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**Bidding and Drilling on Offshore  
Wildcat Tracts**

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# Bidding and Drilling on Offshore Wildcat Tracts\*

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## Abstract

I study a game in which firms first bid on wildcat tracts and then time their drilling decisions. In an equilibrium bids are used as a coordination device: if player  $i$  bid low while player  $-i$  bid high, player  $i$  waits while player  $-i$  drills. This equilibrium is consistent with the empirical findings of Hendricks and Porter (1996). Firms know that by bidding “low” they can be allocated the right to free-ride. This induces “optimistic” firms to submit “low” bids. Nonetheless, this equilibrium need not reduce expected revenues as compared to the benchmark case in which one abstracts from signalling issues.

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# 1 Introduction

Over the last year the price of oil has peaked. This has dented consumers' purchasing power, increased inflationary pressures and forced the world's central bankers into a delicate balancing exercise. To bring the price of oil to more acceptable levels, more effort and money should be devoted to finding new deposits. Oil exploration programs are often initiated by private firms which acquired the right to explore and extract oil (and gas) after participating in an auction. In recent years Algeria, Brazil, Cuba, Ecuador, India, Indonesia, Libya, Nigeria, Peru, Russia, Uganda, the US and Venezuela have put part of their oil and gas reserves under the hammer. This list of countries is set to increase in the future. Greenland and Pakistan, for example, have recently decided to organize future oil and gas auctions. Those auctions often generate huge revenues and secure the supply of crucial energy resources.<sup>1</sup>

To increase our understanding of how firms bid during those auctions, I analyze bidding behavior in outer continental shelf (OCS) wildcat auctions that were (and still are) organized by the department of the interior of the US. Those auctions are interesting to study for two different reasons. First, they started in 1954 and a lot of bidding and drilling data is available about them. This allows me to check whether the existing evidence conforms with theoretical predictions. Second, bidding strategies in those auctions feature trade-offs that have not yet been analyzed. To illustrate this second point, I next explain some institutional features which are most relevant for understanding the game I will study and which motivate some of my modelling assumptions.

## 1.1 Some institutional features

In this paper I focus on wildcat tracts. Such a tract is situated in an offshore geographical area where no exploratory drilling has occurred in the past. Tracts that are situated next to already developed ones are called drainage tracts. Hendricks and Porter (1988) showed that firms possess an informational advantage over the value of a neighboring tract. In contrast, no firm should possess superior information about the value of a wildcat tract.

At the start of the auction process, firms express their desire to drill in some geographical area of the outer continental shelf. The US government then organizes an auction in which a huge number of tracts (situated in the desired area) are simultaneously offered for sale. A tract covers an area not exceeding 5,760 acres ( $\pm 23.3km^2$ ). Firms then bid on a small subset of the tracts offered for sale. For example, between 1998 and 2005 (inclusive) the US government organized

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<sup>1</sup>For example, between 1954 and 2004 the US Government collected around 159 billion dollars solely from auctioning off their offshore oil and gas tracts (Source: [www.mms.gov/ld/PDFs/GreenBook-LeasingDocument.pdf](http://www.mms.gov/ld/PDFs/GreenBook-LeasingDocument.pdf)).

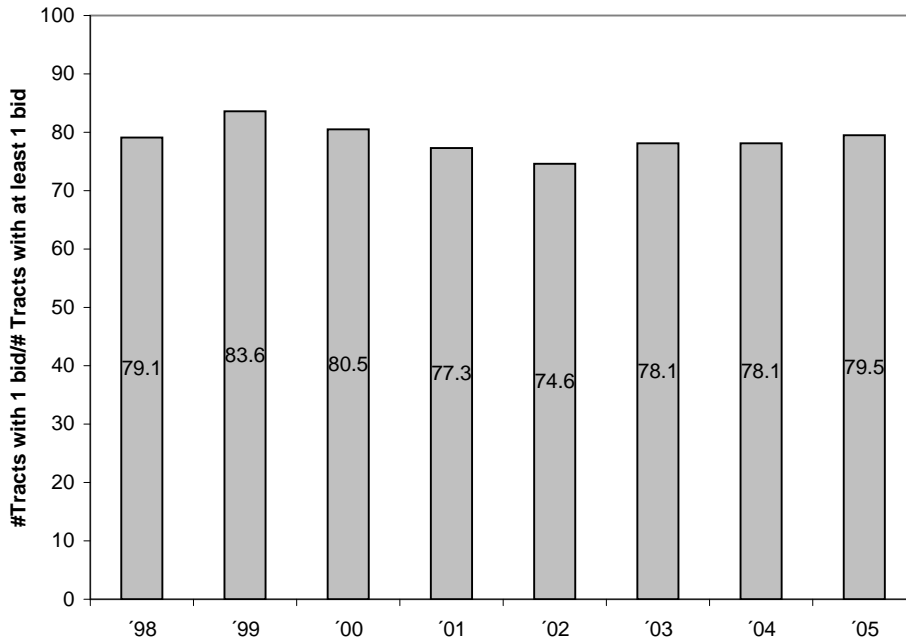


Figure 1: Solo Bidding in OCS Auctions

22 such auctions. On average 3,145 tracts were offered in each one of them.<sup>2</sup> On average only 305 of them received at least one bid.<sup>3</sup> Hence, in those auctions the number of tracts offered for sale by far exceeds total demand. As a result of this, few of the tracts offered for sale receive more than one bid. To illustrate this point consider Figure 1. The Figure reveals that between 1998 and 2005 (inclusive),  $\Pr(\text{tract } i \text{ receives only one bid} | \text{tract } i \text{ receives at least one bid})$  always exceeded 74%.<sup>4</sup>

Firms submit a bid for each tract they are interested in acquiring. A bid is a dollar figure that the firm has to pay if she wins the tract. Firms submit their bids simultaneously. If a tract happens to possess only one bid then the US government decides whether or not to reject the bid. To do so, it estimates the “fair market value” of the tract. Henceforth, this fair-market-value estimate will be called the (government’s) reservation price. A tract which received only one bid is sold if the bid exceeds the reservation price. The reservation price is computed after all bids were submitted. It may depend on rivals’ bids (on other tracts) as well as on information

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<sup>2</sup>Observe, however, that not all those 3,145 tracts were wildcat ones. Some tracts were drainage tracts. Some tracts may have been re-offered for sale as the past owner of the tract let his lease expire without drilling any well (those ones are called development tracts).

<sup>3</sup>Source: own computations based on data taken from <http://www.mms.gov/econ/EconDiv.htm>.

<sup>4</sup>Solo bidding, however, has not always been the norm in OCS auctions. In particular, Hendricks, Porter and Boudreau (1987) documented that  $\Pr(\text{tract } i \text{ receives only one bid} | \text{tract } i \text{ receives at least one bid})$  was approximately 32% for wildcat auctions held during the period 1954-1969.

that only became public after the auction took place. Hence, ex-ante bidders don't know what the realization of the reservation price will be. This insight, combined with my earlier finding that few tracts receive more than one bid, indicate that a player's bidding strategy is primarily determined by her desire to "beat" the reservation price rather than to "beat" a hypothetical competing bid. So far, only Hendricks, Porter and Spady (HPS, 1989) analyzed the government's rejection decision on offshore tracts. They focussed on drainage and development tracts that were sold during the period 1959 - 1979. Unfortunately, wildcat tracts were not included in their sample. They found that the rejection decision on drainage tracts was positively correlated with a tract's size, with the average wellhead price of offshore oil and with the identity of the highest bidder (i.e. the government was more likely to reject a given high bid submitted by a neighbor firm than by a non-neighbor one). The rejection decision was also negatively correlated with the value of the highest bid. The decision, however, was *not* significantly correlated with the amount of oil extracted nor with the bidding history of the neighboring tract. As the reservation price on drainage tracts did not depend on the expected quantity of oil, there is no reason to assume that the contrary situation would prevail on wildcat tracts (where no oil from neighboring tracts was ever extracted). After firms submitted their bids, but before the first drilling date, the government releases the identity of all bidders along with their bids.

After winning her tract, a firm is given five years to initiate an exploratory drilling program. If after five years she has not drilled her tract, her lease expires and the tract is returned to the government which may decide to resell it in some future auction. The tracts are usually smaller than the size of the deposits. For example, Lin (2007) documents that the largest petroleum field in the Gulf of Mexico spans 23 tracts. Depending on water depth, 57% to 67% of all productive tracts had to share their deposits with at least one neighboring firm. Furthermore the costs of drilling an exploratory well are not trivial. According to Zampelli (2000) in 1996 the average exploratory well had a depth of 11,203 feet (3,414 meters) and cost 3.3 million USD. This cost dramatically increases with well depth: A 15,000 feet (4,572 meters) exploratory well cost 10 million USD.

Given those facts, one would expect firms to play a waiting game, i.e. a firm has an incentive to postpone her exploratory drilling in the hope that her neighbor drills first. This plausible strategic behavior is not inconsistent with the available empirical evidence. Hendricks and Porter (1996)<sup>5</sup> documented that the hazard rate of drilling (i.e. the probability to drill at time  $t$  given that the tract has not been drilled before) features a U-shaped pattern. A tract is most likely to be drilled at the start or at the end of her lease term. In years 2, 3 and 4, however, the hazard

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<sup>5</sup>Henceforth, HP will be used instead of Hendricks and Porter (1996).

rate is significantly lower. If a firm drills her tract during the final year of her lease, this indicates that she must hold sufficiently optimistic beliefs about her prospects of finding oil. The fact that she postponed her drilling decision indicates that there was a positive option value of waiting. A plausible explanation behind this option value of waiting is that the firm hoped to learn from her neighbor’s drilling outcomes. Furthermore, HP also found that the probability to drill during the second and the third year of the lease term is positively influenced by the number of past successful drilling outcomes.

## 1.2 Summary of my results and relation to the literature

Studying strategic behavior in this context is thus a delicate matter as players behave strategically both during as after the auction.<sup>6</sup> To analyze the interaction between bidding and drilling I develop the following two-stage game: In the first stage player one bids on tract one while player two bids on tract two. Both players choose their bids to “beat” the random reservation price. The higher a player’s bid, the higher the probability that her bid will exceed the reservation price. In case both players won their tracts, they play a waiting game to determine who will drill first. Prior to the waiting game, but after the bidding stage, the seller discloses bids. I focus on the class of the strongly symmetric strategies. To understand this class, observe that — typically — the waiting game is characterized by three different continuation equilibria. In the first one, player one drills while player two waits. In the second one, player two drills while player one waits. Finally, in the third one both players play a mixed strategy Nash equilibrium. Bluntly stated, a strongly symmetric strategy is a symmetric strategy with the added restriction that if the two players possess the same posterior at the start of the waiting game, they focus on the mixed-strategy Nash equilibrium. This class of strategies describes best the existing empirical evidence (see HP for a detailed defense of this class of strategies in this context). See also Section 3 for a discussion on how my model fits the existing empirical evidence.

In section 2, I analyze equilibrium behavior. I first show that there exist equilibria in which an optimist (i.e. a player who possesses favorable private information) bids “high” (with probability one) as she wants to secure the purchase of the tract. A pessimist (i.e. a player who possesses unfavorable private information) faces the following trade-off: If she bids “low” she might buy her tract “cheaply” but her low bid also makes her neighbor less “optimistic”. This, in turn, reduces the probability that her neighbor will drill (and thus hampers her free-riding opportunities).

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<sup>6</sup>Milgrom and Weber (1982) and Hendricks, Porter and Tan (2007) have developed models that shed some light on how players bid in those auctions. Ausubel, Cramton and Milgrom (2006) argue that a clock-proxy auction may be the most adequate auction format in this setting. Those three papers, however, do not study the interaction between bidding and drilling.

Depending on the values of the parameters she either prefers to bid “high” (in which case there exists a pooling or a semi-separating equilibrium) or she prefers to bid “low” (in which case there exists a separating equilibrium). Next, I also show that there exists a semi-separating equilibrium in which pessimists bid low (with probability one), while optimists with some probability bid as if they have bad private information. To understand the intuition behind this equilibrium, suppose player 1 bid “high” while player 2 bid “low”. Suppose both players won their tracts. As a low bid may have been submitted both by an optimist and by a pessimist, both players do *not* possess the same posterior at time one. Hence, they do not have to drill with the same probability. I then assume that both players focus on a continuation equilibrium in which player 1 drills while player 2 waits. Hence, in this equilibrium an optimist faces the following trade-off: If she bids “low”, she reduces her probability of winning the tract. Conditional upon winning, however, she increases the probability that she will free-ride on her neighbor’s drilling cost. In equilibrium the probability with which an optimist bids low is chosen to balance its advantage with its disadvantage. Finally, I provide sufficient conditions for uniqueness within the class of the strongly symmetric strategies.

In section 3, I argue that the semi-separating equilibrium in which optimists randomize between bidding low and bidding high, explains best the existing empirical evidence. I also contrast my explanation with the one provided by HP. In section 4, I compare expected revenues if players focus on the semi-separating equilibrium (in which optimists randomize between bidding low and bidding high) with the ones if players were to focus on the separating equilibrium instead. I show that in the semi-separating equilibrium pessimists bid more aggressively than in the separating one. This is intuitive: a pessimist knows that her neighbor is more likely to drill in the former equilibrium. This increases her valuation of the tract (and thus also her bid). I show that the increase in the pessimist’s bid may exceed the expected reduction in the optimist’s bid. Hence, the semi-separating equilibrium (in which optimists with some probability bid low) increases efficiency (as it increases the ex ante probability of sequential drilling) and need not result in a reduction in expected revenues.

This is not the first paper to analyze an auction as part of a larger market interaction. Haile (2000), considers a game in which players can resell after the auction took place. Jehiel and Moldovanu (2000) and Goeree (2003) analyze an auction followed by some downstream interaction among all players. In contrast to this paper, downstream interaction is not modelled explicitly. Instead they take a reduced-form approach in which player  $i$ ’s payoff depends on the outcome of the auction.<sup>7</sup> Das varma (2003) models post-auction (Bertrand and Cournot)

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<sup>7</sup>In Goeree a player’s payoff depends (i) on whether she won the object or not, (ii) on her true type and (iii)

competition explicitly and obtains essentially the same results as Goeree (2003). Arozamena and cantillon (2004) analyze incentives to invest in a cost reducing technology prior to a procurement auction. Burguet and McAfee (2005) analyze a model with budget constrained bidders and in which the auction stage is also followed by Cournot competition. Haile, Goeree and Das Varma find that — in the presence of post-auction interaction — it becomes harder to obtain a separating equilibrium because of signaling considerations at the bidding stage. In contrast to my paper, all three papers restrict attention to separating equilibria. Furthermore, Jehiel and Moldovanu and Goeree assume that the payoff function is differentiable in players' types (or in a player's perceived type). This assumption seems reasonable if one thinks of either Cournot or Bertrand competition as the (implicit) post-auction interaction. In this paper, however, after the auction players engage in a battle-of-the-sexes game which typically possesses three different equilibria. I then show that, even if one restricts attention to the class of the strongly symmetric strategies, bids may select a continuation equilibrium in which one player waits while the other one drills. Hence, depending on the selected equilibrium, my payoff function is not continuous in bids: If player  $i$  bids below a certain threshold (and wins her tract), her payoff jumps upwards. Finally, Avery (1998) studies an English auction in which players "jump bid" to signal that their valuations lie above some threshold level and to select an asymmetric continuation equilibrium. I show that bidders in OCS auctions behave similarly: In one semi-separating equilibrium a low bid (partly) signals a low valuation and selects an equilibrium in which the high bidder drills while the low bidder waits.

## 2 The Model

### 2.1 The general set-up

Two risk-neutral players are interested in acquiring one of two adjacent offshore tracts. The seller offers them in two simultaneous first price auctions. Each of the players bid in one of the two auctions.<sup>8</sup> The value of both tracts depends on the realized state of the world. In

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on her perceived type in the post-auction game. Jehiel and Moldovanu consider a two-player set-up in which the payoff from not winning the object depends on both players' types (the winning bidder's payoff only depends on her type). They also assume that a player's type becomes common knowledge after the auction.

<sup>8</sup>Implicitly, I am making two assumptions here. First, I assume that bidders have unit demand. Second, I assume that there is only one bidder per tract. The first assumption can be defended on the grounds that firms may not want to bid on all the tracts offered for sale (remind that in the period 1998 – 2005 on average 3,145 tracts were simultaneously offered for sale!) either because of bidding constraints, or because of a bottleneck in the supply of drilling rigs or because of risk-aversion. None of those reasons, however, are explicitly modeled here.

particular, I assume that the state of the world is either high ( $H$ ) or low ( $L$ ). If the state of the world is high (low), then the value of the oil (underneath both tracts) is equal to one (zero). The probability that the state of the world is high is equal to  $\frac{1}{2}$ . The reservation price of the seller,  $r \sim U[0, 1]$ .<sup>9</sup> Both tracts possess the same reservation price. Both players possess an informative, but imperfect signal concerning the realized state of the world. Formally, if the state of the world is  $H$ , a player receives signal  $h$  with probability  $p \in (\frac{1}{2}, 1)$ , and signal  $l$  with probability  $(1 - p)$ . Similarly, if the state of the world is  $L$ , a player receives signal  $h$  with probability  $(1 - p)$ , and signal  $l$  with probability  $p$ . Signals are (conditionally) independent. I denote the common drilling cost by  $c$ . A tract is called marginal if  $\frac{1}{2} < c < p$ . A tract is called non-marginal if  $1 - p < c < \frac{1}{2}$ .

After players submitted their bids, but before players decide to drill or not the seller (government) discloses both player's bids. Players discount the future at a rate  $\delta < 1$ . I assume that

ASSUMPTION 1  $1 - p < c < p$ .

The assumption implies that a player who received signal  $h$  is - a priori - willing to drill ( $\Pr(H|h) = p > c$ ), and that a player who received a signal  $l$  is a priori not willing to drill ( $\Pr(H|l) = 1 - p < c$ ). Henceforth, I call a player who received a high (low) signal an optimist (pessimist).<sup>10</sup> I consider the following sequencing of events:

-1 Nature draws the state of the world, the reservation price and players receive their signals.

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Next, because of the information externality, a firm's valuation of a particular tract is nondecreasing in the number of neighboring tracts she wins in the auction. Remind, however, that I study how the information externality at the drilling stage affects bidding behavior (and vice versa). Introducing supermodular utility functions in the analysis would therefore unnecessarily complicate matters. The second assumption is consistent with the recent US experience as shown in Figure 1. Moreover, my main result (that bids are used as a coordination device) should not hinge on this assumption.

<sup>9</sup>This assumption can best be understood as follows: suppose the quantity of oil (underneath both tracts),  $Q \in \{0, 1\}$ . The (nominal) value of the oil is equal to  $PQ$ , where  $P$  denotes the price of oil. Hence, the real value of the oil is either equal to zero or equal to one. Furthermore, suppose the (nominal) reservation price,  $R = f(P) + \epsilon$ , where  $\epsilon \sim U[\underline{\epsilon}, \bar{\epsilon}]$  and where  $f$  denotes an arbitrary function. This is consistent with the empirical findings of HPS which showed that the government's rejection decision was not correlated with any variable other than (i) the tract size, (ii) the winning bid, (iii) the identity of the winning bidder and (iv) the price of oil. In my model both tracts have the same size and both bidders do not own a neighboring tract. Perform the following normalizations:  $r \equiv \frac{R}{P}$ ,  $\underline{\epsilon} \equiv -f(P)$  and  $\bar{\epsilon} \equiv P - f(P)$ . Then  $r \sim U[0, 1]$ .

<sup>10</sup>Observe that in our model all players are Bayesian rational: optimists (pessimists) do not overestimate (underestimate) the probability that the state of the world is high. Hence, our definitions differ from the ones that are used by behavioral economists. However, these definitions are intuitive and should not confuse the reader.

0 Player one bids on tract one, player two bids on tracts two.

$\frac{1}{2}$  The auctioneer publicly announces all bids and whether they were higher or lower than the reservation price<sup>11</sup>

1 If player  $i$  won her tract, she decides whether to drill or wait.

2 In case player  $-i$  drilled, player  $i$  observes the state of the world. If player  $i$  waited, she decides whether to drill or not to drill.

3 Players receive their payoffs and the game ends.

## 2.2 Equilibrium

Let  $\mathbf{h}_t(t = 0, 1, 2)$  denote the history of the game at time  $t$ . Thus,  $\mathbf{h}_0 = \{\emptyset\}$ ,  $\mathbf{h}_1 = (b_i, b_{-i})$  and  $\mathbf{h}_2 = (h_1, a_{i,1}, a_{-i,1}, \xi)$  where  $a_{i,1} \in \{drill, wait\}$  represents player  $i$ 's time-one action and  $\xi = \{\emptyset\}$  if  $a_{i,1} = a_{-i,1} = wait$  and is equal to the state of the world if at least one of the two players drilled at time one.  $H_t$  denotes the set of all possible histories at time  $t$ . Let  $H \equiv \bigcup_{t=1}^2 H_t$ . A symmetric behavioral strategy is a  $(\beta, \lambda)$  where  $\beta : \{h, l\} \rightarrow \Delta[0, 1]$  and  $\lambda : \{h, l\} \times H \rightarrow [0, 1]$ .  $\beta(s_i)$  represents a distribution function over player  $i$ 's possible bids.  $\lambda(s_i, \mathbf{h}_1)$  and  $\lambda(s_i, \mathbf{h}_2)$  represent the probabilities with which player  $i$  will respectively drill at times one and two. If  $r > b_i$  (i.e. if player  $i$  does not own tract  $i$ ), then player  $i$  can never drill and, thus,  $\lambda(s_i, \mathbf{h}_1) = \lambda(s_i, \mathbf{h}_2) = 0$ . A player can only drill once. Therefore,  $\lambda(s_i, \mathbf{h}_2) = 0$  if  $a_1^i = drill$ .

When solving my game, I rely on two equilibrium selection criteria. First, I require a candidate equilibrium to belong to the class of the perfect Bayesian equilibria. In a perfect Bayesian equilibrium (PBE) strategies and beliefs (concerning the other player's type) must be such that (i) player  $i$  cannot gain by choosing a  $\beta \neq \beta^*$  and a  $\lambda \neq \lambda^*$  given her beliefs and (ii) beliefs must be computed using Bayes's rule whenever possible. I define a separating equilibrium as a PBE in which a pessimist bids  $b_l$  with probability one while an optimist bids  $b_h$  ( $\neq b_l$ ) with probability one. In such an equilibrium player  $i$  can infer player  $-i$ 's signal out of her bid. A pooling equilibrium is a PBE in which both types bid the same amount with probability one. In such an equilibrium bids have no informational content and do not affect posteriors. A semi-separating equilibrium is a PBE in which one type bids  $y$  with probability one, while the other type randomizes her bid between  $z$  ( $\neq y$ ) and  $y$ .

Second, I restrict attention to the class of the *strongly symmetric* strategies. A strategy is said to be strongly symmetric if it is symmetric and if a player who believes that her rival

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<sup>11</sup>If the reservation price was made public, players could coordinate their drilling decisions on the basis of its realization. In this paper I abstract from this more sophisticated behavior.

possesses the same time-one posterior as herself, computes her time-one drilling probability under the assumption that her rival will drill with the same probability as herself. To illustrate this restriction, suppose beliefs are updated under the assumption that optimists always bid  $y$  while pessimists always bid  $z$  ( $\neq y$ ). Suppose player one is an optimist while player two is a pessimist. Suppose player one bids  $y$  while player two bids  $z$ . At time one, player one's posterior ( $= \Pr(H|h, b_2 = z)$ ) is then equal to the one of player two ( $= \Pr(H|l, b_1 = y)$ ). As both players possess different private information, a symmetric strategy does not put any restriction on their time-one drilling behavior.<sup>12</sup> However, as both players possess the same time-one posterior, a strongly symmetric strategy prescribes them to drill at time one with the same probability.

Observe that some  $\lambda^*(\cdot)$ 's are easy to compute. For example, suppose  $b_{-i} < r < b_i$ . Then, player  $i$  knows that player  $-i$  will never drill. In that case  $\lambda^*(s_i, \mathbf{h}_1) = 1$  if and only if  $\Pr(H|s_i, b_{-i}) \geq c$ . Similarly, suppose player  $i$  owns her tract and that she did not drill at time one. Her time-two equilibrium drilling probabilities are then also easy to compute. For, at time two  $\xi$  is either equal to the state of the world or it is equal to the empty set. In the former case  $\lambda^*(s_i, \mathbf{h}_2) = 1$  if and only if the state of the world is high. In the latter case,  $\lambda^*(s_i, \mathbf{h}_2) = 1$  if and only if  $\Pr(H|s_i, \mathbf{h}_2) \geq c$ . Therefore, from now on I restrict attention to computing optimal bidding and time-one drilling decisions when both players own their tracts. With a slight abuse of notation, let  $\lambda(s_i, b_i, b_{-i})$  denote player  $i$ 's time-one drilling probability given her signal, her bid, her neighbor's bid, and *given that both players own their tracts*.

### 2.3 Equilibrium behavior in the waiting game

In this subsection, I compute equilibrium behavior in the waiting game for a variety of exogenously given bidding strategies. In the next subsection, I endogenize bidding behavior. The analysis in this subsection is not original. In particular, Hendricks and Kovenock (1989) already analyzed a waiting game in the context of oil exploration. Similarly, Chamley and Gale (1994) analyzed a waiting game when the state of the world is known after all players chose their actions. I therefore decided not to include all the proofs of this subsection in this paper. They are, however, available upon request.

Let  $W(s_i, b_i, b_{-i})$  denote player  $i$ 's undiscounted gain of waiting, given her signal and both players' bids. Formally,

$$\begin{aligned} W(s_i, b_i, b_{-i}) &= \Pr(H, a_{-i,1} = \text{drill} | s_i, b_i, b_{-i})(1 - c) \\ &\quad + \Pr(a_{-i,1} = \text{wait} | s_i, b_i, b_{-i}) \max\{0, \Pr(H | s_i, b_{-i}, a_{-i,1} = \text{wait}) - c\}. \end{aligned} \tag{1}$$

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<sup>12</sup>Remember that a strategy is symmetric if players with identical private information who face identical histories behave in an identical way.

**Lemma 1** *Suppose  $(\lambda'(h, b_i, b_{-i}), \lambda'(l, b_i, b_{-i})) \ll (\lambda''(h, b_i, b_{-i}), \lambda''(l, b_i, b_{-i}))$ . Then*

$$W(s_i, b_i, b_{-i}; (\lambda(h, \cdot), \lambda(l, \cdot))) = (\lambda'(h, \cdot), \lambda'(l, \cdot)) < W(s_i, b_i, b_{-i}; (\lambda(h, \cdot), \lambda(l, \cdot))) = (\lambda''(h, \cdot), \lambda''(l, \cdot))$$

Lemma 1 is intuitive: the higher  $(\lambda(h, \cdot), \lambda(l, \cdot))$ , the greater the probability that player  $-i$  will drill and, thus, the greater the probability that player  $i$  will free-ride on her neighbor's drilling cost.

**PROPOSITION 1** *Suppose optimists bid  $b_h$  with probability 1 while pessimists bid  $b_l$  with probability 1 ( $b_l < b_h$ ). Suppose both players won their tracts. Then, there exists a unique continuation equilibrium in which player  $i$  drills with probability*

$$\lambda^*(s_i, b_i, b_{-i}) = \min \left\{ 1, \max \left\{ 0, \frac{(1 - \delta)(\Pr(H|s_i, b_{-i}) - c)}{\delta \Pr(L|s_i, b_{-i})c} \right\} \right\}. \quad (2)$$

*Proof:* As bids perfectly reveal a player's type, both players possess the same posterior at time one. Suppose time-one posteriors are such that

$$0 \leq \Pr(H|s_i, b_{-i}) - c < \delta W(s_i, b_i, b_{-i}; \lambda(\cdot) = 1). \quad (3)$$

The last inequality implies that if player  $i$  expects player  $-i$  to drill with probability 1, it is a best reply for her to wait. My game then possesses three different continuation equilibria. In the first one, player one drills, while player two waits. In the second one, player two drills while player one waits. In the third one, player  $i$  drills with probability  $\lambda^*(\cdot)$  in order to make player  $-i$  indifferent between drilling and waiting. As I focus on the class of the strongly symmetric strategies, I assume that the mixed-strategy Nash equilibrium is played in the continuation game. As bids perfectly reveal a player's type, player  $i$  does not learn anything (about  $s_{-i}$ ) upon observing player  $-i$ 's time-one action. Hence, in this case equation 1 boils down to

$$\begin{aligned} W(s_i, b_i, b_{-i}) &= \Pr(H, a_{-i,1} = \text{drill}|s_i, b_{-i})(1 - c) \\ &\quad + \Pr(a_{-i,1} = \text{wait}|s_i, b_{-i})(\Pr(H|s_i, b_{-i}) - c) \\ &= \Pr(H|s_i, b_{-i}) - c + \Pr(L, a_{-i,1} = \text{drill}|s_i, b_{-i})c \end{aligned} \quad (4)$$

Player  $i$  is indifferent between drilling and waiting if  $\Pr(H|s_i, b_{-i}) - c = \delta W(s_i, b_i, b_{-i})$ . Replacing  $W(\cdot)$  by the right-hand side of 4, this indifference equation can be rewritten as

$$(1 - \delta)(\Pr(H|s_i, b_{-i}) - c) = \delta \Pr(L, a_{-i,1} = \text{drill}|s_i, b_{-i})c. \quad (5)$$

The left-hand side of this last equality represents player  $i$ 's expected discounting cost of waiting. The right-hand side represents her expected benefit of waiting: if she waits, with probability  $\Pr(L, a_{-i,1} = \text{drill}|s_i, b_{-i})$  she will realize that there is no oil. She will then not drill at

time two and, from a time-one perspective, save  $\delta c$ . Replacing  $\Pr(L, a_{-i,1} = \text{drill} | s_i, b_{-i})$  by  $\Pr(L | s_i, b_{-i}) \lambda^*(\cdot)$ , equation 5 boils down to  $\lambda^*(\cdot) = \frac{(1-\delta)(\Pr(H | s_i, b_{-i}) - c)}{\delta \Pr(L | s_i, b_{-i}) c}$ .<sup>13</sup>

If  $\Pr(H | s_i, b_{-i}) < c$ , drilling yields a negative expected payoff and  $\lambda^*(s_i, b_i, b_{-i}) = 0$  (as stated in the Proposition). It follows from 5 that

$$\begin{aligned} \delta W(s_i, b_i, b_{-i}; \lambda(\cdot) = 1) &\leq \Pr(H | s_i, b_{-i}) - c \\ \Leftrightarrow (1 - \delta)(\Pr(H | s_i, b_{-i}) - c) &> \delta \Pr(L | s_i, b_{-i}) c \end{aligned}$$

This case prevails when the discount factor is very low. Player  $i$  then prefers to drill even if her neighbor were to drill with probability one. Therefore in this case  $\lambda^*(s_i, b_i, b_{-i}) = 1$  (as stated in the Proposition). ■

**PROPOSITION 2** *Suppose both tracts are marginal ones. Suppose optimists bid  $b_h$  with probability 1 while pessimists bid  $b_h$  with probability  $x \in (0, 1]$  and  $b_l (< b_h)$  with probability  $1 - x$ . There exists then a unique continuation equilibrium in which  $\lambda^*(l, b_i, b_{-i}) = 0$ ,  $\lambda^*(h, b_i, b_l) = 0$  and  $\lambda^*(h, b_h, b_h) \in (0, 1]$ .*

The proposition states a.o. that a pessimist does not drill at time one. This is intuitive: as both tracts are marginal ones, even if a pessimist learns that her neighbor possesses a favorable signal, drilling at time one would still result in a negative expected payoff. Hence, if both tracts are marginal ones a pessimist only drills at time two in case her neighbor found oil at time one. The proposition also states that if a pessimist bids low, no one ever drills. This is also intuitive: Player  $i$ 's knowledge that her neighbor possesses signal  $l$ , leads to a downward revision of her posterior probability of finding oil. As both tracts are marginal ones, the cost of drilling now exceeds its expected gain and no one drills. As no new information is produced at time one, no drilling takes place at time two either.

More interestingly, suppose player  $i$  is an optimist and that her neighbor submitted a high bid. Player  $i$ 's gain of drilling then becomes  $\Pr(H | s_i = h, b_{-i} = b_h) - c$ , which is positive as  $\Pr(H | s_i = h, b_{-i} = b_h) \geq \Pr(H | h) > c$ . Observe that, if player  $-i$  is an optimist she possesses the same time-one posterior as player  $i$ . In a symmetric equilibrium, both players must drill with the same probability. On the basis of the intermediate value theorem, one can show that there exists a unique  $\lambda^*(h, b_h, b_h)$ . The intuition is similar to the one I explained above: If  $\delta$  is “low”,  $\lambda^*(h, b_h, b_h) = 1$  as the cost of waiting outweighs any gain of waiting. If  $\delta$  is not “low”, player  $i$  chooses  $\lambda^*(h, b_h, b_h)$  such as to make player  $-i$  indifferent between drilling and waiting provided that  $s_{-i} = h$ .

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<sup>13</sup>It follows from the inequalities stated in 3 that this probability  $\in [0, 1)$ .

PROPOSITION 3 *Suppose both tracts are not marginal ones. Suppose pessimists bid  $b_l$  with probability one, while optimists bid  $b_h$  ( $> b_l$ ) with probability  $x \in (0, 1)$  and  $b_l$  with probability  $1 - x$ . Suppose also that  $\delta \Pr(L|h, h)c > (1 - \delta)(\Pr(H|h, h) - c)$ . Then there exists a continuation equilibrium in which pessimists always wait. If player  $i$  is an optimist and if  $(b_i, b_{-i}) = (b_l, b_h)$ , then player  $i$  waits while player  $-i$  drills at time one. If  $(b_i, b_{-i}) = (b_h, b_h)$ , both players drill at time one with probability  $\lambda^*(h, b_h, b_h) = \frac{(1-\delta)(\Pr(H|h, h) - c)}{\delta \Pr(L|h, h)c}$ . If  $(b_i, b_{-i}) = (b_l, b_l)$ , player  $i$  drills at time one with probability*

$$\lambda^*(h, b_l, b_l) = \min \left\{ 1, \frac{(1 - \delta)(\Pr(H|h, b_l) - c)}{\delta \Pr(s_{-i} = h|h, b_l) \Pr(L|h, h)c} \right\}.$$

I first explain the case in which both players submitted a high bid. As a high bid is only submitted by an optimist, this implies that both players possess signal  $h$  (and thus face a positive gain of drilling). As before, there exists a  $\lambda^*(h, b_h, b_h) = \frac{(1-\delta)(\Pr(H|h, h) - c)}{\delta \Pr(L|h, h)c}$  which makes both players indifferent between drilling and waiting.<sup>14</sup>

Suppose now that both players submitted a low bid. If player  $i$  is a pessimist, she computes  $\Pr(H|l, b_l) \leq \Pr(H|l) < c$ . As drilling yields a negative expected payoff, she waits. If player  $i$  is an optimist, she computes  $\Pr(H|h, b_l)$ . Observe that

$$\Pr(H|h, b_{-i} = b_l) \geq \Pr(H|s_i, b_{-i} = b_l, a_{-i,1} = \text{wait}) \geq \Pr(H|h, l) = \frac{1}{2} > c.$$

The inequalities above are intuitive: as both tracts are not marginal ones, player  $i$  faces a positive gain of drilling at time two when her neighbor submitted a low bid and did not drill at time one. This also implies that she faces a positive gain of drilling at time one. As a low bid can come both from an optimist as from a pessimist, at time one player  $i$  is still unsure about player  $-i$ 's type. Suppose player  $-i$  drills with probability one (provided she is an optimist). Player  $i$  then prefers to wait (if and only if)

$$\begin{aligned} \Pr(H|h, b_l) - c &< \delta \Pr(s_{-i} = h|h, b_{-i} = b_l) \Pr(H|h, h)(1 - c) \\ &\quad + \delta \Pr(s_{-i} = l|h, b_{-i} = b_l) (\Pr(H|h, l) - c) \\ \Leftrightarrow (1 - \delta)(\Pr(H|h, b_l) - c) &< \delta \Pr(s_{-i} = h|h, b_l) \Pr(L|h, h)c. \end{aligned} \tag{6}$$

Despite my restriction on  $\delta$  (stated in the Proposition) the above inequality need not be satisfied. To see this, suppose  $x$  is very high. In that case it is very unlikely that a low bid was submitted by an optimist. Hence, even if player  $i$  anticipates that player  $-i$  will drill with probability one (provided  $s_{-i} = h$ ), the above inequality may be violated due to the fact that  $\Pr(s_{-i} = h|h, b_{-i} = b_l)$  is very low. In that case, there exists a unique continuation equilibrium in which

<sup>14</sup>This probability is  $\in (0, 1)$  as  $\delta \Pr(L|h, h)c$  is assumed to be greater than  $(1 - \delta)(\Pr(H|h, h) - c)$ .

player  $i$  drills with probability one (as stated in the Proposition). In case inequality 6 is satisfied, there exists a unique symmetric continuation equilibrium in which player  $i$  drills with probability  $\frac{(1-\delta)(\Pr(H|h,b_i)-c)}{\delta \Pr(s_{-i}=h|h,b_i) \Pr(L|h,h)c}$  (as stated in the Proposition).

Suppose now that player  $i$  submitted a high bid, while player  $-i$  submitted a low one. As the tract is not a marginal one, player  $i$ , despite observing that  $b_{-i} = b_i$ , still faces a positive gain of drilling. Player  $-i$  knows this. As  $x \in (0, 1)$ , both players do *not* possess the same time-one posterior, and thus are not required to drill at time one with the same probability.<sup>15</sup> This insight, combined with the assumption that  $\delta \Pr(L|h, h)c > (1 - \delta)(\Pr(H|h, h) - c)$  implies that, within the class of the strongly symmetric strategies, there exists a continuation equilibrium in which player  $i$  drills at time one and in which player  $-i$ , independently of her signal, waits. In essence, in this continuation equilibrium the right to free-ride is allocated to the low bidder.

## 2.4 Equilibrium bidding behavior

In this section players choose their bids optimally, correctly anticipating how they will affect equilibrium play in the waiting game.

PROPOSITION 4 *If signals are sufficiently precise or if  $\delta$  is sufficiently high or if  $\delta$  is sufficiently low, there exists an equilibrium in which player  $i$  bids*

$$b_i^* = \frac{1}{2} \sum_{s_{-i}} \Pr(s_{-i}|s_i) \max\{\Pr(H|s_i, s_{-i}) - c, 0\}. \quad (7)$$

Moreover, if either signals are sufficiently precise or if both tracts are marginal and  $\delta$  sufficiently small, this equilibrium is unique.

Observe that equation 7 implies that a pessimist submits a lower bid than an optimist. The proposition therefore provides sufficient conditions for the existence and uniqueness of a separating equilibrium. I now explain the intuition behind the three conditions which guarantee the existence of a separating equilibrium. Call  $b_{i,s}^*$  the bid of a pessimist in a separating equilibrium. Call  $b_{h,s}^*$  the bid of an optimist in a separating equilibrium. Let  $E_1(U|s_i, b_i, b_{-i})$  denote player  $i$ 's expected utility conditional on her signal, her bid, her neighbor's bid, conditional on owning the tract and net of bidding costs.<sup>16</sup> Let

$$E_{\frac{1}{2}}(U|s_i, b_i) \equiv \Pr(b_{-i} = b_{i,s}^*|s_i)E_1(U|s_i, b_i, b_{i,s}^*) + \Pr(b_{-i} = b_{h,s}^*|s_i)E_1(U|s_i, b_i, b_{h,s}^*).$$

<sup>15</sup>As a matter of fact, if player  $-i$  is an optimist who bid low, her posterior ( $=\Pr(H|h, b_i = b_h)$ ) is greater than the one of player  $i$ .

<sup>16</sup>Thus,  $E_1(U|s_i, b_i, b_{-i})$  is solely a function of  $(b_i, b_{-i})$  as it influences both players' incentives to drill. Observe, however, that  $E_1(U|\cdot)$  a priori also depends on whether player  $-i$  won her tract or not.

Finally, let  $E_0(U|s_i, b_i) \equiv \Pr(r < b_i)[E_{\frac{1}{2}}(U|s_i, b_i) - b_i]$  denote player  $i$ 's time-zero expected utility. Observe that, as  $r \sim U[0, 1]$ ,  $\Pr(r < b_i) = b_i$ .

To understand the existence (and non-existence) of a separating equilibrium, it is useful to consider first the hypothetical case in which signals instead of bids are revealed at time  $\frac{1}{2}$ . Suppose player  $i$  submits bid  $b_i$  and that she wins her tract. Either player  $-i$  also won her tract or player  $-i$  submitted a bid lower than the government's reservation price. In the latter case,  $E_0(U|s_i, b_i) = \max\{\Pr(H|s_i, s_{-i}) - c, 0\}$ . Suppose the former case prevails. As signals are revealed at time  $\frac{1}{2}$ , both players possess the same time-one posterior. As explained in my previous section, in a strongly symmetric equilibrium this implies that  $E_0(U|s_i, b_i)$  is also equal to  $\max\{\Pr(H|s_i, s_{-i}) - c, 0\}$ . At the start of time  $\frac{1}{2}$ , player  $i$  does not know player  $-i$ 's signal. Therefore,

$$E_{\frac{1}{2}}(U|s_i, b_i) = \sum_{s_{-i}} \Pr(s_{-i}|s_i) \max\{\Pr(H|s_i, s_{-i}) - c, 0\}.$$

Hence, at time zero player  $i$  chooses  $b_i$  to maximize  $b_i(E_{\frac{1}{2}}(U|s_i, b_i) - b_i)$ . This is a very simple strictly concave problem: if player  $i$  increases her bid, she increases her chances of winning her tract. This benefit, however, comes at a cost of having to put more money on the table. The solution to this maximization problem is given in 7.

Suppose now that bids instead of signals are disclosed and that both players focus on the candidate equilibrium in which players bid according to equation 7. I assume that an out-of-equilibrium bid is supposed to have been submitted by a pessimist (i.e.  $\Pr(s_i = l|b_i \notin \{b_{l,s}^*, b_{h,s}^*\}) = 1$ ). What are both types' incentives to deviate from this candidate equilibrium strategy?

Suppose  $s_1 = h$  and that she bids  $b_1 \neq b_{h,s}^*$ . Without loss of generality suppose both firms won their tracts. Player two then computes  $\Pr(H|s_2, b_1 \neq b_{h,s}^*) = \Pr(H|s_2, l)$ . If player two is a pessimist, she computes  $\Pr(H|l, b_1 \neq b_{h,s}^*) = \Pr(H|l, l) < 1 - p < c$ , and refrains from drilling at time one. Rationally anticipating this, player one gets  $\max\{\Pr(H|h, l) - c, 0\}$ . More interestingly, suppose player two is an optimist. Player two then computes  $\Pr(H|h, b_1 \neq b_{h,s}^*) = \Pr(H|h, l)$ . Player one, however, is now more "optimistic" than player two in the sense that her posterior ( $= \Pr(H|h, h)$ ) is greater than player two's. Furthermore, player two believes that player one possesses the same posterior as herself (even though this is not true). As I restrict attention to the class of the strongly symmetric strategies, she computes her drilling probability under the assumption that player one and herself play a mixed-strategy Nash equilibrium in the waiting game. It then follows from Proposition 1 that player two drills with probability  $\max\{0, \min\{1, \frac{(1-\delta)(\Pr(H|h,l)-c)}{\delta \Pr(L|h,l)c}\}\}$ . More importantly, in the Appendix I show that player one's gain of waiting then does not exceed her gain of drilling. The intuition is simple: player one, having observed a high bid from player two, became "very optimistic" about the prospect of

finding oil. For her “time is money” and she is only willing to postpone her drilling decision if player two drills with a “very high” probability. Player two, however, having observed that player one did not bid high, became much less confident about the prospect of finding oil. This dented her incentives to drill at time one. Hence, if player one deviates, at time one she gets  $\max\{\Pr(H|h, s_2) - c, 0\}$ , which is the same (time-one) payoff as the one she would have gotten had she not deviated. As the time-zero payoff function is strictly concave, player one strictly loses by submitting any bid different from  $b_{h,s}^*$ .

I now consider a pessimist’s incentives to deviate. Given my hypothesized out-of-equilibrium beliefs, she cannot gain by submitting a bid  $\neq b_{h,s}^*$ . Suppose she submits  $b_1 = b_{h,s}^*$ , that she wins her tract and that she waits.<sup>17</sup> Then, at time  $\frac{1}{2}$  her gain of waiting equals

$$\Pr(h|l) \left\{ \Pr(H|l, h) \lambda^*(h, b_{h,s}^*, b_{h,s}^*) \delta(1 - c) + (1 - \lambda^*(\cdot)) \delta \max\{\Pr(H|l, h) - c, 0\} \right\} \\ + \Pr(l|l) \left[ \Pr(H, r < b_{l,s}^* | s_1 = s_2 = l, r < b_{h,s}^*) \lambda^*(l, b_{l,s}^*, b_{h,s}^*) \delta(1 - c) \right]. \quad (8)$$

The two terms between curly brackets represent player one’s expected gain of waiting if player two is an optimist: With probability  $\Pr(H|l, h) \lambda^*(h, b_{h,s}^*, b_{h,s}^*)$  player two drills and finds oil in which case player one gets  $\delta(1 - c)$ . With probability  $(1 - \lambda^*(h, b_{h,s}^*, b_{h,s}^*))$  player two waits in which case player one gets  $\delta \max\{\Pr(H|l, h) - c, 0\}$ . The term between square brackets represents her expected gain of waiting if player two is a pessimist: With probability  $\Pr(r < b_{l,s}^* | r < b_{h,s}^*)$  player two then also wins her tract in which case player one’s high bid induces her to drill with probability  $\lambda^*(l, b_{l,s}^*, b_{h,s}^*)$ . With probability  $\Pr(H|l, l)$  player two then discovers oil which allows player one to obtain  $\delta(1 - c)$ . Suppose now that player one submits a low bid, that she wins her tract and that she waits. At time  $\frac{1}{2}$  her gain of waiting equals

$$\Pr(h|l) \left\{ \Pr(H|l, h) \lambda^*(h, b_{h,s}^*, b_{l,s}^*) \delta(1 - c) + (1 - \lambda^*(\cdot)) \delta \max\{\Pr(H|l, h) - c, 0\} \right\}. \quad (9)$$

To understand player one’s incentives to deviate, compare 8 with 9. Observe that in 9 an optimist drills with probability  $\lambda^*(h, b_{h,s}^*, b_{l,s}^*)$ , while in 8 she drills with probability  $\lambda^*(h, b_{h,s}^*, b_{h,s}^*)$ . Similarly, in 9, a pessimist does not drill at all, while in 8 she drills with probability  $\lambda^*(l, b_{l,s}^*, b_{h,s}^*)$ . It is easy to show that  $\lambda^*(h, b_{h,s}^*, b_{l,s}^*) \leq \lambda^*(h, b_{h,s}^*, b_{h,s}^*)$ . This is intuitive: by bidding  $b_{h,s}^*$ , player one succeeds to make her neighbor “more optimistic” about the prospect of finding oil. As explained in my previous section, this induces player two to drill with a (weakly) higher probability. It then follows from Lemma 1 that this (weakly) increases her gain of waiting.

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<sup>17</sup>Of course, it remains to be seen whether she would prefer to wait. It should, however, be obvious that player one’s gain of drilling is unaffected by her bid. To understand player one’s incentives to deviate, I can therefore restrict attention to how her bid affects her gain of waiting.

Submitting a high bid, however, also involves a cost: Player one may have to pay “a lot” of money for a piece of sea below which she thinks there is no oil! If signals are sufficiently precise, the difference between  $b_{h,s}^*$  and  $b_{l,s}^*$  is very big. Optimists are very confident that there is oil underneath the sea and are prepared to submit a “very high” bid to secure the purchase of the tract. Pessimists, however, are very skeptical concerning the probability of finding oil, and therefore refuse to bid as if they possess favorable private information (correctly anticipating that this will dent their neighbor’s incentives to drill). If  $\delta$  is low, player one has also little incentives to submit a high bid. For, any increase in her (undiscounted) gain of waiting (thanks to a higher probability of drilling) is then offset by the low discount factor. Perhaps more surprisingly, if  $\delta$  is high, player one has also little incentives to submit a high bid. To see this, consider equation 5. The equation teaches us that in equilibrium the discounting cost of waiting must balance the gain of waiting. If the discount factor is high, the opportunity cost of waiting is low (even if player two became “very optimistic” about the prospects of finding oil). Player two’s equilibrium drilling probability is then not very sensitive to her time-one posterior. This strongly reduces player one’s gain of bidding as if she had favorable private information. Hence, in all these cases there exists a separating equilibrium.

It is worth stressing that the three conditions guaranteeing existence of a separating equilibrium are not necessary ones. To see this, suppose signals are very imprecise and that player one is a pessimist. Suppose also that players focus on the separating equilibrium. As signals are imprecise,  $b_{h,s}^*$  and  $b_{l,s}^*$  (as computed in 7) are close to each other. Hence, player one’s cost of bidding as if she possesses favorable private information (i.e.  $b_{h,s}^* - b_{l,s}^*$ ) is low. Player one’s gain of submitting bid  $b_{h,s}^*$ , however, is also low. For, if signals are imprecise player two’s posterior (and thus also her drilling probability) is hardly influenced by her observation that player one bid “high”. One can find values of  $(p, c, \delta)$  (where  $p$  is sufficiently low), such that the benefit of bidding “high” is even lower than its cost.

In this paper I mainly focus on equilibria in which at most two different bids can be observed. Many more sophisticated equilibria (involving randomization over more than two bids) may also exist. Proposition 4 states two sufficient conditions under which I can safely rule those ones out (within the class of the strongly symmetric strategies). The logic behind the proof of this uniqueness result is straightforward. Consider candidate equilibrium strategies in which optimists and pessimists randomize their bids according to some distribution functions. Call  $\underline{b}_h$ , the lowest bid that can be submitted by an optimist in a candidate equilibrium strategy. Call  $\bar{b}_l$ , the highest bid that can be submitted by a pessimist in a candidate equilibrium strategy. It is easy to show that if signals are sufficiently precise (or if both tracts are marginal ones and if  $\delta$  is sufficiently small) in any candidate equilibrium  $\bar{b}_l < \underline{b}_h$ . This is intuitive: if signals are sufficiently precise an

optimist would never agree to submit a bid close to zero even if this guaranteed her the right to free-ride with probability one. In that case any bid will perfectly reveal a player's type. It then follows from the second paragraph following Proposition 4 that both players face a very simple (strictly) concave maximization problem, which possesses a unique equilibrium.

**PROPOSITION 5** *Suppose both tracts are marginal ones. Then, either there exists a separating or there exists a pooling equilibrium (in which both types bid  $b_{h,p}^* = \frac{1}{2}(p - c)$ ). The equilibrium, however, need not be unique. In particular, there exist values of  $(p, c, \delta)$  which support a separating, a pooling and a semi-separating equilibrium (in which optimists bid  $b_{h,\bar{s}\bar{s}}^* \in (b_{h,p}^*, b_{h,s}^*)$  while pessimists bid  $b_{h,\bar{s}\bar{s}}^*$  with probability  $x \in (0, 1)$  and zero with probability  $(1 - x)$ ).*

The proposition states a.o. that, as far as marginal tracts are concerned, existence of an equilibrium is always guaranteed. Unfortunately (though not surprisingly) the equilibrium need not be unique.

In a pooling equilibrium a pessimist bids as if she possesses favorable private information. This "high" bid, however, does not succeed to make her neighbor more optimistic about the prospect of finding oil. Nonetheless, it is optimal for her to bid  $b_{h,p}^*$ , because if she were to submit a different bid instead, this would reveal that she possesses unfavorable private information. As the tract is a marginal one, this would eliminate her neighbor's incentives to drill (and any hope she had to free-ride on her neighbor's drilling cost). An optimist cannot gain by deviating either: If she bids  $b_i \neq b_{h,p}^*$ , she destroys her neighbor's incentives to drill. It is then optimal for her to drill and  $E_1(U|h, b_1 \neq b_{h,p}^*, b_{h,p}^*) = p - c$ . If she bids  $b_i = b_{h,p}^*$  (and wins her tract), she engages in a war-of-attrition with her neighbor (which implies that  $E_1(U|h, b_{h,p}^*, b_{h,p}^*) = p - c$ ). Independently of her bid, her time-one payoff is thus equal to  $p - c$ . Correctly anticipating this, at time zero she maximizes  $b_1(p - c - b_1)$ , which possesses as unique solution  $b_1^* = \frac{1}{2}(p - c) \equiv b_{h,p}^*$ .

It follows from 7 and from Proposition 5 that if both tracts are marginal ones

$$b_{h,s}^* = \frac{1}{2} \Pr(h|h) [\Pr(H|h, h) - c], \text{ while } b_{h,p}^* = \frac{1}{2}(p - c).$$

Observe that

$$b_{h,p}^* = \frac{1}{2} (\Pr(H|h) - c) = b_{h,s}^* + \frac{1}{2} \Pr(l|h) [\Pr(H|h, l) - c].$$

As the tract is a marginal one,  $\Pr(H|h, l) = \frac{1}{2} < c$ . Hence, an optimist bids more aggressively in the separating than in the pooling equilibrium. This is intuitive: in the separating equilibrium an optimist learns her neighbor's signal through her bid. As the tract is a marginal one, this information is very valuable to her. For, if she were to find out that her neighbor is a pessimist, she would refrain from drilling and save  $c - \Pr(H|h, l)$ . Stated differently, the separating equilibrium provides an optimist with valuable information which increases her willingness to buy the tract

(and thus to bid more aggressively). Hence, there exist values of  $(p, c, \delta)$  which support multiple equilibria: If players focus on the separating equilibrium, optimists bid aggressively and thereby discourage a pessimist from submitting the same bid. On the other hand if an optimist anticipates that her neighbor will bid  $\frac{1}{2}(p - c)$  independently of her private information, she values the tract less, bids less aggressively and thereby encourages a pessimist to submit the same bid as hers.

In the Appendix, I show that some values of my exogenous parameters also support a semi-separating equilibrium in which optimists bid  $b_{h,ss}^* \in (b_{h,p}^*, b_{h,s}^*)$ , while pessimists bid  $b_{h,ss}^*$  with probability  $x$  and zero with probability  $1 - x$ . The intuition is identical to the one I explained above. An optimist knows that if her neighbor submits a high bid, she will be more confident about her prospects of finding oil. This increases her time-zero willingness to buy the tract (which explains why she now submits a bid between  $b_{h,p}^*$  and  $b_{h,s}^*$ ). If a pessimist bids  $b_{h,ss}^*$ , from Proposition 2 she knows that this increases the likelihood that she will free-ride on her neighbor's drilling cost. The increase in her gain of waiting, however, is fully compensated by the fact that she has to bid more aggressively to hide her bad private information. Therefore, a pessimist is indifferent between bidding zero and  $b_{h,ss}^*$ .<sup>18</sup>

The proposition below shows that my game may also be characterized by an equilibrium in which an optimist bids as if she has “bad” private information.

**PROPOSITION 6** *There exist values of  $(p, c, \delta)$  which support an equilibrium in which pessimists bid  $b_{l,ss}^*$  with probability one, while optimists bid  $b_{h,ss}^*$  ( $> b_{l,ss}^*$ ) with probability  $x \in (0, 1)$  and  $b_{l,ss}^*$  with probability  $(1 - x)$ . Such an equilibrium only exists if  $\delta \Pr(L|h, h)c > (1 - \delta)[\Pr(H|h, h) - c]$ .*

In the appendix I prove the existence of such an equilibrium when both tracts are not marginal ones. I conjecture, however, that such an equilibrium also exists when both tracts are marginal ones. The equilibrium is supported by the continuation strategies summarized in Proposition 3. An optimist knows that if she bids “high” she will either engage in a war-of-attrition with her neighbor (in case her neighbor also submitted a high bid) or she will drill with probability one (in case her neighbor submitted a “low” bid). In either case her time- $\frac{1}{2}$  expected payoff equals  $p - c$ . Moreover, I also assume that any out-of-equilibrium bid is supposed to have been submitted by an optimist. Hence, if player one submits any bid different from  $b_{l,ss}^*$ , she gets:  $E_{\frac{1}{2}}(U|h, b_1 \neq b_{l,ss}^*) = p - c$ . Given this time- $\frac{1}{2}$  expected payoff, player one's optimal non- $b_{l,ss}^*$  bid equals  $\frac{1}{2}(p - c) \equiv b_{h,ss}^*$ .

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<sup>18</sup>Proposition 5 establishes the existence of a semi-separating equilibrium when both tracts are marginal ones. I have been able to prove that a pooling equilibrium fails to exist when both tracts are not marginal ones. A semi-separating equilibrium (in which pessimists bid  $b_{h,ss}^*$  with probability  $x$ ), however, also exists for some  $(p, c, \delta)$ 's when  $c \in (1 - p, \frac{1}{2})$ . As the proofs of both results lack interest, I decided not to include them in this paper.

$x^*$  and  $b_{l,ss}^*$  are determined on the basis of the following two equations in two unknowns:

$$E_0(U|h, b_1 = b_{l,ss}^*) = E_0(U|h, b_1 = b_{h,ss}^*), \text{ and}$$

$$b_{l,ss}^* = \frac{1}{2}E_{\frac{1}{2}}(U|l, b_{l,ss}^*).$$

The first equation ensures that an optimist is indifferent between submitting either one of the two bids. The second equation ensures that a pessimist chooses her bid optimally. To gain some insight behind this system of simultaneous equations suppose player  $i$  is an optimist. In this equilibrium she is indifferent between submitting both bids because the gain of bidding low (i.e. increasing the probability that she will be allocated the right to free-ride) is compensated by its cost (i.e. lower probability of winning the tract). Observe that an optimist only values the right to free-ride if the discount rate is sufficiently high. For, if  $\delta$  were low, player  $i$  would prefer to drill at time one even if she anticipates her neighbor to drill too! This explains why this semi-separating equilibrium only exists if  $\delta$  is sufficiently high. If  $x = 0$ , player  $-i$  never bids high. Hence, the right to free-ride is never allocated to player  $i$ , and there is no gain in bidding “low”. Stated differently, if  $x = 0$  (i.e. if player  $-i$  always bids as if she were a pessimist) it is a best reply for player  $i$  to bid  $b_{h,ss}^*$ . The higher  $x$ , the higher the probability that she will be allocated the right to free ride (provided she bids “low”), and the higher player  $i$ ’s gain of bidding “low”. Similarly, a pessimist values the tract more (and thus bids more aggressively) when  $x$  increases. As  $b_{l,ss}^*$  is increasing in  $x$ , this reduces player  $i$ ’s cost of bidding “low”. Both reasons explain why  $E_0(U|h, b_1 = b_{h,ss}^*)$  is increasing in  $x$ . It can easily be shown that for some  $(p, c, \delta)$  it is a best response for player  $i$  to bid  $b_{l,ss}^*$  when  $x$  is close to one. It then follows from the intermediate value theorem that there exists a semi separating equilibrium of the type described in the Proposition.

According to HP it takes about three months to set up and complete an exploratory drilling program. Hence, if the outcome of a firm’s exploratory drilling program is rapidly learnt by neighboring firms, one should expect the discount factor to be very high. HP therefore estimated a discount factor equal to 0.99 while Lin (2006) worked with a discount factor of 0.9. On the basis of those discount factors it is reasonable to assume that if player  $i$  anticipates her neighbor to drill, she prefers to wait. Hence, the necessary condition set forth in Proposition 6 is most likely satisfied. It needs to be mentioned, however, that HP considered drilling activities that took place between 1954 and 1981. At that time drilling mainly occurred in shallow waters. Nowadays drilling mainly occurs in deep to ultra-deep waters<sup>19</sup> where presumably exploratory

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<sup>19</sup>Shallow water refer to water depths less than 305 meters (1000 feet). Deepwater refers to water depths between 305 meters and 1524 meters (5000 feet). Ultra-deepwater refers to water depths greater than 1524 meters ([www.mms.gov/ld/PDFs/GreenBook-LeasingDocument.pdf](http://www.mms.gov/ld/PDFs/GreenBook-LeasingDocument.pdf)).

drilling programs take more time to complete. Furthermore, a low  $\delta$  can also be interpreted as an anticipated future oil price reduction as firms should then have more incentives to drill early. Hence, if firms anticipate important future oil price reductions, or if it takes much more time to learn about the outcome of exploratory drilling programs in deep to ultra-deep waters, the necessary condition stated in Proposition 6 need not be satisfied.

### 3 Some Empirical Implications

In this section I argue that the equilibrium set forth in Proposition 6 best fits the existing empirical evidence. Consider the following probit regression model:

$$\Pr(\text{drill}) = \beta_0 + \beta_1 \times \text{bid} + \beta_2 \times (\text{bid} \times \text{neighbor\_bid}) + \beta_3 \times \text{neighbor\_bid} + \dots$$

where  $\Pr(\text{drill})$  denotes the probability that player  $i$  drills at time one and where “...” indicates the presence of other explanatory variables. At the risk of stating the obvious, my model implies that this regression may suffer from endogeneity problems. In the equilibrium highlighted in Proposition 6 a pessimist bids “not low” because she knows that it is not unlikely that her neighbor will drill. Her neighbor’s decision to drill, however, is also partly influenced by her bid. Hence, the coefficients in this model should be interpreted as (interesting) correlations. HP found that  $\beta_1 > 0$  and that  $\beta_3 < 0$ . Both coefficients were significantly different from zero at the 5% level. Unfortunately, they did not include the interaction term in their regression equation.

Suppose without loss of generality that  $c < \frac{1}{2}$ , that players focus on the separating equilibrium and that  $(b_i, b_{-i}) = (b_{i,s}^*, b_{i,s}^*)$ . My model predicts then that player  $i$  drills with probability zero. Suppose now that  $(b_i, b_{-i}) = (b_{i,s}^*, b_{h,s}^*)$ . As explained in Proposition 1, player  $i$  then drills with a strictly positive probability. Suppose now that player  $-i$  increases her bid (from  $b_{i,s}^*$  to  $b_{h,s}^*$ ) keeping player  $i$ ’s bid constant at  $b_{i,s}^*$ . It then follows from Proposition 1 that player  $i$ ’s drilling probability also increases from  $\frac{(1-\delta)(\frac{1}{2}-c)}{\delta \frac{1}{2}c}$  to  $\frac{(1-\delta)(\Pr(H|h,h)-c)}{\delta \Pr(L|h,h)c}$ . Hence, the separating equilibrium predicts that  $\beta_3 > 0$ . The intuition behind this result is straightforward: In a separating equilibrium player  $-i$  only increases her bid if she possesses more favorable private information. As players  $i$  and  $-i$  become more confident about their prospects of finding oil, it follows from my discussion in section 2.3 that in a strongly symmetric continuation equilibrium both players increase their drilling probabilities.<sup>20</sup>

The table below summarizes the equilibrium drilling probabilities as a function of observed

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<sup>20</sup>As mentioned in footnote 18, if  $c < \frac{1}{2}$  there may also exist a semi-separating equilibrium in which pessimists bid  $b_{h,\bar{s}\bar{s}}^*$  with probability  $x$ . It can be shown that this semi-separating equilibrium also predicts that  $\beta_3 > 0$  for essentially the same reason as the one I explained in the paragraph above.

bids when players focus on the semi-separating equilibrium (in which optimists bid  $b_{l,ss}^*$  with probability  $1 - x$ ).

**Table 1: Probability that player  $i$  drills at time one as a function of  $(b_i, b_{-i})$  in the equilibrium set forth in Proposition 6.**

$(b_i, b_{-i})$	$\Pr(drill)$	
$(b_{l,ss}^*, b_{l,ss}^*)$	$\Pr(s_i = l   b_i = b_{l,ss}^*) \times 0 + \Pr(s_i = h   b_i = b_{l,ss}^*) \times \lambda^*(h, b_{l,ss}^*, b_{l,ss}^*)$	(A)
$(b_{h,ss}^*, b_{l,ss}^*)$	1	(B)
$(b_{l,ss}^*, b_{h,ss}^*)$	0	(C)
$(b_{h,ss}^*, b_{h,ss}^*)$	$\lambda^*(h, b_{h,ss}^*, b_{h,ss}^*)$	(D)

The table above reveals that an increase in  $b_{-i}$  reduces player  $i$ 's drilling probability both when  $b_i = b_{l,ss}^*$  and when  $b_i = b_{h,ss}^*$ . Moreover, a quick comparison between A and B and between C and D also reveals that — keeping  $b_{-i}$  constant —  $\Pr(drill)$  is increasing in  $b_i$ . Hence, this equilibrium predicts that  $\beta_1 > 0$  and that  $\beta_3 < 0$ . Furthermore, the table also tells us that  $B - A > D - C$  if and only if

$$1 > \Pr(s_i = h | b_i = b_{l,ss}^*) \times \lambda^*(h, b_{l,ss}^*, b_{l,ss}^*) + \lambda^*(h, b_{h,ss}^*, b_{h,ss}^*),$$

which, if  $\delta > 0.9$ , is very likely to be satisfied (as  $\Pr(s_i = h | b_i = b_{l,ss}^*) < \frac{1}{2}$  and as  $\lambda^*(\cdot)$  is low when  $\delta$  is high). Hence, the equilibrium set forth in Proposition 6 also predicts that  $\beta_2 < 0$ .

As mentioned in my introduction, the hazard rate of drilling features a U-shaped pattern. The equilibrium set forth in Proposition 6 is not inconsistent with this finding either. Sometimes (i.e. if player  $i$  bids low while her neighbor bids high) players succeed to coordinate their drilling activities, which explains a high probability of drilling in year one. If players fail to coordinate their drilling decisions through their bids, they play a standard war-of-attrition, which explains why in years 2, 3, and 4 the hazard rate of drilling is “low”. In year 5 the probability of drilling is “high” because of the end-game effect. This explanation is different from the one provided by HP. In their model a player’s bid is assumed to be exogenous and to perfectly reveal her private information (as is the case in the equilibrium set forth in Proposition 4). The high probability of drilling in year one is then explained on the basis that in year one the risk set (i.e. the set of undrilled tracts) contains relatively many tracts for which players share optimistic beliefs. In year three the risk set is less likely to contain tracts with optimistic beliefs as many of them have been drilled in earlier periods. There are two problems with this explanation. First, it is inconsistent with their finding that  $\beta_3 < 0$ . Second, equation 5 teaches us that drilling probabilities are computed to balance the opportunity cost of waiting with its (informational) gain of waiting.

The equation also shows that if the discount factor is close to one, drilling probabilities are close to zero, *independently* of players' posteriors. As argued in my previous section, HP estimated a discount factor equal to 0.99. Unless signals are extremely informative, one would then not expect to see the sharp<sup>21</sup> reduction in the hazard rate observed in the data.

## 4 A Revenue Implication

Suppose  $(p, c, \delta)$  supports both a semi-separating (in which optimists bid  $b_{i,ss}^*$  with probability  $1-x$ ) and a separating equilibrium.<sup>22</sup> Remember that  $b_{h,s}^*$  and  $b_{l,s}^*$  can be interpreted as equilibrium bids if signals (instead of bids) were revealed at time  $\frac{1}{2}$ . One can then show:

*PROPOSITION 7 The semi-separating equilibrium set forth in Proposition 6 may yield more expected revenues in comparison with the benchmark case in which players abstract from any signalling motive.*

Recall that in the separating equilibrium an optimist bids  $b_{h,s}^* = \frac{1}{2}(p-c)$ . In the semi-separating equilibrium she randomizes her bid between  $b_{h,ss}^* = \frac{1}{2}(p-c)$  and  $b_{l,ss}^*$ . As  $b_{l,ss}^* < b_{h,ss}^*$ , it is immediate that an optimist bids more aggressively in the separating equilibrium. Comparing  $b_{l,ss}^*$  with  $b_{l,s}^*$ , however, is a more delicate matter. As argued above,  $b_{l,ss}^*$  is computed out of a system of two equations in two unknowns. As  $x (= \Pr(b_{-i} = b_{h,ss}^* | s_{-i} = h))$  increases, it becomes more likely that player  $i$ 's neighbor will drill and this increases her willingness to bid more aggressively. The Proposition states that  $b_{l,ss}^* - b_{l,s}^*$  can become so big to compensate the government for any lost revenues due to an optimist's strategic "low" bidding behavior.

## 5 Conclusions

In this paper I did not tackle the question: "How should oil and gas fields be auctioned off?" The findings of this paper suggest that the optimal auction format depends on the importance of the information externality at the drilling stage. As documented by HP the information externality is important in drilling for oil in the outer continental shelf of the US. In other parts of the world the information externality is less important. For example in Libya the probability of finding oil is much higher than in the Gulf of Mexico. Similarly, offshore drilling (in the Gulf of Mexico) is more expensive than drilling in Libya. This might explain why the Libyan Government decided

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<sup>21</sup>The hazard rate of drilling in the third quarter is  $\pm 10\%$ , while it is  $\pm 5\%$  in the seventh quarter.

<sup>22</sup>In the appendix I show that the set of  $(p, c, \delta)$ 's which support both types of equilibria is non-empty.

to auction their oil fields (predominantly) using first-price sealed royalty rate<sup>23</sup> bidding while the US (predominantly) used a standard first-price sealed bid auction (followed by bid disclosure). More research is needed to shed light on this and related questions.

## Appendix

### Proof of Proposition 4

I first state and prove:

#### Lemma 2

$$\Pr(H|h, h) - c \geq \delta[\Pr(H|h, h) - c + \Pr(L|h, h)\lambda^*(h, b_{h,s}^*, b_{l,s}^*)c].$$

*Proof:* Suppose  $b_{-i} = b_{h,s}^* \Leftrightarrow s_{-i} = h$  and  $b_{-i} = b_{l,s}^* \Leftrightarrow s_{-i} = l$ . Suppose player  $-i$  expects player  $i$  to follow the same bidding behavior as herself. It follows from Proposition 1 that if  $b_i = b_{l,s}^*$ , player  $-i$  drills with probability

$$\lambda^*(s_{-i}, b_{-i}, b_{l,s}^*) = \min \left\{ 1, \max \left\{ 0, \frac{(1-\delta)(\Pr(H|s_{-i}, l) - c)}{\delta \Pr(L|s_{-i}, l)c} \right\} \right\},$$

while if  $b_i = b_{h,s}^*$  she drills with probability

$$\lambda^*(s_{-i}, b_{-i}, b_{h,s}^*) = \min \left\{ 1, \max \left\{ 0, \frac{(1-\delta)(\Pr(H|s_{-i}, h) - c)}{\delta \Pr(L|s_{-i}, h)c} \right\} \right\}.$$

It is straightforward to see that the latter probability is (weakly) greater than the former one. It follows from the proof of Proposition 1 that

$$\Pr(H|h, h) - c \geq \delta[\Pr(H|h, h) - c + \Pr(L|h, h)\lambda^*(h, b_{h,s}^*, b_{h,s}^*)c],$$

where the right-hand side denotes player  $i$ 's gain of waiting given that  $(s_i, s_{-i}) = (h, h)$  and that  $(b_i, b_{-i}) = (b_{h,s}^*, b_{h,s}^*)$ . As  $(\lambda^*(h, b_{h,s}^*, b_{l,s}^*)) \leq (\lambda^*(h, b_{h,s}^*, b_{h,s}^*))$  and as  $(\lambda^*(l, b_{l,s}^*, b_{l,s}^*)) = (\lambda^*(l, b_{h,s}^*, b_{h,s}^*)) = 0$ , it follows from Lemma 1 that

$$\Pr(H|h, h) - c \geq \delta[\Pr(H|h, h) - c + \Pr(L|h, h)\lambda^*(h, b_{h,s}^*, b_{l,s}^*)c].$$

■

The Lemma above together with the explanations following Proposition 4 prove that an optimist cannot gain by setting  $b_i \neq b_{h,s}^*$ . It follows from Proposition 1 that if a pessimist bids  $b_{l,s}^*$ , she gets (at time  $\frac{1}{2}$ )

$$E_{\frac{1}{2}}(U|l, b_{l,s}^*) = \sum_{s_{-i}} \Pr(s_{-i}|l) \max\{0, \Pr(H|l, s_{-i}) - c\}. \quad (10)$$

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<sup>23</sup>Under royalty rate bidding firms bid percentage figures. If, for example, a firm bids 80%, this means that she is prepared to give 80% of the value of the extracted oil to the government if awarded the tract.

If a pessimist bids  $b_{h,s}^*$ , she gets (at time  $\frac{1}{2}$ )

$$E_{\frac{1}{2}}(U|l, b_{h,s}^*) = \sum_{s_{-i}} \Pr(s_{-i}|l) \max\{\Pr(H|l, s_{-i}) - c, \delta W(l, b_{h,s}^*, b_{-i})\}, \quad (11)$$

where  $\delta W(l, b_{h,s}^*, b_{-i})$  is given in equation 8. As an optimist cannot gain by deviating, a separating equilibrium exists if and only if  $E_0(U|l, b_{l,s}^*) \geq E_0(U|l, b_{h,s}^*)$ . Observe that if  $\delta$  is close to zero

$$E_0(U|l, b_{h,s}^*) = b_{h,s}^* [E_{\frac{1}{2}}(U|l, b_{l,s}^*) - b_{h,s}^*] < E_0(U|l, b_{l,s}^*),$$

where the inequality follows from the fact that  $b_i [E_{\frac{1}{2}}(U|l, b_{l,s}^*) - b_i]$  is a strictly concave function and reaches its maximum when  $b_i = b_{l,s}^*$ . Observe also that if  $\delta$  is close to one,  $\lambda^*(\cdot) = 0$  and  $E_0(U|l, b_{h,s}^*) < E_0(U|l, b_{l,s}^*)$  for the same reason. By continuity, there exists a  $\underline{\delta}(c, p) > 0$  and a  $\bar{\delta}(c, p) < 1$  such that all  $\delta \leq \underline{\delta}(c, p)$  and all  $\delta \geq \bar{\delta}(c, p)$  support a separating equilibrium. Finally, if  $p$  is close to one, it follows from 7, 10, 11 and 8 that  $b_{l,s}^* = 0$ ,  $b_{h,s}^* = \frac{1}{2}(1 - c)$  and  $E_{\frac{1}{2}}(U|l, b_{l,s}^*) = E_{\frac{1}{2}}(U|l, b_{h,s}^*) = 0$ . Hence, if  $p$  is close to one,  $E_0(U|l, b_{h,s}^*) < E_0(U|l, b_{l,s}^*)$ . By continuity, there exists a  $\bar{p}(c, \delta) \in [\frac{1}{2}, 1)$  such that all  $p \geq \bar{p}(c, \delta)$  support a separating equilibrium.

I now prove the uniqueness part of Proposition 4. Suppose  $s_1 = h$  and consider candidate equilibrium strategies in which optimists randomize their bids according to an arbitrary c.d.f.  $\beta(h)$  and pessimists according to an arbitrary c.d.f.  $\beta(l)$ . Let  $b_{min}(\beta(h)) \equiv \inf\{b : \Pr(b_1 = b|s_1 = h, \beta(h)) > 0\}$ . Let  $\underline{b}_h \equiv \min\{b_{min}(\beta(h)) : \beta(h) \text{ is part of an equilibrium strategy}\}$ . Observe that, in any equilibrium,  $E_0(U|h, b_1) \geq \frac{1}{4}(p - c)^2 > 0$  as player one always has the possibility to bid  $\frac{1}{2}(p - c)$  and, if awarded the tract, to drill at time one independent of player two's bid. This implies that  $\forall(p, c, \delta), \underline{b}_h > 0$ .

Suppose  $s_1 = l$ . One has:  $E_0(U|l, b_1) = b_1 \left( E_{\frac{1}{2}}(U|l, b_1) - b_1 \right)$ , where

$$E_{\frac{1}{2}}(U|l, b_1) = \int \max\{\Pr(H|l, b_2) - c, \delta W(l, b_1, b_2)\} dF(b_2),$$

where  $\delta W(l, b_1, b_2)$  denotes player 1's gain of waiting given her signal, her bid and her rival's bid and where  $F(b_2) = \Pr(s_2 = h|l)\beta(h) + \Pr(s_2 = l|l)\beta(l)$  represents the c.d.f. of player two's bid conditional on  $s_1$ . Observe also that  $E_{\frac{1}{2}}(U|l, b_1)$  is computed conditional upon whether  $r < b_2$  or  $r > b_2$ . Observe that

$$E_{\frac{1}{2}}(U|l, b_1) \leq \int \sum_{s_2} \max\{\Pr(H|l, s_2) - c, \delta W(l, s_2, b_1, b_2)\} \Pr(s_2|l, b_2) dF(b_2)$$

The inequality above comes from the fact that player one may take the wrong time-one decision (e.g. she may drill at time one when, had she known player two's type, she would have preferred to wait). Observe also that  $\delta W(l, s_2, b_1, b_2) \leq \delta \Pr(H|l, s_2)(1 - c)$ . Hence,

$$\begin{aligned} E_{\frac{1}{2}}(U|l, b_1) &\leq \int \sum_{s_2} \max\{\Pr(H|l, s_2) - c, \delta \Pr(H|l, s_2)(1 - c)\} \Pr(s_2|l, b_2) dF(b_2) \\ &= \sum_{s_2} \max\{\Pr(H|l, s_2) - c, \delta \Pr(H|l, s_2)(1 - c)\} \Pr(s_2|l) \equiv \bar{b}_l. \end{aligned}$$

Note: if  $p$  is close to one,  $\bar{b}_l$  is close to zero. Similarly, if  $c > \frac{1}{2}$  and if  $\delta$  is close to zero,  $\bar{b}_l$  is also close to zero. Note also that a pessimist will never submit a bid higher than  $\bar{b}_l$  as she would then get a negative payoff. Thus, for  $p$  close to one, or if  $c > \frac{1}{2}$  and if  $\delta$  is close to zero,  $\bar{b}_l < \underline{b}_h$ . As  $\bar{b}_l$  is continuous in  $p$  and  $\delta$ , there exists a  $p^c \in [\frac{1}{2}, 1)$  and a  $\delta^c \in (0, 1)$ , such that if  $p \geq p^c$  or if  $c > \frac{1}{2}$  and  $\delta \leq \delta^c$  in any equilibrium the highest bid of a pessimist is lower than the lowest bid of an optimist.

Suppose  $p$  is sufficiently high such that  $\bar{b}_l < \underline{b}_h$ . It then follows from my two previous paragraphs that in any equilibrium

$$E_{\frac{1}{2}}(U|s_1, b_1) = \sum_{s_2} \Pr(s_2|s_1) \max\{\Pr(H|s_1, s_2) - c, \delta W(s_1, s_2, b_1, b_2), 0\}.$$

As a bid reveals a player's type, at time one both players possess the same posterior. As I focus on the class of the strongly symmetric strategies, this implies that both players must drill with the same probability (provided both players won their respective tracts). In particular, this implies that  $\delta W(s_1, s_2, b_1, b_2) \leq \max\{\Pr(H|s_1, s_2) - c, 0\}$ . Hence, at time zero player one chooses  $b_1$  to maximize

$$E_0(U|h, b_1) = b_1 \left[ \sum_{s_2} \Pr(s_2|s_1) \max\{\Pr(H|s_1, s_2) - c, 0\} - b_1 \right],$$

which yields as unique solution:

$$b_1^* = \frac{1}{2} \sum_{s_2} \Pr(s_2|s_1) \max\{\Pr(H|s_1, s_2) - c, 0\}.$$

■

### Proof of Proposition 5

Let  $\lambda_0 \equiv \frac{(1-\delta)(p^2(1-c)-(1-p)^2c)}{\delta(1-p)^2c}$ ,  $\lambda_1 \equiv \frac{(1-\delta)(p-c)}{\delta(1-p)^2c}$ , and  $\lambda_2 \equiv \frac{p-c}{\delta p^2(1-c)}$ . Observe that

$$\lambda_0 < 1 \Leftrightarrow p^2(1-c) - (1-p)^2c < \delta p^2(1-c). \quad (12)$$

I first state and prove the following Lemmas.

**Lemma 3** *If  $c > \frac{1}{2}$ ,  $\lambda_0 > \lambda_1$ .*

*Proof:* The stated inequality can be written as

$$\Pr(h|h)[\Pr(H|h, h) - c] > \Pr(h|h)[\Pr(H|h, h) - c] + \Pr(l|h)[\Pr(H|h, l) - c],$$

which is satisfied as  $\Pr(H|h, l) = \frac{1}{2} < c$ . ■

**Lemma 4**  $\lambda_0 < 1 \Leftrightarrow \lambda_1 < \lambda_2$

*Proof:*

$$\lambda_1 < \lambda_2 \Leftrightarrow (1 - \delta)p^2(1 - c) < (1 - p)^2c,$$

which is identical to inequality 12. ■

**Lemma 5**  $\lambda^*(h, b_{h,p}^*, b_{h,p}^*) = \min \left\{ 1, \frac{(1-\delta)(p-c)}{\delta(1-p)^2c}, \frac{p-c}{\delta p^2(1-c)} \right\}$ .

The proof of this Lemma is identical to the one present in the proof of Proposition 2 (available upon request) and is therefore omitted.

Suppose  $c > \frac{1}{2}$  and that beliefs are updated under the assumption that optimists bid  $b_h$  with probability one, while pessimists bid  $b_h$  with probability  $x$  and zero with probability  $1 - x$ . Suppose also that out-of-equilibrium beliefs are computed under the assumption that  $\Pr(s_i = l | b_i \notin \{b_l, b_h\}) = 1$ . Let  $b_h \equiv \frac{1}{2} \Pr(b_{-i} = b_h | h) (\Pr(H|h, b_h) - c)$ .

Suppose  $s_i = h$  and that she bids  $b_h$ . By definition,  $E_{\frac{1}{2}}(U|h, b_h) \equiv \Pr(b_{-i} = b_h | h) E_1(U|h, b_h, b_h) + \Pr(b_{-i} = b_l | h) E_1(U|h, b_h, b_l)$ . As  $c > \frac{1}{2} = \Pr(H|h, b_{-i} = b_l)$ ,  $E_1(U|h, b_h, b_l) = 0$ . If  $b_i = b_{-i} = b_h$ , both players play a war-of-attrition. In the symmetric equilibrium (in which pessimists do not drill at time one while optimists drill with some probability) optimists either strictly prefer to drill at time one (i.e. when  $\delta$  is “low”) or they will be indifferent between drilling and waiting (i.e. when  $\delta$  is not “low”). In both cases,  $E_1(U|h, b_h, b_h) = \Pr(H|h, b_h) - c$ , and

$$E_{\frac{1}{2}}(U|h, b_i = b_h) = \Pr(b_{-i} = b_h | h) (\Pr(H|h, b_h) - c). \quad (13)$$

Suppose now that  $b_i \neq b_h$ . As mentioned above, players compute their posteriors under the assumption that  $\Pr(s_i = l | b_i \neq b_h) = 1$ . Hence,  $\Pr(H|s_{-i} = h, b_i \neq b_h) = \frac{1}{2} < c$ . Player  $i$  knows that, if  $b_i \neq b_h$ , she will never free-ride on her neighbor’s drilling cost and

$$E_{\frac{1}{2}}(U|h, b_i \neq b_h) = \Pr(b_{-i} = b_h | h) (\Pr(H|h, b_h) - c). \quad (14)$$

It follows from 13 and 14 that player  $i$ ’s maximization problem can be written as

$$\max_{b_i} E_0(U|h, b_i) = b_i [\Pr(b_{-i} = b_h | h) (\Pr(H|h, b_h) - c) - b_i],$$

which yields the solution

$$b_i^* = \frac{1}{2} \Pr(b_{-i} = b_h | h) (\Pr(H|h, b_h) - c) = b_h. \quad (15)$$

Hence, an optimist cannot gain by bidding differently than  $b_h$ .

Suppose now that  $s_i = l$ . Let

$$\Delta(l, x) = E_0(U|l, b_i = 0; x) - E_0(U|l, b_i = b_h; x).$$

Intuitively,  $\Delta(l, x)$  measures player  $i$ 's incentives to bid low (as opposed to bidding as if she had a high signal) given that player  $-i$  computes her posterior under the assumption that  $\Pr(b_i = b_h | s_i = l) = x$ . If  $\Delta(l, x) \geq 0$ , player  $i$  prefers to bid low (despite the fact that she knows that this will reduce her neighbor's incentives to drill). From my preceding paragraphs we know that an optimist cannot gain by setting  $b_i \neq b_h$ . Hence, a separating equilibrium exists if and only if  $\Delta(l, 0) \geq 0$ . A pooling equilibrium exists if and only if  $\Delta(l, 1) \leq 0$ , while a semi-separating equilibrium (in which pessimists bid  $b_h$  with probability  $x^* \in (0, 1)$ ) exists if and only if  $\Delta(l, x^*) = 0$ .

Observe that  $E_0(U|l, 0; x) = 0 \forall x$ . Furthermore,

$$E_0(U|l, b_h; x) = b_h \{ \Pr(H, s_{-i} = h|l) \lambda^*(h, b_h, b_h) \delta(1 - c) - b_h \}. \quad (16)$$

Observe that  $b_h$  and all the probabilities in the equation above are continuous in  $x$ . Moreover, it follows from the proof of Proposition 2 (available upon request) that  $\lambda^*(h, b_h, b_h)$  is also continuous in  $x$ . Hence,  $\Delta(l, x)$  is continuous in  $x$ , and there exists a strongly symmetric PBE.

It follows from equations 15 and 16 that

$$\Delta(l, 0) \geq 0 \Leftrightarrow \Pr(H, s_{-i} = h|l) \lambda^*(h, b_{h,s}^*, b_{h,s}^*) \delta(1 - c) \leq \frac{1}{2} \Pr(h|h) [\Pr(H|h, h) - c], \quad (17)$$

and that

$$\Delta(l, 1) \leq 0 \Leftrightarrow \Pr(H, s_{-i} = h|l) \lambda^*(h, b_{h,p}^*, b_{h,p}^*) \delta(1 - c) \geq \frac{1}{2} [\Pr(H|h) - c]. \quad (18)$$

**Lemma 6** *If  $c > \frac{1}{2}$ , and if  $p^2(1-c) - (1-p)^2c < \delta p^2(1-c)$  there either exists a separating or there exists a pooling equilibrium. No  $(p, c, \delta)$  supports both a separating and a pooling equilibrium.*

*Proof:* From equation 12 we know that  $p^2(1-c) - (1-p)^2c < \delta p^2(1-c) \Leftrightarrow \lambda_0 < 1$ , and, thus,  $\lambda^*(h, b_{h,s}^*, b_{h,s}^*) = \lambda_0$ . This insight, combined with Lemmas 3, 4, 5 and with our assumption that  $c > \frac{1}{2}$  allows me to conclude that  $\lambda^*(h, b_{h,p}^*, b_{h,p}^*) = \lambda_1$ . Hence, inequalities 17 and 18 can respectively be rewritten as  $p(1-\delta)(1-c) \leq \frac{1}{2}(1-p)c$ , and as  $p(1-\delta)(1-c) \geq \frac{1}{2}(1-p)c$ . Obviously, both inequalities cannot be simultaneously satisfied (except in the non-generic case in which  $p(1-\delta)(1-c) = \frac{1}{2}(1-p)c$ ). ■

**Lemma 7** *If  $c > \frac{1}{2}$  and if  $p^2(1-c) - (1-p)^2c > \delta p^2(1-c)$ , there either exists a separating or there exists a pooling equilibrium. Moreover there exists values of the parameters which support a separating, a pooling and a semi-separating equilibrium.*

*Proof:* As  $p^2(1-c) - (1-p)^2c > \delta p^2(1-c)$ , it follows from inequality 12 that  $\lambda_0 > 1$ , and, thus, that  $\lambda^*(h, b_{h,s}^*, b_{h,s}^*) = 1$ . This insight, combined with Lemma 4, allows me to conclude that  $\lambda_1 > \lambda_2$ . There are two possible cases: (i)  $\lambda_2 \geq 1$ , and (ii)  $\lambda_2 < 1$ .

In case (i), inequalities 17 and 18 boil down to

$$\delta p(1-p)(1-c) \leq \frac{1}{2}(p^2(1-c) - (1-p)^2c), \text{ and}$$

$$\delta p(1-p)(1-c) \geq \frac{1}{2}(p-c).$$

Observe that, if  $c > \frac{1}{2}$ ,  $p^2(1-c) - (1-p)^2c > p-c$ . Hence, there are three different subcases: either  $\delta p(1-p)(1-c) \leq \frac{1}{2}(p-c) < \frac{1}{2}(p^2(1-c) - (1-p)^2c)$ , in which case there exists a separating, but no pooling equilibrium, or  $\frac{1}{2}(p-c) < \delta p(1-p)(1-c) < \frac{1}{2}(p^2(1-c) - (1-p)^2c)$ , in which case there exists a separating, a pooling and, by continuity, a semi-separating equilibrium, or  $\frac{1}{2}(p-c) < \frac{1}{2}(p^2(1-c) - (1-p)^2c) \leq \delta p(1-p)(1-c)$ , in which case there exists a pooling but no separating equilibrium. Note that in this case, there always exists either a separating or a pooling equilibrium.

In case (ii), inequalities 17 and 18 boil down to

$$\delta p(1-p)(1-c) \leq \frac{1}{2}(p^2(1-c) - (1-p)^2c), \text{ and} \quad (19)$$

$$p \leq \frac{2}{3}.$$

I now show that if  $p > \frac{2}{3}$  (i.e. if there does not exist a pooling equilibrium), then there exists a separating one. Observe that  $p > \frac{2}{3} \Leftrightarrow \frac{1-p}{p} < \frac{1}{2}$ . Moreover in this case  $\delta p^2(1-c) < p^2(1-c) - (1-p)^2c$ . As  $\frac{1-p}{p} < \frac{1}{2}$ ,  $\frac{1-p}{p}\delta p^2(1-c) < \frac{1}{2}(p^2(1-c) - (1-p)^2c)$ , which is equivalent to 19. Hence, as in the former case, there always exists either a pooling or a separating equilibrium. ■

## Proof of Proposition 6

The equilibrium is supported by the continuation strategies summarized in Proposition 3. Moreover, I assume that off-the-equilibrium path, players compute their posteriors under the assumption that  $\Pr(s_i = h|b_i \notin \{b_{l,ss}^*, b_{h,ss}^*\}) = 1$ . I first show that a pessimist cannot gain by deviating (Step 1). Next, I show that an optimist cannot gain by deviating (Step 2). Finally, I show that  $b_{l,ss}^* < b_{h,ss}^*$  (Step 3).

Step 1: Suppose  $s_1 = l$  and that  $b_1 = b_{l,ss}^*$ . As  $b_{l,ss}^* < b_{h,ss}^*$ ,  $\Pr(r < b_2|r < b_1) = 1$ . It then follows from Proposition 3 that

$$\begin{aligned} E_{\frac{1}{2}}(U|l, b_1 = b_{l,ss}^*) &= \Pr(b_2 = b_{h,ss}^*|l) \Pr(H|l, h)\delta(1-c) \\ &\quad + \Pr(s_2 = h, b_2 = b_{l,ss}^*|l) \Pr(H|l, h)\lambda^*(h, b_{l,ss}^*, b_{l,ss}^*)\delta(1-c). \end{aligned} \quad (20)$$

Observe that  $E_{\frac{1}{2}}(U|l, b_1 = b_{l,ss}^*)$  only depends on  $(p, c, \delta, x^*)$  but not on player one's bid. Let  $b_{l,ss}^* \in \arg \max_{b_1} E_0(U|l, b_1) = b_1(E_{\frac{1}{2}}(U|l, b_1 = b_{l,ss}^*) - b_1)$ . Observe that  $b_{l,ss}^* = \frac{1}{2}E_{\frac{1}{2}}(U|l, b_1 =$

$b_{l,\underline{ss}}^*$ ) and that

$$\lim_{x \rightarrow 1} b_{l,\underline{ss}}^* = \frac{1}{2} \Pr(H, h|l) \delta(1 - c). \quad (21)$$

Suppose  $s_1 = l$ ,  $b_2 = b_{h,\underline{ss}}^*$  and  $b_1 \notin \{b_{l,\underline{ss}}^*, b_{h,\underline{ss}}^*\}$ . If  $b_2 = b_{h,\underline{ss}}^* < r$ , player one's payoff (net of bidding costs) equals zero. Suppose that  $r < b_2 = b_{h,\underline{ss}}^*$ . As player two computes her posterior under the assumption that player one is an optimist, she believes that her time-one posterior ( $= \Pr(H|h, h)$ ) is equal to the one of player one ( $= \Pr(H|h, b_2 = b_{h,\underline{ss}}^*)$ ). As I focus on strongly symmetric strategies, I assume that player two believes that player one will drill with the same probability as herself. It follows from Proposition 3 that this implies that player two will drill at time one with probability  $\lambda^*(h, b_{h,\underline{ss}}^*, b_{h,\underline{ss}}^*) = \frac{(1-\delta)(\Pr(H|h,h)-c)}{\delta \Pr(L|h,h)c}$ , which, by assumption, is less than one. Suppose now that  $s_1 = l$ ,  $b_2 = b_{l,\underline{ss}}^*$  and  $b_1 \notin \{b_{l,\underline{ss}}^*, b_{h,\underline{ss}}^*\}$ . As player two believes that player one is an optimist and as  $b_2 = b_{l,\underline{ss}}^*$ , I assume that she anticipates that player one will drill. As  $\delta \Pr(L|h, h)c > (1 - \delta)(\Pr(H|h, h) - c)$ , it is then optimal for her to wait. Hence,  $E_{\frac{1}{2}}(U|l, b_1 \notin \{b_{l,\underline{ss}}^*, b_{h,\underline{ss}}^*\}) = \Pr(r < b_{h,\underline{ss}}^*, b_2 = b_{h,\underline{ss}}^* | r < b_1) \Pr(H|l, h) \lambda^*(h, b_{h,\underline{ss}}^*, b_{h,\underline{ss}}^*) \delta(1 - c)$ . Observe that  $E_{\frac{1}{2}}(U|l, b_1 \notin \{b_{l,\underline{ss}}^*, b_{h,\underline{ss}}^*\}) \leq \bar{E}_{\frac{1}{2}}(U|l, b_1 \notin \{b_{l,\underline{ss}}^*, b_{h,\underline{ss}}^*\})$ , where

$$\bar{E}_{\frac{1}{2}}(U|l, b_1 \notin \{b_{l,\underline{ss}}^*, b_{h,\underline{ss}}^*\}) \equiv \Pr(b_2 = b_{h,\underline{ss}}^* | l) \Pr(H|l, h) \lambda^*(h, b_{h,\underline{ss}}^*, b_{h,\underline{ss}}^*) \delta(1 - c), \quad (22)$$

which is independent of player one's bid.

Let  $b_l^{\text{od}} \in \arg \max_{b_1 \notin \{b_{l,\underline{ss}}^*, b_{h,\underline{ss}}^*\}} b_1 \left( \bar{E}_{\frac{1}{2}}(U|l, b_1 \notin \{b_{l,\underline{ss}}^*, b_{h,\underline{ss}}^*\}) - b_1 \right)$ .<sup>24</sup> Observe that both  $b_l^{\text{od}}$  and  $b_{l,\underline{ss}}^*$  were chosen to maximize  $b_i(E_{\frac{1}{2}}(U|l, \cdot) - b_i)$ , where both time-one expectations are independent of  $b_i$ . Observe that this is a strictly concave function which is symmetric around  $b_i^* = \frac{1}{2} E_{\frac{1}{2}}(U|l, \cdot)$ . In particular, this implies that there exists an increasing relationship between  $E_{\frac{1}{2}}(U|l, b_i^*)$  and  $E_0(U|l, b_i^*)$ . Mere inspection of 20 and 22 reveals that  $\bar{E}_{\frac{1}{2}}(U|l, b_1 \notin \{b_{l,\underline{ss}}^*, b_{h,\underline{ss}}^*\}) < E_{\frac{1}{2}}(U|l, b_1 = b_{l,\underline{ss}}^*)$ . Thus, player one cannot gain by setting  $b_1 \notin \{b_{l,\underline{ss}}^*, b_{h,\underline{ss}}^*\}$ .

Suppose now that  $s_1 = l$  and that  $b_1 = b_{h,\underline{ss}}^*$ . Using an identical reasoning as in our previous paragraph, player two will drill with probability  $\lambda^*(h, b_{h,\underline{ss}}^*, b_{h,\underline{ss}}^*)$  if  $b_2 = b_{h,\underline{ss}}^*$  and with probability zero if  $b_2 = b_{l,\underline{ss}}^*$ . As above, player one can then not gain by setting  $b_1 = b_{h,\underline{ss}}^*$ .

Step 2: Suppose  $s_1 = h$  and that she bids  $b_{h,\underline{ss}}^*$ . Suppose she won her tract. It then follows from Proposition 3 that her payoff is equal to the one she gets if she were to drill at time one with probability one. Hence,  $E_{\frac{1}{2}}(U|h, b_{h,\underline{ss}}^*) = p - c$ . Let  $b_{h,\underline{ss}}^* \in \arg \max_{b_1} E_0(U|h, b_1) = b_1(p - c - b_1)$ . Observe that  $b_{h,\underline{ss}}^* = \frac{1}{2}(p - c)$ .

Suppose  $s_1 = h$  and that she bids  $b_{l,\underline{ss}}^*$ . Suppose she wins her tract. As  $b_{l,\underline{ss}}^* < b_{h,\underline{ss}}^*$ ,  $\Pr(r < b_2 | r < b_1) = 1$ . It then follows from Proposition 3 that

$$E_{\frac{1}{2}}(U|h, b_1 = b_{l,\underline{ss}}^*) = \Pr(b_2 = b_{h,\underline{ss}}^* | h) \Pr(H|h, h) \delta(1 - c) \quad (23)$$

<sup>24</sup>The superscript "od" stands for "optimal deviation".

$$\begin{aligned}
& + \Pr(b_2 = b_{l,ss}^* | h) \max \left\{ \Pr(H|h, b_2 = b_{l,ss}^*) - c, \right. \\
& \Pr(s_2 = h | h, b_2 = b_{l,ss}^*) \lambda^*(h, b_{l,s}^*, b_{l,ss}^*) \Pr(H|h, h) \delta(1 - c) + \\
& \left. \delta \Pr(a_{2,1} = \text{wait} | h, b_2 = b_{l,ss}^*) \left( \Pr(H|h, b_2 = b_{l,ss}^*, a_{2,1} = \text{wait}) - c \right) \right\}.
\end{aligned}$$

Observe that  $\Pr(H|h, b_2 = b_{l,ss}^*, a_{2,1} = \text{wait}) \geq \Pr(H|h, l) = \frac{1}{2} > c$ . Observe also that if  $b_1 = b_2 = b_{l,ss}^*$  in a strongly symmetric equilibrium either player one strictly prefers to drill at time one, or she is indifferent between her two time-one actions. This insight allows me to rewrite the equation above as

$$E_{\frac{1}{2}}(U|h, b_{l,ss}^*) = p - c + \Pr(b_2 = b_{h,ss}^* | h) (\delta \Pr(L|h, h) c - (1 - \delta) (\Pr(H|h, h) - c)). \quad (24)$$

It follows from the first paragraph of this step that  $E_0(U|h, b_{h,ss}^*; x \rightarrow 0) = \frac{1}{2}(p - c)(p - c - \frac{1}{2}(p - c))$ . It follows from 24 that  $E_0(U|h, b_{l,ss}^*; x \rightarrow 0) = b_{l,ss}^*(p - c - b_{l,ss}^*)$ . As  $b_{h,ss}^* = \frac{1}{2}(p - c) \in \arg \max_{b_1} b_1(p - c - b_1)$ , as  $b_{l,ss}^* < b_{h,ss}^*$  and as  $b_1(p - c - b_1)$  is strictly concave it follows that  $E_0(U|h, b_{h,ss}^*; x \rightarrow 0) > E_0(U|h, b_{l,ss}^*; x \rightarrow 0)$ . It follows from 21 and from 24 that

$$\begin{aligned}
E_0(U|h, b_{l,ss}^*; x \rightarrow 1) & = \frac{1}{2} p (1 - p) \delta (1 - c) (p - c + \delta (1 - p)^2 c - (1 - \delta) (p^2 (1 - c) \\
& - (1 - p)^2 c) - \frac{1}{2} p (1 - p) \delta (1 - c).
\end{aligned}$$

It follows from the first paragraph of this step that

$$E_0(U|h, b_{h,ss}^*; x \rightarrow 1) = \frac{1}{4} (p - c)^2.$$

Let

$$\begin{aligned}
\Omega_2 & \equiv \left\{ (p, c, \delta) \mid 1 - p < c < \frac{1}{2}, \delta \Pr(L|h, h) c > (1 - \delta) (\Pr(H|h, h) - c), \right. \\
& \left. E_0(U|h, b_{h,ss}^*; x \rightarrow 1) < E_0(U|h, b_{l,ss}^*; x \rightarrow 1) \right\}. \quad (25)
\end{aligned}$$

Observe that  $\Omega_2$  is non-empty. For example,  $(p, c, \delta) = (0.52, 0.49, 1) \in \Omega_2$ . As  $E_0(U|h, b_{h,ss}^*; x \rightarrow 0) > E_0(U|h, b_{l,ss}^*; x \rightarrow 0)$ , and as both expectations are continuous in  $x$ , it follows that  $\forall (p, c, \delta) \in \Omega_2, \exists x \in (0, 1)$  such that  $E_0(U|h, b_{l,ss}^*; x) = E_0(U|h, b_{h,ss}^*; x)$ .

Suppose  $s_1 = h$ , that  $b_1 \notin \{b_{l,ss}^*, b_{h,ss}^*\}$  and that she won the tract. If  $r > b_2$ , player one drills her tract at time one. If  $r < b_2 = b_{l,ss}^*$ , player two believes that player one is an optimist who will drill at time one. From Proposition 3 we know that it is a best reply then for player one to drill at time one. If  $r < b_2 = b_{h,ss}^*$ , player two believes that player one possesses the same posterior as herself and drills at time one with probability  $\lambda^*(h, b_{h,ss}^*, b_{h,ss}^*) = \frac{(1 - \delta) (\Pr(H|h, h) - c)}{\delta \Pr(L|h, h) c} < 1$ . Hence, player one is, at best, indifferent between drilling and waiting and  $E_{\frac{1}{2}}(U|h, b_1 \notin \{b_{l,ss}^*, b_{h,ss}^*\}) =$

$E_{\frac{1}{2}}(U|h, b_1 = b_{h,ss}^*) = p - c$ . As  $b_{h,ss}^* \in \arg \max_{b_1} E_0(U|h, b_1) = b_1(p - c - b_1)$ , player one cannot gain by setting  $b_1 \notin \{b_{l,ss}^*, b_{h,ss}^*\}$ .

Step 3: By contradiction, suppose that  $b_{h,ss}^* < b_{l,ss}^*$ . As an optimal bid is always equal to  $\frac{1}{2}E_{\frac{1}{2}}(U|\cdot)$ , this implies that  $E_{\frac{1}{2}}(U|h, b_{h,ss}^*) < E_{\frac{1}{2}}(U|l, b_{l,ss}^*; x^*)$ . However, mere inspection of 20 and 23 reveals that  $E_{\frac{1}{2}}(U|l, b_{l,ss}^*; x^*) < E_{\frac{1}{2}}(U|h, b_{l,ss}^*; x^*)$ . Hence,  $E_{\frac{1}{2}}(U|h, b_{h,ss}^*) < E_{\frac{1}{2}}(U|h, b_{l,ss}^*; x^*)$ . Moreover, in step one I argued that there exists an increasing relationship between  $E_{\frac{1}{2}}(U|\cdot)$  and  $E_0(U|\cdot)$ . Hence,  $E_0(U|h, b_{h,ss}^*) < E_0(U|h, b_{l,ss}^*; x^*)$ , and an optimist cannot be indifferent between the two bids. ■

## Proof of Proposition 7

Let  $E(R|s)$  denote the expected revenue if players focus on the separating equilibrium. One has:

$$E(R|s) = \Pr(s_i = h) \Pr(r < b_{h,s}^*) b_{h,s}^* + \Pr(s_i = l) \Pr(r < b_{l,s}^*) b_{l,s}^*.$$

Similarly,

$$\begin{aligned} E(R|ss) &= \Pr(s_i = h) \left[ x \Pr(r < b_{h,ss}^*) b_{h,ss}^* + (1 - x) \Pr(r < b_{l,ss}^*) b_{l,ss}^* \right] \\ &\quad + \Pr(s_i = l) \Pr(r < b_{l,ss}^*) b_{l,ss}^*, \end{aligned}$$

where  $E(R|ss)$  denotes the expected revenue if players focus on the semi-separating equilibrium.

Taking into account that  $\Pr(s_i = h) = \Pr(s_i = l) = \frac{1}{2}$  and that  $r \sim [0, 1]$ , one has:

$$E(R|ss) > E(R|s) \Leftrightarrow \left( b_{l,ss}^* \right)^2 - \left( b_{l,s}^* \right)^2 > (1 - x^*) \left[ \left( b_{h,s}^* \right)^2 - \left( b_{l,ss}^* \right)^2 \right]. \quad (26)$$

Suppose  $c$  is close to (but nonetheless strictly greater than) 0.4,  $\delta$  is close to (but nonetheless strictly less than) 1, and  $p = 0.6$ . As  $\delta$  is close to one, it follows from proposition 4 that there exists a separating equilibrium. It is also easy to check that  $(p, c, \delta) = (0.6, 0.4 + \epsilon, 1 - \epsilon) \in \Omega_2$  (see 25). Thus  $(p, c, \delta) = (0.6, 0.4 + \epsilon, 1 - \epsilon)$  also supports a semi-separating equilibrium in which optimists bid  $b_{l,ss}^*$  with probability  $1 - x$ . Furthermore, it can be checked that if  $(p, c, \delta) = (0.6, 0.4 + \epsilon, 1 - \epsilon)$ ,  $x^* \simeq 0.72$  and that inequality 26 boils down to  $0.00211 > 0.00205$ , which is obviously satisfied. ■

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## Appendix B (Not for Publication)

### Proof of Lemma 1

Observe that equation 1 can be rewritten as:

$$\begin{aligned} W(s_i, b_i, b_{-i}) &= \Pr(H|s_i, b_{-i})(1-c) - (1-\mathcal{I})\Pr(H, a_{-i,1} = \text{wait}|s_i, b_i, b_{-i})(1-c) \\ &\quad - \mathcal{I}\Pr(L, a_{-i,1} = \text{wait}|s_i, b_i, b_{-i})c, \end{aligned}$$

where  $\mathcal{I} = 1$  if  $\Pr(H|s_i, b_{-i}, a_{-i,1} = \text{wait}) \geq c$  and  $\mathcal{I} = 0$  otherwise. The Lemma then follows from the fact that  $\Pr(\cdot, a_{-i,1} = \text{wait}|\cdot)$  is decreasing in  $(\lambda(h, \cdot), \lambda(l, \cdot))$ . ■

### Proof of Proposition 2

Suppose  $s_i = l$ . At time 1/2, player  $i$  computes  $\Pr(H|l, b_{-i}) \leq \frac{1}{2} < c$ , and there does not exist a continuation equilibrium in which  $\lambda^*(l, b_i, b_{-i}) \neq 0$ . Suppose  $s_i = h$  and that  $b_{-i} = b_l$ . As a “low” bid can only come from a pessimist,  $\Pr(H|h, b_{-i} = b_l) = \frac{1}{2} < c$ , and there does not exist a continuation equilibrium in which  $\lambda^*(h, b_i, b_l) \neq 0$ .

I now compute  $\lambda^*(h, b_h, b_h)$ . Suppose  $s_i = s_{-i} = h$ .  $\hat{\lambda}(h, b_h, b_h)$  is defined as a real number with which player  $-i$  must drill to equate player  $i$ 's gain of drilling (at time one) with her gain of waiting. Formally,  $\hat{\lambda}(h, b_h, b_h)$  is computed such that

$$\begin{aligned} \Pr(H|h, b_h) - c &= \delta \Pr(s_{-i} = h|h, b_h)\hat{\lambda}(h, b_h, b_h) \Pr(H|h, h)(1-c) \\ &\quad + \delta[\Pr(s_{-i} = h|h, b_h)(1 - \hat{\lambda}(h, b_h, b_h)) + \Pr(s_{-i} = l|h, b_h)] \\ &\quad \times \max \left\{ 0, \frac{p(1-p)x + p^2(1 - \hat{\lambda}(h, b_h, b_h))}{2p(1-p)x + (p^2 + (1-p)^2)(1 - \hat{\lambda}(h, b_h, b_h))} - c \right\}. \end{aligned} \tag{27}$$

Suppose  $\hat{\lambda}(h, b_h, b_h) < 1$ . Then, both players will only drill at time one with the same probability if  $\lambda^*(h, b_h, b_h) = \hat{\lambda}(h, b_h, b_h)$ . Suppose  $\hat{\lambda}(h, b_h, b_h) > 1$  (which is the case for sufficiently low values of  $\delta$ ). Then player  $i$  prefers to drill at time one even if she knows that her neighbor will drill with probability one. Thus, in any strongly symmetric equilibrium  $\lambda^*(h, b_h, b_h) = \min\{1, \hat{\lambda}(h, b_h, b_h)\}$ . I now show that there exists a unique value of  $\hat{\lambda}(h, b_h, b_h)$  which satisfies 27.

If  $\Pr(H|h, b_h, a_{-i,1} = \text{wait}) \geq c$ , 27 boils down to  $\Pr(H|h, b_h) - c = \delta(\Pr(H|h, b_h) - c) + \delta \Pr(L, s_{-i} = h|h, b_h)\hat{\lambda}(h, b_h, b_h)c \equiv RHS_1$ . Denote by  $\lambda_1$  the value of  $\hat{\lambda}(\cdot)$  which equates the LHS of the above equation with  $RHS_1$ . Formally,  $\lambda_1 \equiv \frac{(1-\delta)(\Pr(H|h, b_h) - c)}{\delta \Pr(L, h|h, b_h)c}$ . If  $\Pr(H|h, a_{2,1} = \text{wait}) < c$ , 27 boils down to

$$\Pr(H|h, b_h) - c = \delta \Pr(H, s_{-i} = h|h, b_h)\hat{\lambda}(h, b_h, b_h)(1-c) \equiv RHS_2.$$

Denote by  $\lambda_2$  the value of  $\hat{\lambda}(\cdot)$  which equates the LHS of the above equation with  $RHS_2$ . Formally,  $\lambda_2 \equiv \frac{\Pr(H|h, b_h) - c}{\delta \Pr(H, h|h, b_h)(1-c)}$ .

Observe that  $\Pr(H|h, b_h, a_{2,1} = wait)$  is decreasing in  $\hat{\lambda}(\cdot)$ . Call  $\lambda^c$  the value of  $\hat{\lambda}(\cdot)$  such that  $\Pr(H|h, b_h, a_{2,1} = wait) = c$ . Observe that  $\lambda^c < 1 \Leftrightarrow c > \frac{1}{2}$ . If  $\hat{\lambda}(\cdot) < \lambda^c$ ,  $RHS_1$  is the relevant right-hand side of equation 27. If  $\hat{\lambda}(\cdot) > \lambda^c$ ,  $RHS_2$  is the relevant right-hand side of equation 27. If  $\hat{\lambda}(\cdot) = \lambda^c$ ,  $RHS_1 = RHS_2$ . Observe also that

$$\frac{\partial RHS_1}{\partial \hat{\lambda}(\cdot)} < \frac{\partial RHS_2}{\partial \hat{\lambda}(\cdot)} \Leftrightarrow (1-p)^2 c < p^2(1-c) \Leftrightarrow \Pr(h|h)[\Pr(H|h, h) - c] > 0,$$

which is obviously satisfied.

I now show that  $\hat{\lambda}(\cdot) = \min\{\lambda_1, \lambda_2\}$ . Suppose  $\hat{\lambda}(\cdot) = \lambda_2$  and that  $\lambda_1 < \lambda_2$ .  $\hat{\lambda}(\cdot)$  will only be equal to  $\lambda_2$  if

$$\Pr(H|h, b_h, a_{-i,1} = wait; \hat{\lambda}(\cdot) = \lambda_2) < c \Leftrightarrow \lambda_2 > \lambda^c. \quad (28)$$

As  $\lambda_1 < \lambda_2$ , and as  $0 < \frac{\partial RHS_1}{\partial \hat{\lambda}(\Pr(H|h))} < \frac{\partial RHS_2}{\partial \hat{\lambda}(\Pr(H|h))}$ ,  $RHS_1$  will only be equal to  $RHS_2$  at a value  $\lambda^c > \lambda_2$ , which contradicts inequality 28. Using a similar reasoning, one can check that  $\hat{\lambda}(\cdot)$  cannot be equal to  $\lambda_1$  when  $\lambda_2 < \lambda_1$ . If  $\hat{\lambda}(\cdot) > 1$ , this means that player two cannot make player one indifferent between drilling and waiting (not even if she drills for sure if  $s_2 = h$ ) and in that case player one strictly prefers to drill. Hence,  $\lambda^*(h, b_h, b_h) = \min\{1, \lambda_1, \lambda_2\}$ . ■

### Proof of Proposition 3

The proof proceeds in two steps. First I compute  $\lambda^*(h, b_i, b_{-i})$  under the assumption that  $\lambda^*(l, b_i, b_{-i}) = 0$ . Next, I take  $\lambda^*(h, b_i, b_{-i})$  as given and show that it is a best reply for pessimists to wait.

Step 1: Suppose  $s_i = h$ . There are then three different cases: (i)  $(b_i, b_{-i}) = (b_h, b_h)$ , (ii)  $(b_i, b_{-i}) = (b_l, b_l)$  and (iii)  $(b_i, b_{-i}) = (b_l, b_h)$ .

Consider case (i). As only optimists bid  $b_h$ , both players infer that their neighbor is an optimist. This implies that  $\Pr(H|h, b_h, a_{-i,1} = wait) = \Pr(H|h, h) > c$ . Observe also that both players possess identical private information and face identical histories. As players use symmetric strategies, both of them drill at time one with the same probability. Player  $i$  is indifferent between drilling and waiting if

$$\Pr(H|h, h) - c = \delta \Pr(H, a_{-i,1} = drill|h, h)(1-c) + \delta \Pr(a_{-i,1} = wait|h, h)(\Pr(H|h, h) - c).$$

The equality above can be rewritten as  $\lambda^*(h, b_h, b_h) = \frac{(1-\delta)(\Pr(H|h, h) - c)}{\delta \Pr(L|h, h)c}$ , which, by assumption, is less than one.

Consider case (ii). Observe that  $\Pr(H|h, b_l) \geq \Pr(H|h, b_l, a_{-i,1} = wait) \geq \frac{1}{2} > c$ . If  $s_{-i} = h$ , both players possess identical private information and face identical histories. Hence, they drill

at time one with the same probability. Define  $\hat{\lambda}(h, b_l, b_l)$  as a real number with which player  $-i$  must drill (provided she is an optimist) to make player  $i$  indifferent between drilling and waiting (provided player  $i$  is an optimist). Formally,

$$\begin{aligned} \Pr(H|h, b_l) - c &= \delta \Pr(H, a_{-i,1} = \text{drill}|h, b_l)(1 - c) + \delta \Pr(a_{-i,1} = \text{wait}|h, h) \\ &\quad \times (\Pr(H|h, b_l, a_{-i,1} = \text{wait}) - c). \end{aligned}$$

The equality above can be rewritten as  $\hat{\lambda}(h, b_l, b_l) = \frac{(1-\delta)(\Pr(H|h, b_l) - c)}{\delta \Pr(s_{-i} = h|h, b_l) \Pr(L|h, h)c}$ . If  $\hat{\lambda}(h, b_l, b_l) > 1$ , this means that, due to a low discount factor (or to a low  $\Pr(s_{-i} = h|h, b_l)$ ), player  $i$  strictly prefers to drill at time one despite the fact that player  $-i$  will drill with probability one if she is an optimist. Hence, if  $\lambda^*(h, b_l, b_l)$  is defined as  $\min\{1, \hat{\lambda}(h, b_l, b_l)\}$ , player  $i$  cannot gain by drilling at time one with a different probability.

Consider case (iii). I show that  $\lambda(h, b_l, b_h) = 0$  and  $\lambda(h, b_h, b_l) = 1$  constitutes an equilibrium in the continuation game. As  $b_{-i} = b_h$ , player  $i$  knows that  $s_{-i} = h$ . Suppose player  $i$  expects player  $-i$  to drill at time one with probability one. Player  $i$  prefers to wait if  $\delta \Pr(H|h, h)(1 - c) > \Pr(H|h, h) - c$ . Rewriting the inequality above yields  $\delta \Pr(L|h, h)c > (1 - \delta)(\Pr(H|h, h) - c)$ , which, by assumption, is satisfied. Player  $-i$  expects player  $i$  to wait with probability one. As  $\Pr(H|h, b_l) \geq \frac{1}{2} > c$ , and as  $\delta < 1$ , it is a best reply for her to drill at time one with probability one.

Step 2: Suppose  $s_i = l$ . There are then two different cases: either  $b_{-i} = b_l$  or  $b_{-i} = b_h$ . If  $b_{-i} = b_l$ , player  $i$  computes  $\Pr(H|l, b_l) \leq \Pr(H|l) < c$  and she strictly prefers to wait. If  $b_{-i} = b_h$ , player  $i$  computes  $\Pr(H|l, b_h) = \Pr(H|l, h) = \frac{1}{2}$ , which is greater than  $c$ . As  $x < 1$ , player  $-i$  computes  $\Pr(H|h, b_l) > \frac{1}{2} =$  player  $i$ 's posterior. As both players possess different posteriors, they do not have to drill at time one with the same probability. Player  $i$  strictly prefers to wait if and only if

$$(1 - \delta) \left( \frac{1}{2} - c \right) < \delta \frac{1}{2} c. \quad (29)$$

By assumption  $(1 - \delta)(\Pr(H|h, h) - c) < \delta \Pr(L|h, h)c$ . As  $(1 - \delta)(\frac{1}{2} - c) < (1 - \delta)(\Pr(H|h, h) - c)$  and as  $\delta \Pr(L|h, h)c < \delta \frac{1}{2}c$ , I conclude that inequality 29 holds. Thus, in this continuation equilibrium a pessimist always waits with probability one. ■