

*Behemoths' Dance*

EBay Talks to Microsoft, Yahoo

About a Common Foe: Google

**Auction Firm Both Needs**

**And Fears Search Giant;**

**To Compete or Cooperate?**

**Discussions Focus on Ad Buys**

**By MYLENE MANGALINDAN and ROBERT A. GUTH**

**April 21, 2006; Page A1**

[EBay](#) Inc. is talking to both [Yahoo](#) Inc. and [Microsoft](#) Corp. to determine whether one of them might be a worthy ally against a common threat: [Google](#) Inc.

After years of working closely with the search giant, eBay last year became alarmed as Google started assaulting its turf in multiple ways. In one case, Google launched a classified-advertising service that competes directly with eBay's online auctions and other listings.

The two-track discussions began in earnest last autumn, people familiar with the talks say. They could result in some kind of alliance in which eBay, of San Jose, Calif., would increase ad spending with its chosen partner and provide access to the wealth of data it has collected about its consumers. The two sides could also more tightly integrate technical aspects of their systems to better cross-promote their businesses.

It's not clear how much money would be involved or whether the parties have considered a more complex financial transaction, such as one side taking an equity stake in the other.

But choices are seldom clear-cut in today's Web business. Upon hearing of eBay's talks, Google, Mountain View, Calif., offered an olive branch, in the form of a series of proposals designed to tighten the relationship between the two companies. The superiority of Google's search technology makes it a better place to advertise, say people familiar with eBay's thinking.

Today, eBay is in a curious position -- negotiating alliances to wean itself from Google while discussing deeper ties with it. Tech companies have long had to walk such a delicate line between cooperation and competition. But these days, Google's clout has magnified the problem.

EBay has "known for some time that Google poses tremendous opportunity in the short term but is perhaps their biggest threat in the long term," says Jeff Lanctot, general manager of Avenue A/Razorfish, an online-advertising agency.

EBay, Yahoo, Google and Microsoft are clear leaders in the tech world and yet their competitive landscape is still profoundly uncertain. In particular, the rapid growth of online advertising has injected new competition into the Web, forcing the foursome to challenge each other in ways they hadn't in the past.

So dizzying is the array of potential options that eBay executives have drawn up a chart mapping its three main businesses -- an auction marketplace, the PayPal online-payment service and Skype, an Internet phone service -- along with potential partners for each. The decision eBay makes will go a long way toward determining what kinds of businesses it will be in. Executives from the companies involved think these talks could herald mergers or acquisitions that would reshape consumer commerce on the Web.

Each company is offering eBay a somewhat different package. At their core, though, the talks are about advertising. Whoever wins eBay will probably gain the right to display their clients' ads on eBay's millions of auction pages. Google, Yahoo and Microsoft all have systems in place that syndicate advertising to third-party Web sites, with all parties sharing the revenue. eBay doesn't currently run such ads. The winner would also get ad dollars from eBay, one of the Web's biggest advertisers.

People involved in the talks say that any, or all, of the discussions may fall through and that no date has been set for a decision. eBay already does business with all three companies and will likely maintain ties with all.

eBay spokesman Chris Donlay declines to comment on any talks and plays down the company's rivalry with Google. "Given how fast the Internet changes, it's no surprise that the line between competition and cooperation is sometimes blurry," he says. Spokespeople for Yahoo, Google and Microsoft also decline to comment.

eBay's conundrum stems from its deep dependence on Google, one that started when eBay became one of the first customers of Google's search-based advertising system. When Internet users search on Google, the service brings up text ads related to those words on the results page. In 2001, eBay paid Google to post ads for its auctions pegged to thousands of search words. Search for "antiques," say, and Google would post an eBay ad with text such as: "Whatever you're looking for, you can get it on eBay."

eBay's spending on Google soared, dwarfing spending on similar services such as Yahoo's Overture and Microsoft's MSN. John Aiken, managing director at Majestic Research, an independent equity-research firm, estimates that eBay spends about twice as much on Google ads as other individual search engines, and that Google brings up to three times as much traffic to eBay as other search engines. eBay won't give details about its ad spending.

Few at eBay initially saw reason to fear Google, say people at the company, in part because of a 2003 study it commissioned from McKinsey & Co. McKinsey concluded that Google wouldn't use its search capabilities to break into e-commerce. That made Google a manageable threat, say people familiar with the study. eBay's dependence on Google increased as it shifted ad dollars to online ads from traditional media throughout 2004.

But 2005 brought worrying signs that Google had the potential to become an entry point to the Internet for online shoppers, challenging eBay. Google, as part of a broader hiring

spree, began recruiting eBay engineers and business staff. Senior eBay executives feared Google was staffing up for a move into e-commerce, say people familiar with the matter. In June, news broke that Google was developing a system for online merchants to take payments securely. Few details were available, but it sounded like a competitor to PayPal, eBay's own online-payment service.

Then, in October, Google started testing a free online-classified service, Google Base, a product targeted at the heart of eBay's business.

Even before news of Google Base became public, eBay executives met that summer to assess the threat. In a role-playing exercise, they split into two groups: A "green team" pondered eBay's interests; a "red team" tried thinking like Google, say people familiar with the meetings. The greens returned with status-quo scenarios in which eBay and Google continued collaborating, these people say. The reds, in Google's shoes, concluded that Google would move onto eBay's turf.

The conclusion was troubling. eBay was boxed in to its relationship with Google. A big chunk of eBay's approximately \$400 million global online-marketing budget goes to Google, say people familiar with the matter.

In September, in Telluride, Colo., at an annual retreat, senior eBay executives discussed how Google might attack eBay, according to people familiar with the meeting. PayPal executives theorized that Google could offer free ad services to companies in return for agreeing to use Google's rival online-payments system.

PayPal President Jeff Jordan, called for eBay to be more aggressive in shoring up its defenses. Google "has catalyzed the Valley" into figuring out ways to oppose it, says Mr. Jordan. Other eBay executives, by contrast, considered Google the best search company and played down the competitive threat.

By mid-Autumn, there was a consensus that eBay needed to consider alliances to wean itself from Google. The logical choices were Yahoo, Sunnyvale Calif., and Microsoft, Redmond, Wash.

Both companies wanted eBay's ad dollars and access to its huge number of users. Yahoo and Microsoft covet information about eBay's shoppers, who are more likely than regular Internet users to buy products online. The data would help the companies finesse the underlying algorithms that guide their search systems.

In early talks, Microsoft wanted eBay to advertise on its embryonic AdCenter, a service currently on trial designed to compete with Google's ad system. But eBay thought the quality of Microsoft's search results lagged behind Google's and worried that Microsoft's site didn't have enough users, say people familiar with the talks. That meant eBay ads there would be less effective.

But by the time of the September Telluride retreat, eBay was feeling the pressure and decided to step up talks with Microsoft. eBay Chief Executive Meg Whitman discussed with her Microsoft counterpart Steve Ballmer ways the companies could work together, says a person familiar with the meeting. Ms. Whitman and Mr. Ballmer decline to comment through their respective spokespeople.

Behind the scenes, Microsoft was negotiating with [Time Warner](#) Inc.'s AOL unit a partnership that could increase traffic to Microsoft's site, a deal that Microsoft managers hoped would address part of eBay's concerns. In December, Microsoft's plans took a big hit when Google swept in, investing \$1 billion in AOL for a 5% stake.

Days after losing the deal, Microsoft Vice President Yusuf Mehdi wrote a memo to Microsoft's search team. Under the heading "Plan B," the email said Microsoft needed to step up its efforts to make alliances with eBay and other e-commerce sites.

That directive helped intensify the talks. Microsoft talked about giving eBay special access to its search results, say people familiar with the matter. That would allow eBay users who didn't find what they were looking for on the auction site to immediately see information gleaned from Microsoft's search. The two companies also discussed how to make PayPal a more integral part of Microsoft's software and Web portal, say people familiar with the talks.

eBay, however, was also exploring other options. After the Telluride retreat, it stepped up talks with Yahoo. The pair had held inconclusive talks earlier in the year.

Yahoo itself had been rattled by Google Base, the classified-ad system, which seemed aimed at several Yahoo businesses from personal ads to shopping listings. "Both companies realized they needed each other," says a person familiar with the talks.

Through the fall, groups of Yahoo executives, including Chief Operating Officer Dan Renshaw and Chief Financial Officer Sue Decker, considered ideas, including making PayPal an integral part of Yahoo's shopping business as well as a back-office payment system for Yahoo's advertisers. Yahoo would syndicate its ads on eBay's site. The pair also talked about embedding a link to eBay's Skype phone service within Yahoo's ads, enabling consumers to immediately call the retailer in question over their PCs, say people familiar with the matter.

In addition to the talks with Yahoo and Microsoft, eBay considered buying or building its own search and ad technology. Some eBay executives advocated staying neutral, doing business with none or all three search companies equally.

In December, eBay told Google about its talks with Microsoft and Yahoo, says a person familiar with the matter. eBay wanted to see what Google would offer, but Google showed little interest.

In February, Google approached eBay about pursuing a competing agreement. The proposed partnership would let Google run ads on eBay's sites and, much like Yahoo's proposal, would find a way to promote Skype, according to a person familiar with the situation.

eBay had to consider the Google offer, says a person familiar with the matter, because Google's search technology was still superior to that of Microsoft and Yahoo. Since early this year, eBay's talks with the three suitors have ebbed and flowed and all three are trying to sweeten their offers; eBay is still in discussions with all three, say people familiar with the talks.

Indecision within eBay will probably delay any conclusion. Some eBay insiders think Google's momentum is widening its technology edge. Others say that building closer ties to Google would be like "letting the fox into the henhouse," says one person familiar with the matter.

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**Friends and Enemies**  
eBay both cooperates and competes with Google, creating a strategic conundrum.

**COOPERATE**

- eBay spends heavily on Google ads.
- Many customers find eBay through Google.
- Google provides up-to-date auction listings from eBay.

**COMPETE**

- Google is developing a competing electronic payment service.
- Google Base service competes with eBay's auctions and other classified listings.
- Google could become a rival portal for e-commerce.

**MICROECONOMIC APPLICATION ANALYSIS OF TRADE-OFFS, PRICES,  
AND MARKETS IN  
BEHEMOTH'S DANCE:  
EBAY TALKS TO MICROSOFT, YAHOO ABOUT A COMMON FOE:  
GOOGLE  
WALL STREET JOURNAL, APRIL 21, 2006 – SECTION A PAGE 1**

**Vivek Mohan  
GSI: Jung-Moh Chang  
Economics 100A  
Professor Gordon Rausser**

**Microeconomic Application Analysis of Trade-offs, Prices, and Markets in  
Behemoth's Dance:**

**EBay talks to Microsoft, Yahoo About a Common Foe: Google  
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Microeconomics by definition is a very applicable and practicable field of study. The study of the way individual firms act is representative, at some level, of how they do – even if the models learned are much too simple for direct application to the real world. In this article, which discusses the complicated and emerging relationships between EBay, the online auction marketplace, Google, the rapidly-growing search giant, Yahoo, Google's main search rival and a major Internet portal, and Microsoft, the software and internet titan. Although each company has a core business, each has a number of secondary and tertiary interests that also form an integral part of its business. At issue in this article is how to reconcile those secondary and tertiary businesses, which are beginning to infringe on the interactions of the companies' main businesses. EBay's auctions marketplace, which draws millions of visitors daily, is a heavy spender of advertising dollars to bring more and more viewer eyes to itself – for each auction completed is money in EBay's coffers. Google, up to this point, has been the main recipient of these ad dollars, as their market dominating search features direct huge volumes of customers to EBay's site. Thrown into this fray are Yahoo and Microsoft, who both have search portals – Yahoo! and MSN, respectively, which also garner some ad dollars from EBay. However, as Google begins competing with EBay on certain fronts, EBay is beginning a thorough analysis of its business and advertising models. It is this analysis of the trade-offs, pricing, and market power held by each of these companies that we will look at in this application analysis.

EBay, the main player in this case, has two cards to play. The more visible from the outside is its advertising budget - \$400 million a year – the bulk of which goes to Google, with less going to Yahoo and Microsoft. In the online search and advertising market, EBay has very little monopsony power. Google enjoys the revenue from EBay, but it is by no means the only buyer of its online ads. Google, however, has fairly significant market power in this market. Its search technology is recognized as superior to Microsoft's and Yahoo's, and it is the market leader in terms of the number of eyes it draws to its website. Its clean, uncluttered layout allows for a higher "click-through" rate which means a higher percentage of Google's users use advertisements as the answer to their search queries. It retains monopoly power because although EBay can cut their spending to advertisements on Google's website, spending the same dollars on Yahoo or MSN's advertisements is an inferior and heterogeneous product. In other words, EBay is willing to pay a premium to have its ads on Google's site. As the sole provider of ads with such high returns, Google can afford to charge prices that are significantly higher than what would otherwise be charged in a perfectly competitive market.

One must wonder how this happy equilibrium is being disturbed. EBay pays a premium to Google so that more viewers come to its site, and as viewers come to its site more auctions are completed, and EBay generates more commissions. At issue is one of Google's secondary businesses, Google Base, a beta product that competes with EBay but offers free listings. EBay sees this as competition in the otherwise monopolistic online-auction industry, and as the cost put forth by Google is zero, EBay cannot cut prices enough to equal it without sacrificing its core business model. Google's Base service is ad-supported, not commission-supported. EBay's second card comes into play

here as a mitigating factor, for otherwise it seems like Google will compete EBay out of existence, at least as a commission-driven online auctioneer. Besides its monopoly power (up to this point) towards consumers in terms of its huge auction listing database, it has monopoly power over a set of data that Google, Yahoo, and Microsoft all want. EBay's clientele – and the information it has about them – profile a demographic in the United States that is willing to do e-commerce. These individuals are the preferred target of most other online advertisers, as they likely have money and are willing to spend it.

Therefore, there are trade-offs to consider. EBay, threatened by the specter of Google's competition in the auction market, can shut off its advertising dollars and use of its customer base to Google. This will likely hurt Google in the short run, as EBay is a large advertiser, and it will force them to either lower the price they charge EBay to advertise on their superior search service or to shut down the business that competes with EBay, Google Base. However, the trade-off lies in the waiting game. EBay will also be hurt – viewership to its website will decrease because the same amount of advertising dollars spent on other outlets, such as Yahoo and Microsoft, bring fewer users to their website. The question is who can last longer without the other as a supporting crutch. It is interesting because some elements of this are of a dual oligopoly-oligopsony interaction. Google has significant, almost monopolistic power over high-percentage click-through searches and EBay has monopoly power over its customer base. EBay has very slight monopsony power over Google's search business, as it is a significant buyer, and Google is an almost totally monopsonistic user of EBay's customer information, in that Google uses it to tweak and continually improve its search features.

From this analysis, it seems that Google would win the battle because the trade-offs would be greater to EBay than to Google, and customers would flock to the free site Google Base. However, there are two other competitors to add into the fray – Microsoft, the ubiquitous software maker, as well as Yahoo, the internet portal. Both offer search and advertising features similar but less effective than Google's, and both are very interested in using EBay's customer information to refine their search engines. As both Microsoft and Yahoo jockey to one-up each other in offering EBay sweetened deals and lowered prices to advertise on their sites, EBay is attempting to use this as leverage to force Google's hand.

There are a slew of other business that are inextricably tied to these companies – PayPal, EBay's online payment system, Skype, EBay's online telephone system, Yahoo's popular shopping websites, and Microsoft's widespread consumer software. Yet while all of these business vie for dominance within their respective conglomerates, the net benefit of the corporation is all that is of matter to the executives in charge. The result of the interaction between all of these companies cannot be determined due to the complex oligopoly-oligopsony interactions, the lack of exact data regarding consumer "click-through," how badly each company would be affected by changes in the status quo, and infinitely more variables. In the end, it seems like something must change, however. Google's foray into a monopolistic market has started a nightmare for EBay, and in the end, it will be a test of the personal fortitudes of the leaders of each of these companies to see who emerges victorious.

Victory itself in this case can be hard to define – for no matter what actions are taken, some aspect of each company's business will suffer. If EBay switches from

Google to Yahoo or Microsoft, Google will be out advertising dollars and a consumer data, but EBay will also lose viewership and potential revenue. However, EBay's secondary businesses – PayPal and Skype, would benefit from better advertising placement and integration into the MSN or Yahoo portals. Microsoft or Yahoo will gain EBay's advertising dollars, but have competed the prices in their secondary search-engine advertising market down to a much lower equilibrium than the oligopolistic market currently supports. If EBay is to stay with Google, Google must make some concessions, such as abandoning Google Base. EBay, in its desire to maintain its position almost as a monopolist at the top of the online auction houses, is likely to be willing to pay more to force Google out of this market and maintain its relationship with the premier search-advertising service.

Clearly there exist many trade-offs in the interactions of these technology titans. Each of them has a vested interest in the success of the other, and each of them competes with others in different ways. Microeconomic analysis can be applied to all of these and empirical results regarding pricing and decisions can be predicted with decent accuracy. However, there are a number of variables that need to be resolved, as well as the ever-present variable of human tenacity and the randomness of consumer preference. Yet the models that explain how prices are determined by the degree of market power can be applied here to great effect – and it will be interesting to see how EBay acts in the future – and if these actions are consistent with the predictions of the microeconomic models learned in class.