The benefits of Randomization Mechanisms in Counter-Strike: Global Offensive

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1 Research Question

In the world of video games, a market has appeared for in-game purchases. These cosmetic items affect the aesthetics of a player, but often do not influence the game-play and are sold by the designer. Recently the method of the sales has moved away from the traditional market approach of individual prices for each item, and towards the "loot box" approach. These items are sold in randomized lotteries, often given away, with a cost of opening.

Traditional economic research on randomization informs us that for the risk-neutral customer, there is no benefit to randomization, as the consumer is indifferent. So for this mechanism to be so far-reaching into the market, there must be a risk-loving nature to the consumers. This begs the question of how much money are these companies gaining by exploiting the risk-loving nature of the consumers.

Counter-Strike global offensive presents an interesting case study for these types of markets, as there is a secondary market where individuals can buy and sell these loot boxes, as well as their contents. This was one of the first games to introduce the concept of the randomized "loot box" so there is a long market history available. As important as the secondary market is the public information about the probability of obtaining the contents of the boxes, as required by Chinese Law. Because the supply of the boxes is strictly controlled, the market for these items is lively, with many items trading for hundreds of dollars, and a few entering the thousands.

These factors combine to allow for a structural estimation of demand, and risk-tolerance. I intend to combine a demand estimation BLP (1995) model with Cumulative Prospect Theory to estimate the monetary value of randomization in the market for weapon skins in Counter-Strike Global Offensive.

2 Literature Review

The literature in demand estimation is primarily focused around the seminal paper written by Berry, Levinsohn, and Pakes (1995). This paper presents a framework for estimation of a heterogenous consumers in a discrete choice logit demand framework. This allows for a richer substitution framework, and an ability for the substitution affects to escape the independence of irrelevant alternatives result of traditional logit demand.

One such example of estimation is the paper by Nevo (2001). It estimates the demand in the cereal industry in order to determine the market power in the industry, and determine if

the high product margins were caused by brand recognition, or by collusive behavior between the few firms in the industry. This type of counter-factual estimation is common within the literature, and is tested in many ways from both the supply and the demand side of the estimation.

I intend to take a different path from what is commonly performed with these tools, and attempt to use the estimated parameters to compute what these consumers would have been willing to pay for an item under some different policy regime (no randomness)

Estimation of these models began with the strategy first suggested by Berry et al. (1995) commonly referred to as the Nested Fixed Point Algorithm, but has recently been superseded by the Mathematical Programming under Equality Constraints suggested by Su and Judd (2012). This algorithm performs extremely well under sparse Hessian and gradients, of which my method contains many. This will allow for significantly easier estimation of the demand system.

Barberis (2013) presents a broad review of where Prospect theory has been applied, as well as its problems with its application, particularly in the choice of a reference point, which appears to be very significant, but there is little guidance on what to choose beyond possibly the expected value of the lottery. Applications of the model, originally proposed by Tversky and Kahneman (1992) exist mostly in finance and insurance. I intend to extend this body to look at the behavior of non-expert individuals in a market scenario. I believe that this area has not had many applications, likely because of the rarity of quality data outside of these fields.

3   Data

The data are market transaction history for all items sold on the *Steam Community Market* for Counter-Strike: Global Offensive.

Counter-Strike Global Offensive is a first-person shooter game where one team (terrorists) attempt to plant a bomb and defend it while the counter-terrorists attempt to defuse the bomb. Each team has specific guns that they are able to purchase at the start of every round. The in-game cost, game balance, and meta-game all contribute to the popularity of each weapon. Players may choose to purchase purely cosmetic "skins" for their weapons which change the appearance of their weapon when they buy it. These skins are sold in lotteries called weapon crates which are dropped randomly to players in-game. The drop rates are unknown, and believed to change often. Upon receiving a weapon crate, a player may elect to spend $2.50 to open it, or sell it on the community market.

These crates display which weapon skins they may contain, and the probability of obtaining each item within the crate is public knowledge. That is, the contents of the crate follow a known distribution, and can therefore be estimated under theories of risk. The contents of the crate can then be held onto, or sold at market.

3.1   Market

The market that these weapons can be sold at is the *Steam Community Market* which is run by Valve, the same company that makes Counter-Strike: Global Offensive. The market is a

continuous time double-auction. Sellers may place sell orders, and buyers buy orders, and the market functions by matching the buyers and sellers, always selling at the seller's price. This is known to converge quickly to a competitive market, and will be treated as such for this project. Cripps and Swinkels (2004) There are two complications however, there is a 15% tax placed on the market by Valve, which is taken from the seller's earnings. This is complicated by the discrete nature of the selling, and the tax always rounds up in favor of Valve. That is, an item selling for $0.03 would return $.02 to Valve rather than 15%. This will not be a large factor in my model as I am primarily interested in calculating demand.

For the past 30 days, there is data on hourly median market price as well as quantity sold. For the remaining time that an item has been at market, there is data for daily median price and quantity sold. The data also contain active buy and sell orders at the time of its mining: (June 7th 2018). No history for these buy and sell orders is available.

3.2   Characteristics

Since the model used will be in the characteristic space rather than the product space, I am especially interested in characteristics of the different weapons in the game. I shall ignore the characteristics that will be used to determine the market for the weapon, detailed in Assumption 1 in the model section. Unique to each weapon is a float value, between 0 and 1, which indicates the wear on the weapon. Wear does not change with use, and is determined when a weapon is un-boxed. This float is distributed uniformly, but based on its value, places the weapon into different brackets for sale. We will consider all weapons in a particular bracket as homogenous.

Float	Condition
0.00 - 0.07	Factory New
0.07 - 0.15	Minimal Wear
0.15 - 0.38	Field-Tested
0.38 - 0.45	Well-Worn
0.45 - 1.00	Battle-Scarred

Independent of wear, each item also has a 10% chance of being StatTrak™, where the gun includes a tracker that counts the number of kills a player has with this weapon. This number is reset on sale, so it can be treated simply as a binary indicator.

The contents of the crate are divided into several tiers, based on their rarity from being obtained in a box. These tiers and their probability of being obtained are given below:

Probability	Rarity
.0026	Special (Gold)
.0064	Covert (Red)
.032	Classified (Pink)
.1598	Restricted (Purple)
.7992	Mil-spec (Blue)

4   Model

4.1   Discrete Choice Demand

Let us believe that individuals have a valuation for loot boxes as suggested by Cumulative Prospect Theory. Following a discrete choice framework for demand estimation, I assume that the utility of a consumer i for loot box j in time t is given by:

$$u_{ijt} = V(x_{jt}, p_{jt}; \theta) + \xi_{jt} + \epsilon_{ij} \quad \epsilon_{ij} \sim Gumbel$$

Where V is the valuation for the loot box, p_{jt} is the price, x_{jt} are the covariates, ξ_{jt} is some demand shock common to all consumers (this can be rationalized as unobserved benefits), ϵ_{ij} is a type-1 extreme value shock unique to the consumer and good, and θ is the vector of parameters for the valuation function

The demand for this good then is given by the probability that it has the maximum utility. This can be computed using the properties of the Type-1 extreme value distribution. The maximum follows a logistic distribution, and the probability is given by:

$$\Pr(i \to j) = \frac{\exp(V(x_{jt}, p_{jt}; \theta) + \xi_{jt})}{\sum_{k \in \mathcal{F}} \exp(V(x_{jt}, p_{jt}; \theta) + \xi_{kt})}$$

In this sense, demand is non-random, and the Econometrician observes the price of the box, the covariates of the box, as well as the equilibrium quantity q_{jt}. All facets here observed, save the fact that the price and quantity are equilibrium prices and quantity rather than various points along the same demand curve.

Following the structure of Berry (1994) we consider an outside option that has some market share. The outside option is simply not partaking in any of the lotteries, and thus the valuation of this is 0. However there is still some unobserved demand ξ_{0t}. Inversion to solve for this parameter is simple, as $\Pr(i \to 0) = \frac{\xi_0}{\sum_{k \in \mathcal{F}} \exp(V(x_{jt}, p_{jt}; \theta) + \xi_k)}$. Dividing each demand equation by the outside option and taking logs yields us:

$$\log s_{jt} - \log s_{0t} = V(x_{jt}, p_{jt}; \theta) + \xi_{jt}$$

Since ξ_{jt} is unobserved by the econometrician, it takes the form of the unobserved error in the demand estimation procedure. However, it is sometimes endogenous to price as price is formed by the intersection of both supply and demand shocks. We need valid instruments for the estimation of this demand.

4.2   Instruments

Endogeneity occurs in this model via the simultaneity of supply and demand. Valid instruments for the price therefore must be supply shifters that do not affect the demand. Supply can be thought of as the players who have received a loot box randomly and wish to sell it. To simplify the dynamics of the problem, upon receiving the item individuals plan to sell it or not, so the supply of these loot boxes is heavily dependent on active players in that day and the previous day.

It is assumed that demand is a function of the long-run average number of players, or the amount of "active players" over the period of the month. This number is different from the daily players that play each day, as relatively few people are able to play each day for many reasons. However, loot boxes are given randomly to each player who plays in a day. We wish to use this fact to construct instruments for the demand. Suppose the true number of active players is N. Then daily players is $N + \epsilon_t$, i.e. some shock that determines daily player-base. We wish to use this shock ϵ_t as a cost-shifter that does not affect demand. If we estimate N by the average of all players over a significant time period, we can instrument demand using the daily deviations from this average. We instrument for price with the deviations of the current day of sale as well as the previous days.

Supply can be thought of as upward sloping with an active price floor at a price of .03 which is often binding. In the set of transactions where the price floor is binding, there is no concern of simultaneity, and therefore price is exogenously determined by the existence of the price floor. Since we use multiple instruments for price in the endogenous case, the remaining instruments will be made zero for the exogenous price case.

Demand can then be estimated off of the condition that:

$$\mathbb{E}\left[Z_t(\xi_{tj})\right] = 0 \qquad \mathbb{E}\left[p_{jt}\xi_{jt}\right] = 0 \quad \text{When } p = \$.03$$

Also present in the data is active buy orders, these are orders that there is not yet supply to fulfill. However it is a dominant strategy for place your valuation as the bid. Therefore there is no concerns about shading, and we may treat these orders as true valuations. In the case of these estimates, we should find that demand shock is equal to zero, and uncorrelated with the valuation, or that $\mathbb{E}\left[p_{jt}\xi_{jt}\right] = 0$. I note that the same choice and discrete choice framework holds for those that post unfulfilled buy orders, so there is no different model for valuations under the unfulfilled order framework.

This gives us price moments for each of the possible cases of the data. The rest of the covariates are the probabilities of obtaining each of the items, which are obviously exogenous and the last known prices of the contents of the loot boxes. We shall takes these prices as exogenous as they were determined by the supply and demand of the item in previous time periods.

We may combine all of these into a vector x_{jt} along with a constant term and our condition becomes one of $\mathbb{E}\left[x_{jt}\xi_{jt}\right] = 0$. This provides us with $2k + 2$ moments per data point, when there are k contents, and there are 3 parameters of interest to estimate. We are extremely over-identified, and may be able to consider more complicated functional forms given additional time.

4.3   Estimation

$$\xi_{jt} = \log s_{jt} - \log s_{0t} - V(x_{jt}, p_{jt}; \theta)$$

Consider a matrix of exogenous variables Z_j defined as above, we wish to estimate the parameters of V based on the condition that this matrix is orthogonal to ξ. This could be accomplished using either Nonlinear Least-Squares or Generalized Method of Moments, I shall employ the latter.

All of the orthogonality conditions combine to:

$$\mathbb{E}\left[Z'_{jt}\xi_{jt}\right] = 0$$

The estimation procedure can be written as:

$$\min_{\boldsymbol{\xi}_{j,t},\xi_{j,t}} \sum_{j,t} \boldsymbol{\xi}'_{j,t}\Omega\boldsymbol{\xi}_{j,t} \tag{1}$$

$$\text{subject to: } \xi_{j,t} = \log s_{jt} - \log s_{0t} - V(x_{jt}, p_{jt}; \theta) \tag{2}$$

$$\boldsymbol{\xi}_{j,t} = \xi_{j,t}\boldsymbol{Z}_{j,t} \tag{3}$$

4.4   Cumulative Prospect Theory

We now examine the structure of the Valuation function $V(x_j, p_j; \theta)$. Denote the probabilities of each of the contents of the lotteries by π_i and their values as x_i. We now re-index these by a permutation s_i such that $x_{s_1} < x_{s_2} < ...$ and so on. The cumulative probability Π_i can be written as $\sum_{i=1}^{K} \pi_{s_i}$. From these objects we can construct the value function for the lottery.

Cumulative Prospect Theory includes several important concepts not observe in classical decision making under risk.It incorporates reference dependence, which implies that people view things in the context of losses and gains rather than changes to their overall wealth. This is attractive for computational reasons. It also utilizes loss aversion, the notion that losses are relatively more costly than gains. The model also incorporates diminishing sensitivity, the notion that valuations are concave in losses and convex in gains. The final concept is probability weighting, the notion that consumers act as if they were facing different probabilities than what they encounter.

We note that the price of opening a case is two-fold, first the case must be bought at the market for its price, and then the price of the key, denoted p_{key} must also be paid to open the case. The time required to open the case is trivial, and will not be considered. Since gains are treated differently than losses, let the parameterization of these gains and losses be defined as:

$$v(x) = \begin{cases} x^{\alpha} & x \geq 0 \\ -\lambda(-x)^{\alpha} & x < 0 \end{cases}$$

In this sense, α captures the risk-loving or risk-averse nature of the consumer, while λ captures their level of loss-aversion.

In cumulative prospect theory, the cumulative mass (distribution) function is weighted such that individuals overweight the tail probabilities. This is especially important in this model, as there are many high valued rare items. If this is the case, a severely distorted distribution could lead to individuals systematically overvaluing lotteries despite even being risk-averse. Colloquially, it is believed that this concept is what allows for this type of randomization to flourish in a market that is primarily populated by young people.

$$w(P) = \frac{P^{\delta}}{(P^{\delta} + (1-P)^{\delta})^{\frac{1}{\delta}}}$$

For some item that is within the contents of the box, a consumer's valuation is transformed by the function:

$$F(x_i) = \left[w(\Pi_{s_i}) - w(\Pi_{s_i-1}) \right] v(x_i - p_j - 2.50)$$

The valuation for the lottery can then be written as the sum of this transformation for all of the contents of the lottery:

$$V(x, \pi, p_j) = \sum_{i=1}^{K} F(x_i)$$

5 Counerfactuals

Of interest is how much better this market structure is performing compared to a monopoly pricing schedule. This would require estimating the demand for the contents of the lottery, and then computing the optimal monopolist price for each good.

5.1 Demand Estimation

We wish to estimate the demand for this model using a discrete choice model for demand. This immediately raises the concern that it only allows for one good to be purchased, and it is common for individuals to have many weapon skins in the game. To this end, we shall split the market into several sub-markets and make a heavy identifying assumption. This assumption will allow for the discrete choice model to be applicable, and also creates price instruments for estimation.

Assumption 1. *Items are split into markets defined by the in-game role that all of the weapons in this market fulfill.*

These markets are defined by domain knowledge. For example, we treat the AK-47, the single most popular gun in the game as its own market, competing only with its own skin and condition variants. However, the M4A4 and the M4A1-S will be considered as competitors, as will the CZ75, Tec9, and Five-Seven. Weapons that fill the same role, or the same weapon slot will be considered in the same market. The assumption takes the form of claiming that one individuals do not substitute between roles, and only consider substitution between weapon skins for the same role. This ensures that consumers only purchase a single item at a time, as one could never equip multiple skins for the same role. The full power of this assumption will become clear in the instruments section.

5.1.1 BLP

To estimate the demand for the contents of the boxes, I intend to implement a standard BLP demand estimation model (1995). This is a discrete choice demand system. Consider J goods in T markets for I consumers indexed by j, t, i respectively. Assuming quasilinear utility, the utility for consumer i purchasing good j is:

$$u_{ij} = \alpha_i p_j + x_j \beta_i + \xi_j + \epsilon_{ij}$$

Where p_j is the price of good j, x_j are the observed characteristics of good j, ξ_j are the characteristics of good j observed by consumers and producers but not by the econometrician, α_i, β_i are consumer i's individual preference parameters over these characteristics, and $\epsilon_{ij} \sim T1EV(0)$ is a random shock only observed by the consumer. This is a standard logit model, but we have unobserved heterogeneity among consumers.

Consumer i then chooses the good that gives him the highest utility, the probability that that good is good j is given by:

$$\Pr(i \to j) = \frac{\exp(\alpha_i p_j + x'_j \beta_i + \xi_j)}{\sum_{k \in \mathcal{F}_t} \exp(\alpha_i p_k + x'_k \beta_i + \xi_k)}$$

Each consumer has individual logit demand. If we choose to normalize the mass of consumers to one, then the market share of good j should be equal to the expected value of this individual demand, averaged over the distribution of valuations.

$$\pi_j = \mathbb{E}\left[\Pr(i \to j)\right]$$

Let us define the observed market shares as:

$$\hat{s}_j = \frac{1}{I} \sum_{i=1}^{I} \mathbb{1}_{\{y_i = j\}}$$

From the Weak Law of Large Numbers, we believe that $\hat{s}_j \xrightarrow{p} \pi_j$. Define the distribution of (α_i, β_i) as θ. By assuming that this convergence in probability has been reached, we arrive at:

$$\hat{s}_j \approx \mathbb{E}\left[\Pr(i \to j)\right] = \int \Pr(i \to j) d\theta \approx \frac{1}{N_s} \sum_{i=1}^{N_s} \Pr(i \to j)$$

Where we approximate the integral of $\int \Pr(i \to j) d\theta$ through any numerical integration technique. This expression can then be inverted to solve for ξ_j, which is unobserved.

5.1.2 Instruments

In this specification of the model, there are two sets of endogenous variables. Price is obviously correlated with the unobserved characteristics of the model, but market share is also endogenous within the model. We shall require two sets of instruments, one for price, and one for market share.

Valid price instruments are those that are correlated with supply shocks, but are not correlated with the demand shocks in the model. It is worth defining precisely what are the supply and demand for this model.

The supply for each weapon skin is the set of people who have opened the loot box that contains that item and have elected to sell it. Shocks that will affect this are changes in

consumer tastes leading to less people choosing to sell, as well as changes in the drop rates of the crates, controlling the flow of this item into the market.

Demand for this good is the individuals who elect to buy the good at the market rather than attempt to earn it through opening loot boxes. The shocks that affect these people are entrance and exit to the market as well as changes in taste. (Needs more here)

A Valid price instrument is something that is correlated with supply shocks, but not with the demand shocks. For this we will take the prices of the other contents of the box that are not in the same market as the good at hand. By Assumption 1, these prices are exogenous to the unobserved characteristics of the good at hand. They are however affected by the changes in the drop rate of the loot box that provides them, since they come from (nearly) the same supply. This is a form of the Hausman instruments used often in the literature.

For market share, we intend to use the BLP instruments, which require that the valuation of one characteristic of a good is not random across the consumers. When this is satisfied, we may use the sum of the characteristics of the competitors of the good as instruments for the market share. If necessary, following Gandhi and Houde (2017), we may construct higher order approximations of the optimal instrument for the market shares using the observed characteristics.

5.1.3 Estimation

Once a set of instruments has been computed, estimation of the model requires using the orthogonality condition of the instruments against the computed values of ξ_j. Our orthogonality condition is: $\mathbb{E}\left[\xi_j z_j\right] = 0$.

This can be estimated using the generalized method of moments. Following the method of Su and Judd (2012), we may estimate this using Mathematical Programming under Equality Constraints as follows:

$$\min_{\boldsymbol{\xi}_{j,t}, \xi_{j,t}} \boldsymbol{\xi}'_{j,t} \Omega \boldsymbol{\xi}_{j,t} \tag{4}$$

$$\text{subject to: } s_{j,t} = \frac{1}{N_s} \sum_{i=1}^{N_s} \frac{\exp(\alpha_i p_j + x'_j \beta_i + \xi_j)}{\sum_{k \in \mathcal{F}_t} \exp(\alpha_i p_k + x'_k \beta_i + \xi_k)} \tag{5}$$

$$\boldsymbol{\xi}_{j,t} = \xi_{j,t} \boldsymbol{z}_{j,t} \tag{6}$$

This method allows for the exploitation of sparseness in many commercial solvers. This is important as assumption 1 has imposed this level of sparseness on the model in part for computational ease.

From these estimates, a monopoly pricing schedule that sets price where marginal revenue equals marginal cost for all goods can be computed, and its revenue compared to the revenue generated under the randomization scheme.

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