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Registry-Registrar Separation: Vertical Integration Options

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The Policy Issue

Vertical integration frequently benefits consumers and competition. It can lead to lower prices, higher quality and better service. Vertical integration also can facilitate innovation. In some circumstances, however, vertical integration could also harm competition. The potential harms could involve higher prices, lower quality levels, too little product variety, or less innovation. The fact that vertical integration could have either or both pro-competitive and anti-competitive effects, depending on the factual conditions, makes vertical integration policy a complicated issue.

Vertical integration and vertical contracts between registries and registrars can create both competitive harms and competitive benefits. Vertical contracts for promotion or favored placement could well be the result of efficient contracting and produce benefits for registrants. A vertically integrated owner of a registry would have the incentive to charge a lower registration fee. Vertical integration also might help jump start a struggling registry and enable the creation of a superior registry product. Vertical promotional deals between registrars and

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registries are common today and are capable of driving a significant increase in registrations. There is no indication that these promotional deals are anticompetitive and they appear to be pro-competitive. While these efficiencies could cause harm to competitors, they would be beneficial for consumers.

Under limited circumstances, vertical contracts and vertical integration can lead to the exercise and enhancement of market power by an integrated registry or registrar. Market power is the power to raise price above the competitive level. Market power might be exercised on the sell-side (that is, over registrants) by either registries or registrars. In the case of registrars, market power also might be exercised on the buy-side (that is, over registries). For example, a registrar with market power could seek to vertically integrate by trading page coverage for a new gTLD registry for an ownership interest in that registry. However, the exercise of buy-side market power through vertical integration need not harm registrants.[2] At the same time, it is noteworthy that market power generally can also be exercised when there is vertical separation. For example, a registrar with market power could charge registries a high price for access to its shelf space. An unintegrated registry with market power could charge registrars a high registration fee.[3]

Assessing the likely competitive effects of any particular contractual arrangement between a registry and registrar is a difficult and complex task that depends on a

[2] Harm to registrants would occur if the conduct raises prices paid by registrants or reduces the quality of the products they purchase.

[3] There is also the issue of the potential for misuse of sensitive competitive information by a vertically integrated registrar/registry (e.g., front-running, domain tasting, and so on). These involve more of a consumer protection issue than a competition issue. There has been debate about whether the sensitive information is already public and whether it would be large enough to cause a significant problem. Our policy proposals do not address this issue. First, this issue does not provide a rationale for vertical separation rules because such activities can occur with or without integration. Second, to the extent there is a concern that it is harder to detect this conduct for a vertically integrated firm , that concern might be addressed a number of ways; one way might be to require internal firewalls or structural separation of vertically integrated entities, if it were concluded that this is a legitimate concern.

number of factors including, but not limited to, whether a firm has market power, the duration of the agreement, and barriers to entry.[4]

The most important factor in predicting whether vertical integration is capable of generating competitive harms is the presence of registry or registrar market power. Harm from vertical integration is generally more likely when there is market power on the sell-side or the buy-side. A reasonable approach to relaxing registrar/registry vertical separation restrictions that is consistent with the economics of vertical integration, therefore, would be to allow vertical integration and contracts for registries and registrars that are unlikely to have market power, and impose restrictions or conditions on vertical integration between registries and registrars only when market power is likely to be present. Such an approach necessitates identifying those registries and registrars that potentially possess market power on the sell-side or the buy-side.

Vertical contracts can have effects like vertical integration.[5] The fact that vertical integration and contracts by particular registries or registrars can have both benefits and (in some limited cases) harms – and that detailed economic analysis is required to determine the relative benefits and harms -- means that it is difficult to create one-size-fits-all bright-line rules for all vertical contracts and vertical integration. For example, when the expert economists and antitrust lawyers at the competition agencies analyze vertical mergers, they engage in a lengthy, complex, and fact-intensive analysis of market power and likely competitive effects.[6] In the absence of this sort of expert, fact-intensive evaluation, a bright-line rule allowing all vertical integration and contracts for registries and registrars

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[4] Michael H. Riordan and Steven C. Salop, Evaluating Vertical Mergers: A Post-Chicago Approach, 63 Antitrust Law Journal, 513 (1995).

[5] Ronald H. Coase, The Nature of the Firm, 4 Economica 386; Oliver E. Williamson, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting (1985).

[6] Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings, available at: http://ec.europa.eu/comm/competition/mergers/legislation/nonhorizontalguidelines.pdf; See also Riordan and Salop, supra note 4.

unlikely to have market power would allow consumers to reap the competitive benefits of vertical integration while minimizing the likelihood of harms. At the same time, an approach that mandates vertical separation for all registries and registrars is unlikely to be in the interest of registrants.

It is difficult to accurately measure market power. Market definition and the evaluation of market power are contentious issues in most antitrust cases and often require complex economic and econometric analysis. This type of analysis is likely beyond the scope of ICANN's current expertise. In the absence of such economic analysis, market share is a common, albeit imperfect, proxy used to identify market power when there are entry barriers. Therefore, ICANN might base its vertical separation rules on market share, though it should be recognized that market share is an imperfect indicator of actual market power.

Options

There are several options that ICANN might consider with respect to the vertical separation issue. We believe that, given all the circumstances, the most reasonable approach to this issue would be to permit an existing registry to apply to acquire a significant ownership interest in any new or existing registrar and a registrar to apply to acquire a significant ownership interest in any registry. (This approach would not regulate contracts where there is no significant ownership interest.) Upon receipt of this application, ICANN staff would calculate the market share of the applying registry or registrar. If the market share exceeds a critical threshold, ICANN would take a certain action. If this approach is adopted, there are two relevant variables that must be decided: the relevant market share threshold, and the action that would be taken if a registrar or registry exceeds that share.

We do not recommend that ICANN attempt to regulate specific forms of conduct associated with vertical integration or vertical contracts that fall short of involving a significant ownership interest. This is because of the large variety of ways in which these abuses could be manifested and the complex ways in which vertical contracts would increase efficiency and benefit registrants. Instead, we recommend that ICANN adopt rules relating solely to whether a registry or registrar can obtain additional ownership interests in an entity at the other level.[7] We would define a significant ownership interest as follows: One firm is assumed to have a significant ownership interest in another firm if it has more than a 20-25% financial interest and/or a significant corporate influence over the competitive decisions the other firm.

We believe that the following options are worth considering as possible approaches to balancing the more likely pro-competitive effects of vertical integration with the less likely potential for anticompetitive effects in some limited circumstances:

1. Option 1 (Blanket Prohibition): If the share of the registrar or the registry that applies to acquire a significant ownership interest in any new or existing entity at the other vertical level exceeds the relevant market share threshold, then the request will be denied.

2. Option 2 (Notification and Potential Stay): If the share of the registrar or the registry that applies to acquire a significant ownership interest in any new or existing entity at the other vertical level exceeds the relevant market share threshold, then ICANN will notify the appropriate governmental competition enforcement agency or agencies. ICANN will place the application on hold for a period not to exceed 45 days. This matches the existing waiting period for new registry services that might raise competitive issues. *See* *http://www.icann.org/en/registries/rsep/rsep.html*. If the agency or agencies notify ICANN and the registry or registrar during that 45 day period that the acquisition of the entity at the other vertical level may violate its competition laws, ICANN will place the application on hold for another period not to exceed 120 days to allow the agency or agencies and the applicant to resolve any concerns. At the end of this period, or sooner if notified by the agency or agencies that any issues have been

[7] We do not recommend any constraints on the ability of a registrar or registry to vertically integrate into the provision of registry infrastructure (back-office operational) services. That market appears to lack significant barriers to entry. Therefore, we are not concerned that vertical integration would lead to the achievement or exercise of market power in that market.

resolved, ICANN will resume processing the application.

3. Option 3 (Notification Only): If the share of the registrar or the registry exceeds the relevant market share threshold, then ICANN will notify the appropriate governmental competition enforcement agency or agencies. ICANN will place the application on hold for a period not to exceed 45 days to allow the agency or agencies to take whatever action, if any, it or they deem appropriate. At the end of that 45 day period, ICANN will continue to process the application, and the registrar or registry will bear the risk of any subsequent enforcement action.

The problem with Option 1 as a blanket rule for all registries and registrars is that it is more likely to prevent some beneficial vertical contracts or vertical integration. Given the likely pro-competitive effects of vertical integration, we do not believe that vertical integration generally should be prohibited based on market share alone, and instead any potentially suspect arrangement should be evaluated by expert competition enforcement authorities, who can then take action if that expert evaluation determines that it is appropriate.

Therefore, we generally prefer either Option 2 or Option 3. Either would be within the range of reasonable decisions by ICANN considering all the circumstances. Whichever option is selected, ICANN must also specify the appropriate market share threshold to trigger any action. We recommend that ICANN choose a market share threshold in the 40-60% range (the market share measured would be that of the acquiring company). The lower end is the market share at which U.S. competition authorities begin to be concerned about market power. The upper end is the market share at which U.S. competition authorities typically begin to be concerned about monopoly power. EU competition authorities typically begin to be concerned about possible market dominance (a concept similar to market power) at a market share in the 40% range.

The appropriate market share threshold might depend on the Option selected. For example, if ICANN were to select the more restrictive Option 1 of prohibiting the acquisition of any significant ownership interest, which we do not generally recommend, then a more permissive market share standard at the upper end of the range would be more appropriate. Similarly, if ICANN selects the less restrictive Option 3 which merely requires that ICANN notify the relevant competition authorities, a market share towards the lower end of the range might be more appropriate.

Alternatively, ICANN might choose a hybrid approach, whereby a relatively lower market share (e.g., 40%) would trigger Notification-Only while a higher market share (e.g., 60%) would trigger the Notification and Potential Stay. The only situation in which a Blanket Prohibition could be a reasonable option would be if an applicant already has a high market share and is also subject to price caps.

Finally, to calculate a market share requires the identification of a universe on which the market shares are based. We recommend the following:

- The registrars' market share threshold could be based either on the percentage of total gTLD registrations under management by the registrar, or it could be based on the percentage of newly created gTLD registrations by the registrar in the last year. For gauging market power with respect to registrars, we believe that the percentage of newly created gTLD registrations is a more appropriate measure, because this measure is a more accurate proxy for the potential buy-side market power issues that exist at the registrar level.

- The registries' market share threshold similarly could be based on either the percentage of total gTLD registrations accounted for by the registry, or it could be based on the percentage of newly created gTLD registrations in the last year. For gauging registry market power, we believe that the percentage of total gTLD registrations is a more appropriate measure.

- These market share calculations should be based on the share of the entire company. We also believe that it is most appropriate to base the calculation of market shares on the total number of gTLD registrations.

These measurements are both conceptually sound and practical, because ICANN registrars, registries and the public all have access to these market share figures.