Google Inc.
1600 Amphitheatre Parkway
Mountain View, CA 94043

Google

Main 650 253.0000
Fax 650 253.0001
www.google.com

August 12, 2008

Senator Herb Kohl
Senate Judiciary Committee
Subcommittee on Antitrust,
Competition Policy and Consumer
Rights
SH 308
Washington, DC 20510

Re: July 28, 2008 Letter with follow-up questions to the July 15th hearing on "The Google-Yahoo Agreement and the Future of Internet Advertising"

Dear Senator Kohl:

I appreciated the opportunity to speak with you and your Subcommittee at the July 15, 2008 hearing and am writing to respond to the follow-up questions posed in your letter dated July 28, 2008.

Before turning to the follow-up questions, I would like to clarify an incorrect assertion made by Microsoft at the hearing. Microsoft suggested that Google's nonexclusive advertising services agreement with Yahoo! would give Google a 90% share of a relevant market. This claim is incorrect. In fact, Google has less than a 30% share of the online advertising market and will continue to have less than 30% after this agreement is implemented.

First, the relevant market in this matter is not limited, as Microsoft now suggests, to a narrow category of search-targeted text advertisements purchased from web search providers such as Google, Yahoo!, Microsoft, and Ask. The relevant market includes, at a minimum, all online advertisements.[1] Google and other web search companies face vigorous competition from online ads that employ other targeting technologies, such as contextual and behavioral targeting, as well as from other online ad formats, such as display ads. Before Google and Yahoo! announced their nonexclusive commercial arrangement, Microsoft agreed with this point.

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[1] For purposes of this letter, I limit my discussion to online ads but note that newspapers and other off-line advertisements increasingly compete with Google, Yahoo!, and Microsoft, as Microsoft has previously acknowledged. *See, e.g.*, Don Dodge, Director of Business Development of Microsoft, *Web Advertising Gone Wild*, Don Dodge on the Next Big Thing, Apr. 30, 2007, http://dondodge.typepad.com/the_next_big_thing/2007/04/web_advertising.html ("Google proved there was billions of dollars in small text ads from millions of small businesses. Something the newspapers already knew. And it is newspapers that are feeling the pain of Google's success.").

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For example, in connection with Google's acquisition of DoubleClick, Microsoft made submissions to the Federal Trade Commission asserting that the relevant market includes both text and display ads.[2] Microsoft's General Counsel, Brad Smith, confirmed this point in an interview with Fortune Magazine last year. When asked whether text ads compete with display ads, Mr. Smith explained: "Are they in the same market? It's a very objective question. If the price of one goes up, will publishers switch to the other? We think the answer's yes."[3] Microsoft repeated this claim in testimony before your Subcommittee, asserting that DoubleClick, a display ad serving company, was Google's "single largest competitor."[4]

AT&T has also apparently changed its public position on the relevant market. In a submission to authorities opposing the Google-DoubleClick transaction, for example, AT&T said that text and display ads are relatively close substitutes and that advertisers switch between these alternatives based on price and performance. This is inconsistent with what AT&T told the Subcommittee at the July 15th hearing.

Microsoft and AT&T even jointly funded research by two professors who conducted a study of advertiser behavior and concluded that the relevant market includes both text and display ads. In their published report, Professors Hahn and Singer stated: "the data show that a large percentage of search and contextual advertising customers would substitute to graphic [display] ads in response to a relative change in prices, indicating that consumers perceive those alternative online advertising channels to be substitutes."[5]

We are of course aware of the brief passage in the FTC's closing statement from the DoubleClick transaction suggesting that search ads on web search sites do not often compete with other forms of online ads. We respectfully disagree. This issue was not particularly relevant to the FTC's review of that transaction as DoubleClick does not sell ads of any kind, so the FTC did not engage in a dialogue with Google or DoubleClick about this question. Nor, to our knowledge, did the FTC conduct any economic study to examine the issue or cite such work

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2 *See, e.g.,* Louise Story, Microsoft's Arguments Against Google-DoubleClick Marriage, N.Y. Times Bits Blog, December 21, 2007 http://bits.blogs.nytimes.com/2007/12/21/microsofts-arguments-against-google-doubleclick-marriage.

3 Bradford Smith, Senior Vice President, General Counsel & Corporate Secretary, Legal & Corporate Affairs of Microsoft, *quoted in* Roger Parloff, *On Google-DoubleClick: An Interview with Microsoft GC Brad Smith*, Fortune Legal Pad, Apr. 26, 2007, http://legalpad.blogs.fortune.com/2007/04/26/on-google-doubleclick-an-interview-with-microsoft-gc-brad-smith/. Microsoft's most recent annual report also reflects a view by Microsoft that it competes broadly in online advertising. *See* Microsoft Corp., Annual Report (Form 10-K), at 9 (Aug. 3, 2007), *available at* http://sec.gov/Archives/edgar/data/789019/000119312507170817/d10k.htm.

4 Hearing before the Senate Judiciary Comm. Subcommittee on Antitrust, Competition Policy, and Consumer Rights (Sept. 27, 2007), Transcript of Oral Remarks of Bradford L. Smith, Senior Vice President, General Counsel & Corporate Secretary, Legal & Corporate Affairs of Microsoft at 9.

5 *See* Robert W. Hahn & Hal J. Singer, *An Antitrust Analysis of Google's Proposed Acquisition of DoubleClick 24* (AEI-Brookings Joint Center Related Publication, No. 07-24 Feb. 2008), at 37 and note ††, *available at* http://www.brookings.edu/~/media/Files/rc/papers/2007/09useconomics_hahn.pdf, (thanking AT&T and Microsoft for providing support for the paper).

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in its statement. In contrast, the European Commission analyzed the market definition issue in depth, and in its lengthy and detailed published opinion declined to find that search-targeted ads constitute a separate relevant market. Finally, in addition to being at odds with the views of major companies like Microsoft and AT&T and with the EC decision, we note that the FTC's passing statement on this issue conflicts with at least one U.S. court case.[6]

Both Microsoft and AT&T have acknowledged previously that text ads compete vigorously with display ads. In this more relevant online advertising space, Google's share of revenue is less than 30%.

Second, I would like to address another serious flaw in Microsoft's "90%" claim. Even focusing on just search-targeted text ads sold by web search companies,[7] following implementation of the nonexclusive agreement with Google, Yahoo! will still control the entirety of its search ad business. Yahoo! will make the competitive decisions regarding its own ad inventory, including how many ads to show, where to show them, and which ones (if any) to match through Google's technology. Yahoo! has indicated that it will continue to run its own ad auction and use its own ad matching technology for many of its own ads. Moreover, to the extent that Yahoo! turns to Google for ads, Yahoo! will retain the majority of the revenue generated by those ads; thus, Yahoo!'s share of revenue will actually grow relative to Google's.

Finally, Microsoft's "90%" sound bite is also misleading because even if one focuses on this narrow segment of the online ad market, and even if one incorrectly attributes all of Yahoo's current share within that segment to Google, Google still would not have any market power or "control." To suggest that Google faces no competitive pressure in the sale of search-targeted text ads ignores not only Yahoo!, Microsoft and Ask (not to mention competitors offering other ad formats and targeting technologies), it also ignores several other important sources of existing and potential competition. For example, eBay offers online sellers the ability to list and advertise their products in response to specific searches, and there are over 100 million users who search for product information on eBay.[8] Similarly, Amazon offers online sellers an opportunity to list and advertise their products in response to product searches conducted by its tens of millions of users. These ads are priced on a per-click basis and sold through an online system that is similar to Google's. An example of powerful potential competition is Wikipedia, a web site that tens of millions of users use to search for information which could easily offer

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6 *See KinderStart.com v. Google*, 2007 WL 831806 (N.D. Cal.) ("[T]here is no logical basis for distinguishing the Search Ad Market from the larger market for Internet advertising").

7 Microsoft explains its "90%" number by asserting that Google has a 70% share of search-targeted text ads sold by web search engines and Yahoo! has 20%. But, even looking at the narrowest possible segment these numbers are questionable. For example, Nielsen.netRatings reports that Google has 59% of web search, Yahoo has 16.6%, and Microsoft has 14%. *See* Press Release, Nielsen Online, Nielson Online Announces June U.S. Search Share Rankings (July 18, 2008), *available at* http://www.nielsen-netratings.com/pr/pr_080718.pdf.

8 eBay's 2007 annual report also notes that the company is deriving an increasing portion of its revenues from advertising. eBay Inc., Annual Report (Form10-K), at 22 (Feb. 29, 2008), *available at* http://sec.gov/Archives/edgar/data/1065088/000095013408003741/f36571e10vk.htm.

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search advertising. As Microsoft's own executive has explained, "Online advertising is exploding, it's kind of a white hot space."[9]

1. Supporters of the Google-Yahoo! agreement argue that advertisers should not worry about price increases because the price of one of your internet search ads is set by an <u>auction</u> among advertisers, not by Yahoo or Google. Michael Callahan of Yahoo!, for example, stated that "prices for search terms are set by open and fair market-based auctions." A couple of questions about this:

<u>First</u>, doesn't Google set a <u>minimum price</u> for each search term in the auction? Isn't there a risk that this minimum price will increase if Google and Yahoo! no longer compete?

Google and Yahoo! will continue to compete after the agreement is implemented. The agreement is simply a commercial arrangement between Yahoo! as a publisher and Google as a supplier of ads, under which Yahoo! will have the option of using Google's strong ad matching technology to supply ads for a portion of Yahoo!'s inventory. The agreement will have no effect on minimum bids in Google's auction. Google's auction determines minimum bids based on a particular advertiser's Quality Score for a specific keyword/ad combination.[10]

Minimum bids in Google's auction help ensure ad quality, and they also help advertisers understand whether their bids are "in the ballpark." Minimums have very little effect on revenue – in fact, before Google changed its policy a few years ago to allow the minimums to go lower for high quality ads (and higher for low quality ads), Google's minimum bid was 5 cents. In contrast, until just a few months ago, Yahoo!'s minimum was 10 cents across the board. This difference simply underscores that Google's minimums are about quality and transparency, not about Yahoo!, and there is no reason for Google to change this now.

<u>Second</u>, isn't it true that the highest bidder in the auction doesn't always win? You determine the winner by looking at other factors, such as whether the bidder is a strong advertiser which consumers are likely to click on, right?

Google's technology determines the winner of an auction based on a combination of the advertiser's bid and the relevance of the advertiser's ad to the user's search query. Microsoft and Yahoo!'s auctions both use similar approaches – in fact, this is simply a matter of good sense. For example, in announcing its introduction of a quality score metric in 2007 Microsoft explained, "we improved how we establish the quality and relevance of ads and landing pages in

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9 Yusuf Mehdi, Senior Vice President, Strategic Partnerships of Microsoft, Remarks at Goldman Sachs Internet Conference (May 23, 2007), *available at* http://www.microsoft.com/msft/download/transcripts/fy07/YusufMehdi0523207.docx.

10 Google AdWords Learning Center, Lessons Catalog, http://www.google.com/adwords/learningcenter/text/18719.html. *See also* Google AdWords Help Center, What is 'Quality Score' and How is it Calculated?, http://adwords.google.com/support/bin/answer.py?hl=en&answer=10215.

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relation to the search user's likely intent. This improvement will ensure that we maintain a high quality of ads and relevance to the Live Search user and is not a radical change, but an enhancement to our existing guidelines around relevance and quality."[11]

Bidding a high price per click is meaningless standing alone when ads are priced on a per click basis – if an advertiser bids a high price but no one will click on his ad, he is not the most relevant ad to users. To take a simple example, suppose FTD bids 5 cents per click for the keyword "flowers" so that it can advertise nationwide flower delivery. If the Milwaukee Flower Shop with only local Milwaukee delivery bids 10 cents per click for the keyword "flowers", users will benefit more if the top slot goes to FTD, even though the Milwaukee shop bid twice as much, as more users will find the FTD ad useful and click on it, generating more revenue.

Taking quality into consideration is therefore useful on many different levels. It means that FTD can bid less to win the top slot. As for the Milwaukee Flower Shop, it might want to bid on a different term, for example "Flowers Milwaukee" – users who click on its ad after typing in those words are much more likely to live in Milwaukee and buy flowers from that store, meaning that each click that the shop pays for will generate more sales for the store. Put another way, the Milwaukee Flower Shop does not want to pay for lots of clicks from users in other parts of the country who will never actually buy flowers from the shop. Taking quality into consideration is good for everyone: FTD wins the top slot for less, users see more relevant ads, and the Milwaukee flower shop can refine its targeting approach and get more for its advertising dollars through smarter strategies.

Google's "AdWords Help Center" provides a detailed tutorial about how Google's system works. As the Help Center explains, when a user enters a search query, Google's sophisticated ad matching technology compiles a list of all ads that it determines to match that query. The list of ads is then ordered based on their Ad Rank.[12] The ad with the highest Ad Rank appears in the most prominent position, the second highest ranked ad appears in the second most prominent position, and so on down the page. On search results pages, the Ad Rank is defined by the Quality Score of the keyword/ad combination and the cost-per-click bid,[13] with Quality Score being derived from the ad's click-through rate on Google, the relevance of the keyword and ad to the search query, and other relevance factors.

2. In response to my question at the hearing about what Google would do if the Justice Department recommended against the Yahoo!-Google deal, you said that you would "work through" any issues that the Justice Department has with the deal. But this does

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11 Microsoft AdCenter Blog, http://adcenterblog.spaces.live.com/Blog/cns!85E824269AB8C30D!352.entry.

12 Google AdWords Help Center, *How is my keyword's Quality Score used?*, http://adwords.google.com/support/bin/answer.py?answer=49174&query=quality+score&topic=&type=f&%20onclick=.

13 Google AdWords Help Center, *How is my keyword's Quality Score used?*, http://adwords.google.com/support/bin/answer.py?answer=49174&query=quality+score&topic=&type=f&%20onclick=.

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not answer my question, so let me restate it. If the Justice Department opposed this deal as anti-competitive, would Google terminate it or would you go through with it anyway, forcing the Justice Department to bring, and win, an antitrust suit in court in order to block it?

We believe that the Department of Justice will and should agree that this agreement is pro-competitive. We have cooperated with the Department in its investigation and have agreed to delay implementation of the agreement in order to give the Department the opportunity to review it (a step not required under federal law). Google is in regular contact with the Department and anticipates that it will continue to have a constructive dialogue with the Department. We cannot predict at this stage every possible scenario if the Department ultimately objects to some aspect of the agreement.

3. We understand that under this agreement the amount of advertising outsourced is at Yahoo!'s discretion. We can all agree that if almost none is outsourced that we have fewer competition concerns than if most or all of it is.

What is the correct way to analyze this transaction under the antitrust laws? Given that the amount of advertising outsourced is at Yahoo!'s discretion, should we presume in the analysis that Yahoo! does, in fact, outsource all of its advertising?

Yahoo! has stated publicly that it plans to use Google's strong ad matching technology for only a portion of its inventory. Indeed, Yahoo! has every incentive not to backfill all of its ads using Google's technology. Yahoo! earns 100% of the revenue generated from every ad it provides itself, but it must share with Google a portion of the revenue generated from any ad Google provides. Yahoo! has repeatedly and publicly expressed its intention to continue innovating and competing in search advertising, a business it believes to be crucial to its corporate mission. And, adding to Yahoo!'s incentive, given that this agreement only involves North America, Yahoo! will continue to supply ads outside of North America in the same manner in which it does today.

The way to analyze the transaction is as a non-exclusive arrangement under which Yahoo! retains control over its own inventory. Therefore, the agreement should not be viewed as combining shares of the companies, who will continue to innovate and compete in the highly competitive online advertising space.

4. The Federal Trade Commission analyzed the most recent transaction in this sector – when Google purchased DoubleClick. Given the FTC's background and understanding of the market, is there a reason that you gave the review to the Justice Department and not to the FTC? Do you think that the FTC should also review the agreement?

The agencies, not the parties, select the reviewing agency. Google played no role in the selection of the Department of Justice and was informed of the decision by the Department.

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Google Inc.
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www.google.com

I hope this information is helpful, and stand ready to answer any further questions you or the Subcommittee might have.

Sincerely,

David Drummond
Senior Vice President, Corporate Development and
Chief Legal Officer, Google