BRIEFING: BATCHING OF NEW gTLD APPLICATIONS

Executive Summary

The Board is asked to select one of two models for batching of new gTLD applications (if batching is necessary): auctions or a secondary timestamp (a.k.a. "digital archery").

ICANN's executive team unanimously believes that the auction model presents significant program, legal and reputational risks that clearly and convincingly outweigh the benefits; and therefore recommends that the Board confirm its earlier approval of the digital archery model for the first round.

After discussion in the Costa Rica meeting, a Board working group was formed to work with ICANN staff members to:

- Develop a batching model based on auctions, in particular, a modified "Dutch" auction[1] that would minimize payments by applicants. See appendix for model.
- Determine operational feasibility of two models: digital archery[2] and auction.
- Compare benefits and risks of both models.

Based on this work, the Board working group reports three sets of recommendations:

1. Operational feasibility: Both models can be implemented to operate in a reliable way. There is a medium-level risk that the auction model will not be implemented in time for the planned announcement of batches on May 18 due to unanticipated operational issues. That delay could probably be managed in an acceptable manner.

2. Preference: This preference considers operating features of the models only – not risk, timing or other aspects. The Board working group members express a slight preference for the auction model, especially one that redistributes the proceeds to the applicants in some way. There are some implementation details to be decided; recommendations on these are details are provided in the last section below.

3. Risk: Implementation of the auction model at this late date presents significant risk of: program delay, legal action and significant reputational impact as described below. Board working group members tend to agree with this viewpoint but there is a split of opinion. The digital archery model presents minor risks; primarily a minor reputational risk from the perceived awkwardness of the model.

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[1] Auction in which the lowest price necessary to sell the entire offering becomes the price at which all those items offered are sold. See appendix for how this model applies to batching.

[2] The "secondary timestamp" was approved by the Board in December 2011.

Discussion of Issues

I. *Operational Feasibility*

1) Auction model
   Auction implementation can be implemented but presents a medium risk that scheduled dates will be slipped (e.g., May 18 publication of batches). In most cases, this delay can be ameliorated with shifts to the evaluation schedule that will not materially disadvantage applicants.

   ICANN worked with a reputable auction provider Contact Information Redacted to develop an auction model. Additional operational detail is provided in the appendix. Some detail on the model is provided below, a larger description can be found in the Appendix. As of one week ago, Contact Information Redacted stated that the necessary deadlines could be met. Even with that, some issues remain to be settled (see Preference section below) and some are probably unknown.

2) Digital archery model
   Implementation of the digital archery model is essentially completed. It presents no schedule risk. Its operation is straightforward.

   The model can be communicated in simple terms through an online demonstration (that is being developed) and a slide set that is available now. A demonstration can be given to the Board for the Wednesday, 28 March teleconference.

II. *Preference*

The Board working group expresses slight preference for auctions as a model for batching (setting aside related issues such as risk[3]). With that preference is a realization that some issues with the auction must be settled.

1) Auction model
   Specific aspects of the model are described in the appendix. Briefly, auctions provide a clearly objective solution that can be made revenue neutral by returning proceeds to applicants. In addition, auctions provide the benefit of early evaluation to those that value that benefit most highly.

   Those who do not participate in the auction can receive benefit if proceeds are redistributed to all applicants. Alternatively, the proceeds of a "charity auction"

[3] Risks are described elsewhere in this paper and include possible implementation and operational schedule delay; program delay; and reputational and legal risk.

can be distributed to the Applicant Support Program participants.

There are also negatives to the auction model. Most of those are discussed in the Operational Feasibility and Risk sections of this document. ICANN might realize direct costs in the range of $100K-$300K.

2) Digital archery model
Work on this model is essentially complete. The model has been socialized with the community and with applicants. This model is inexpensive.

It is regarded by some in the community and by Board and staff as somewhat awkward. In addition, there is only a loose relationship between the value an applicant places on batching order and the outcome of the contest.

III. *Risk*

The most important aspect of this decision is left for the Board. The risks are significant and probably the overriding concern in this analysis.

1) Auction model
The auction model, if introduced and implemented now, presents significant program, legal and reputational risk issues. This is because it is a significant change to the Guidebook just before the application window closes.

a. **Program delay** will likely result. Adoption of the auction model is a change that will require applicants to rethink their investment strategies in a compressed timeframe. Entities pay $185K for evaluation but may pay an equal or greater amount more than that for a “first movers” advantage. The introduction of the auction might cause an entity to reduce the number of applications it submits in order to ensure one or more of them are included in the first batch. This might not be a pervasive phenomenon among applicants, but if only a few (or one) are affected, those applicants can make a good case for delay.

The anticipation for delay is compounded by the fact that representatives of applicants are filing many of the applications. These representatives will have to go back to their clients, who in turn might have to consult with their Boards for decisions.

Another source of likely delay could be demand for public discussion. Any change to the program that is perceived as a "policy change" would create demands for public discussion. That would apply to batching approaches that would give preference to a particular group based on ICANN’s judgment.

Any auction mechanism is likely to be interpreted as a change in fees. All fees in the program (the evaluation fee, dispute resolution fees, auction proceeds), have been thoroughly debated. There will be claims that ICANN is creating new policy through this "fee change."

c. Finally the late change presents **significant reputational risk** by: changing the "complete" Guidebook, bringing delay to the project, being insensitive to the situation of applicants, and favoring deep pockets.

   When approved, ICANN stated the Guidebook was complete and committed to limiting / avoiding change to the Program. Prior to the Costa Rica meeting, it was thought that segments of the community anticipated Guidebook changes and delay to the program. Neither happened as ICANN kept to its commitment. Late changes will harm our reputation for not following through and keeping to commitments.

   As has been stated often, there is a need for certainty in this environment so that applicants can make sound decisions. By changing the game, ICANN will demonstrate an apparent insensitivity or ignorance of this need. In addition, the use of the term "auction" connotes (in our community) a fee increase and an advantage to "deep pockets" (antithetical to the "IDN / Community first" model). Even an auction that returns proceeds to applicants will be framed as ICANN favoring business over community types of applications.

2) Digital archery

   Adoption of the digital archery program has a small reputational risk associated with it. It has been somewhat vetted with the community although operational details have been withheld pending Board approval. Release of those details should demonstrate the relative simplicity of the program and relieve some of the concern. Although the solution is viewed as somewhat "silly," it will be unambiguous and easy to execute.

   Analysis indicates that the legal risk raised by a random selection program will be satisfactorily addressed. This is true even though the results appear to have an element of randomness.

IV. *Auction: remaining issues*

The auction designer has recommended certain features given ICANN's stated objectives for the process. The Working Group recommends retaining those features specified by the provider that are strictly related to conducting an auction and not related to ICANN policy. These are within the provider's sphere of expertise and it would take ICANN some time to study and possibly refute them.

Should there be a preference for IDNs or a mechanism to ensure geographical diversity? This would be a policy decision on the side of the board and would push the auction model beyond mere implementation. Further, it is not clear how to fairly integrate an "IDN first" policy with an auction model. Although, having IDNs "go first" might be desirable in many ways and might blunt criticism of auctions, those participating in the auction are paying value for a benefit. That benefit should be conferred

How should the money be redistributed? Should it be redistributed back to applicants directly or should it go into the applicant support program? There is a preference for providing it directly to applicants so that applicant costs are minimized and it is clearly a revenue neutral event for ICANN. In any event, those applying for financial support will benefit from both choices.

> Example. Say there are 1500 applicants, and the auction raises $4.5MM after expenses. Each applicant would be paid $3000. (The trouble with examples in we have no idea whether this estimate is considerably too high or too low.)

Handling contention where contending strings are in different batches. There is a preference for promoting all contending strings to the earliest batch. Although this preference raises the possibility of gaming of "freeloading," the auction provider states that in a large population such as this, such an effect is unlikely.

APPENDIX TO BOARD BRIEFING – An auction model for batching

Below is a "rough sketch" auction design. It is presented as if there are 1500 applications and they are limited to 500 per batch, but the structure fully generalizes to larger numbers. All of the bidding occurs in a single auction (but see design feature (7) below).

Program objectives are: to “recycle” payments to make auctions revenue neutral for ICANN and provide benefit to a good cause; conducting the auction quickly; developing a process that is adaptable after the number of applications are known and is straightforward for applicants.

We are working to ensure whether we have the capability to implement this on a schedule so that the final results can be announced on May 18; initial planning indicates that the response will be affirmative.

The design as currently envisioned:

(1) The bids that an applicant submits are:[1]

1. v1: Applicant "value" of having its application evaluated in the first batch.
2. v2: Applicant "value" of having its application evaluated in the second batch.
3. v3: Applicant "value" of having its application evaluated in the third batch.

Since these "values" are relative and in the case where there is 1500 applications, the value v3 will automatically equal zero, and applicants will only submit two values (v1 and v2). The model adapts to any number of applications.

(2) An algorithm (which requires greater technical explanation but is thought to be available) that will generate prices (p1, p2 and p3) that will apply to the "winners" of the three batches. Conceptually, all of the winners of the first batch pay the same price p1, which is based on the lowest winner of the first batch; all of the winners of the second batch pay the same price p2, which is based on the lowest winner of the second batch; and all of the winners of the third batch have the same price p3, which may be negative. According to the auction provider, these prices will be very close to being "incentive compatible," (i.e., non-manipulable).[2]

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[1] The reason for an applicant to provide distinct bids for the first and second batch is that the applicant may have a different tradeoff between being in the first versus the second batch. Therefore, a bidder needs to be allowed to bid two different numbers.

[2] By this it is meant it "cannot be gamed". This holds only approximately, since the lowest applicant in a batch could potentially affect the amount that it pays, but with 500 applicants per batch, the likelihood of affecting ones own payment is small.)

(3) After the auction, the implied payments are summed over all bidders, to yield an amount of money, S. Let the expenses equal E, and let the number of bidders equal N. The excess of S - E is recycled to the applicants in the form of an equal lump-sum payment, (S - E) / N , paid to each bidder. This makes the auction revenue-neutral, or can be modified to give any desired net revenues.

It is suggested that:

a. The reduction in fees due to auction proceeds be provided directly to the applicants in the form of recycled payments,[3] [4] or

b. That excess auction fees go directly to the applicant support program.

This model describes the mechanism where revenue is recycled to applicants. Recycling payments creates the incentive to participate in the auction. This in turn makes the model more robust by decreasing the likelihood that more than 500 applicants will not participate.

(4) Applicants who do not bid will be assigned to the third batch and will not receive any share of the recycled payment. If too many applicants do not bid, they will be randomly allocated among the last two batches. If less than 500 applicants submit a bid, the round will be fleshed out with randomly selected applicants.[5] (However, the recycled payment gives applicants a very strong incentive to bid, so it is highly unlikely that there will be too many applicants who do not bid.)

(5) Any applicant who bids and then reneges on making its payment will be treated as if it did not bid (i.e., relegated to the last batch, and not given a share of the recycled payment). This should be sufficient disincentive to reneging that no upfront deposit is needed from bidders, saving on administration.

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[3] By "recycled payment", we mean the lump-sum rebate, (S - E) / N, paid to each bidder. The incentive created to bid is that, if you bid $1 (or even $0 but participate), then you pay at most $1 yet you receive a lump-sum rebate of (S - E) / N. If you do not participate you pay zero but you forgo the lump-sum rebate of (S - E) / N. Since bidding will be very easy, the financial incentive to bid should be overwhelming.

[4] The recycled payment or “refund” could be capped at a number, say $85K, to ensure a certain minimal payment. (However, it is highly doubtful that the recycled payment would reach anything close to that.)

(6) In cases of string contention there are two options:

a. All contending applications will be evaluated with the one in the earliest batch and then be delegated as soon as they complete the process. The downside to this option is potential gaming; applicants for a name where contention is likely might not bid and be promoted by the bids by others.

b. All contending applications will be evaluated with the one in the earliest batch but delegation timing will be delayed to a later batch for those applicants whose bid did not merit inclusion into the earlier batch. The downside to this option is that the process is somewhat tortured. Why hold up an application that is approved?

We recommend the first option. The potential downside may be ameliorated by option (7) below.

(7) [Optional, but recommended] The entire process above may best be conducted in two bidding rounds (e.g. two 24-hour bidding periods, one day apart). After the first bidding round, the tentative results are calculated and announced to applicants. Applicants are free to increase their bids in the second round; if they do not change their bids, their first-round bids are automatically carried forward into the second round. Development of this multi-round process can be accommodated within the existing timeline. At the same time, it would be valuable for bidders, to avoid unintentionally ending up in the second batch when they value it higher.[6]

The above is obviously hasty and subject to change. There are several issues not yet addressed, for example: opt out and its effects, and development of process flows.

The model seems technically implementable. The infrastructure can be reliably built to conduct the auctions. However, certain questions might require public discussion.

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[6] This raises the question of whether the first round basically amounts to meaningless indicative bidding. This would be true of there were 10 or 20 bidders. However, with 1500 bidders, any one bidder has minimal effect on the outcome, so concealing one's bid doesn't really accomplish anything. Meanwhile, there is one significant advantage to bidding in the first round: it insures you against something happening that prevents you from bidding in the second round. As a result, it is likely that many applicants will submit meaningful bids in the first round.

One other benefit: The results after the first round are likely to receive some publicity, so an applicant who was somehow unaware of the first round might be informed about the auction by the publicity, and would be able to bid in the second round.