

Auctioning the Right to Choose When Competition Persists*

Vlad Mares[†] Ronald M. Harstad[‡]

First Draft: February, 2009

This Draft: April 14, 2009

Abstract

Several papers compare auctioning heterogeneous assets sequentially with sequentially selling the right to choose among assets not yet taken. Typically motivated by auctions of condos for owner occupation, these papers have assumed that each winning bidder exits, so each successive auction has less competition. In many heterogeneous-asset-sale situations, a winning bidder may still be interested in acquiring further assets. We build a simple model of persistent competition, in which the distribution of equilibrium revenue from separate sales is shown to be a mean-preserving spread of the distribution of revenue from selling rights to choose. Persistent competition reveals that a high bidder does not always select his most preferred asset, and that one asset being slightly more likely to be a favored asset discontinuously affects equilibrium bidding.

1 Introduction

When a seller seeks to auction similar but distinct assets, it is commonplace in some settings and predominant in others to sell “rights to choose.” In such an auction, each round determines the price at which the high bidder gets to select from those assets not yet taken. Ashenfelter and Genesove’s [1992] exciting empirical paper on condominium conversion auctions has led to the handful of theoretical models of rights-to-choose auctions focusing primarily on this example. While illustrative, it is in an important aspect a limiting example. Gale and Hausch [1994], Burguet [2005], [2007], follow the condo conversion auctions that Ashenfelter and Genesove studied in assuming that a winning bidder ceases competing in later rounds, so that the level of competition is steadily decreasing.

*Corresponding Author: Harstad, harstadr@missouri.edu

[†]Kellogg School of Management, Northwestern University, Evanston, IL

[‡]Economics, University of Missouri

Condo auctions in Miami in recent years have not restricted bidding to those who intended to occupy the condo won, and have seen a bidder win, select a condo they intend to rent out, and continue competing. On many occasions, especially when several pieces from the estate of an art collector are being sold, art auctioneers have offered rights to choose, and a winning bidder choosing an artwork has remained to bid for further rights to choose. Some half-dozen recent mergers or acquisitions in the US banking industry have received regulatory approval only subject to a requirement that the newly combined entity divest a certain number of retail banking locations in key metropolitan areas where its dominance would otherwise be unacceptable. Our understanding of the resulting transactions is that they carry negotiation aspects making them less formal than the usual auction, but in some ways closely resemble right-to-choose auctions. As the number of branches sold typically is well in excess of the number of purchasing banks, clearly acquirers of some prime locations persist to compete for others.¹

We illuminate persistent competition in right-to-choose auctions by modeling the polar case: winning a right-to-choose not only leaves all bidders in competition, but all bidders, including the one now choosing an asset, have undiminished values (relative to the initial auction round) for any assets still in competition.

A key advantage of this modeling assumption is that it opens the choice a winning bidder makes to strategic considerations. A winner who chooses and then exits obviously selects his most-preferred asset. A winner who remains to compete for assets offered later decides whether to select his favorite asset or to remove from competition an asset less highly valued by him in order to reduce the competitiveness in the follow-up auctions.

Introducing this strategic dimension also serves to isolate a previously unexplored assumption, now found here to a razor's edge case rather than robust. Prior papers have assumed that the identity of the most-highly-valued asset for a given bidder is determined equiprobably, making the assets homogenous from an ex-ante perspective.² Initially, our model maintains this assumption. Under ex-ante homogeneity, the symmetric equilibrium bid function is the average of a bidder's values for the assets yet unchosen. In equilibrium, the preferred asset is always chosen; expected revenue if the assets were sold separately is a mean-preserving spread of the expected revenue of selling rights to choose.

Both of these results are seen to be idiosyncratic consequences of the ex-ante homogeneity assumption. Section 4 expands the model by assuming that each bidder draws the identity of his most-highly-valued asset from a common distribution that favors a particular asset, below called the "usual" favorite. The

¹Our limited knowledge of all three examples stems primarily from private correspondence with participants in these markets; we have no data on the relative frequency of the right-to-choose format.

²Gale and Hausch [1994], Burguet [2005, 2007] and Goeree, Plott and Wooders [2004] (this last primarily an experimental paper) employ this assumption without comment on its robustness. Though types are drawn without replacement in the experimental study of Eliaz, Offerman and Schotter [2008], their assets are ex-ante homogeneous.

outcome is strikingly different, and does not converge to the ex-ante-homogenous outcome as the preference distribution converges to uniform. The equilibrium bid function is a bidder’s value of the usual favorite, whether or not the bidder in question values that asset more highly; equilibrium revenue now matches in distribution that from selling the assets separately. Most striking: the right to choose is always used to select the asset which would yield the greatest competition in the follow-up auction were it still available, even if the bidder selecting this asset values another asset far more highly, and even if the odds differential that the chosen asset would yield the greatest competition is arbitrarily small.

To sort out the role of ex-ante homogeneity, section 5 briefly discusses a model in which bidders typically diverge in their tastes. It also finds that the right to choose is always used to select the asset most likely to draw a higher rival bid in upcoming rounds.

2 A Model with Ex-Ante Homogeneity

To focus on the issues just identified, we analyze the two-asset, two-bidder case. The two assets are labeled \mathfrak{U} and \mathfrak{R} , to make the presentation in section 4 more mnemonic; for now, it may help to think of \mathfrak{U} as a painting of an urban scene, \mathfrak{R} as a painting of a rural scene. In keeping with the prior literature on rights-to-choose auctions, bidders’ values will be private and independent. Without loss of generality, the bidders will be numbered, and assets labeled, so that an analyst knows that bidder 1 has a higher value for asset \mathfrak{U} , U_1 , than for asset \mathfrak{R} , R_1 , although this convention is not knowledge of bidder 2. Bidder 2’s values, U_2 and R_2 , allow an analyst to distinguish two cases: C , Convergence, when the bidders concur as to which asset is more valuable (thus, $U_2 > R_2$), and D , Divergence, when their tastes diverge: $U_2 < R_2$. Of course, neither bidder knows whether they are in case C or case D .

As with the prior literature, we assume that a bidder’s private knowledge is completely characterized by one scalar variable and one binary variable, evading the major complications of multi-dimensional signaling. Bidder $i = 1, 2$ privately observes random signal $X_i \sim G_i$ on $[0, 1]$, and variable $F_i \in \{\mathfrak{U}, \mathfrak{R}\}$, equiprobably until section 4, to maintain the ex-ante homogeneity assumption of prior papers. The interpretation is that F_i is i ’s “favored” asset, the one with the higher value to him. Then if $F_i = \mathfrak{U}$ [correspondingly, $F_i = \mathfrak{R}$], $U_i = X_i$ [$R_i = X_i$]. Valuation specification is completed via a commonly known “lower value” function $L: [0, 1] \rightarrow [0, 1]$, with $L(0) = 0$, $L'(k) < 1 \forall k \in [0, 1]$. Thus, if $F_i = \mathfrak{U}$, i ’s asset values are $U_i = X_i$, $R_i = L(X_i)$; if $F_i = \mathfrak{R}$, i ’s asset values are $U_i = L(X_i)$, $R_i = X_i$. The impact of this assumption is to make a higher-value bidder place a higher premium on obtaining his preferred asset than does a lower-value bidder: $X_1 > X_2 \Leftrightarrow |U_1 - R_1| > |U_2 - R_2|$.³ Recall that bidder i obtaining \mathfrak{U} [\mathfrak{R}] at price p earns a profit of $U_i - p$ [$R_i - p$], regardless of whether

³This assumption is introduced in Burguet [2005], and is more general than the assumptions regarding the ratio of (preferred value/less preferred value) in Gale and Hausch [1994], Goeree, Plott and Wooders [2004], and Eliaz, Offerman and Schotter [2008],

the other asset is obtained.

The baseline auction simply sells the assets in separate auctions, English or second-price, in either order. Bidders have a dominant strategy to bid their value in each auction, whether risk-neutral or risk-averse, and expected revenue is $Y_B = E[\min\{U_1, U_2\} + \min\{R_1, R_2\}]$.

In the rights-to-choose auction, the high bidder in the first round pays the second-highest bid, and chooses one of the assets. It is straightforward to show that in equilibrium he selects his favored asset; under the homogeneity assumption, there will, on average, be just as strong competition in the following round no matter which asset he chooses. The remaining asset is then auctioned off in round two by English or second-price auction, soon enough that no discounting occurs. Again, in round two, bidders have a dominant strategy to bid their value.

Proposition 1 *For both bidders to bid $b^*(U, R) = (U + R)/2$ is an equilibrium.*⁴

Proof. Let bidder 2 bid b^* , and consider bidder 1 upon observing values $(U_1, R_1) = (U_1, R_1)$. To focus issues, presume the auction is competitive, in that $X_2 > L(X_1)$ and $X_1 > L(X_2)$, so that each bidder can outbid the other on his favored asset if it is not also the other's favored asset; it is trivial to show that a symmetric equilibrium bid function for a competitive auction remains one if this competitiveness is not satisfied. Suppose that by bidding b^* , bidder 1 will either outbid bidder 2 or will be awarded the right to choose due to a random tie-breaking mechanism. Since, by convention, we have labeled the assets so that $F_1 = \mathfrak{U}$, bidder 1 chooses asset \mathfrak{U} and pays price $p = b^*(U_2, R_2)$, attaining profit $U_1 - (U_2 + R_2)/2 \geq (U_1 - R_1)/2$ in round 1, with equality iff the bids are tied, and the strict inequality resulting from bidder 1 having the higher average value if his bid won outright. In the remaining round, the two equally likely cases yield as follows. *C*: both bidders bid the value of their less-favored asset, bidder 1's profit is $\max\{0, R_1 - R_2\}$, positive if his round 1 bid was higher, 0 if he tied. *D*: bidder 2 bids for his favored asset and wins, with bidder 1 attaining 0 profit. Under this supposition, then, bidder 1's profit on both auctions is

$$U_1 - (U_2 + R_2)/2 + \max\{0, R_1 - R_2\}/2 \geq (U_1 - R_1)/2 + \max\{0, R_1 - R_2\}/2,$$

with equality iff the bids are tied.

Next, suppose the contrary: that by bidding b^* , bidder 1 will either be outbid by bidder 2 or will lose the right to choose due to a random tie-breaking mechanism. Bidder 1 earns 0 profit in round 1, and bidder 2 chooses his favorite asset, yielding two equally likely cases. *C*: bidder 2 chooses asset \mathfrak{U} , both bidders bid the value of their less-favored asset, bidder 1's profit is $\max\{0, R_1 - R_2\}$. *D*: bidder 2 chooses asset \mathfrak{R} , and then bids against bidder 1 for 1's favored asset; bidder 1 wins at price U_2 , attaining profit $[U_1 - L(X_2)]$.

⁴It is straightforward to adapt the method of proof in Levin and Harstad [1986] to show that this is the unique symmetric equilibrium in increasing strategies; details are omitted.

Under the contrary supposition, then, bidder 1's profit on both auctions is $[U_1 - L(X_2)]/2 + \max\{0, R_1 - R_2\}/2$.

Subtract bidder 1's profit when he does not get the right to choose from his profit when he does. If the round 1 bids tied, this difference is $(U_1 - R_1)/2 - [U_1 - L(X_2)]/2 = 0$, as tied bids require $X_1 = X_2$, so he is indifferent over the tie-breaking outcome. If he outbid bidder 2 in round 1, this difference is

$$U_1 - (U_2 + R_2)/2 - [U_1 - L(X_2)]/2 > (U_1 - R_1)/2 - [U_1 - L(X_2)]/2 > 0, \quad (1)$$

so bidder 1 prefers to win in exactly those circumstances where bidding b^* will win. Finally, if bidder 2 outbid him in round 1, this difference is

$$U_1 - (U_2 + R_2)/2 - [U_1 - L(X_2)]/2 < (U_1 - R_1)/2 - [U_1 - L(X_2)]/2 < 0 \quad (2)$$

(both inequalities are reversed because bidder 1 being outbid implies $X_1 < X_2$), so bidder 1 prefers to lose in exactly those circumstances where bidding b^* will lose. A corresponding argument implies that b^* is also a best response for bidder 2. ■

3 Revenue Comparison

Expected revenue summed over the two rounds of the right-to-choose auction is calculated as follows. Round 1 expected revenue is

$$Y_1 = E[\min\{(X_1 + L(X_1))/2, (X_2 + L(X_2))/2\}].$$

In case C round 2 expected revenue is

$$Y_2^C = E[\min\{L(X_1), L(X_2)\}].$$

Let $w \in \{1, 2\}$ denote the round 1 winner, and $\neg w$ the loser. Then in case D , the round 1 loser is bidding for his favored asset, and expected revenue is

$$Y_2^D = E[\min\{X_{\neg w}, L(X_w)\}].$$

Combining, right-to-choose expected revenue is

$$\begin{aligned} EY &= E\left[\min\left\{\frac{X_1 + L(X_1)}{2}, \frac{X_2 + L(X_2)}{2}\right\}\right] \\ &\quad + \frac{E[\min\{L(X_1), L(X_2)\}]}{2} + \frac{E[\min\{X_{\neg w}, L(X_w)\}]}{2}. \end{aligned}$$

It is straightforward to see that expected revenue from separate auctions,

$$\begin{aligned} EY_B &= E[\min\{U_1, U_2\} + \min\{R_1, R_2\}] \\ &= E[\min\{X_1, X_2\} + \min\{L(X_1), L(X_2)\}]/2 \\ &\quad + E[\min\{X_1, L(X_2)\} + \min\{L(X_1), X_2\}]/2, \end{aligned}$$

Case C		Case D	
U_1		U_1	
	$\{U_2\}$		R_2
Avg_1		Avg_1	
	<i>Avg₂</i>		<i>Avg₂</i>
R_1		$\{R_1\}$	
	$\{R_2\}$		$\{U_2\}$

Figure 1: Revenue Comparison

is a mean-preserving spread of EY . To avoid over-involvement in notation, consider without loss of generality the case where the bidder winning the right to choose is labeled bidder 1, and his favored asset continues to be \mathfrak{U} . Then the expected revenue comparison follows the illustration in Figure 1.

Variables shown higher in the figure represent higher expected values (per the labeling). Right-to-choose revenue Y is half the sum of the four values shown in bold italic text. Separate auction revenue Y_B is half the sum of the four values shown in brackets. So the expected average value of the right-to-choose loser appears in the right-to-choose revenue (twice, once in each case), but is replaced in the separate revenue, in case C by that bidder's higher value and in case D by that bidder's lower value. Hence, a risk-neutral seller is indifferent between auctioning the assets separately or auctioning the right to choose, while a risk-averse seller prefers the latter.

4 Ex-Ante Differentiation, or Adding a Usual Favorite

Now consider a single modification: each bidder is type \mathfrak{U} with probability $\pi > 1/2$, and type \mathfrak{R} with probability $1 - \pi$. That is, asset \mathfrak{U} is “usually” a bidder's favorite asset, \mathfrak{R} “rarely” a bidder's favorite asset. Now it is essential to consider bidding behavior separately for each type, as cases C and D have different probabilities and potentially different analyses for bidder types \mathfrak{U} and \mathfrak{R} .

Comparable to the analysis of the equiprobable situation, we seek an equilibrium in which a bidder of type $f = \mathfrak{U}, \mathfrak{R}$ employs a bid function of the form $b_f(X) = w_f X + (1 - w_f) L(X)$, $w_f \in [0, 1]$, a type-specific weighted average.

It is straightforward that a type $f = \mathfrak{U}$ bidder winning the right to choose selects his favored asset, \mathfrak{U} : competition would more likely be stronger were he to select \mathfrak{R} , and his current-round payoff would be lower.

Initially suppose that a type $f = \mathfrak{R}$ bidder also selects his favored asset, \mathfrak{R} , in an equilibrium. Carefully following the steps in Proposition 1 that lead up to inequalities (1) and (2), but separately for the two types, and keeping track of the probabilities π and $1 - \pi$, leads to best response functions $w_U(w_R)$ and $w_R(w_U)$ that are parallel. Hence, this initial supposition is inconsistent with an equilibrium of this form.

Instead suppose, then, that a type $f = \mathfrak{R}$ bidder selects his less-favored asset, \mathfrak{U} , in an equilibrium (b_U, b_R) . The above cases of convergence and divergence now require type-specific calculations, for cases \mathfrak{UC} , when he is type \mathfrak{U} and types converge, \mathfrak{UD} , when he is type \mathfrak{U} and types diverge, and \mathfrak{RC} and \mathfrak{RD} , correspondingly. Conditional on a bidder drawing the indicated type, \mathfrak{UC} and \mathfrak{RD} have probability π , \mathfrak{UD} and \mathfrak{RC} probability $1 - \pi$.

To find such an equilibrium, as above, assume that the auction is competitive (without loss of generality). Initially consider bidder 1 when he is of type \mathfrak{U} , and $w_U \in (0, 1)$. If he wins the right to choose, and selects \mathfrak{U} , his payoff is

$$X_1 - \{\pi [w_U X_2 + (1 - w_U) L(X_2)] + (1 - \pi) [w_R X_2 + (1 - w_R) L(X_2)]\} \\ + \pi \max\{0, L(X_1) - L(X_2)\},$$

where the subtracted term is the price of the right to choose, and the last term the expected payoff in the second auction, where competitiveness implies he is necessarily outbid in case \mathfrak{UD} , which has probability $1 - \pi$. If he loses the right to choose, his payoff is

$$\pi \max\{0, L(X_1) - L(X_2)\},$$

as his rival selects asset \mathfrak{U} no matter what his type. Since this is smaller (equal only in the zero-probability event of a tie for right-to-choose) for any $w_U \in (0, 1)$, bidder 1 of type \mathfrak{U} improves his payoff by increasing w_U . Hence, an equilibrium requires $w_U = 1$; that is, a bidder favoring the same asset usually favored bids his entire value of that asset for the right to choose, even if the chances that his rival favors the same asset only slightly exceed 1/2.

Now consider bidder 1 when he is of type \mathfrak{R} , and $w_R \in (0, 1)$. If he wins the right to choose, and selects \mathfrak{U} (as the sought equilibrium requires), his payoff is

$$L(X_1) - \{\pi X_2 + (1 - \pi) [w_R X_2 + (1 - w_R) L(X_2)]\} \\ + \pi [X_1 - L(X_2)] + (1 - \pi) \max\{0, L(X_1) - L(X_2)\},$$

where the case \mathfrak{RD} (probability π) has him bidding in the second round for his favored asset against a rival whose favorite asset has already been taken. If he loses the right to choose, his payoff is

$$\pi [X_1 - L(X_2)] + (1 - \pi) \max\{0, L(X_1) - L(X_2)\},$$

as his rival selects asset \mathfrak{U} no matter what his type.

Now consider type \mathfrak{R} 's choice between bidding weights w_R and $w'_R = w_R/2$. With some probability, both bids win or both lose. However, in the event that the bidding weight choice w_R wins and w'_R loses, the price in $\{\}$ above necessarily exceeds $L(X_1)$, so bidder 1 of type \mathfrak{R} prefers to lose. Consequently, only $w_R = 0$ can be an equilibrium. As it is straightforward to show that bidder 1 of type \mathfrak{R} cannot gain by selecting asset \mathfrak{R} when $(w_U, w_R) = (1, 0)$, this is then the only weighted-average equilibrium.⁵

The type of bidder whose favored asset is favored more often, however slightly, bids the full value of his favored asset, while the other type of bidder bids no more than the value of his less-favored asset. As the more frequently favored asset is selected whether it is the winning bidder's preferred asset or not, the distribution of revenue is necessarily unaffected by switching between separate auctions and selling rights to choose.

5 Ex-Ante Homogeneity without Equiprobability

Briefly consider a model (to us, more artificial) in which an analyst cannot find an ex-ante favorite, but instead of equiprobability, the chances that bidders diverge in their preference over assets exceeds one half. This can be done by adjusting the previous section's model to assume that bidder 1 is type \mathfrak{U} with probability $\pi > 1/2$, while bidder 2 is type \mathfrak{R} with probability π . Thus, the ex-ante expected highest value of either asset is the same, but the probability that the two bidders favor different assets is $\pi^2 + (1 - \pi^2) > 1/2$.

This model can be shown to have no equilibrium in undominated strategies which exhibits all types selecting their favored asset if winning the right to choose. An equilibrium exists in which all types select the asset most likely to be favored by the other bidder (1 selects \mathfrak{R} , 2 selects \mathfrak{U}). Thus, in equilibrium, type \mathfrak{U} [\mathfrak{R}] of bidder 1 [2] selects asset \mathfrak{R} [\mathfrak{U}], despite favoring the other asset. This equilibrium yields less straightforward characterization: type \mathfrak{R} [\mathfrak{U}] of bidder 1 [2] bids $\pi X + (1 - \pi)L(X)$ for the right to choose; type \mathfrak{U} [\mathfrak{R}] of bidder 1 [2] has a nonlinear bid function for the right to choose that is bounded below by $(1 - \pi)X + \pi L(X)$ and above by $[X + L(X)]/2$, and depends both on the underlying distributions of signals and the specific form of the L function. The details are cumbersome, unilluminating, and omitted.

Note that, unlike the usual-favorite model, here a bidder planning to choose his favorite asset (1 \mathfrak{R} or 2 \mathfrak{U}) does not bid the full value of that asset. There, such a bidder knew that his favorite asset would be selected no matter which bidder won. Here, the rival bidder will select the other asset, so the right to choose is less valuable. Aggressive bidding comes from types not planning on selecting their favorite asset, but who know that their rival will select it.

⁵Thus, if $\pi \in (0, 1/2)$, correspondingly, both types bid R_i and select R if the right to choose is obtained.

6 Conclusion

This analysis has extended right-to-choose auctions in two important directions with respect to the inherited literature. First, removing the single-unit-demand constraint on bidders lets competition in rights-to-choose auctions persist and obtains revenue equivalence across auction formats. Second, weakening prior papers' assumption of ex-ante asset homogeneity allows for the possibility that a high bidder optimally selects the asset which will reduce competitiveness in follow-up rounds over his highest-valued asset. This selection occurs in equilibrium with probability approaching $1/2$. Critically, the equilibrium bid function in the more realistic case of ex-ante asset heterogeneity does not converge to the equilibrium bid function for the ex-ante homogeneous case as the degree of heterogeneity vanishes.

The discontinuity found above has a natural interpretation. The equilibria in sections 4 and 2 indicate that choosing the asset which would have led to the highest expected competitive bid in the next round (were it still available) is lexicographically more important than choosing the highest-valued asset. Since all bidders agree as to which asset to remove to minimize follow-up competition, it is known in advance which asset will be chosen first, and hence each bidder bids his value of that asset. However, in the razor's-edge case when favored assets are equiprobable, this lexicographically more important consideration is unavailable, and with it, certainty over which asset will be chosen first is unavailable. So each bidder reverts to the lexicographically secondary criterion, which is to bid the average value of assets currently available. Thus, choosing the highest-valued asset is trivial if not remaining in competition, but of secondary importance if your competition will persist.

The model considered briefly in section 5 shows some robustness of the greater importance of removing the asset which is expected to yield the greatest competition; in that model the favored asset is selected less than half the time.

Many markets where rights-to-choose auctions are used probably fit poorly to either the prior models or the polar opposite model here: neither is no further competition by a winning bidder guaranteed, nor is persisting competition with each winning bidder still bidding as strongly as if he had not won.⁶ These intermediate cases deserve analysis; this paper strikingly points to the importance of not limiting that analysis to the ex-ante-homogeneous case.

References

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⁶A high bidder may often continue to compete, but follow-up bidding may be influenced by marginal valuations that are reduced by assets already won, or by budget constraints; neither has been examined here.

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