &\geq 0 \Leftrightarrow \\ c_2^2 v_2^2 &\geq c_2^3 v_2^3 \end{aligned} \quad (48)$$

Inequalities (47) and (48) are the first two conditions in Proposition 5.

Now suppose that the lower bound in (45) is positive.

$$c_3^2 v_3^2 > c_3^3 v_3^3 \quad (49)$$

Obviously, (47) and (48) remain necessary. But we also need that the upper boundary in (43) is not less than the lower boundary in (45):

$$\begin{aligned} v_1^1 - \frac{c_1^3}{c_1^1} v_1^3 &\geq v_3^2 - \frac{c_3^3}{c_3^2} v_3^3 \Leftrightarrow \\ c_1^1 v_1^1 - c_1^3 v_1^3 &\geq \frac{c_1^1}{c_3^2} (c_3^2 v_3^2 - c_3^3 v_3^3) \end{aligned} \quad (50)$$

If (47), (48) and (50) hold, then the difference on the left hand side of (42) is minimized when b_2 is at the lower bound given by (45), and b_3 is at the upper bound given by (44). Thus, a necessary and sufficient condition for the existence of a non-negative solution is that for these choices of b_2 and b_3 inequality (42) holds:

$$\begin{aligned} v_3^2 - \frac{c_3^3}{c_3^2} v_3^3 - \frac{c_1^2}{c_1^1} \left(v_2^2 - \frac{c_2^3}{c_2^2} v_2^3 \right) &\leq v_1^1 - \frac{c_1^2}{c_1^1} v_1^2 \Leftrightarrow \\ (c_1^1 v_1^1 - c_1^2 v_1^2) + \frac{c_1^2}{c_2^2} (c_2^2 v_2^2 - c_2^3 v_2^3) &\geq \frac{c_1^1}{c_3^2} (c_3^2 v_3^2 - c_3^3 v_3^3) \end{aligned} \quad (51)$$

Inequalities (50) and (51) are the second pair of conditions in Proposition 5.

□