

# Auctioning the Digital Dividend

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## **Introduction**

Today I am going to talk about auctioning the digital dividend. More broadly I am going to talk about auctions, and even more broadly I am going to talk about market design. The basic idea of market design is to establish the rules of market interaction for the market participants consistent with the objectives of the market maker. It can be viewed as economic engineering, and typically relies on many disciplines. In fact my initial training was as an engineer, but the primary fields that are used are economics, computer science, and operations research. Market design can be broken down into two categories: matching problems where we don't use prices, such as matching medical interns to hospitals, students to schools, or kidneys to patients, and auctions where we do use prices.

I would argue that market design fosters innovation by improving price formation, enhancing competition, and mitigating market failure. In my mind a good mantra for regulators is "make markets work better." Thus, the commissioners at the FCC in the United States should strive to determine how they can design the regulation to make the markets work better, identifying where there are market failures and stepping in to address them as directly and simply as possible. This process of finding or anticipating market failures and addressing them with effective market rules is what market design is all about.

There are many examples of market design applications utilizing auctions. Recently I have worked on auctions for emission allowances, airport slots, radio spectrum, electricity, gas, timber, and rough diamonds.

Today I am going to focus on spectrum auctions, but another application that I spent a lot of time on this fall is the global financial crisis. US Treasury Secretary Henry Paulson initially had a Plan A that involved auctioning the mortgage-related securities or toxic assets of the banks. The Treasury intended to buy some \$700 billion of the toxic assets, and a law passed in the United States to do just that. I became involved in the development of Plan A at the end of September, but then at the end of October the Treasury decided not to auction, but instead to bailout the banks on a bank-by-bank basis. Now we appear to be going to Plan C where the Treasury may return to using an auction. So eventually it will happen, but my view is that auctions would have been a very good thing in the context of the financial crisis. The crisis was caused by mispricing: investment bankers were able to sell poor securities for full value based on misleading ratings. This mispricing was supported by the absence of a transparent secondary market for these mortgage-related securities. If we had transparent prices, a lot of the bad things that happened would not have happened. In particular the housing bubble would have been much less, and the investment bankers would not have been able to make such clever use of the rating agencies and create tens-of-thousands of senseless securities obscuring prices. Even a tiny bit of good market design would have averted the financial crisis by preventing its root cause: the sale of subprime mortgages as near-riskless securities.

But I am not here to talk about the financial crisis and its resolution. I am here to talk about spectrum auctions, and in particular how spectrum auctions can be employed with respect to the digital dividend. As a result of digital technology, we have lots of TV broadcast spectrum that can be freed up for better use. This is the digital dividend. Auctions are the best approach to ensuring that the spectrum is put to its best use. However, auctions are not the only instrument. Some spectrum should be set aside for common property use. For spectrum applications that do not create additional scarcity, the commons model is better than the auction model. There are many examples of this: garage door openers, car locks, and other device controllers. This use requires little bandwidth or power, and thus, does not make the spectrum scarce. Scarcity problems are mitigated by operator separation. In contrast, mobile phones require much greater power and bandwidth, creating spectrum scarcity, and hence an auction is needed to allocate the scarce resource.

In the US, we have about 435 MHz of spectrum devoted to TV broadcast. This is prime, beach-front, spectrum with outstanding propagation properties for all sorts of communications. Broadcasters are scheduled to switch to digital-only transmission in February 2009 (postponed to June), freeing up large blocks of the spectrum for other use. Europe is planning a similar digital dividend. In fact, countries have been slow to release spectrum for mobile communications and other high-value uses creating a false scarcity of spectrum, and higher auction prices than would have occurred if countries pursued more aggressive plans to free up new spectrum. Nonetheless, the auctioning of spectrum has made countries aware of how important it is to manage the spectrum resource well. This is seen in both the developed and developing economies of the world. Effective communications policy is a cornerstone of economic development.

The spectrum auction application is an exciting one, and it has been going on for some time. The first spectrum auctions took place beginning in July of 1994 in the United States. It is an interesting problem, because in a spectrum auction one is auctioning many things that are heterogeneous but similar. There are competing technologies that could be used by operators to provide a wide range of communication services. As a result, the setting has a complex structure of substitutes and complements. This is a long-term investment market, because the operators that are buying the spectrum are building networks, and building a network is an extremely expensive operation—one that the operator is going to do on a long-term basis.

The goal for the government should be efficiency, not revenue maximization. The government should focus on ensuring that those who can put the spectrum to its highest use get it. Focusing simply on revenue maximization is short-sighted. Some measures such as technical and service flexibility and aggregation of licenses can enable more efficient use which could increase auction revenues. But short-run revenue maximization by creating monopolies, which would create the highest profits before spectrum fees, and therefore would sustain the largest fees should be resisted. Indeed, competition, which ultimately will lead to greater innovation and better and cheaper services, will likely generate *greater* government revenues from a long-run perspective. The government can best accomplish this objective with an efficient auction, putting the spectrum to its best use.

There are large inefficiencies—and I do not mean technical inefficiencies, I mean economic inefficiencies—where spectrum is not being put to its best use. We need to do better. The digital dividend is a wonderful example of where we have a large amount of the highest quality spectrum for communication purposes. This spectrum is now devoted to an increasingly low-value use— broadcast television. Broadcast TV is increasingly low-value because the vast majority of people are not getting their TV from over-the-air broadcast, rather most receive their TV signals from cable or satellite. There is a tremendous opportunity to make better use of this TV spectrum, an opportunity that has been a long time coming.

The regulator may find it necessary to introduce spectrum caps or other preferences favoring new entrants so as to level the playing field between incumbents and new entrants. Incumbents include in their private value, the benefit of foreclosing competition, thus driving a wedge between social value and private value. In theory the regulator can correct this externality by favoring the new entrant, but in practice this has proven to be difficult. The FCC's experience with preferences for certain bidders—set asides, bidding credits, and installment payments—has been largely a failure at least with respect to mobile broadband communication, which is where most of the value lies.

In contrast, a good example of successful intervention was Canada's use of a set aside in its 2008 Advanced Wireless Services or AWS auction. As a result, multiple deep-pocketed new entrants came to the auction, and bid up the price of not only the set-aside block, but the non-set-aside blocks. The result was a much more competitive auction (with much higher revenues) and the introduction of some potentially strong new service providers going forward. The approach effectively broke up regional market-splitting by the dominant incumbents. Another successful intervention was the FCC's use of a spectrum cap in early broadband PCS auctions. The cap limited the quantity of spectrum any one operator could hold in a geographic area, addressing the potential market failure of limited competition in the market for wireless services.

Despite these successes in Canada and the US, I believe the FCC's long and troubled history with bidder preferences is an important case study to other countries considering preferences for various parties. Installment payments proved especially problematic, as it led to speculative bidding, bankruptcy, and lengthy delay in the use of the spectrum.

In addition, the regulator must resist the temptation to force more "winners" than the market can efficiently support. Sometimes regulators fragment the spectrum and prohibit aggregation in the auction in an effort to create as many winners as possible. The upcoming 3G spectrum auction in India may be one example. Aggregation up to a suitable competitive constraint is preferred.

### ***Three main points***

There are three main points I wish to emphasize today.

*Enhance substitution.* First in terms of the auction design, it is important to enhance the substitution across the items that are being sold. Enhanced substitution is accomplished through both the product design—what you are auctioning—and of the auction format. Often in the settings that I deal with, the product design can be just as important as the auction design.

*Encourage price discovery.* Second, encouraging price discovery is extremely important. We need a dynamic process here, because unlike some situations, in the case of spectrum auctions, there is a lot of uncertainty about what things are worth. The bidders need to do a lot of homework to develop a crude valuation model, and they need the benefit of some collective market insights, which can be revealed in a dynamic auction process, in order to improve their decision-making. The nice thing about a dynamic auction is that through this price process the bidders gradually have their sights focused on the most relevant part of the price space. Focusing bidder decisions on what is relevant is in my mind the biggest source of benefit from the dynamic process. This benefit is generally ignored by economists, because economists assume that the bidders fully understand their valuation models, when in practice bidders almost never have a completely specified valuation model. Yes, they do a lot of homework, but there is still a lot of uncertainty about what exactly things are worth, and how they should be valuing the spectrum. The experience of the 3G spectrum auctions in Europe is a good example. The bids were based more on stock prices in a bubble situation, rather than on solid homework about values.

*Induce truthful bidding.* The third feature I wish to emphasize is the importance of inducing truthful bidding. This is accomplished in the auction design through an effective pricing rule and an activity rule. The two rules work together to encourage bidders to truthfully express preferences throughout the entire auction. This truthful expression of preferences is what leads to excellent price discovery and ultimately an efficient auction outcome.

A variety of different pricing rules are used in practice. The two most common are pay-as-bid pricing, where you pay what you bid if you are the winner, and for a homogenous product, uniform pricing, where you pay the market clearing price. In the particular applications I am discussing today, we generally do not have clearing prices, because of strong complementarities and heterogeneous items. As a result, we need a new kind of pricing rule. The pricing rule that I will describe in detail later is a generalization of Vickrey's second-price rule.

I now give a brief overview of the package clock auction I recommend. The approach may appear complex. Some amount of complexity is required given the complex economic problem at hand. Simpler versions, such as a simultaneous clock auction are possible in settings where all bidders intend to use the same technology. This may well be the case in developing countries that are conducting spectrum auctions for a particular use after the technology battles have been resolved from the experience in developed countries.

### ***An overview of the package clock auction***

The package clock auction is especially useful in situations where the regulator does not know which technology will make best use of the spectrum. In such cases, the auction itself can determine the ultimate band plan specifying how the spectrum is organized. Such an auction is said to be technology neutral, since it allows the competing technologies to determine the winning technologies, as well as operators. A good example is an auction that accommodates both paired and unpaired technologies, such as LTE and WiMAX, respectively. A package auction is essential in this case, since the two uses require that the spectrum be organized in fundamentally different ways. The package clock auction is an especially simple, yet powerful, auction that lets competitive bids determine the ultimate band plan.

The package clock auction has features to address each of my three main points.

First, the product design simplifies the products whenever possible. For example, if bidders primarily care about the quantity of spectrum won in a geographic area, we auction generic spectrum and the bidders bid for a quantity of spectrum in each area. This simplifies the auction, enhances substitution, and improves competition. The specific assignment of lots is determined in the last stage of the auction, once the critical decisions have been made (who won how much in each area). This approach also allows a technology neutral auction, which lets the spectrum be organized in different ways for the different technologies. Each bidder indicates the quantity of spectrum and the type of use in its bids. In this case, the first stage of the auction determines not only who won how much in each area, but the overall quantity of spectrum allocated for a particular use in the area.

Second, to encourage price discovery, the auction begins with a clock stage. Prices ascend for each product with excess demand until there is no excess demand for any product. This simple and familiar price discovery process works extremely well when bidders have incentives for truthful bidding. In the important case of substitutes, the clock stage determines an efficient assignment together with supporting competitive equilibrium prices. Moreover, complements are handled with no increase in the complexity of the clock process. Each bid in the clock stage is a package bid, so bidders can bid without fear of winning only some of what they need.

The bidders may find that they are unable to express preferences for all desirable packages in the clock stage, so following the clock stage is a supplementary round. Bidders can increase their bids on packages bid in the clock stage and submit new bids on other packages. All the clock stage bids and the supplementary round bids then are run through an optimizer to determine the value maximizing assignment of the spectrum. This is the generic assignment.

Third, to induce truthful bidding, the auction uses closest-to-Vickrey core pricing. The efficient assignment is priced to minimize the bidders' total payments subject to competitive constraints (no group of bidders has offered the seller more). In practice, this often implies Vickrey pricing, ensuring truthful bidding. However, because of complements, there may be one or more competitive constraints that causes the payments to be greater than Vickrey payments for some bidders. In this event, the smallest deviations from Vickrey prices are used. This maximizes incentives for truthful bidding subject to competitive constraints.

To induce truthful bidding throughout the clock stage, an activity rule based on revealed preference is used. This rule encourages bidders to bid in a manner consistent with profit maximization. Deviations from bidding on the most profitable package throughout the clock stage may impose a constraint on subsequent bids, either later in the clock stage or in the supplementary round. To simplify the auction, a simplified revealed preference rule is desirable that maintains the same one-dimensional structure of the traditional activity rule. In particular, every bid in the clock stage or the supplementary stage is constrained by at most a single constraint. This simplified rule encourages straightforward bidding—always bidding on the most profitable package—without complicating the auction.

Once the generic assignments are determined and priced, the specific assignment stage is run. Each winner submits top-up bids for each specific assignment that is better than the winner's worst specific assignment. The bids indicate the incremental value for each feasible alternative. Then an optimization program is run to determine the efficient specific assignment. Again the prices for the specific assignments are closest-to-Vickrey core prices. This concludes the auction.

I begin by describing some of the problems of the simultaneous ascending auction. Then I present the package clock auction, which retains the benefits, while addressing the weaknesses, of the simultaneous ascending auction. I emphasize two essential elements of the package clock auction: the pricing rule and the activity rule. Along the way, I summarize both experimental and field results with the package clock auction.

## **Simultaneous ascending auction**

The workhorse for spectrum auctions since 1994 has been the simultaneous ascending auction, a simple generalization of the English auction to multiple items in which all items are auctioned simultaneously. Thus, unlike Sotheby's or Christie's auctions in which the items are auctioned in sequence, here all the items are auctioning simultaneously.

The process is as follows. Each item or lot has a price associated with it. Over a sequence of rounds, we ask bidders to raise the bid on any of the lots they find attractive, and we identify the standing high bidder for each lot at the end of every round. We continue this process until nobody is willing to bid any higher. This process was originally proposed by Preston McAfee, Paul Milgrom, and Robert Wilson for the FCC spectrum auctions. Since its introduction in July 1994, the design has undergone numerous enhancements, but the basic design has remained intact in its application worldwide for the vast majority of spectrum auctions.

An important element of the basic design is an activity rule to address the problem of bid sniping—waiting until the last minute to bid seriously. The rule adopted by the FCC and used in all simultaneous

ascending auctions to date is a quantity-based rule. In short, the rule states, “if you want to be a big bidder at the end of the auction, you must be a big bidder throughout the auction.” You must maintain a level of eligibility, based on the quantity of spectrum you are bidding for, in order to continue with that level of eligibility later on. Thus, you cannot play a snake-in-the-grass strategy where you hold back and wait, and then pounce late in the auction and win without making your true intent known until the last instant.

As mentioned, the simultaneous ascending auction has been with us for a long time. The FCC has conducted 72 simultaneous ascending auctions, since it was introduced in July of 1994. The FCC has gotten very good at conducting the auctions, and the design has worked reasonably well. Nonetheless, it is perhaps surprising how quickly inertia set in. The FCC was initially highly innovative in its choice of design the first time out of the block, but since then they have just made minor incremental improvements in response to obvious and sometimes severe problems with the original simultaneous ascending auction design.

Why has the design held up so well? It is an effective and simple price discovery process. It allows arbitrage across substitutes. It lets bidders piece together desirable packages of items. And, because of the dynamic process, it reduces the winner’s curse by revealing common value information during the auction.

But the design does, and has been observed to have, many weaknesses.

- As a result of the pricing rule, there is a strong incentive for large bidders to engage in demand reduction—reducing the quantity demanded before the bidder’s marginal value is reached in order to win at lower prices.
- Especially if there is weak competition, bidders have an incentive to engage in tacit collusion. The bidders employ various signaling strategies where they attempt to work out deals through the language of the bids. The goal of the strategies is to divvy-up the items among the bidders at low prices.
- As a result of the activity rule, there are parking strategies. A bidder maintains eligibility by parking its eligibility in particular spots that the bidder is not interested in and then moves to its true interest later.
- The simultaneous ascending auction is typically done without package bids. The bidders are bidding on individual lots and there is the possibility that a bidder will win some of the lots that it needs for its business plan, but not all. This exposure to winning less than what the bidder needs has adverse consequences on efficiency. Essentially the bidder has to guess. Either the bidder goes for it or not. When there are complementarities, this is a tough decision for the bidder to make. The bidder may make the wrong decision and win something it actually does not want.
- The lack of package bids also makes the simultaneous ascending auction vulnerable to hold up, which is basically a speculator stepping in and taking advantage of a bidder. For example say you are Verizon, a big bidder, and I am Mario Gabelli, owner of a \$30 billion investment fund. Gabelli was a frequent participant in the FCC spectrum auctions until recently, when he was sued and paid a \$130 million settlement in a fraud case brought against him, because he always claimed to be a very small business, and received a discount of between 25% and 40% for making such a claim, despite his \$30 billion in assets and \$1 billion in net worth. But anyway, Gabelli’s apparent strategy was to make it clear to the large bidders that it would be expensive to push him out of the way. As a result, the large bidders would let him win some desirable lots

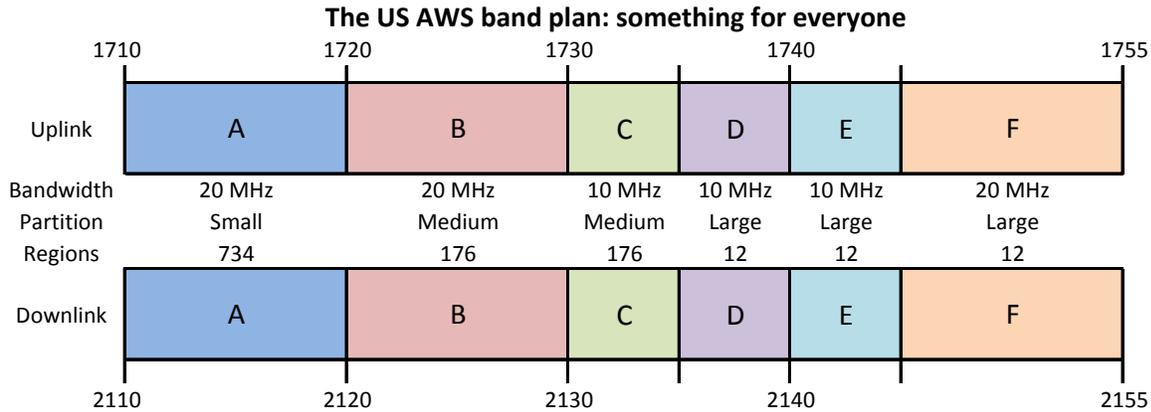
at low prices, and then he would turn around and sell them to the big players after the auction was over, and make some quick money. That is the holdup strategy. It is easy to do and effective. Preventing resale would reduce this problem, but resale is desirable in a rapidly changing dynamic industry.

- There is limited substitution across licenses, which is something I am going to emphasize. You might think that it would be easy to arbitrage across the lots, but in fact that is not the case. Especially in a large country like the United States, where the FCC splits up the frequency bands in different ways, geographically, and you can only bid on individual lots, rather than packages.

As a result of all these factors, the bidding strategies are quite complicated, which is nice if you happen to be advising bidders on spectrum auctions, but is a problem if you are a bidder, because you have to learn how to engage in all this complex bidding.

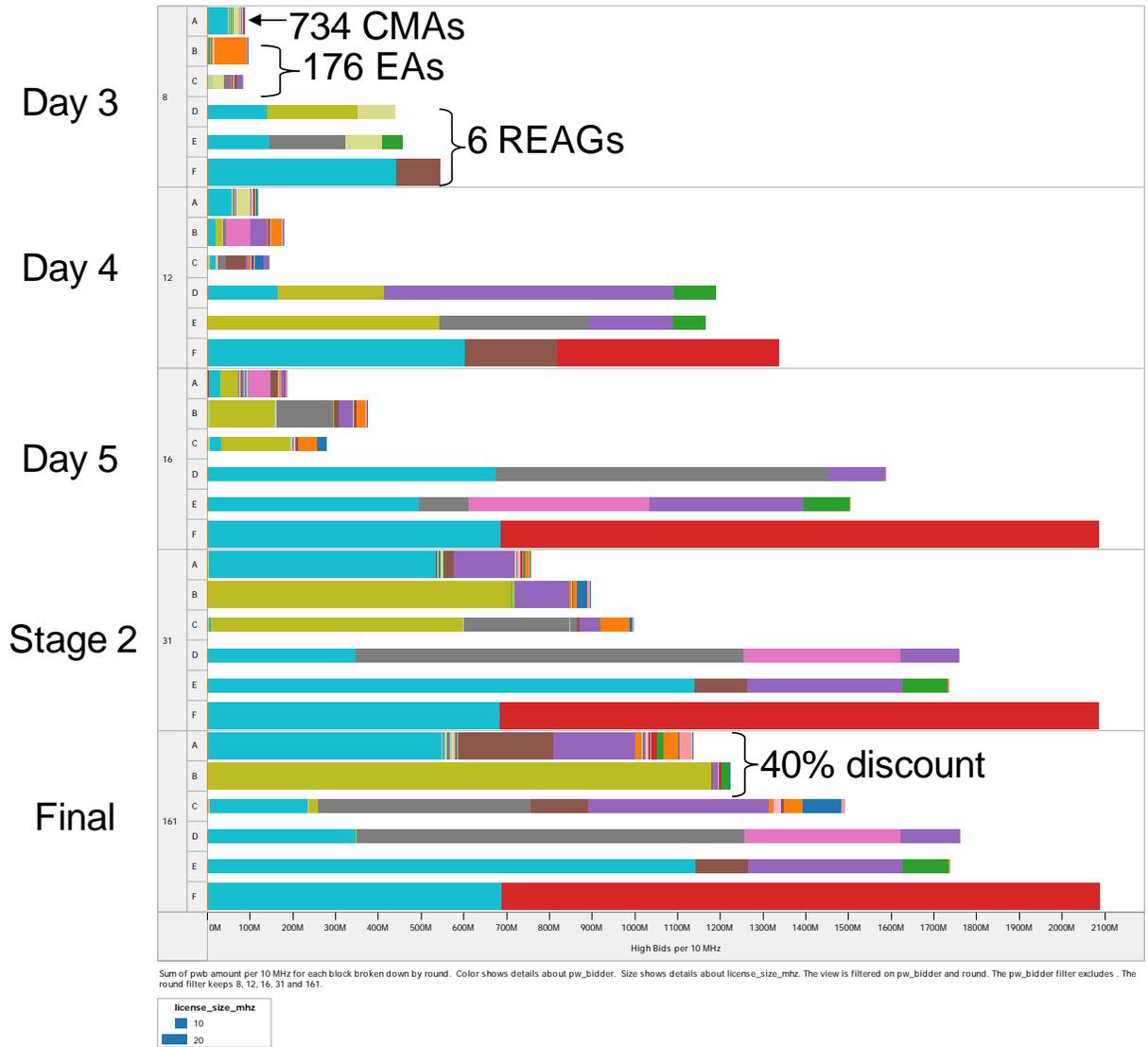
### ***The US AWS and 700 MHz auctions***

The difficulties in arbitraging across substitutes are best illustrated in the two most recent major auctions in the United States: AWS and 700 MHz.



First the AWS, Advances Wireless Services, auction sold 90 MHz of spectrum in 161 rounds, and raised 14 billion dollars. As in all of its auctions, the FCC began the process by settling on a specific band plan (the product design), which effectively determined how the available bandwidth in each location was going to be split up into lots, where each lot is a particular frequency band covering a particular geographic area. In the case of the AWS auction, the FCC decided that six frequency blocks of paired spectrum (A-F) were to be auctioned, as shown above. Three blocks were 20 MHz and three were 10 MHz. Because the US is so large, each frequency block was also partitioned geographically. And because the FCC was attempting to accommodate all types of bidders, the FCC partitioned the blocks in three different ways: for blocks D-F the country was split into 12 large regions; for blocks B and C the country was split into 176 medium-size regions; and for block A the country was split into 734 small regions. Remarkably, the different partitions do not form a hierarchy in the sense that you cannot construct one of the medium-sized lots by aggregating a number of small lots. This inability to aggregate small into medium clearly limits substitution across blocks.

### The absence of arbitrage across substitutes in the US AWS auction



The underlying substitution problem was caused both by the product design—the use of specific blocks following three different geographic schemes—and the auction format. The graphic above illustrates the severe problems bidders had substituting across blocks in the AWS auction. It shows the price per 10 MHz of spectrum for each of the blocks at the end of critical days in the auction. Recall there are six blocks, so there are six bars (A through F) at the end of each day. The 20 MHz bars are twice as thick as the 10 MHz bars so the area of the bar corresponds to revenues at the time indicated. Finally, different colors represent different bidders, so you can see who the provisional winners are at the various times in the auction. The two largest bidders are T-Mobile (turquoise) and Verizon (red).

If there was perfect arbitrage across blocks, then what you would see is the length of the bars would be the same at each time in the auction, indicating equal prices across blocks. Over time, the prices would move higher, but the prices would tend to move together across the blocks, as bidders would arbitrage to the cheaper lots per MHz of spectrum.

What happened in the AWS auction is extremely far from that. Look at the end of day five. At this point, the F block has already reached its final price. The A block is less than one twentieth the price of the F block. If the A block is roughly equivalent to the F block, why wouldn't Verizon, say, switch to the much cheaper A block, instead of placing bids twenty times higher on the F block? The reason has to do with substitution difficulties. When Verizon is bumped off a large F block license, it is easy for Verizon to substitute down to the A block, submitting say the 100 or so bids on the A lots that roughly cover the corresponding F lot. The problem is that once shifting down it would be nearly impossible to shift back up to F. The reason is that in subsequent rounds Verizon would only be bumped from some of the corresponding A block lots. Verizon would have to withdraw from many A lots in order to return to F, exposing itself to large withdrawal penalties. In addition on block A, Verizon would be vulnerable to various hold-up strategies, where speculators could pick important holes in a synergistic aggregation of lots.

Since substituting down from large (F, E, D) to small (C, B, A) lots is easier than substituting up, the auction essentially proceeded in a sequential fashion. First, the bidders competed for the large-lot blocks (F, E, D), then they competed for the medium-lot blocks (C and B), and finally the competition fell to the small-lot block (A). This explains the sequential, rather than simultaneous price process across blocks..

**Band plan and final prices (\$/MHz-pop) for paired spectrum in 700 MHz auction**

Block	A	B	C
Bandwidth	12 MHz	12 MHz	22 MHz
Type	paired	paired	paired
Partition	176	734	12
Price	\$1.16	\$2.68	\$0.76

The next major auction in the US was the 700 MHz auction. The band plan for the paired spectrum is shown above. The FCC did the same thing in this auction. Specific blocks were auctioned, using three different partitions of the US. Again the different partitions did not form a hierarchy. The final prices per MHz-pop range from \$0.76 for the C block to \$2.68 for the B block. These final prices differ by over a factor of three. We see again that the substitution across blocks is far from perfect. Interestingly, this time it is the small-lot block B that sold for a high price, and the large-lot block C that sold for a low price—just the opposite of what happened in the AWS auction.

Although the C-block had an open access provision, requiring that the operator not discriminate against either devices or applications, the terms of open access were sufficiently watered down that I doubt it had much of an impact on the C-block price. In my view, the price difference was because competing bidders thought that competing on the C-block against Verizon (or perhaps AT&T and Verizon) was sufficiently hopeless that it would be better to focus on the A and B blocks.

The conclusion from the now long history of spectrum auctions using the simultaneous ascending auction is that it works reasonably well in simple situations with a single geographic scheme. However in more complex settings, the approach leads to complex bidding strategies that complicate the auction and may undermine the efficient assignment of spectrum.

**A better way: the package clock auction**

Fortunately, there is a better way. All that is needed is a number of complementary enhancements that ultimately simplify the bidding process, improve its efficiency, and greatly expand its power.

First, much of the game playing, such as tacit collusion and other bid signaling, can be eliminated with a shift to anonymous bids. In a package clock auction the round-by-round revelation of information

is limited to aggregate measures of competition. Limiting round reports to prices and excess demand for each product gives the bidders the information needed to form expectations about likely prices and in resolving common value uncertainty, yet such reports do not allow the signaling strategies that support tacit collusion. Moreover, the streamlined report simplifies bidder decision-making and keeps the bidders focused on what is most relevant, the relationship between prices and aggregate demand.

In most instances, spectrum lots covering the same region in adjacent frequencies are nearly perfect substitutes. To a close approximation, the bidder simply cares about the quantity of spectrum in MHz it has in the region, rather than the exact frequency location. Moreover, to minimize interference problems bidders prefer contiguous spectrum within any region. Thus, it makes sense in the initial stage to auction generic spectrum. The stage determines the quantity of contiguous spectrum won in each region. In this stage the spectrum is treated as if it were a homogenous good within each region. This is an enormous simplification of what is being sold. The idea is to treat each MHz of spectrum within a geographic region and a particular frequency band as perfect substitutes. We let the auction resolve first the main question of how much spectrum in each region each winner gets and at what price, before the auction turns to the more subtle and less important question of the exact frequencies.

Of course, there are some auctions where the differences across frequencies are too great to allow this simplified treatment, for example because of major interference differences by frequency, as the result of incumbents with a right to stay in the particular band. In such cases, the specific spectrum lots can be auctioned from the start, but in most cases, it is desirable to auction generic spectrum first and then determine the specific assignment in a second stage.

The specific assignment stage is simplified, since it only involves winners in the generic stage. The number of specific assignments typically is limited to the number of ways that the winners can be ordered. Thus, if there are  $m$  winners there are  $m!$  different specific assignments. For example, an auction with four winners in a particular region would have  $4! = 4 \times 3 \times 2 = 24$  different possible specific assignments. Assuming separability across regions, each of the four bidders would only need to express preferences among at most 24 different specific assignments. This number is reduced further if we assume that the bidder only cares about its own specific assignment and not the location of the other winners, as is commonly the case. Then for example with four winners of equal size, each winner would only need to express three preferences: the incremental value from the bidder's third-best specific assignment compared with its fourth-best, the incremental value from the bidder's second-best assignment compared with its third-best, and the incremental value from the bidder's first-best assignment compared with its second-best.

The use of generic lots, wherever possible, simplifies the auction, enhances substitution, and improves price discovery. Despite these advantages the FCC has chosen in each of its 72 auctions to sell specific lots. This is a common mistake in auction design. Interestingly, even in countries that recognized the advantages of selling generic lots, such as the German 3G auction, the generic lots were auctioned using a method for specific lots; that is, in the German 3G auction, even though the lots were perfect substitutes, the bidders bid on specific lots.

Once generic lots are adopted the next innovation becomes easier to see—the adoption of simple and powerful techniques that are well-suited to auctioning many divisible goods.

The first innovation is an improved product design, based on generic spectrum in each service area, accommodating multiple types of use.

The second innovation is the use of a simultaneous clock auction. This is a simplification of the simultaneous ascending auction. Each product has its own clock indicating its current price. Because of generic lots, each product may consist of multiple lots. In each round, the bidder is asked to indicate for

each product the quantity of lots desired at the current price. At the end of the round, the auctioneer adds up the individual bids and reports the excess demand for each product. The price is then increased on any product with excess demand. This process is repeated until there is no excess demand on any product.

The two critical differences between the clock auction and the simultaneous ascending auction are 1) the bidder only answers demand queries, stating the quantities desired at the announced prices, and 2) there is no need to identify provisionally winning bidders at the end of every round.

The third innovation is more subtle, but extremely powerful. One can interpret the demand vector reported by each bidder in each round as a package bid. The bidder is saying, "At these prices, I want this package of lots." Taking this interpretation seriously yields a combinatorial auction (or package auction) without the need for any optimization. This allows bidders to express complementarities within a simple price discovery process.

Larry Ausubel and I have been conducting exactly this sort of package auction since 2001 for electricity and gas products in France, Germany, Belgium, Denmark, Spain, Hungary, and the United States. Thus, far we have conducted over 60 high-stakes auctions with this format for assets worth about \$10 billion. We also used the approach in a spectrum auction in Trinidad and Tobago in 2005. The approach has been highly successful.

The clock auction may end with some products in excess supply, as a result of complementarities among lots. In addition, since the clock process follows a single price path and only includes a limited number of price points, it is desirable to allow the bidder to specify additional bids in a supplementary round following the clock stage. The purpose is to let the bidder express preferences for additional packages that were missed by the clock process. In addition, the bidder can improve its bids on packages already bid on in the clock stage.

Once the clock bids and the supplementary bids are collected, an optimization is run to determine the value-maximizing generic assignment and prices. This two-step process of a clock auction followed by supplementary bids, which I call a package clock auction, was proposed by Larry Ausubel, Paul Milgrom, and me for spectrum auctions at an FCC auction conference in 2003. We proposed the same approach for spectrum auctions in the UK in 2006, as well as for airport takeoff and landing rights in 2003. Meanwhile, David Porter, Stephen Rassenti, Anil Roopnarine, and Vernon Smith demonstrated in the experimental lab the high efficiency of the approach in 2003.

Two critical elements of a successful package clock auction are the pricing rule and the activity rule. I will discuss both at length. These two important rules work together to ensure that the bids are an accurate expression of bidder preferences throughout the entire auction. The high efficiency of the package clock auction derives mainly from incentives for nearly truthful bidding. A pricing rule based on second pricing encourages truthful bidding; whereas, the activity rule based on revealed preference ensures that these incentives for truthful bidding are felt throughout the clock stage.

## **UK spectrum auctions**

The need for a technology neutral auction is commonplace in today's world of rapidly developing communications technologies and applications. While the regulator can typically identify the viable candidate technologies based on early development, the regulator cannot decide how available spectrum should be split among the technologies without a market test. Examples are numerous, and several will be discussed here.

Ofcom, the independent regulator and competition authority for the UK communications industries, was the first to recognize and act on this need for a technology neutral auction. In spring 2006, Larry Ausubel and I proposed to Ofcom a version of the package clock auction. Since June 2006, I have been working with Ofcom in developing, testing, and implementing the design for a number of its auctions. Two such auctions, the 10-40 GHz auction and the L-band auction have occurred already. Both went very well, and provided a useful field test for the economically much larger 2.6 GHz auction scheduled to take place in the second-half of 2009. The Netherlands has also adopted this approach for its 2.6 GHz auction. Finally, Ofcom has proposed to use the package clock auction for the digital dividend auction to take place in 2010. The initial proposal presents some computational challenges given the quantity of spectrum and the number of technologies that are competing for that spectrum, although I suspect that some simplifications will be made as the range of possibilities narrows as we get closer to the auction date.

Ofcom has three main goals for the auction design. The auction should be technology neutral, allowing alternative viable technologies to compete for the spectrum on an equal basis. The auction should accommodate flexible spectrum usage rights, permitting the user to decide how the spectrum would be used, subject to minimizing interference externalities with neighbors. And the auction should promote an efficient assignment of the spectrum, putting the spectrum to its best use.

Simplicity and transparency are important secondary objectives. On simplicity, Ofcom recognized that satisfying the main objectives posed serious challenges, which could not be addressed with an auction design that is too simple. Moreover, simplicity has to be assessed recognizing the complexity of bidder participation. For example, the simultaneous ascending auction has simple rules, but incredibly complicated bidding strategies. In contrast, the package clock auction has more complex rules, but the rules have been carefully constructed to make participation especially easy. For the most part, the bidder can focus simply on determining its true preferences for packages it can realistically expect to win. In a package clock auction it is the auctioneer that needs to do the complex optimization, whereas the bidders can focus on their values for realistic packages.

Revenue maximization was explicitly excluded as an objective. Nonetheless, an efficient auction necessarily will generate substantial revenues. Indeed, my advice to countries is to focus on efficiency. A focus on revenues is short-sighted. In my view, the government is better off finding as much spectrum as possible and then auctioning it so as to put the spectrum to its best use. This approach creates a competitive and innovative market for communications, which has substantial positive spillovers to the rest of the economy. Under this approach, long-term revenues likely will far exceed those that would come from the maximization of short-term auction revenues.

### ***The UK 2.6 GHz auction***

The UK 2.6 GHz auction illustrates well the benefit of the package clock auction. This auction is for 190 MHz of spectrum at frequencies (2.6 GHz) that make it especially well-suited for mobile broadband communications. Currently, there are two fourth-generation (4G) technologies competing worldwide to be the next standard for broadband wireless communications: LTE, which uses paired spectrum, and WiMAX, which uses unpaired spectrum. Both technologies work well with a lot size of 5 MHz, but LTE requires that the lots come in pairs, one for uplink and another for downlink. In addition, a 5 MHz guard band is required between the paired and unpaired use, as well as between any two competing unpaired operators.



be lower than the paired price per 5 MHz. Thus, the clock stage has at most two prices, the price for unpaired lots and the price for paired lots. So long as there is excess demand of lots the clock prices continue to increase. Indeed, the clock prices will continue to increase until the point that the demands are feasible, which means that the demands can be met with contiguous awards. Notice that the clock stage is much simpler than the simultaneous ascending auction.

Following the clock stage, the bidders submit supplementary bids. The supplementary bids are either improvements to clock bids or bids on additional packages that were not bid on in the clock stage. For unpaired bidders, these additional bids can include the possibility of an award split between the lower block of unpaired spectrum and an upper block, which would be necessary if more than 9 unpaired lots are awarded.

Once the clock and supplementary bids are collected, the auction system takes all these bids and performs a series of optimizations to determine the value maximizing generic assignment, and the base prices to be paid by each winner.

The system also determines the feasible options each winner faces for specific assignments. These are reported to each winner, and the winner is asked to submit assignment bids indicating the incremental value derived from each option that is better than the winner's least preferred option. These assignment stage bids are then collected and another series of optimizations is performed to determine the value maximizing specific assignments and the additional payments the winners make in addition to the base prices calculated at the end of the supplementary round.

I now explain the details of two essential rules in the package clock auction: the pricing rule and the activity rule. The rules may appear complex, but the complexity actually simplifies the bidding strategies, making it easier for bidders to participate in the auction.

### **Pricing rule: Closest-to-Vickrey core pricing**

Prices are determined at two points in the auction, after the clock stage, including the supplementary bids, to determine the base prices for the winners in the value-maximizing generic assignment, and after the assignment stage to determine the additional payments for specific assignments.

The pricing rule plays a major role in fostering incentives for truthful bidding. Pay-as-bid pricing in a clock auction or a simultaneous ascending auction creates incentives for demand reduction. Large bidders shade their bids, recognizing their impact on price. This bid shading both complicates bidding strategies and also leads to inefficiency.

In contrast, Vickrey pricing provides ideal incentives for truthful bidding. Each winner pays the social opportunity cost of its winnings, and therefore receives 100 percent of the incremental value created by its bids. This aligns the maximization of social value with the maximization of individual value for every bidder. Thus, with private values, it is a dominant strategy to bid truthfully.

Unfortunately, as a result of complements, it may be that the Vickrey prices are too low in the sense that one or more bidders would be upset with the assignment and prices paid, claiming that they had offered the seller more. For example, suppose there are two items, A and B. Bidder 1 bids \$4 for A, bidder 2 bids \$4 for B, and bidder 3 bids \$4 for A and B. The Vickrey outcome is for 1 to win A, 2 to win B, and each winner pays \$0. Bidder 3 in this case has a legitimate complaint, "Why are you giving the goods to bidder 1 and 2, when I am offering \$4 for the pair?" The basic problem is that with complements, the Vickrey outcome may not be in the core. Some coalition of bidders may have offered the seller more than the sum of the Vickrey prices. This point has been emphasized by Larry Ausubel and

Paul Milgrom. (The core is defined as a set of payments that support the efficient assignment in the sense that there does not exist an alternative collation of bidders that has collectively offered the seller more.)

The solution is to increase one or more prices to assure that the prices are in the core. In order to provide the best incentives consistent with core pricing, we find the lowest payments that are in the core; that is, such that no alternative coalition of bidders has offered the seller more than the winning coalition is paying.

If we are auctioning a single item, then this is the second-price auction. Suppose the highest bidder bids \$100 and the second-highest bidder bids \$90. The item is awarded to the highest bidder, who pays the second-highest price of \$90—the social opportunity cost of awarding the good to the highest bidder. Alternatively, we can think of assigning the item to maximize value, so we assign it to the highest bidder, and then we find the smallest payment that satisfies the core constraints. In this case, the second-highest bidder would be upset if the highest bidder paid less than \$90, so \$90 is the bidder-optimal core price. When the items are substitutes, then the bidder-optimal core point is unique and identical to the Vickrey prices.

Typically, the payment minimizing core prices, or bidder-optimal core prices, will not be unique. Thus, it will be important to have a method of selecting a unique bidder-optimal core point when there are many. The sensible approach adopted in each of the recent Ofcom auctions for both the base prices and the assignment prices is to select the payment minimizing core prices that are closest to the Vickrey prices. This is what I call closest-to-Vickrey core pricing. Since the set of core prices is convex—a polytope formed from the intersection of half-spaces—and the Vickrey prices are always unique, there is a unique vector of core prices that is closest in Euclidean distance to the Vickrey prices. Not only are the prices unique, but since they are bidder-optimal-core prices, they maximize the incentive for truthful bidding among all prices that satisfy core constraints.

The approach then is to take all the bids from the clock stage and the supplementary bids, determine the value maximizing assignment, and then determine the payment minimizing core prices that are closest to the Vickrey prices. It is my experience that bidders are quite happy with this approach—they like the idea of minimizing payments, and they recognize the importance of making sure that the prices are sufficiently high that no coalition of bidders has offered the seller more. Prices are as small as possible subject to all the competitive constraints.

Calculating the winning assignments and prices involves solving a sequence of standard optimization problems. The basic problem is the winner determination problem, which is a well understood set-packing problem. The main winner determination problem is to find the value maximizing assignment. To guarantee uniqueness, there is a sequence of lexicographic objectives, such as: 1) maximize total value, 2) minimize concentration, 3) maximize quantity sold, and 4) random. Thus, first you maximize total value. Then you add a constraint that the value equals this maximum value and you minimize concentration. Then you add another constraint that the concentration equals this minimum concentration and you maximize the quantity sold. Finally, you add a constraint that the quantity sold equals this maximum quantity and you maximize an objective based on random values for each bid rather than the true bids and resolve the optimization. This guarantees uniqueness.

Calculating the prices is a bit more involved. First, we determine the Vickrey prices by solving a sequence of winner determination problems, essentially removing one winner at a time to determine each winner's social opportunity cost of winning its package. Then we determine the bidder-optimal core prices using a clever constraint generation method proposed by Robert Day and S. Raghavan. Having found the Vickrey prices, we solve another optimization to find the most violated core

constraint. If there is none, then we are done, since the Vickrey prices are in the core. Otherwise, we add this most-violated constraint and resolve the optimization, again finding the most violated core constraint. We add it to the optimization and re-solve. We keep doing this until there is no violated core constraint, and then we are done.

The reason that the Day-Raghavan approach is a highly efficient method of solution is because in practice there are typically only a handful of violated core constraints; thus, the procedure stops after just a few steps. In contrast the number of core constraints grows exponentially with the number of bidders and that makes including all the core constraints explicitly an inefficient method of solving the problem, both in time and memory.

As mentioned, the tie-breaking rule for prices is going to be important, since typically ties will arise along the southwest face of the core polytope. Finding the prices that are closest to the Vickrey prices involves solving a simple quadratic optimization. This gives us a unique set of prices. Uniqueness is important; it means that there is no discretion in identifying the outcome, either in the assignment or the prices.

An example will help illustrate all of these concepts. Suppose there are five bidders, 1, 2, 3, 4, 5, bidding for two lots, A and B. The following bids are submitted:

$$b_1\{A\} = 28$$

$$b_2\{B\} = 20$$

$$b_3\{AB\} = 32$$

$$b_4\{A\} = 14$$

$$b_5\{B\} = 12$$

Bidders 1 and 4 are interested in A, bidders 2 and 5 are interested in B, and bidder 3 is interested in the package A and B.

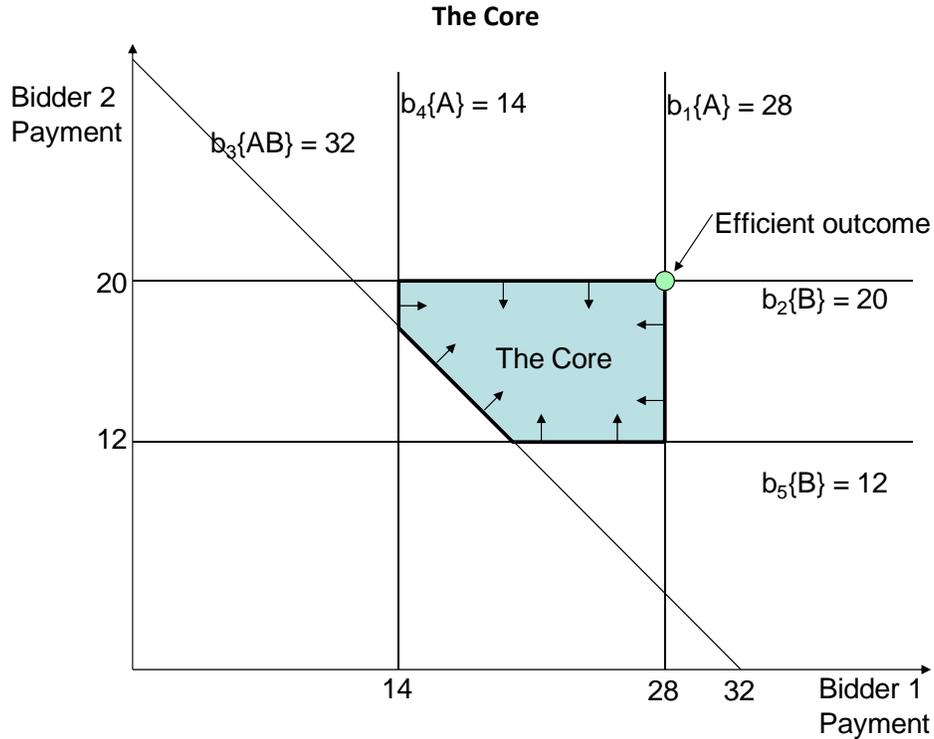
Determining the value maximizing assignment is easy in this example. Bidder 1 gets A and bidder 2 gets B, generating 48 in total value. No other assignment yields as much. Vickrey prices are also easy to calculate. If we remove bidder 1, then the best assignment gives A to bidder 4 and B to bidder 2, resulting in 34, which is better than the alternative of awarding both A and B to bidder 3, which yields 32. Thus, the social opportunity cost of bidder 1 winning A is  $34 - 20 = 14$  (the value lost from bidder 4 in this case). Similarly, if we remove bidder 2, then the efficient assignment is for bidder 1 to get A and bidder 5 to get B, resulting in 40. Then the social opportunity cost of bidder 2 winning B is  $40 - 28 = 12$  (the value lost from bidder 5). Hence, the Vickrey outcome is for bidder 1 to pay 14 for A and for bidder 2 to pay 12 for B. Total revenues are  $14 + 12 = 26$ . Notice that bidder 3 has cause for complaint, since bidder 3 offered 32 for both A and B.

Now consider the core for this example. The core is represented in the payment space of the winning bidders—in this case the payments of bidders 1 and 2. Each bid defines a half-space of the payment space:

- Bidder 1's bid of 28 for A implies 1 cannot pay more than 28 for A.
- Bidder 2's bid of 20 for B implies 2 cannot pay more than 20 for B.
- Bidder 3's bid of 32 for AB implies that the sum of the payments for A and B must be at least 32.
- Bidder 4's bid of 14 for A implies that bidder 1 must pay at least 14 for A.

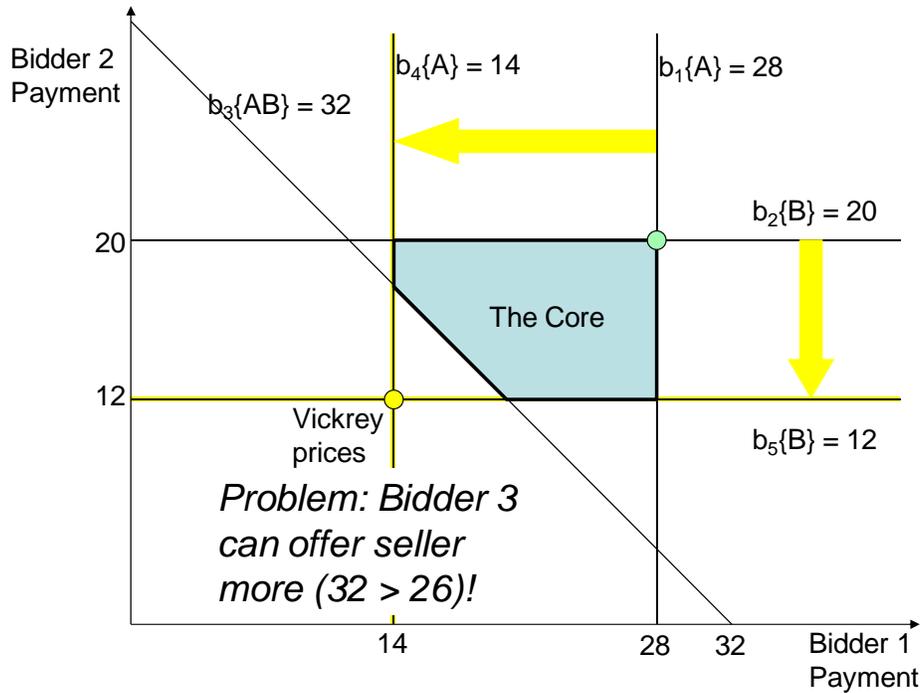
- Bidder 5's bid of 12 for B implies that bidder 2 must pay at least 12 for B.

The core is the intersection of these half-spaces as shown below.



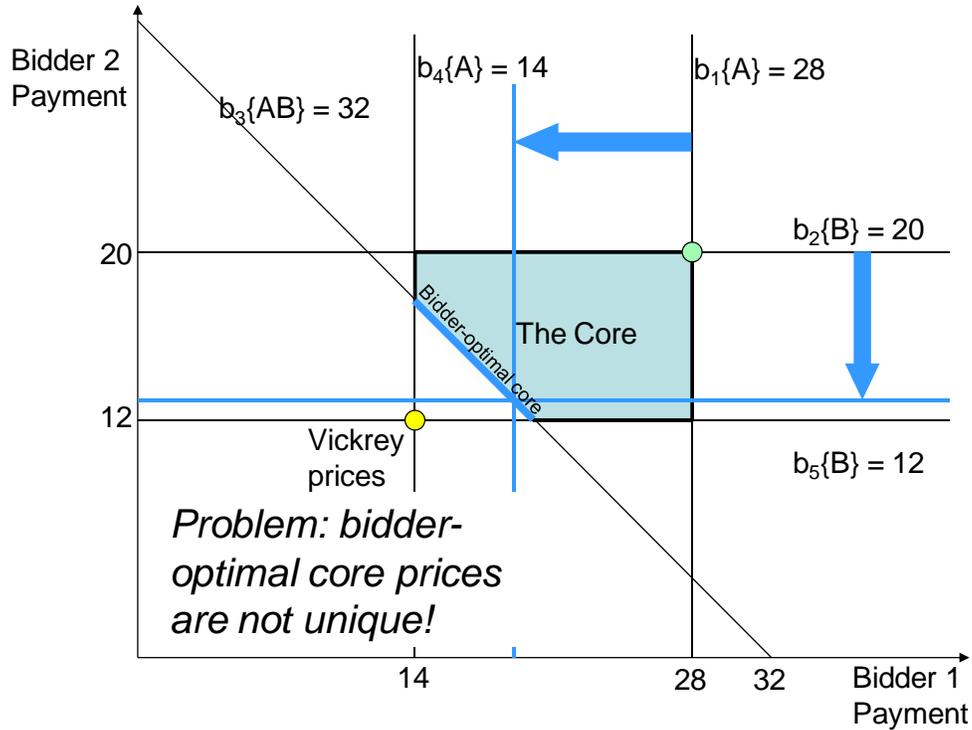
This example is quite general. First, unlike in some economic settings, in an auction, the core is always nonempty. The reason is that the core always includes the efficient outcome. The reason is that all the constraints are southwest of the efficient point, since the efficient point maximizes total value. Second, the core is always a convex polytope, since it is the intersection of numerous half-spaces. Third, complementarities, like bidder 3's bid for AB, are the source of the constraints that are neither vertical nor horizontal. These are the constraints that can put the Vickrey prices outside the core. Without complementarities, all the constraints will be vertical and horizontal lines, and there will be a unique extreme point to the southwest: the Vickrey prices.

**Vickrey prices: how much can each winner's bid be reduced holding others fixed?**

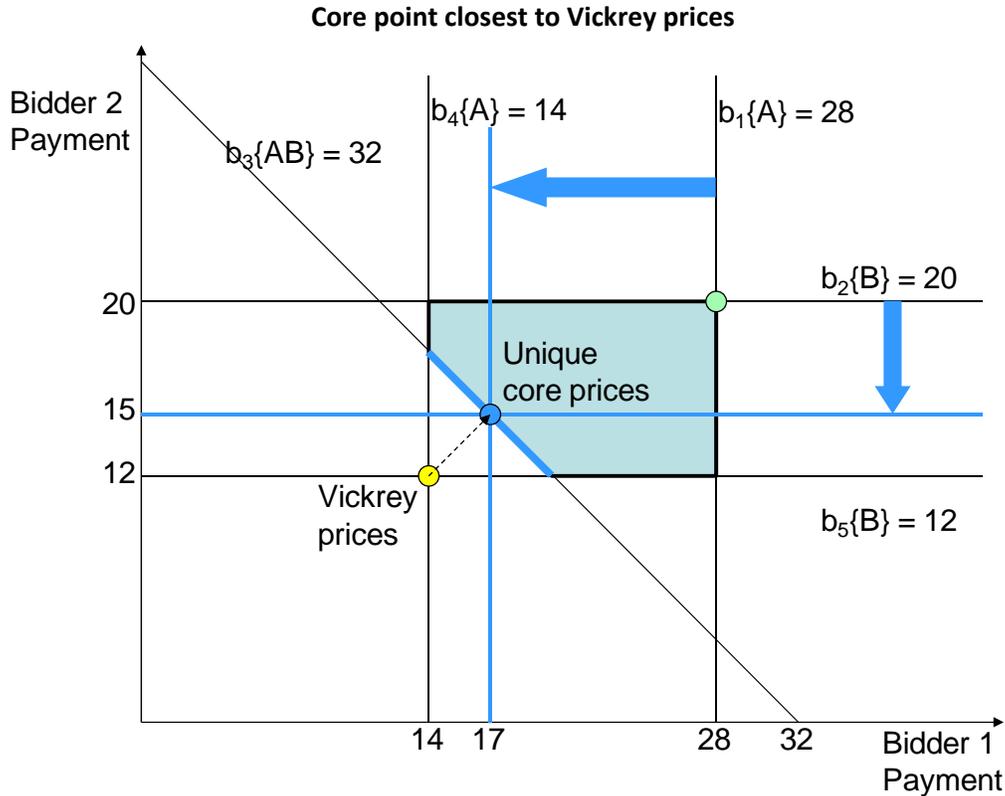


The graphical representation of the core is also a useful way to see the Vickrey prices. Vickrey is asking how much can each winner unilaterally reduce its bids and still remain a winner. As shown above, bidder 1 can reduce its bid to 14 before bidder 1 is displaced by bidder 4 as a winner. Similarly, bidder 2 can reduce its bid to 12 before being displaced by bidder 5. Thus, the Vickrey prices are 14 and 12. The problem is that these payments sum to 26, which violates the core constraint coming from bidder 3's bid of 32 for AB.

**Bidder-optimal core prices: jointly reduce winning bids as much as possible**



Bidder-optimal core prices can also be thought of maximal reductions in the bids of winners, but rather than reducing the bids of each winner one at a time, we jointly reduce all the winning bids, as shown above, until the southwest face of the core is reached. As can be seen, this does not result in a unique core point, since the particular point on the southwest face depends on the rate at which each winner's bids are reduced. The bidder-optimal core points consist of the entire southwest face of the core. If the southwest face is a unique point, then it is the Vickrey prices; if the southwest face is not unique then the face is a core constraint involving complementarities, and the Vickrey prices lie outside the core.



Nonetheless, there is always a unique core point that is closest to the Vickrey prices. This is seen above, as the bidder-optimal core point that forms a 90 degree angle with the line that passes through the Vickrey prices. This point minimizes the Euclidean distance from the Vickrey prices.

Closest-to-Vickrey core pricing was adopted in each of the UK spectrum auctions, both the two that have already been held as well as the proposed auctions for the 2.6 GHz spectrum and the digital dividend spectrum. Closest-to-Vickrey core pricing is also proposed in the Netherlands 2.6 GHz auction, and in the US auction for takeoff and landing slots at the New York City airports.

Bidder-optimal core pricing has several advantages. First, it minimizes the bidders' incentive to distort bids in a Pareto sense: there is no other pricing rule that provides strictly better incentives for truthful bidding. Bidder-optimal core pricing implies Vickrey pricing, whenever Vickrey is in the core. For example, when lots are substitutes, Vickrey is in the core, and the bidders have an incentive to bid truthfully. Since the prices are in the core, it avoids the problem of Vickrey prices being too low as a result of complements. Finally, the rule has the desirable property that revenue is monotonic in bids and bidders. Adding either bids or bidders can only increase revenues. In contrast, Vickrey prices, as a result of complements, can either increase or decrease as either bids or bidders are added.

### **Activity rule: simplified revealed preference**

Good price discovery is essential in realizing the benefits of a dynamic auction. Good price discovery stems from providing incentives for the bidders to make truthful bids throughout the auction process. The pricing rule discussed in the prior section is one essential element, but you also have to be concerned about what we see on eBay every day: bid sniping—jumping in at the last instance in an auction, holding your information back and not revealing it to the market. Bid sniping is an effective strategy in eBay auctions, and is typically used by experienced eBay bidders. The strategy is made

possible on eBay, because eBay does not have an activity rule. In contrast, nearly all high-stake auctions, such as the FCC spectrum auctions, do have an activity rule. The FCC uses a quantity-based rule. This rule has worked reasonably well in the FCC's simultaneous ascending auctions, but in a package clock auction with closest-to-Vickrey core pricing, we need a more complex rule, one that is based on revealed preference. A rule based on revealed preference is effective at getting bidders to focus on their valuations and to bid in a profit maximizing way throughout the auction.

Absent an activity rule, bidders will have an incentive to hold back to conceal information. This bid sniping behavior is so common in eBay auctions that the auctions are better modeled as sealed-bid second-price auctions, rather than ascending auctions. The activity rule is intended to promote truthful bidding throughout the auction process. An effective activity rule will enhance price discovery, enabling the bidders to better focus on relevant packages and to resolve common-value uncertainty.

As mentioned, the traditional activity rule in both simultaneous ascending auctions and clock auctions has been a quantity-based rule: to be a large winner at the end of the auction, the bidder must be a large bidder throughout the auction. In particular, each lot corresponds to a particular quantity of spectrum, measured in either MHz-pop (the bandwidth times the population) or in eligibility points. The bidder starts with an initial eligibility based on the bidder's initial deposit. To maintain this level of eligibility in future rounds, the bidder needs to bid on a sufficiently large quantity of spectrum in the current round, where "sufficiently large" is stated as some percentage, typically between 80% and 100% of the bidder's current eligibility. If the bidder bids on a smaller quantity, the bidder's eligibility is reduced in future rounds. This quantity-based rule has worked reasonably well, although as mentioned, it does create an incentive for parking eligibility on lots that a bidder is not truly interested in, especially if the eligibility points are not a good measure of relative value across lots. (The FCC's MHz-pop measure is especially poor with small lots. Spectrum in New York City is much scarcer than spectrum in Montana. As a result, spectrum prices (and values) are much higher in New York City on a per MHz-pop basis. Despite this obvious fact, demonstrated in many dozens of spectrum auctions, the FCC still continues to use MHz-pop as the quantity measure in its auctions, exacerbating parking and other problems associated with the activity rule.)

In many clock auctions, an activity requirement of 100% is used, which means that the bidder cannot increase the size of the package, as measured in eligibility points, as prices rise. For the case of a single product, this means that the bidder must bid in a manner consistent with a downward-sloping demand curve.

In a package clock auction, one can use this quantity-based rule in the clock stage, but one also needs to specify how the rule limits bids in the supplementary round. This linkage between the clock bids and the supplementary bids is of critical importance, for otherwise the bidder could bid snipe, submitting all of its bids in the supplementary round.

Ofcom proposed the following, which I call the *eligibility point rule*. During the clock stage, the bidder cannot increase the package size. Moreover, whenever the bidder reduces the package size, the bid on all larger packages is capped by the prices at the time of the reduction. For example, if during the clock stage a bidder drops from a package of size 10 to 6 at prices  $p$ , then for all packages  $q$  of size 7 to 10, the supplementary bid cannot be more than  $p \cdot q$ .

The eligibility point rule, which Ofcom used in its first two package clock auctions, has the advantage of simplicity. For each package there is at most a single linear constraint on the supplementary bid. However, it has a potentially serious problem. The straightforward strategy of bidding on the most profitable package in the clock stage is a poor strategy. A bidder following such a strategy would find that its supplementary bids would be sharply constrained, well below true values. To

avoid this problem, the bidder must instead bid in the clock stage to maximize package size, subject to a nonnegative profit constraint. That is, the bidder throughout the clock stage bids on the largest package that is still profitable.

Larry Ausubel, Paul Milgrom, and I proposed an alternative activity rule based on revealed preference for the package clock auction. Revealed preference is the underlying motivation for all activity rules. We wish to require that a bidder bid in a way throughout the auction that is consistent with the bidder's true preferences. Since we do not know the bidders true preferences, the best we can hope for is for the bidder to bid in a manner that is consistent with its revealed preferences. In the simplest case of a single-product clock auction, this is equivalent to monotonicity in quantity, just like the eligibility point rule, but when we have multiple products the two rules differ in important ways.

For the package clock auction, the *revealed preference rule* is as follows. During the clock stage, a bidder can only shift to packages that have become relatively cheaper; that is, at time  $t' > t$ , package  $q_{t'}$  has become relatively cheaper than  $q_t$ :

$$(P) \quad q_{t'} \cdot (p_{t'} - p_t) \leq q_t \cdot (p_{t'} - p_t).$$

Moreover, every supplementary bid  $b(q)$  must be less profitable than the revised package bid  $b(q_t)$  at  $t$ :

$$(S) \quad b(q) \leq b(q_t) + (q - q_t) \cdot p_t.$$

That is, each clock bid for package  $q_t$ , as improved in the supplementary round, imposes a cap on the supplementary bid for package  $q$ .

An important advantage of the revealed preference rule is that a bidder following the straightforward strategy of bidding on its most profitable package in the clock stage would retain the flexibility to bid its full value on all packages in the supplementary round.

To illustrate the implications of the two activity rules, consider the following example with two bidders and two identical lots (one product) in a setting of substitutes. The bidders' preferences are given in the table below, indicating the marginal and average value for 1 lot and 2 lots.

		Marginal Value		Average Value	
		Bidder A	Bidder B	Bidder A	Bidder B
1 lot		16	8	16	8
2 lots		2	2	9	5

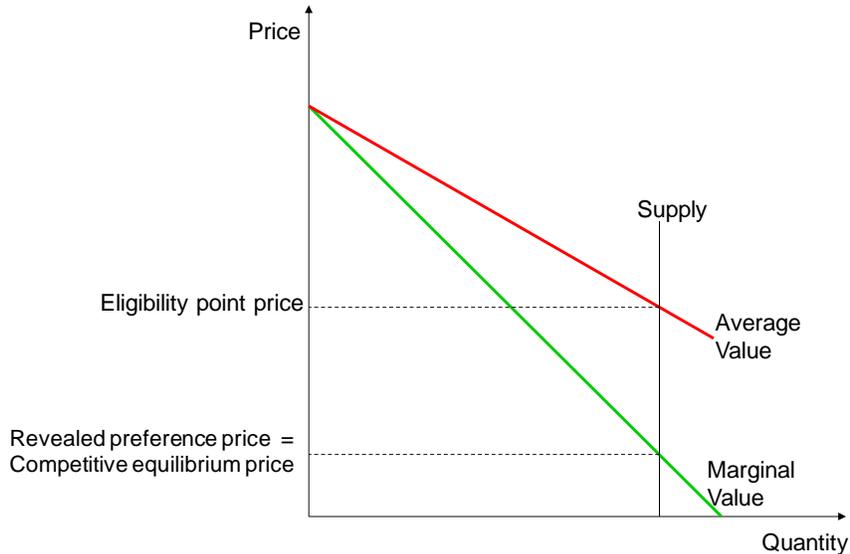
Since the lots are substitutes, both bidders want to bid their true values in the supplementary round. However, consider what happens in the clock stage in response to the two different rules.

With the revealed preference rule, each bidder has an incentive to bid on its most profitable package in each round. Thus, the bidding simply moves up each bidder's marginal value (demand) curve. When the clock price reaches 2, both bidders drop from a package of size 2 to 1, and excess demand drops to zero. The clock stage ends at the competitive equilibrium price of 2 and the efficient assignment. Indeed, there is no need for any supplementary bids in this case. Bidder A can enter supplementary bids of 16 and 18, and bidder B can enter supplementary bids of 8 and 10, but these supplementary bids will not change the outcome in any way. Each bidder wins one lot and pays 2 (the Vickrey price). The supplementary round is unnecessary. The clock stage, by revealing the bidders marginal value information, up to the point of no excess demand, has revealed all that is needed to determine and price the efficient assignment. This is a general result with substitutes.

With the eligibility point rule, bidders are forced to distort their bidding away from the straightforward strategy of profit maximization. In order to preserve the ability to bid full values in the supplementary round, the bidders instead bid on the largest package that is still profitable. This entails moving up the average value curve, since when the average value is exceeded a package is no longer profitable. Thus, when the clock price reaches 5, bidder B's average value for 2 is reached and the bidder drops its demand to 1. Then when the clock price reaches 8, bidder B's average value for 1 is reached and bidder B drops out. At this point there is no excess demand, so the clock stage ends with bidder A demanding 2, bidder B demanding zero, and the clock price at 8. In the supplementary bid round, the bidders again submit their true preferences, and the optimization determines that each bidder should win one lot and should pay 2. The supplementary round was required to determine the efficient assignment and price the goods. Notice that the clock stage did little but mislead the bidders into thinking that bidder A would win all the items at a high price.

The reader might think that I somehow rigged this example to make the eligibility point rule look bad. This is not the case. Whenever lots are substitutes, the same features will be observed. With revealed preference, the clock stage will converge to the competitive equilibrium, revealing the efficient outcome and supporting prices; whereas with the eligibility point rule, the clock stage ends with an assignment that is excessively concentrated and prices that are too high. This result follows from the simple fact that average value exceeds marginal value, whenever aggregate demand is downward sloping, as shown below. Having participated in many dozens of major spectrum auctions, I can confirm that this is indeed the typical case.

**Downward sloping aggregate demand implies average value > marginal value**



Below I show another example with a supply of 18 identical lots and five bidders, each with a different constant elasticity of demand. Marginal values are shown in the first five columns and average values are shown in the next five. The clock stage with the revealed preference rule is shown in green. The bidders bid to maximize profit and so reduce demands as marginal values are reached. The clock stage ends at a price of 370, the competitive equilibrium price and the assignment is efficient.

**An example with five bidders and constant demand elasticity**

		Demand Elasticity										Weaker bidder reveals too much
		0.50	0.60	0.70	0.80	0.90						
		Marginal Value					Average Value					
Lots	Bidder	Bidder	Bidder	Bidder	Bidder	Bidder	Bidder	Bidder	Bidder	Bidder	Bidder	
	A	B	C	D	E	A	B	C	D	E		
1	10,000	4,642	2,683	1,778	1,292	10,000	4,642	2,683	1,778	1,292		
2	2,500	1,462	997	748	598	6,250	3,052	1,840	1,263	945		
3	1,111	744	558	450	381	4,537	2,282	1,413	992	757		
4	625	461	370	314	277	3,559	1,827	1,152	823	637		
5	400	317	269	238	216	2,927	1,525	975	706	553		
6	278	234	207	189	176	2,486	1,310	847	620	490		
7	204	181	166	156	149	2,160	1,149	750	553	441		
8	156	145	138	132	128	1,909	1,023	674	501	402		

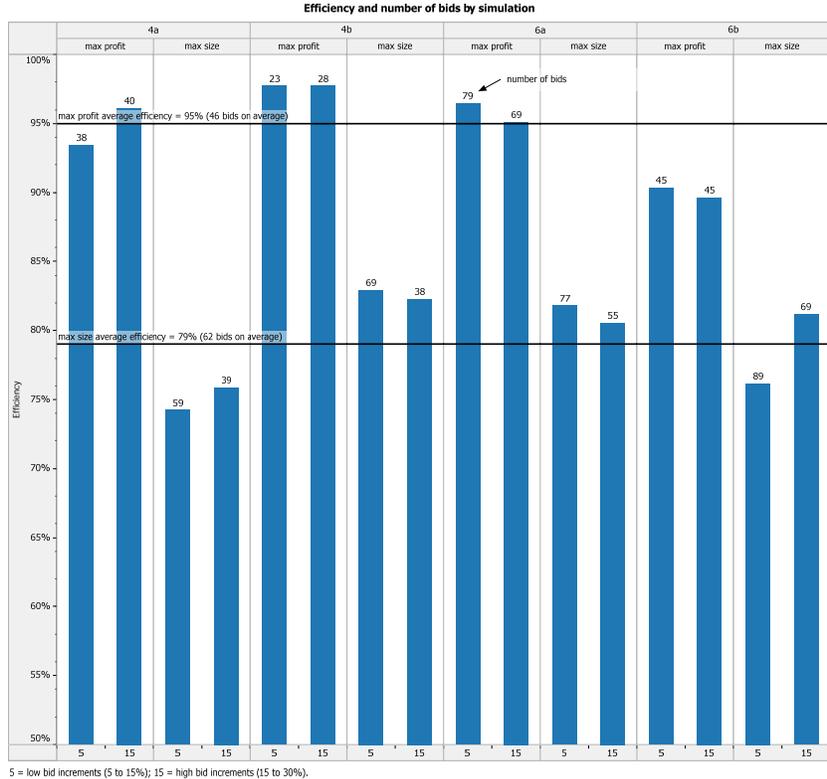
		Clearing Price	Too concentrated		Total Value
Bidding norm			Supply	Misassigned	
Max profit	370		18		Max profit 31,428
Max size	1,292	Price too high	5		Max size 29,150
Difference	249%		Fraction misassigned 28%		Inefficiency 7.3%

In contrast, with the eligibility point rule, the outcome is shown in yellow. The clock stage outcome is too concentrated, misassigning 5 of the 18 lots and causing an inefficiency of 7.3%. The final price is 2.5 times the competitive equilibrium. The rule also forces the weakest bidder to reveal its entire demand schedule; whereas the strongest bidder reveals nothing.

What is essential for price discovery is the revelation of the marginal value information. This helps bidders make the marginal tradeoffs that are of greatest relevance in figuring out what the outcome should be. This is why I believe the eligibility point rule is a poor choice.

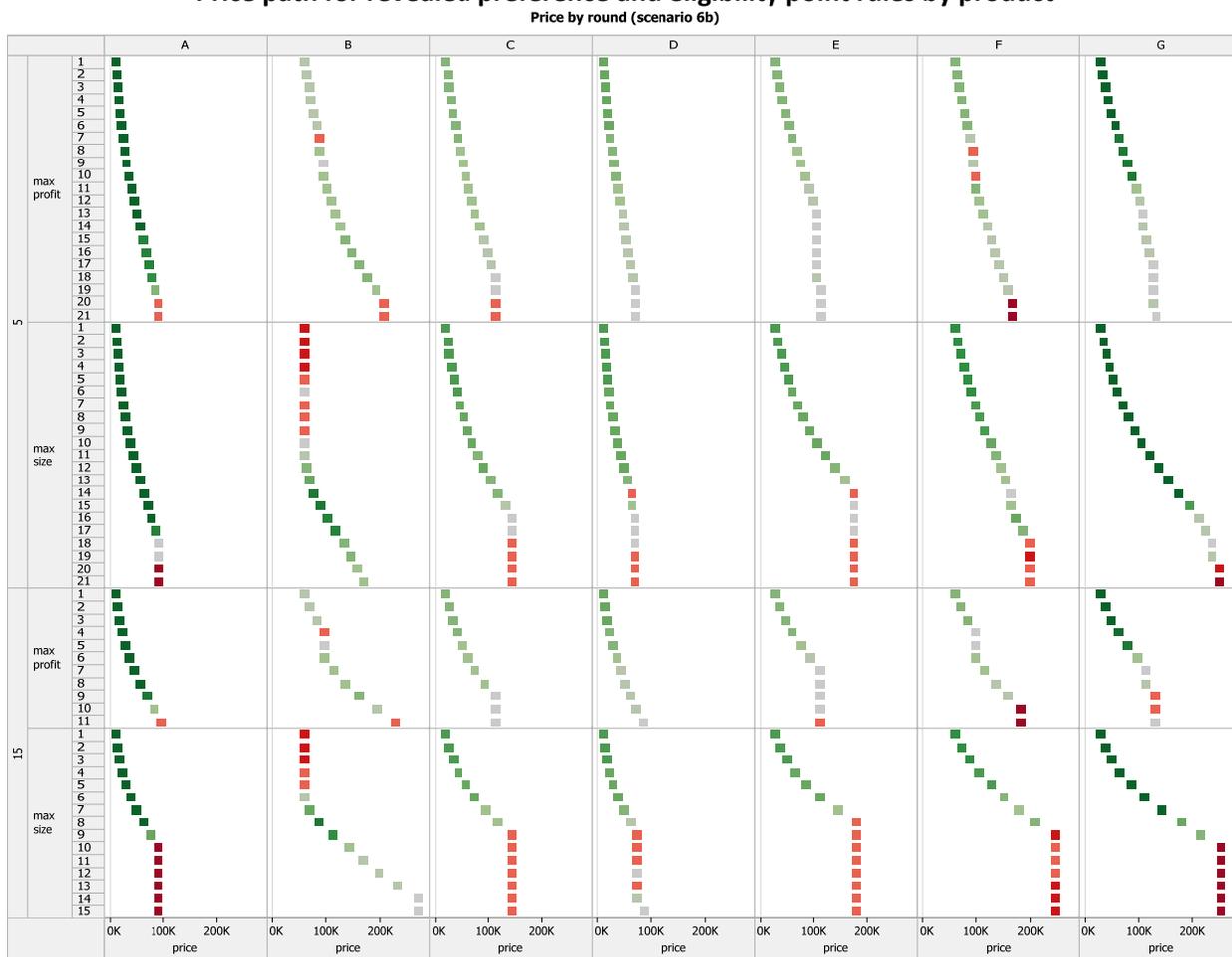
To further test the two activity rules, I conducted numerous simulations using realistic demand scenarios with significant complementarities from both technological and minimum scale constraints. I assumed that the bidders bid on the most profitable package with revealed preference (max profit) and bid on the largest profitable package with the eligibility point rule (max size). The results are summarized below. Notice how the revealed preference rule achieves substantially higher efficiency in many fewer rounds.

## Revealed preference rule yields higher efficiency and fewer bids in the clock stage



The figure below shows the better price discovery of the revealed preference rule as observed in the simulations. The top-two rows show the price path with a minimum bid increment of 5% under the revealed preference rule and the eligibility point rule, respectively. Notice the tendency for the price path under max-size bidding to go up too quickly and overshoot the competitive equilibrium price, creating excess supply (in red). The bottom two rows show the same scenarios, but with a larger minimum bid increment of 15%.

## Price path for revealed preference and eligibility point rules by product



Price for each round by category. Color shows excess demand. Top two panels have small increments (5% to 15%); bottom two panels have large increments (15% to 30%). Under "profit" case, bidders select the profit maximizing package; under "size" bidders select the size maximizing package subject to a positive profit constraint.



As a final test of the two activity rules, as well as other elements of the auction design, I conducted a series of full-scale tests in the experimental lab. For the tests, the Ofcom auction platform was used and indeed Ofcom staff served as the auctioneer. The subjects in the test were PhD students, who had taken an advanced course in game theory and auction theory, and had prior participation in package clock auction experiments. I chose such an experienced and expert subject pool, since in the actual spectrum auctions bidders often hire experts and devote substantial time and money to understand the strategic implications of the rules.

Each subject participated in several auctions over a two-week period. In each auction, the subject was given a bidding tool, which calculated the subject's value for each package consistent with the bidder's business plan. The scenarios as represented by the various bidding tools were chosen to be realistic. The valuation models included both substitutes and complements. Complements came from minimum scale constraints as well as technological requirements. A training session was held before the auctions to explain the details of the package clock auction, including the two different activity rules. All subjects participated in both activity rule treatments. Each subject was paid an amount based on her experimental profits. The average subject payment was \$420.

The experiments confirmed that the eligibility point rule caused a major deviation from straightforward bidding in the clock stage. Bidders quickly realized the need to bid on the largest profitable package. This undermined price discovery, but given the private value setting and simple valuation models, the poor performance of the clock stage was largely corrected by the supplementary bids and the optimization that followed. There were some instances of inefficiency when bidders deviated from bidding on the largest profitable package and then found they were unable to bid full values in the supplementary stage.

In contrast, with the revealed preference rule, bidders almost always followed the straightforward strategy of bidding on the most profitable package. In the supplementary round, bidders typically bid full value and were not constrained by the revealed preference rule. As a result, efficiency was nearly 100%.

One issue that was discovered in the lab was the complexity of the revealed preference rule. The few bidders who deviated from bidding on the most profitable package in each round of the clock stage found they were unable to bid full value in the supplementary round as a result of the revealed preference constraint. The difficulty for these bidders was that it was difficult for them to determine how high they could bid, since revealed preference is not a single constraint, but one constraint for each clock bid. Moreover, improving the bids on various clock packages causes the constraints to change. The challenge for the bidder is to figure out how best to adjust numerous bids in order to satisfy many constraints (one per round). Even the brightest PhD students found this to be a daunting task without some computational help.

One solution to the complexity problem is for the auction system to provide the bidder with some help. For example, the bidder could provide the system with its desired bids. The auction system then would indicate a summary of the bids that currently violate revealed preference constraints and suggest an alternative set of bids that satisfies all constraints and is closest (in Euclidean distance) to the desired bids. This is exactly the information the subjects in the lab were looking for in the few instances of deviations from straightforward bidding. In the lab, the deviations were minor and the bids would have been easily adjusted with the help of a smart auction system. The optimization I propose is a quadratic optimization with linear constraints. It is easily solved in an instant.

In addition to complexity, the revealed preference rule may at times be too strong. Bidders' values may change over the course of the auction for example as the result of common value uncertainty.

### ***Simplifying revealed preference***

A simplified revealed preference rule may address both the complexity and changing values issues. The idea behind the rule is that it may be unnecessary to include all of the revealed preference constraints to get the bidders to adopt the straightforward bidding. Since the incentive for bid sniping is not too strong, even the possibility of a revealed-preference constraint may be sufficient to induce the desired behavior. People put coins in parking meters in order to avoid the possibility of a parking ticket. We can hope that a simplified revealed preference rule will have the same effect in the package clock auction.

The *simplified revealed preference rule* imposes only a subset of revealed preference constraints. At most one revealed preference constraint applies to each bid. In the clock stage, the bidder can shift to any package of the same or smaller size without constraint. However, the bidder can only shift to larger packages that satisfy revealed preference with respect to the prior bid; that is, at time  $t$ , if package  $q_t$  is larger than package  $q_{t-1}$ , then  $q_t$  has become relatively cheaper than  $q_{t-1}$ :

$$(P') \quad q_{t'} \cdot (p_{t'} - p_t) \leq q_t \cdot (p_{t'} - p_t).$$

Moreover, all supplementary bids  $b(q)$  are capped by a single revealed preference constraint. Packages  $q$  the same size or smaller than  $q_f$  are capped by revealed preference with respect to the final clock package  $q_f$ :

$$(S') \quad b(q) \leq b(q_f) + (q - q_f) \cdot p_f.$$

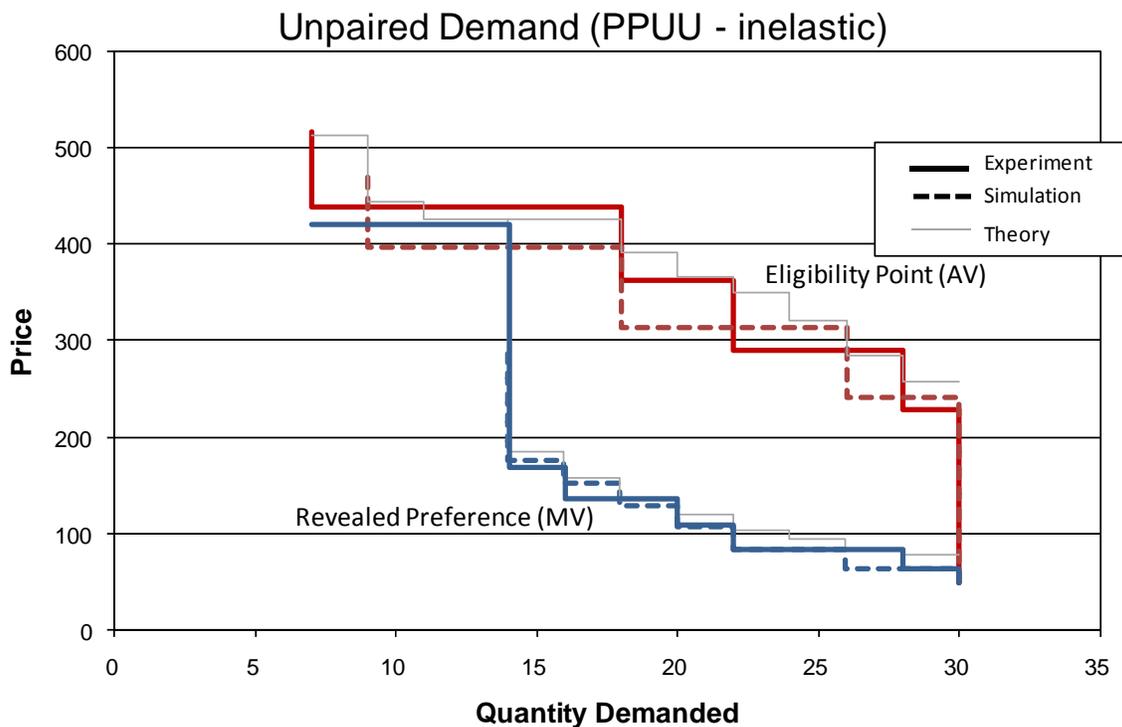
Packages  $q$  larger than  $q_f$  also must satisfy revealed preference with respect to the smaller package  $q_s$  (where round  $s$  is the first round a package smaller than  $q$  was bid for):

$$(S'') \quad b(q) \leq b(q_s) + (q - q_s) \cdot p_s.$$

Notice that all the constraints are revealed preference constraints, so this indeed is a simplified revealed preference rule. Also, notice that for each package, there is at most a single revealed preference constraint that limits the bid. Thus, conforming to the rule is a simple one-dimensional problem. Just as with the eligibility point rule, there is no need for optimization tools to help the bidder conform to the rule.

One of the desirable features of the rule is that the final package in the clock stage plays an especially important role in limiting bids on all packages that are not larger than the final package. Thus, any distortion from profit maximization in the final clock package is especially costly to the bidder. Of course, the bidder never knows, which clock round will be the last, so there is always some incentive to bid consistent with profit maximization. Moreover, as excess demand falls, the probability that the current round will be the last tends to increase, strengthening the incentive for straightforward bidding throughout the clock stage.

**Comparison of theory, simulation, and experiment in the 2.6 GHz auction**



I tested a version of the simplified revealed preference rule for the UK 2.6 GHz auction. The methodology was as in the earlier tests. First I developed a number of realistic scenarios. The two activity rules were then evaluated using a theoretical clock auction with continuous prices, a simulation with discrete increments, and then in the experimental lab with the same experienced PhD students that participated in the earlier tests. The figure above compares the demand curves as bid in the clock stage under the two activity rules for a typical scenario. The subjects bid in a manner consistent with the assumed behavior in both the theory and the simulation. From this I conclude that the simplified revealed preference rule has all of the desirable properties of the revealed preference rule, without the complexity.

Ofcom has adopted a version of the simplified revealed preference rule for the 2.6 GHz auction.

## **Challenges of the digital dividend**

The 2.6 GHz auction is an especially simple application of the package clock auction. There are just two technologies (WiMAX and LTE) and they interact in an especially simple way. The challenges of the digital dividend are much greater. At least currently, there are many competing technologies. In addition to WiMAX and LTE, mobile TV and digital terrestrial television are also possible. Moreover, there are many ways to break the spectrum up.

In 2008 the UK made one proposal for auctioning the digital dividend. The proposal was among the most complicated auction proposals ever made. The reason for the complexity is that Ofcom wants the auction to make the tough decisions about how to organize the spectrum based on the bids, rather than through regulatory dictate. Because the preliminary proposal was made so far in advance of the auction date, there was greater uncertainty about how much flexibility will ultimately be needed. My guess is that as we get closer to the auction date, more features will be resolved and as a result a simpler auction ultimately will be possible. Nonetheless, even in its most complex form, the complexity was on the auctioneer side, not on the bidder side. The original proposal would be entirely manageable for the bidders. This is a key feature of good auction design. The auction system, not the bidders, should do the heavy lifting in terms of optimization of bids; the bidders then can focus on valuing the assets and expressing preferences.

## **Conclusion**

The package clock auction is a large advance over the standard simultaneous ascending auction. It eliminates the exposure problem, it eliminates most gaming behavior, it enhances substitution, and it encourages competition. Most importantly, the package clock auction enables a technology neutral auction, which should be especially important with respect to the digital dividend. The auction, through the competitive bids, determines how the spectrum is organized, rather than the regulator. In an environment where the regulator has only a rumor of an idea about what technology or use is best, letting the auction resolve such matters can greatly expand the realized value of the scarce spectrum resource.

A further advantage of the package clock auction is that it is readily customized for a variety of settings. Typically, a communications regulator will have a sequence of auctions over many years, as new spectrum gradually is made available. The package clock auction can be adapted to the unique characteristics of any particular auction. Adopting a consistent and flexible auction platform reduces transaction costs for the government and, more importantly, the bidders.

The auction design also enhances competition. The process is highly transparent and encourages price discovery. There is enhanced substitution both through the product design and the auction format. Bidder participation costs are reduced.

As in any market design problem, an important task for the regulator is to identify and mitigate potential market failures. In this setting and many others, the most important potential failure is market power. This is especially an issue in settings where there already is a highly concentrated communications market and the spectrum is an essential input for any new entrant. The approach here allows the regulator to address this potential market failure, as well as others, with a variety of instruments, such as spectrum caps, set asides, or bidding credits. The instruments must be used with care, or else they may do more harm than good.

One of the greatest harms is delaying the allocation and award of spectrum. Avoiding economic loss from delay should be a main priority of the regulator. Incumbents often will argue that spectrum awards should be put off. Such arguments may simply be a far less costly means of impeding competition than outbidding an entrant in an auction.

Fortunately, the use of a state-of-the-art auction design, such as the package clock auction and its variants, does not cause delay. These auctions can be designed and implemented, even by developing countries, in short order, provided the country is using successful techniques adopted elsewhere. The bottleneck is regulatory procedures, not auction design and implementation. Providers of auction services can readily meet deadlines of a few months if necessary.

The package clock auction can be applied in many other industries. For example, the approach was proposed and tested for the auctioning of takeoff and landing slots at New York City's airports. The approach is well-suited for any setting in which there are many interrelated items, some of which are substitutes and some of which are complements.

More broadly, the approach described here is an example of using auction design to harness the power of markets. The approach leads to improved pricing of a scarce resource, improving decision making, both short term and long term. Innovation is fostered from the better pricing and assignment of the scarce resource.

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