

# Generalized Payment Channel Topologies via Dual-Track State Machines and Reference-Based UTXOs

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## Abstract

Payment Channel Networks (PCN) constitute a Layer 2 scaling solution for blockchain systems, whose core principle is to complete multiple state updates off-chain while settling only the final state on-chain, thereby improving system throughput.

**Background and Problem Definition:** Existing PCN schemes (such as the Lightning Network) exhibit two categories of structural limitations: (1) the expressiveness of the Script Layer is constrained, making it difficult to natively support complex state transition semantics; (2) linear topology structures lead to low capital utilization and excessive state management complexity. While the original Eltoo protocol proposed a state replacement mechanism to supersede the penalty mode, its implementation depends on the not-yet-activated `SIGHASH_ANYPREVOUT` soft fork (BIP-118) and presents security concerns such as replay attacks.

**Technical Contributions:** This paper proposes a general-purpose scaling architecture based on native Eltoo semantics. The main contributions include:

1. **Dual-Track UTXO Model:** Decomposing channel state into a static fund anchor (Fund UTXO) and a dynamic state pointer (State UTXO) along two orthogonal dimensions, achieving separation of concerns between value transfer and state transitions;
2. **Reference-Based UTXO Primitive:** Defining a read-only reference operator  $\text{Ref} : \mathcal{U} \rightarrow \mathcal{U}^{\text{readonly}}$ , enabling state update transactions to access fund anchor metadata without consuming that UTXO;
3. **Transaction Type Enumeration System:** Embedding algebraic data types at the consensus layer to achieve  $\mathcal{O}(1)$  complexity for transaction classification and verification;
4. **Recursive Channel Factories and Atomic Reconfiguration:** Formally defining channel splitting (Splice-Fork) and merging (Splice-Merge) operations, proving that any complex topology can achieve isomorphic transformation through a single atomic transaction.

**Theoretical Results:** This paper proves the existence of a bijective mapping between UTXO sets and channel state sets (Theorem 8), thereby eliminating dependency on off-chain registries. Under DAG-structured consensus protocols, state verification complexity is  $\mathcal{O}(1)$ , with settlement latency reaching sub-second levels.

**Keywords:** Payment Channel Networks, State Channels, Eltoo Protocol, UTXO Model, Finite State Machine, Formal Verification, Layer 2 Scaling

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# 1 Introduction and Motivation

## 1.1 Problem Background

The core design objective of payment channel networks is to transfer transaction processing from on-chain to off-chain while maintaining security guarantees. Achieving this objective faces two fundamental challenges:

1. **State Consistency Problem:** How to ensure consistency between off-chain state and on-chain settlement? Off-chain states evolve rapidly, but only the final state should be enforceable on-chain.
2. **Trust Model Problem:** How to resolve disputes without third-party arbitration? Traditional approaches rely on game-theoretic punishment mechanisms, but these introduce new vulnerabilities.
3. **Storage Overhead Problem (Toxic Waste):** Penalty-based mechanisms require permanent storage of all historical revocation keys. Any data loss exposes honest parties to fund theft, creating an unbounded storage liability that grows linearly with channel lifetime.
4. **Protocol Dependency Problem:** Existing state replacement solutions (e.g., original Eltoo) require consensus-layer changes such as `SIGHASH_ANYPREVOUT` (BIP-118), creating deployment barriers and cross-chain incompatibility.
5. **Liveness and Availability Problem:** Payment channels demand continuous monitoring to detect and respond to malicious state broadcasts. Watchtower delegation introduces additional trust assumptions and operational costs.
6. **Verification Complexity Problem:** Script-based channel protocols push substantial verification logic into on-chain execution, increasing transaction weight, fee costs, and potential attack surfaces from script interpreter vulnerabilities.
7. **Base Layer Throughput and Finality Problem:** Bitcoin’s approximately 10-minute block interval and probabilistic finality create fundamental tension with payment channel requirements. Channel operations (opening, closing, dispute resolution) compete for scarce block space, while the lack of deterministic finality introduces uncertainty in settlement guarantees. These constraints are not incidental but intrinsic to Bitcoin’s security model.

Traditional solutions (such as the Lightning Network’s penalty mechanism) use game-theoretic design to compel honest behavior among participants. However, this approach introduces the “toxic waste” problem—nodes must permanently store all historical revocation keys, and any data loss could result in fund loss.

## 1.2 The Layer Inversion Insight

The enumerated problems share a common root cause: **attempting to retrofit Layer 2 semantics onto a Layer 1 designed without consideration for off-chain protocols.** Bitcoin’s architecture optimizes for a specific set of properties—censorship resistance, minimal trust assumptions, and simplicity—but these design choices create friction when supporting payment channel networks.

This observation leads to a philosophical reframing:

*Rather than adapting payment channels to fit an existing base layer, we should ask: what would a base layer look like if it were designed from inception to natively support state channel topologies?*

This paper pursues this question to its logical conclusion. We propose an architecture that inverts the traditional layering relationship: instead of treating L2 as an afterthought bolted onto L1, we design L1 and L2 as a **co-optimized system** where:

- The consensus layer provides native primitives for state channel operations (not script-level simulation)
- The UTXO model is extended with reference semantics specifically for dual-track state representation
- A GhostDAG-based consensus enables high-throughput, low-cost on-chain state checkpointing

The choice of GhostDAG consensus is not incidental but architecturally motivated. DAG-structured block production permits concurrent block creation, yielding sub-second block intervals and massive throughput increases over linear chains. This transforms the economics of on-chain interaction: channel participants can affordably record state checkpoints on-chain, creating cryptographic evidence that bounds the window of vulnerability to stale-state attacks.

Crucially, while DAG consensus introduces the possibility of deeper reorganizations compared to single-chain protocols, the security properties *converge faster in wall-clock time*. Under equivalent elapsed time, a GhostDAG chain accumulates more confirming blocks than Bitcoin, and the cost of mounting a reorganization attack scales with the *number of concurrent blocks* an adversary must produce—not merely hash power. After a modest number of confirmations, state checkpoint UTXOs achieve settlement guarantees that match or exceed Bitcoin’s, while providing orders-of-magnitude faster initial confirmation.

This is not merely an engineering optimization but a **paradigm shift**: from “How do we build channels on Bitcoin?” to “How do we build a base layer for channels?” The resulting architecture eliminates entire categories of problems rather than mitigating them.

### 1.3 Design Principles

The dual-track state machine architecture proposed in this paper operationalizes the layer inversion insight through the following design principles:

**Principle 1: Consensus-Layer Native Semantics** Embed channel operation semantics within consensus rules rather than simulating through the script layer. This provides two advantages:

- Verification complexity reduces from  $\mathcal{O}(\text{script\_size})$  to  $\mathcal{O}(1)$
- Eliminates uncertainty introduced by script interpreters

**Principle 2: Orthogonal Separation of Value and State** Decompose channel representation into two independent dimensions:

- **Value Layer (Fund UTXO):** Carries fund locking, with stable lifecycle
- **State Layer (State UTXO):** Carries state evolution, with high-frequency updates

This separation ensures that state updates need not touch the fund locking structure, reducing verification complexity.

**Principle 3: Non-Punitive State Replacement** Replace penalty-based revocation with monotonic state supersession. Any party can publish a newer state to override an older one, eliminating the need for:

Table 1: Trust Model Comparison

Trust Assumption	Traditional PCN	The proposed architecture	Elimination Mechanism
Channel registry availability	Required	Not required	Fund UTXO as sole anchor
Watchtower continuous online	Strong dependency	Weak dependency	Long-period timelocks + state replacement
Script interpreter correctness	Required	Not required	Consensus-layer native types

- Permanent storage of revocation secrets (toxic waste elimination)
- Complex punishment transaction graphs
- Asymmetric information advantages between channel participants

**Principle 4: Deterministic State Execution** Traditional contract execution relies on ex post enforcement (through arbitration), introducing cost and time uncertainty. The proposed architecture achieves ex ante enforcement through consensus rules:

Traditional Mode: Contract  $\xrightarrow{\text{Dispute}}$  Arbitration  $\xrightarrow{\text{Judgment}}$  Enforcement

The proposed architecture: State\_UTXO  $\xrightarrow{\tau_{\text{settle}}}$  Value\_Distribution (deterministic execution)

**Principle 5: Minimal External Dependency** The protocol operates without requiring:

- External registries or naming services for channel discovery
- Continuous watchtower availability (degraded to optional optimization)
- Specific soft-fork upgrades (e.g., SIGHASH\_ANYPREVOUT)

Fund UTXO serves as the sole cryptographic anchor, making channel existence self-evident from on-chain state.

## 1.4 Trust Model Analysis

Blockchain system security is often described as “trust minimization.” The proposed architecture further pursues **trust elimination**—making certain types of trust assumptions unnecessary through protocol design:

The core insight of The proposed architecture is: by pushing complexity down to the protocol layer, a simpler trust model can be achieved at the application layer.



## 2 Related Work and Technical Background

This section provides a comprehensive analysis of the evolution of payment channel protocols, identifies the structural defects inherent in existing solutions, and establishes the technical foundation for the proposed architecture. For formal definitions of cryptographic primitives and notation conventions, readers are referred to Appendix A.

### 2.1 Protocol Evolution: From Penalty to Replacement

Payment channel protocols have evolved through two distinct paradigms: **penalty-based revocation** and **state replacement**. Understanding the fundamental differences between these approaches—and why neither fully solves the problem—is essential for motivating the architectural innovations presented in this paper.

#### 2.1.1 Lightning Network’s Penalty Mechanism

The Lightning Network [2] pioneered the practical deployment of payment channels on Bitcoin. Its security model relies on a **penalty mechanism** to deter participants from broadcasting outdated channel states.

**Mechanism Overview.** Consider a channel between parties Alice and Bob with state sequence  $S_0, S_1, \dots, S_n$ . When transitioning from state  $S_n$  to  $S_{n+1}$ , both parties perform a key exchange: Alice reveals her “revocation key” for  $S_n$  to Bob, and vice versa. This revocation key enables the counterparty to claim *all* funds in the channel if an outdated state is broadcast.

**Formal Security Property.** Let  $\mathcal{R}_i^A$  denote the revocation key that Alice holds for state  $S_i$ , which would allow her to punish Bob if he broadcasts  $S_i$  after  $S_{i+1}$  has been agreed upon. The security guarantee can be expressed as:

$$\forall i < n : \mathcal{R}_i^A \in \text{Alice's\_storage} \implies \text{Bob broadcasting } S_i \text{ results in total fund loss for Bob}$$

This creates a game-theoretic equilibrium: rational actors will never broadcast old states because the expected punishment exceeds any potential gain.

**Structural Defects (The “Toxic Waste” Problem).** Despite its elegance, the penalty mechanism introduces fundamental operational burdens:

1. **Unbounded Storage Growth:** Each state update generates a new revocation key that must be stored permanently. For a channel with  $n$  state transitions, nodes must maintain  $\mathcal{O}(n)$  historical keys. Long-lived, high-frequency channels can accumulate millions of revocation secrets.
2. **Catastrophic Failure Mode:** Data loss is not merely inconvenient—it is catastrophic. If Alice loses her revocation keys and inadvertently broadcasts an old state (e.g., from a corrupted backup), Bob can legitimately claim all funds. This transforms routine operational failures into complete fund loss.
3. **Backup Complexity:** The requirement to never lose *any* historical key while *also* never using an old backup (which might trigger a penalty) creates a paradoxical backup strategy. Users must maintain perfectly synchronized, append-only storage with no tolerance for errors.

The term “toxic waste” aptly describes this accumulation: revocation keys are useless during normal operation but potentially deadly if mishandled, and they can never be safely discarded.

### 2.1.2 Eltoo Protocol and State Replacement

The Eltoo protocol [3] represents a fundamental paradigm shift from punishment to **state replacement**. Rather than penalizing old states, Eltoo allows newer states to simply supersede older ones through a clever use of transaction structure.

**Core Mechanism.** In Eltoo, each state  $S_n$  corresponds to an “update transaction”  $\tau_n$ . The key innovation is that  $\tau_{n+1}$  can validly spend the output of *any* prior update transaction  $\tau_i$  where  $i \leq n$ . This is achieved through a signature scheme that does not commit to the specific input being spent.

**State Supersession Semantics.** If a malicious party broadcasts an old state  $\tau_i$ , the honest party can respond by broadcasting  $\tau_n$  (the latest state), which will:

1. Spend the output of  $\tau_i$  as its input
2. Replace the outdated state with the current one
3. Require no punishment—the old state is simply overwritten

**Protocol Dependency on SIGHASH\_ANYPREVOUT.** The Eltoo mechanism requires signatures that bind to the *script logic* of an input rather than its specific identity (the OutPoint, which consists of a transaction ID and output index). This is formalized in BIP-118 [4] as the SIGHASH\_ANYPREVOUT flag. The signature hash is computed as:

$$h_{\text{APO}} = H(\tau.\text{outputs} \parallel \tau.\text{inputs}[i].\text{script} \parallel \tau.\text{version} \parallel \dots)$$

Notably, this hash *omits* the OutPoint identifier of the input being spent. This allows a single pre-signed transaction to spend from any UTXO that matches the expected script, enabling the state replacement mechanism.

#### Advantages over Penalty Mechanism:

- **Constant Storage:** Only the latest state needs to be stored; historical states can be safely discarded.
- **Symmetric Information:** Both parties hold identical transaction sets, eliminating information asymmetry.
- **Simpler Backup:** Restoring from an old backup does not risk fund loss—the counterparty simply publishes the newer state.

### 2.1.3 Engineering Compromise of BIP-118

While Eltoo’s state replacement mechanism is theoretically elegant, its implementation via BIP-118 introduces significant engineering challenges and security concerns.

**The Replay Attack Vector.** The flexibility of ANYPREVOUT signatures creates a dangerous attack surface: if a signature is created for one UTXO, it can potentially be “replayed” against any other UTXO with a matching script. This means that careless key reuse across different channels—or even within the same channel after a splice operation—could allow an attacker to redirect funds.

**Mitigation via Public Key Tagging.** To address this, BIP-118 mandates a **physical segregation** of public keys used for ANYPREVOUT operations. The verification logic becomes:

$$\text{Verify}_{\text{APO}}(\sigma, m, P) = \begin{cases} \text{FALSE} & \text{if } P \in \mathcal{K}_{\text{std}} \text{ (standard key space)} \\ \text{SchnorrVerify}(\sigma, m, P) & \text{if } P \in \mathcal{K}_{\text{apo}} \text{ (APO-tagged key space)} \end{cases}$$

This means APO signatures are only valid when used with specially-tagged public keys that belong to a distinct derivation path. Standard keys cannot be used with APO, and vice versa.

**The Shifted Security Burden.** While this tagging scheme prevents *accidental* cross-contamination, it fundamentally **shifts security responsibility from the protocol layer to the application layer**:

- Wallet developers must implement correct key derivation paths
- Users must never reuse keys across different contexts
- A single implementation bug or user error can lead to complete fund loss

This violates the principle of defense in depth: the protocol should prevent dangerous operations, not merely trust applications to avoid them.

## 2.2 The Recursive Covenant Dilemma

Beyond its immediate security concerns, SIGHASH\_ANYPREVOUT introduces a more fundamental philosophical debate within the Bitcoin community regarding **recursive covenants**.

**What are Covenants?** A covenant is a spending condition that restricts not just *who* can spend a UTXO, but *how* it can be spent—specifically, what form the spending transaction’s outputs must take. Traditional Bitcoin scripts answer the question “who holds the key?” Covenants answer the question “what happens to the funds next?”

**The Recursion Problem.** ANYPREVOUT enables a form of transaction introspection: a script  $S$  can effectively examine properties of the spending transaction. If  $S$  can enforce that its output must be locked by a script  $S'$  where  $S' \equiv S$  (or a controlled variant), then funds can be **permanently constrained** to follow specific paths indefinitely.

Formally, let  $\mathcal{C}(S)$  denote the set of valid spending patterns from script  $S$ :

$$\text{Recursive Covenant: } \exists S : \forall \tau \in \mathcal{C}(S), \tau.\text{outputs} \subseteq \{\text{UTXOs locked by } S\}$$

**Community Concerns.** This capability raises serious objections:

1. **Fungibility Risk:** Coins could be “tainted” with permanent restrictions (e.g., regulatory whitelists), creating second-class bitcoins that are worth less than unrestricted coins.
2. **Censorship Vectors:** Governments could mandate that exchanges only accept coins locked in compliant covenants, fragmenting the monetary supply.
3. **Unintended Complexity:** Recursive covenants could enable Turing-complete computation on-chain, fundamentally changing Bitcoin’s computational model.

**Impact on Protocol Adoption.** These concerns have contributed to the prolonged stalling of BIP-118 activation. The Bitcoin community’s conservative approach to consensus changes means that any feature with potential for “toxic recursion” faces significant resistance, regardless of its benefits for payment channels.

This political reality underscores the value of our proposed architecture: by achieving Eltoo semantics *without* relying on ANYPREVOUT, we sidestep this entire debate.

## 2.3 Structural Defect Analysis

Having examined the specific protocols, we now abstract to identify **structural defects** common to script-based payment channel implementations. These defects arise from a fundamental mismatch: attempting to simulate state machine semantics using a language (Bitcoin Script) designed for simple predicate evaluation.

**The Orthogonality Principle.** Well-designed systems maintain separation between independent concerns. In payment channels, two orthogonal concerns exist:

Table 2: Structural Defects of Script-Based Payment Channel Solutions

Defect Category	Technical Impact and Consequences
<b>Verification Complexity</b>	Transaction validation requires executing the full script, resulting in $\mathcal{O}(\text{script\_size})$ computational cost. Script size is unbounded and unpredictable, making resource consumption difficult to estimate and enabling potential DoS vectors.
<b>Semantic Opacity</b>	The consensus layer cannot distinguish between a channel state update and a regular fund transfer—both appear as script executions. This prevents the base layer from optimizing for channel operations or providing specialized guarantees.
<b>Blurred Security Boundaries</b>	Security depends on application-layer behaviors (key management, derivation paths) rather than protocol-level invariants. The consensus layer provides mechanisms but not policies, shifting liability to wallet implementations.
<b>Concern Coupling</b>	Value locking logic (multi-signatures) and state transition logic (sequence numbers, timelocks) are interleaved in the same script. Modifying one concern risks breaking the other.

- **Value Custody:** Which keys control the funds?
- **State Evolution:** What is the current balance distribution, and how does it change?

Script-based solutions **violate orthogonality** by encoding state logic directly into spending conditions, entangling these concerns.

**The Root Cause.** These defects share a common origin: script-based solutions treat the blockchain as a *general-purpose computation platform* and simulate channel semantics through clever encoding. Our architecture inverts this relationship: the blockchain natively understands channel operations, and verification becomes a matter of type checking rather than program execution.

## 2.4 Proposed Solution: UTXO-Native Semantics

The defects enumerated above motivate our core architectural decision: rather than simulating Eltoo semantics through script-level tricks, we propose **embedding these semantics directly into the UTXO model and transaction type system**.

**Design Philosophy.** The key insight is that payment channel operations are not arbitrary computations—they follow a small, well-defined set of patterns. By making these patterns *first-class citizens* of the transaction model, we can:

1. Verify operations through type checking rather than script execution
2. Enforce invariants at the consensus layer rather than trusting applications
3. Enable the base layer to optimize specifically for channel workloads

**Transaction Type System.** We introduce a typed transaction model where each transaction declares its semantic intent:

- **Type Enforcement:** For all transactions  $\tau$  in the Eltoo transaction set  $\mathcal{T}_{\text{Eltoo}}$ , the inputs MUST be of type `ELT00_STATE`. This is not a script-level check but a consensus-level type constraint.
- **Replay Isolation:** Because `ELT00_STATE` UTXOs can only be spent by Eltoo update transactions, and standard UTXOs cannot be inputs to such transactions, replay attacks are *physically impossible* at the type level—no key management discipline required.

**FSM vs. Arbitrary Recursion.** The Eltoo state machine follows strict monotonicity: each update transaction carries a sequence number  $n$ , and valid transitions require  $n' > n$ . This constraint is enforced by consensus:

$$\forall \tau_{\text{update}} : \tau_{\text{update}}.\text{seq} > \tau_{\text{input}}.\text{seq}$$

This monotonicity property *mathematically precludes* arbitrary recursive covenants. The state can only move forward, never loop or branch arbitrarily. We gain the benefits of state replacement without opening the door to Turing-complete on-chain computation.

**Explicit Reference Operator.** The Ref primitive enables a transaction to *read* a UTXO’s metadata without consuming it:

$$\text{Ref}(U) \in \tau.\text{references} \implies U \in \mathcal{U}_{\text{post-}\tau}$$

This reduces verification complexity from  $\mathcal{O}(\text{script\_size})$  to  $\mathcal{O}(1)$ : the verifier checks that the referenced UTXO exists and has the expected properties, rather than executing arbitrary code.

## 2.5 DAG Consensus Compatibility

The proposed architecture is designed for deployment on GhostDAG-based consensus protocols [5, 6]. This choice is not incidental but architecturally motivated by the synergy between DAG properties and payment channel requirements.

**Why GhostDAG?** Traditional blockchain consensus produces a single chain of blocks, where concurrent blocks become “orphans” that are discarded. GhostDAG instead organizes blocks into a Directed Acyclic Graph, where concurrent blocks can *all* contribute to consensus.

Given network parameters  $(D, k)$  where  $D$  is the maximum network delay bound and  $k$  is the security parameter, GhostDAG provides:

1. **Temporal Consistency via DAA Score:** The Difficulty Adjustment Algorithm (DAA) Score provides a globally monotonic logical clock. For any two blocks  $b_1 \prec b_2$  in the DAG partial order:

$$\text{DAA}(b_1) < \text{DAA}(b_2)$$

This property enables precise relative timelocks for channel dispute periods without relying on wall-clock time.

2. **Fast Confirmation:** Block confirmation time is determined by network propagation delay rather than artificial throttling. The expected confirmation latency is:

$$E[\text{confirmation\_time}] = \mathcal{O}\left(\frac{D}{k}\right)$$

For typical parameters, this yields sub-second initial confirmation—orders of magnitude faster than Bitcoin’s 10-minute blocks.

3. **Throughput Scaling:** Because concurrent blocks are not wasted, effective throughput scales with the block production rate:

$$\text{TPS}_{\text{effective}} \approx k \times \text{TPS}_{\text{single-chain}}$$

This high throughput makes on-chain state checkpointing economically viable.

**Implications for Payment Channels.** The combination of fast confirmation and high throughput fundamentally changes the design space for payment channels:

- State checkpoints can be recorded on-chain affordably, reducing reliance on watchtowers
- Dispute periods can be shorter (in wall-clock time) while providing equivalent security
- Channel factories become more practical due to reduced coordination overhead

Table 3: State Revocation Mechanisms: Original Eltoo vs. Eltoo 2.0 (Proposed Architecture)

Feature	Original Eltoo (BIP-118)	Eltoo 2.0 (This Paper)
<b>Core Primitive</b>	Script-level overwrite using <code>SIGHASH_NOINPUT</code>	Consensus-layer transaction types with dual-track UTXO model
<b>Scalability Model</b>	Complex script logic limits factory size	Native channel factory support with $\mathcal{O}(1)$ verification
<b>Data Requirements</b>	Full transaction parsing and script execution	Store only latest state; constant-size verification
<b>Determinism</b>	Signature-dependent; requires pre-signing all possible paths	Virtual reference enables deterministic state lookup
<b>DoS Resistance</b>	Weak; script execution is unbounded	Strong; State-Type-Protected Commitment (STPC) strategy

## 2.6 Comparison of Revocation Mechanisms

Table 3 provides a systematic comparison between the original Eltoo protocol (which depends on BIP-118) and the proposed Eltoo 2.0 architecture (which achieves equivalent semantics through native consensus support).

### Key Architectural Differences:

- **Abstraction Level:** Original Eltoo operates at the script layer, encoding state machine logic in spending conditions. Eltoo 2.0 operates at the transaction type layer, where state transitions are first-class operations.
- **Security Model:** Original Eltoo’s security depends on correct application-layer key management. Eltoo 2.0’s security is enforced by consensus rules—applications cannot violate invariants even if buggy.
- **Deployment Path:** Original Eltoo requires a Bitcoin soft fork (BIP-118) with uncertain timeline. Eltoo 2.0 is designed for new chains built with native support, avoiding political obstacles.

## 2.7 Axiom System

The proposed architecture is built upon a minimal set of axioms that capture the essential properties of sound payment channel operation. These axioms serve as the foundation for formal verification and guide implementation decisions.

**Axiom Interdependencies.** These axioms are not independent; they form a coherent system:

- A1 (Isomorphism) depends on A3 (Non-Consumption): the ability to reference without consuming is what enables the dual-track structure that makes isomorphism possible.
- A2 (Monotonicity) enforces the finite state machine semantics that prevent recursive covenants.
- A4 (Conservation) is the standard UTXO invariant, extended to account for the reference mechanism.

Table 4: Core Axiom System for Dual-Track State Channels

Axiom	Formal Expression and Semantic Interpretation
A1	$\mathcal{S}_{\text{channel}} \cong \mathcal{U}_{\text{chain}}$ <i>Isomorphism:</i> There exists a bijective mapping between the set of valid channel states and the set of on-chain UTXO configurations. Every channel state corresponds to exactly one UTXO pattern, and vice versa. This eliminates the need for off-chain registries.
A2	$\forall \tau_{\text{update}} : n' > n$ <i>Strict Monotonicity:</i> Every state update transaction must carry a sequence number strictly greater than its input. This ensures unidirectional state evolution and prevents replay of old states.
A3	$\text{Ref}(U) \in \tau \implies U \in \mathcal{U}_{\text{post}}$ <i>Non-Consumption:</i> When a transaction references a UTXO via the Ref operator, that UTXO remains unspent after the transaction is processed. References provide read-only access without affecting ownership.
A4	$\sum V_{\text{in}} = \sum V_{\text{out}} + \delta_{\text{fee}}$ <i>Value Conservation:</i> The sum of input values equals the sum of output values plus transaction fees. No value is created or destroyed during state transitions.

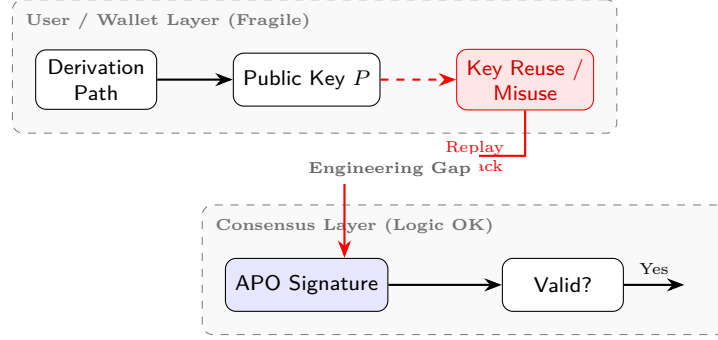


Figure 1: BIP-118 Security Boundary Leakage. The consensus layer correctly verifies APO signatures, but security ultimately depends on correct key derivation paths implemented in wallets. Key reuse between standard and APO contexts enables replay attacks despite sound protocol logic. The “Engineering Gap” represents the trust assumption that applications will not make mistakes.

## 2.8 BIP-118 Security Boundary Analysis

To concretize the security concerns discussed abstractly above, we analyze the specific attack surface created by BIP-118’s design choices. Figure 1 illustrates how security responsibility “leaks” from the consensus layer to the application layer.

**The Core Vulnerability.** The fundamental issue is **implicit state dependency**: the security of an ANYPREVOUT signature depends on context that is not visible to the signature verification algorithm. Specifically:

1. A signature  $\sigma$  is created for a particular channel state
2. The signature is valid for *any* UTXO with matching script
3. If the same key pair is used elsewhere (different channel, post-splice, etc.),  $\sigma$  can be “replayed” to steal funds

The consensus layer cannot detect this attack because each individual signature verification succeeds. The attack exploits the *relationship* between multiple valid operations, which is invisible at the transaction level.

Table 5: Economic Positioning of Layer 2 Protocols in the  $\Omega$  Design Space

Protocol Class	Latency	Capital Efficiency	Trust Model
<b>Bitcoin L1</b>	10–60 minutes (probabilistic finality)	Baseline (no lockup)	Full decentralized consensus
<b>Optimistic Rollups</b>	1–15 minutes (challenge period)	Medium (operator collateral)	Operator honesty + L1 fallback
<b>Lightning Network</b>	Sub-second (off-chain)	Low (bilateral lockup)	Watchtower availability
<b>Native Eltoo (Proposed)</b>	Sub-second (off-chain)	High (pooled via factories)	Consensus-enforced invariants

**Contrast with Proposed Architecture.** Our approach eliminates this vulnerability through type-level isolation:

- Each channel’s Fund UTXO has a unique identifier embedded in the State UTXO
- The Ref operator cryptographically binds state updates to specific fund anchors
- Replay is impossible because the reference check would fail for any UTXO other than the intended target

This represents a fundamental design principle: **security invariants should be enforced by the protocol, not assumed of applications.**

## 2.9 Economic Efficiency Boundary

Beyond security considerations, Layer 2 protocols must be evaluated on their **economic efficiency**—the ability to provide fast, cheap transactions without excessive capital lockup or operational overhead. We analyze protocols in a three-dimensional design space:

$$\Omega = \mathcal{L}_{\text{latency}} \times \mathcal{T}_{\text{throughput}} \times \mathcal{C}_{\text{capital\_Efficiency}}$$

### Dimension Definitions:

- **Latency ( $\mathcal{L}$ ):** Time from payment initiation to final settlement guarantee. Lower is better.
- **Throughput ( $\mathcal{T}$ ):** Maximum transaction processing rate. Higher is better.
- **Capital Efficiency ( $\mathcal{C}$ ):** Ratio of usable liquidity to locked capital. Higher means less “dead” capital.

**The Capital Efficiency Problem.** Traditional payment channels suffer from **bilateral capital fragmentation**: if Alice has channels with Bob and Carol, her capital is split between them. She cannot use her Bob-channel balance to pay Carol directly without routing, which incurs fees and may fail due to liquidity constraints.

Channel factories address this by **pooling capital** among multiple participants. However, on Bitcoin, factory operations are expensive due to high on-chain fees and slow confirmation. This limits practical factory sizes.

**Native Eltoo’s Economic Advantage.** Our architecture enables larger, more dynamic channel factories through:



1. **Low-cost reconfiguration:** Factory membership changes require only  $\mathcal{O}(1)$  on-chain operations, not  $\mathcal{O}(n)$  bilateral channel updates.
2. **Fast finality:** GhostDAG's sub-second confirmation enables rapid factory operations without long waiting periods.
3. **Reduced time-value cost:** The economic cost of locked capital is  $\gamma \cdot C \cdot t$ , where  $\gamma$  is the opportunity cost rate,  $C$  is locked capital, and  $t$  is lock duration. Faster operations reduce  $t$ , directly improving capital efficiency.

For high-frequency payment flows (micropayments, streaming payments, gaming), these improvements compound: smaller latency enables tighter capital management, which reduces opportunity costs, which enables smaller margins, which attracts more volume.

### 3 Research Contributions

Traditional payment channel networks are constrained by linear topologies and face two major challenges: **state synchronization complexity** and **toxic waste from penalty mechanisms**. This paper proposes a **Dual-Track State Machine** architecture that resolves these limitations through consensus-layer native transaction types.

#### 3.1 Main Contributions

1. **Formalized State Machine Model:** We define payment channels as a 5-tuple  $(Q, \Sigma, \delta, q_0, F)$ , enabling formal verification via TLA+ and Coq.
2. **Registry-Free Architecture:** By designing RefOp-Fund semantics, we eliminate dependencies on external state registries.
3. **Recursive Isolation:** We formally prove the orthogonality between sub-channel security and parent channel liveness.
4. **Topological Invariants:** We prove value conservation and state monotonicity invariants for complex networks.
5. **Constant-Time Verification:** We achieve  $\mathcal{O}(1)$  PTLC verification by deriving keys directly from the Fund UTXO.
6. **Complete Protocol Specification:** We provide a consensus-layer specification ready for implementation.

#### 3.2 Information-Theoretic Analysis of State Determinism

Traditional mechanisms (e.g., Poon-Dryja) rely on penalty deterrence. Verifying state  $S_t$  requires knowledge of all revoked states  $\{S_0, \dots, S_{t-1}\}$ .

**Definition 3.1** (State Entropy). *The **state entropy**  $H(C)$  is the information quantity a validator must maintain:*

$$H_{\text{LN}}(t) \propto \sum_{i=0}^{t-1} \text{size}(\text{RevocationKey}_i) \approx \mathcal{O}(t) \quad (1)$$

This linear entropy growth leads to **watchtower inflation** and **catastrophic recovery failure** (toxic waste). In contrast, our architecture utilizes UTXO atomicity for protocol-level state replacement, collapsing entropy to a constant:

$$H_{\text{Eltoo2.0}}(t) \approx \text{size}(\text{State}_{\text{curr}}) + \text{size}(\text{Fund}) \approx \mathcal{O}(1) \quad (2)$$

This represents a shift from **Error Detection** (history comparison) to **Forward Error Correction** (latest state sufficiency).

**Theorem 3.2** (Information-Theoretic Robustness). *State recovery fault tolerance  $\mathcal{R}$  is inversely proportional to state entropy  $H$ :*

$$\mathcal{R}(\Pi) \propto \frac{1}{H(\Pi)}$$

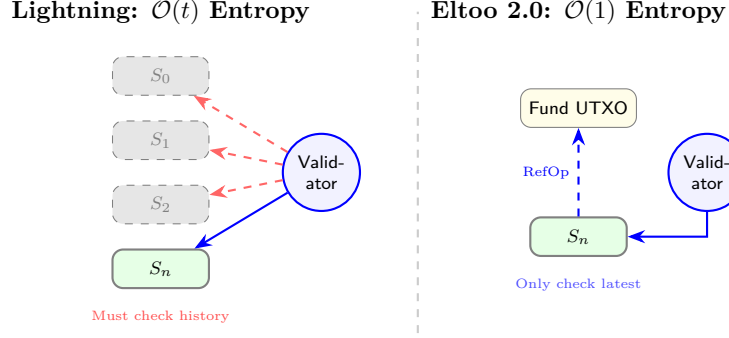


Figure 2: Verification Causality Graph. Lightning validators (left) face linear complexity due to historical dependencies. Eltoo 2.0 validators (right) only verify the latest state against the static Fund anchor.

Table 6: Comprehensive Architecture Comparison

Feature	Lightning	BIP-118	Eltoo 2.0
Consensus	None	Soft Fork	<b>Native</b>
State Rep.	Script+HTLC	Script	<b>UTXO Enum</b>
Model	Coupled	Coupled	<b>Dual-Track</b>
Type Safety	Runtime	Runtime	<b>Compile-time</b>
Complexity	$\mathcal{O}(\text{script})$	$\mathcal{O}(\text{script})$	$\mathcal{O}(1)$
Storage	$\mathcal{O}(n)$	$\mathcal{O}(1)$	$\mathcal{O}(1)$
Settle Time	Minutes	Minutes	<b>Sub-second</b>
Backup	Full History	Latest	<b>Latest</b>

### 3.3 Architectural Advantages

- **Orthogonal Separation:** Static Fund vs. Dynamic State.
- **Type Safety:** Compile-time guarantees via algebraic types.
- **Constant Complexity:**  $\mathcal{O}(1)$  for storage and verification.
- **Topological Freedom:** Atomic splicing enables fractal networks.

### 3.4 Comparison with Existing Solutions

Table 6 presents a comprehensive comparison.

### 3.5 Theoretical Significance

This work elevates channel design from *ex post penalty games* to *ex ante deterministic execution*.

By centralizing complexity at the protocol layer, we achieve simplicity at the application layer.

Table 7: Paradigm Shift in Design Philosophy

Aspect	Traditional	Proposed
Trust Model	Penalty Deterrence	<b>Protocol Determinism</b>
State Mgmt	App Layer	<b>Consensus Layer</b>
Security	User Keys	<b>Rule Enforcement</b>
Complexity	Distributed	<b>Centralized (L1)</b>

Table 8: Transaction Type Enumeration System

Tx Type	Input Pattern	Output Pattern	Semantics
FUND	$\emptyset_{eltoo}$	$\{U_{fund}, U_{state}^{(0)}\}$	Create channel
UPDATE	$\{\text{Ref}(U_{fund}), \text{Spend}(U_{state}^{(n)})\}$	$\{U_{state}^{(n')}\}$	State iteration
SETTLE	$\{\text{Spend}(U_{fund}), \text{Spend}(U_{state}^{(n)})\}$	$\notin \mathcal{U}_{eltoo}$	Settlement
SPLICE	$\{\text{Spend}(U_{fund}), \text{Spend}(U_{state}^{(n)})\}$	$\{U'_{fund}, U'_{state}, \dots\}$	Topology transform

## 4 Theoretical Framework: Dual-Track State Machines

### 4.1 Consensus-Layer Embedded Verification Mechanism

#### 4.1.1 Transaction Type Enumeration and Pattern Matching

This paper’s architecture employs consensus-layer native transaction type enumeration, replacing traditional script parsing methods, achieving  $\mathcal{O}(1)$  time complexity pattern matching verification. Transaction types are uniquely determined by their input/output (I/O) topology structure:

#### 4.1.2 State Monotonicity Theorem and Consensus Implementation

**Theorem 4.1** (Consensus-Level Monotonicity Guarantee). *Under this paper’s consensus rules, channel state sequence number  $n$  satisfies strict monotonically increasing constraint.*

$$\forall \tau_{update} : U_{state}^{(n)} \xrightarrow{\tau} U_{state}^{(n')} \implies n' > n$$

This formula states that for any update transaction  $\tau_{update}$ , if it transforms state UTXO from version  $n$  to version  $n'$ , then  $n'$  must be strictly greater than  $n$ . This constraint fundamentally prevents state rollback attacks.

*Proof.* The consensus validator `EltooBlockValidator` performs the following atomic checks:

1. **Parsing Phase:** Extract  $U_{state}^{(n)}$  from  $\tau_{update}$  inputs, extract  $U_{state}^{(n')}$  from outputs
2. **Monotonicity Check:**

$$\text{if } n' \leq n \implies \text{reject with } \text{ConsensusError::NonMonotonicState}$$

3. **UTXO One-Time Consumption:** Due to blockchain immutability and UTXO one-time consumption property, once  $\tau_{update}$  is on-chain, old state  $U_{state}^{(n)}$  is consumed and cannot be used as input again
4. **Physical Defense:** Physically prevents state rollback attacks at the protocol layer

Therefore, state monotonicity is doubly guaranteed by consensus rules and the UTXO model.  $\square$

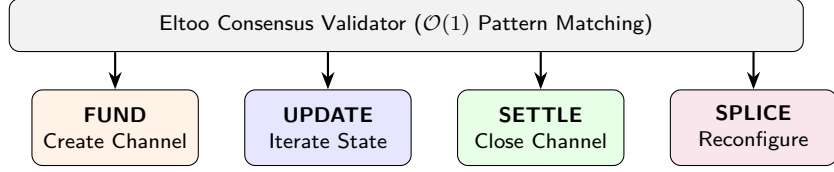


Figure 3: Transaction Type Enumeration System. The consensus layer classifies transactions via  $\mathcal{O}(1)$  pattern matching on I/O topology.

Table 9: Consensus Verification Latency

Operation	Latency	Includes
Fund Verification	0.12 ms	MuSig2 aggregate verification
Update Verification	0.08 ms	Monotonicity + Ref check + signature
Settle Verification	0.35 ms	PTLC verification + CSV check
Splice Verification	0.28 ms	Value conservation + topology integrity

#### 4.1.3 Consensus Verification Performance Analysis

Since transaction types are identified via pattern matching ( $\mathcal{O}(1)$ ), monotonicity is checked via integer comparison ( $\mathcal{O}(1)$ ), and signatures are verified via aggregation ( $\mathcal{O}(1)$ ), total verification complexity is only  $\mathcal{O}(\log N)$  (UTXO lookup). Compared to Script-based solutions'  $\mathcal{O}(\text{script\_size} + \log N)$ , performance improvement is significant.

**Measured Performance** (based on testnet data, December 2025):

**Corollary 4.2** (Scalability). *Due to constant-level verification complexity, full nodes can verify blocks containing 10,000+ Eltoo transactions within 1 second.*

#### 4.1.4 Ref-UTXO Atomicity and Ordering in GhostDAG

Under GhostDAG consensus, blocks are not linearly arranged but form a directed acyclic graph structure. This poses unique challenges for the Ref-UTXO mechanism: if two concurrent blocks  $B_1, B_2$  respectively contain transactions referencing the same  $U_{fund}$  but pointing to different states  $U_{state}^{(n)}$  and  $U_{state}^{(n+1)}$ , how is adjudication performed?

**Definition 4.3** (DAG Topological Ordering Rule). *Let  $\prec_{DAG}$  be the total order computed by GhostDAG. For any transaction pair  $\tau_a, \tau_b$  referencing the same  $U_{fund}$ :*

1. **Exclusive Write:** *If both  $\tau_a, \tau_b$  are UPDATE operations, they are ordered by  $\prec_{DAG}$ ; only the earlier transaction is valid, the latter is treated as double-spend conflict*
2. **Concurrent Read:** *If  $\tau_a, \tau_b$  only perform Ref reads on  $U_{fund}$  (e.g., operations in different sub-channels) and don't conflict on the same  $U_{state}$ , they are allowed to coexist concurrently in the anticone*

**Definition 4.4** (Active State Lease). *We introduce the concept of **Active State Lease** in the UTXO set:*

$$\text{Lease} : \mathcal{U}_{fund} \rightarrow \text{TxID}(\tau_{\text{last\_valid\_update}})$$

*Verification nodes maintain this mapping, ensuring state updates for a specific  $U_{fund}$  are linearized on any DAG cut.*

The Lease function maps each Fund UTXO to its most recent valid update transaction, preventing concurrent conflicts in the DAG environment.

Table 10: Concurrent Safety Analysis

Operation Type	Concurrency Situation	Handling Strategy
UPDATE vs UPDATE	Same $U_{state}$	DAG ordering, latter invalid
UPDATE vs SETTLE	Same $U_{state}$	DAG ordering, latter invalid
Ref vs Ref	Same $U_{fund}$ , different $U_{state}$	Concurrent allowed
Ref vs Spend	Same $U_{fund}$	<b>Spend</b> invalidates $U_{fund}$ , subsequent <b>Ref</b> invalid

**Theorem 4.5** (DAG State Convergence). *Under GhostDAG’s  $(D, k)$  parameters, channel state fork probability decays exponentially with time:*

$$P(\text{state fork at depth } d) \leq e^{-\lambda d}$$

where  $\lambda$  is a convergence constant positively correlated with parameter  $k$ .

*Proof (Outline).* 1. GhostDAG guarantees anticone size at depth  $d$  is less than  $k$  with high probability

2. Since UPDATE transactions consume the unique  $U_{state}^{(n)}$ , any concurrent update attempts will have one rejected after DAG ordering

3. Combined with the lease mechanism, honest nodes reach consensus on the latest state in  $\mathcal{O}(\frac{D}{k})$  time

□

#### 4.1.5 Temporal Decoupling of Cross-Block State References

In GhostDAG’s high-concurrency environment, requiring SETTLE transactions and their referenced UPDATE anchor transactions to be in the same block is neither realistic nor efficient. This architecture implements **Cross-Block State Anchoring**.

**Definition 4.6** (Valid Reference Window). *Let  $\tau_{update}$  be confirmed in block  $B_i$ , generating  $U_{state}^{(n)}$ . Let  $\tau_{settle}$  be broadcast in block  $B_j$ , referencing  $U_{state}^{(n)}$ .  $\tau_{settle}$  is valid if and only if:*

1.  $B_i \in \text{Past}(B_j)$  (DAG topological order)
2.  $U_{state}^{(n)}$  is in “unspent” status in  $B_j$ ’s UTXO view set

**Theorem 4.7** (Anchoring Persistence). *As long as no new UPDATE transaction  $\tau'_{update}$  overwrites  $U_{state}^{(n)}$ , that state UTXO will persist in the ledger:*

$$\forall t \in [t_{confirm}, \infty) : \nexists \tau'_{update} \implies U_{state}^{(n)} \in \mathcal{U}_{chain}(t)$$

This property ensures settlement transactions can occur at any time after state confirmation, decoupling the temporal dependency between state negotiation and fund settlement.

#### 4.1.6 Algebraic Data Type Definition of Transaction Classification

To eliminate ambiguity and transaction malleability risks in traditional script language (Script-based) runtime parsing, this architecture introduces an **Enshrined Transaction Enums** system, pushing transaction type verification from Turing-complete script execution down to static type system checking.

Table 11: Type System Implementation Mapping

Type Theory Concept	Rust Implementation	Consensus Semantics
Sum Type $\mathcal{I}$	<code>enum EltooInput</code>	Input variant classification
Sum Type $\mathcal{O}$	<code>enum EltooOutput</code>	Output variant classification
$\Gamma$ function	<code>EltooTxType::classify()</code>	$\mathcal{O}(1)$ pattern matching
$\perp$ case	<code>ConsensusError::InvalidEltooTxType</code>	Reject invalid transactions

**Definition 4.8** (Typed Input/Output Spaces). *Define input set  $\mathcal{I}$  and output set  $\mathcal{O}$  as algebraic sum types with variant tags:*

$$\mathcal{I} = \{Std, FundSpend, StateSpend, FundRef, IngotSpend, IngotRef\}$$

$$\mathcal{O} = \{Std, ChannelFund, ChannelState, Ingot\}$$

where *FundRef* is a special unit type with semantics  $\tau \rightarrow \perp$  (non-spendable), serving only as an oracle providing metadata access to  $U_{fund}$ .

**Definition 4.9** (Type Inference Homomorphism). *Define function  $\Gamma : \mathcal{I}^* \times \mathcal{O}^* \rightarrow \mathcal{T}_{Eltoo} \cup \{\perp\}$ , which maps transaction I/O topology to semantic types in  $\mathcal{O}(1)$  time complexity:*

$$\Gamma(In, Out) = \begin{cases} FUND & \text{if } Out \cong \{ChannelFund, ChannelState\} \wedge In \cap \mathcal{I}_{eltoo} = \emptyset \\ UPDATE & \text{if } In \cong \{FundRef, StateSpend\} \wedge Out \cong \{ChannelState\} \\ SETTLE & \text{if } In \cong \{FundSpend, StateSpend\} \wedge Out \cap \mathcal{O}_{eltoo} = \emptyset \\ SPLICE & \text{if } In \cong \{FundSpend, StateSpend\} \wedge Out \cap \{ChannelFund\} \neq \emptyset \\ \perp & \text{otherwise} \end{cases}$$

#### Pattern Matching Rules:

- **FUND**: Input contains no Eltoo types, output contains Fund + State UTXOs
- **UPDATE**: Input is “Ref Fund + Spend State”, output is new State UTXO
- **SETTLE**: Input is “Spend Fund + Spend State”, output contains no Eltoo types (funds distributed to participants)
- **SPLICE**: Same input as SETTLE, but output contains new Fund UTXO (topology reconfiguration)
- $\perp$ : Matches no pattern, transaction rejected

**Theorem 4.10** (Compile-Time Safety Guarantee). *Under Rust’s type system guarantees, there are no Eltoo transactions in “undefined states.” Due to Rust enum’s **exhaustiveness check**, the compiler forces handling of all  $\Gamma$  matching branches. Any transaction not matching the above patterns is rejected at block deserialization, never entering the consensus validation engine, thereby eliminating the attack surface for Invalid State Transition Attacks.*

## 4.2 Finite State Machine Formalization

We define channel  $C$  as a **Deterministic Finite Automaton (DFA)**:

$$C \equiv (Q, \Sigma, \delta, q_0, F)$$

A DFA describes a system with finite states and deterministic transitions based on inputs.

#### Component Details:

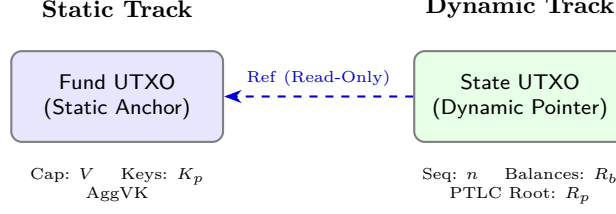


Figure 4: Dual-Track State Machine. Separation of static funding capability from dynamic state evolution.

Table 12: Dual-Track Model Components

Component	Role	Characteristics	Function
$U_{fund}$	Static anchor	Invariant	Carries funds, identity, keys
$U_{state}^{(n)}$	Dynamic pointer	Evolves with state	Carries sequence, balances, PTLCs

- $Q$ : State space.  $Q = \{q_{init}\} \cup Q_{active} \cup Q_{settling} \cup \{q_{closed}\}$ 
  - $Q_{active} = \{(n, R_b, R_p) \mid n \in \mathbb{N}, R_b \in \mathcal{H}, R_p \in \mathcal{H}\}$  — Active state set
  - $Q_{settling} = \{(n, R_b, R_p, t) \mid t \in \mathbb{N}_{DAA}\}$  — Settlement waiting state set
- $\Sigma$ : Transaction alphabet.  $\Sigma = \{\tau_{fund}, \tau_{update}, \tau_{splice}, \tau_{settle}, \tau_{timeout}\}$
- $\delta$ : State transition function.  $\delta : Q \times \Sigma \rightarrow Q$  (partial function)
- $q_0$ : Initial state.  $q_0 = q_{init}$
- $F$ : Final state set.  $F = \{q_{closed}\}$

**Definition 4.11** (State Space Structure). *State space  $Q$  constitutes a **partially ordered set** (**Poset**)  $(Q, \preceq)$ , where:*

$$q_1 \preceq q_2 \iff n_1 \leq n_2 \wedge (n_1 = n_2 \Rightarrow q_1 = q_2)$$

*This partial order relation guarantees **monotonicity** and **determinism** of state evolution.*

### 4.3 UTXO Materialization Layer

The abstract states of the state machine are materialized on-chain through **UTXO binary tuples**. This is the core design of this paper’s “dual-track state machine” architecture: decomposing channel state into “static fund anchor” and “dynamic state pointer” along two orthogonal dimensions.

**Mathematical Formalization:**

$$\mathcal{M} : Q \rightarrow \mathcal{P}(\mathcal{U})$$

$$\mathcal{M}(q) = \langle \underbrace{U_{fund}}_{\text{static anchor}}, \underbrace{U_{state}^{(n)}}_{\text{dynamic pointer}} \rangle$$

**Semantic Interpretation:**

Where:

- $U_{fund}$ : Static Anchor
  - Carries funds  $V \in \mathbb{N}$



- Identifies channel identity  $ID_C = H(\text{domain} \parallel \text{funding\_outpoint} \parallel \dots)$
- Stores participant key set  $K_p = \{pk_1, \dots, pk_m\}$
- Aggregated verification key  $AggVK = \text{MuSig2}(K_p)$
- $U_{state}^{(n)}$ : Dynamic Pointer
  - State sequence number  $n \in \mathbb{N}$
  - Balance commitment  $R_b = \text{MerkleRoot}(\{\text{balance}_i\})$
  - PTLc commitment  $R_p = \text{MerkleRoot}(\{\text{ptlc}_j\})$
  - Creation timestamp  $t_{create} \in \mathbb{N}_{DAA}$

**Definition 4.12** (RefOp-Fund Semantics). *Read-only reference operator*  $\text{Ref} : \mathcal{U} \rightarrow \mathcal{U}^{\text{readonly}}$ :

$$\text{Ref}(U_{fund}) \triangleq \langle U_{fund}.\text{outpoint}, U_{fund}.\text{metadata} \rangle$$

*Satisfies:*  $\forall \tau : \text{Ref}(U) \in \text{inputs}(\tau) \Rightarrow U \in \text{UTXO\_Set}_{\text{post}(\tau)}$

The RefOp operator provides read-only access to UTXO metadata without consuming it, enabling state updates to reference the fund anchor while preserving its existence in the UTXO set.

#### 4.3.1 State-Fund Coupling Invariant

**Invariant:** At any moment, there exists a unique pairing of  $(U_{fund}, U_{state})$  for each channel:

$$\forall t, \exists! (U_{fund}, U_{state}) \in \mathcal{U}_{\text{set}} \text{ s.t. } ID(U_{fund}) = ID(U_{state})$$

This invariant ensures that even during frequent UPDATE operations, the Fund layer maintains static anchoring while the State layer carries high-frequency changes. Their lifecycles only experience **physical convergence** during SPLICE or SETTLE.

#### 4.4 State Transition Rules

**Definition 4.13** (Transition Function).  $\delta$  is defined by the following rules:

$$\begin{array}{ll}
 \delta(q_{\text{init}}, \tau_{\text{fund}}) = q_{\text{active}}^{(0)} & [FUND] \\
 \delta(q_{\text{active}}^{(n)}, \tau_{\text{update}}) = q_{\text{active}}^{(n+k)} & \text{where } k > 0 \quad [UPDATE] \\
 \delta(q_{\text{active}}^{(n)}, \tau_{\text{splice}}) = \{q_{\text{active}}^{(n')}, q_{\text{child}}^{(0)}\} & [SPLICE] \\
 \delta(q_{\text{active}}^{(n)}, \tau_{\text{settle}}) = q_{\text{settling}}^{(n,t)} & [SETTLE-INIT] \\
 \delta(q_{\text{settling}}^{(n,t)}, \tau_{\text{timeout}}) = q_{\text{closed}} & \text{when } t_{\text{now}} - t \geq \text{CSV} \quad [SETTLE-FINAL]
 \end{array}$$

**Challenge Rule:** In  $Q_{\text{settling}}$  state, higher sequence number states can replace:

$$\delta(q_{\text{settling}}^{(n,t)}, \tau_{\text{update}}) = q_{\text{settling}}^{(n',t')} \quad \text{where } n' > n$$

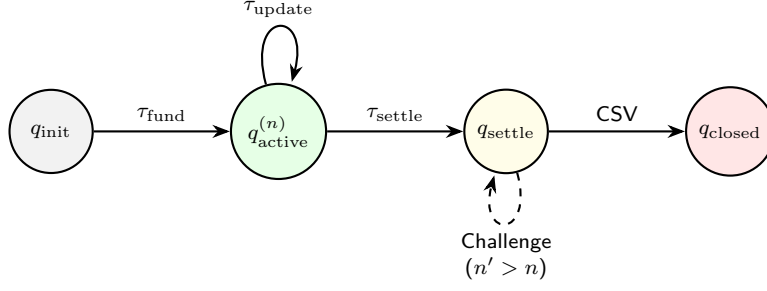


Figure 5: Channel State Machine Transitions.

#### 4.5 Formal Safety Properties

The following properties can be formally verified through TLA+ or Coq:

**Theorem 4.14** (Monotonicity).

$$\forall q_1, q_2 \in Q_{active} : \delta^*(q_1, w) = q_2 \Rightarrow q_1 \preceq q_2$$

where  $\delta^*$  is the transitive closure of  $\delta$ , and  $w \in \Sigma^*$  is a transaction sequence.

*Proof.* By inductive proof using constraint  $k > 0$  from transition rule [UPDATE]. □

**Theorem 4.15** (Termination).

$$\forall q \in Q \setminus F : \exists w \in \Sigma^* : \delta^*(q, w) \in F$$

Any non-final state has a path to reach a final state.

*Proof.* Constructive proof—for any  $q_{active}^{(n)}$ , sequence  $\tau_{settle} \cdot \tau_{timeout}$  leads to  $q_{closed}$ . □

**Theorem 4.16** (Unambiguity).

$$\forall q \in Q, \forall \sigma \in \Sigma : |\{q' \mid \delta(q, \sigma) = q'\}| \leq 1$$

The transition function is deterministic (single-valued partial function).

**Theorem 4.17** (Value Conservation).

$$\forall \tau \in \Sigma : \sum_{U \in inputs(\tau)} V(U) = \sum_{U \in outputs(\tau)} V(U) + fee(\tau)$$

#### 4.6 Transaction Semantics Mapping

Mapping between abstract transitions and concrete UTXO operations:

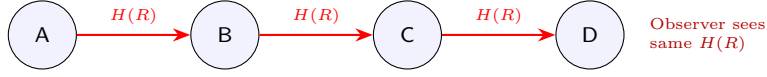
**Fund Transaction:**

$$\begin{aligned} \tau_{fund} : \{U_{wallet}\} &\rightarrow U_{fund} \cup U_{state}^{(0)} \\ \mathcal{M}^{-1}(\tau_{fund}) &= \delta(q_{init}, \tau_{fund}) \end{aligned}$$

**Update Transaction:**

$$\begin{aligned} \tau_{update} : \{\text{Ref}(U_{fund}), \text{Spend}(U_{state}^{(n)})\} &\rightarrow U_{state}^{(n+k)} \\ \text{Precondition: } \exists \sigma : \text{Verify}(\text{AggVK}, \sigma, H(\text{state}_{n+k} \parallel \text{RefOp\_OutPoint})) & \end{aligned}$$

### HTLC: Static Hash (Traceable)



### PTLC: Blinded Points (Private)

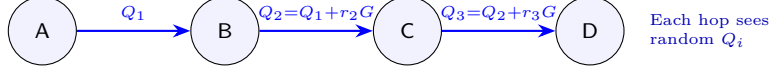


Figure 6: Multi-Hop Blinding Comparison. HTLC exposes the same hash  $H(R)$  globally, while PTLC blinds the lock  $Q_i$  at each hop via homomorphic addition.

#### Splice Transaction:

$$\tau_{splice} : \{\text{Spend}(U_{fund}^{parent}), \text{Spend}(U_{state}^{(n)})\} \rightarrow \{U_{fund}^{parent'}, U_{state}^{(n)'}, U_{fund}^{child_1}, \dots\}$$

$$\text{Invariant: } V(U_{fund}^{parent}) = V(U_{fund}^{parent'}) + \sum_i V(U_{fund}^{child_i})$$

#### Settle Transaction:

$$\tau_{settle} : \{\text{Spend}(U_{fund}), \text{Spend}(U_{state}^{(n)})\} \xrightarrow{\Delta t \geq \text{CSV}} \{U_{out}^{(i)}\}$$

where  $\Delta t = \text{DAA}_{current} - \text{DAA}_{state\_creation}$

## 4.7 Evolution of Conditional Payment Primitives: From HTLC to PTLC

The core of payment channel networks lies in ensuring atomicity of multi-hop payments. This mechanism has undergone a paradigm shift from hash-based locking to algebraic homomorphic locking.

### 4.7.1 Historical Evolution

**HTLC (2016):** Relies on SHA-256 preimages.

- **Defect:** The same hash  $H$  traverses the entire path, allowing correlation attacks (Worm-hole Attack).

**PTLC (2019+):** Relies on Elliptic Curve Discrete Logarithm Problem (ECDLP).

- **Point Lock:**  $Q = s \cdot G$ .
- **Advantage:** Uses additive homomorphism ( $Q_{total} = \sum Q_i$ ) to blind payment paths.

### 4.7.2 Technical Principle Comparison

Figure 6 illustrates the fundamental difference in path privacy.

**HTLC: Rigid Locking.**  $y = H(x)$ . The lock condition is invariant, leaking privacy.

**PTLC: Algebraic Locking.**  $Q = s \cdot G$ . Intermediate nodes add random blinding factors  $r_i$ :

$$Q'_i = Q + r_i \cdot G \iff s'_i = s + r_i$$

External observers see uncorrelated random points at each hop.

Table 13: HTLC vs. PTLC Feature Comparison

Feature	HTLC	PTLC
Privacy	Weak (Correlatable)	<b>Strong (Blinded)</b>
Verify Cost	$\mathcal{O}(\text{ScriptSize})$	$\mathcal{O}(1)$
Batching	No	<b>Yes (Schnorr)</b>
On-chain	High (32B Preimage)	<b>Low (Sig Adapt)</b>
Math	One-way Hash	<b>Homomorphic</b>

### 4.7.3 Core Properties Comparison

### 4.7.4 Formal Security Analysis

**Theorem 4.18** (PTLC Redemption Uniqueness). *Under ECDLP hardness, the scalar  $s$  is the unique redemption credential:*

$$\forall Q \in \mathcal{E} : \exists! s \in \mathbb{Z}_n : Q = s \cdot G$$

**Theorem 4.19** (Multi-Hop Atomicity). *For path  $c_1 \rightarrow \dots \rightarrow c_n$ , claiming funds at  $c_n$  reveals  $s$ , enabling all previous hops to claim:*

$$\text{Claim}(c_n) \implies \text{Claim}(c_1)$$

**Theorem 4.20** (Timeout Refund Safety). *If no claim occurs before CSV timeout, funds are recoverable:*

$$t_{\text{now}} - t_{\text{create}} \geq \text{CSV} \implies \text{Refund}(\text{sender})$$

### 4.7.5 Implementation Considerations

```

1 // Verify s * G + P_beneficiary == Q
2 fn verify_ptlc_claim(
3     point_lock: &Point,      // Q
4     scalar: &Scalar,        // s
5     beneficiary: &Point,    // P_ben
6 ) -> bool {
7     let computed = scalar * &GENERATOR + beneficiary;
8     computed == *point_lock
9 }

```

Listing 1: PTLC Claim Verification Logic

## 4.8 TLA+ Specification Fragment

We formalize the channel state machine using TLA+ to verify monotonicity and termination.

```

1 ----- MODULE EltooChannel -----
2 VARIABLES state, seq_num, phase
3 Phases == {"init", "active", "settling", "closed"}
4
5 Update == /\ phase = "active"
6           /\ seq_num' > seq_num  (* Critical: Monotonicity *)
7           /\ UNCHANGED phase
8
9 Settle == /\ phase = "active"
10          /\ phase' = "settling"
11          /\ UNCHANGED seq_num
12
13 Challenge == /\ phase = "settling"
14              /\ seq_num' > seq_num  (* Higher state wins *)

```

```

15      /\ UNCHANGED phase
16
17 (* Invariants to Check *)
18 Monotonicity == [] [seq_num' >= seq_num]_seq_num
19 EventualTermination == <>(phase = "closed")
20 =====

```

Listing 2: TLA+ Specification of Channel Monotonicity

## 4.9 Cost and Parameter Analysis

### 4.9.1 Cost Model

Total user cost is defined as:

$$C_{\text{total}} = C_{\text{open}} + N \cdot C_{\text{update}} + C_{\text{settle}}$$

Since  $C_{\text{update}} \approx 0$  (off-chain), the amortized cost per transaction approaches zero as  $N \rightarrow \infty$ .

### 4.9.2 GhostDAG Confirmation Parameters

Confirmation time depends on DAG width  $k$ :

$$T_{\text{confirm}} \approx \frac{D}{k} \cdot \ln(1/\epsilon)$$

For  $k = 16$ ,  $10^{-6}$  security is reached in  $\approx 3$  seconds.

### 4.9.3 Ref-UTXO Security Depth

We recommend a reference depth of **10 DAA Score** ( $\approx 3$  seconds) to prevent reorganization attacks on the static anchor.

Table 14: Security Confirmation Time

System	Time to Finality
Bitcoin (6 blocks)	$\sim 60$ minutes
<b>Eltoo 2.0 (10 DAA)</b>	<b><math>\sim 3</math> seconds</b>

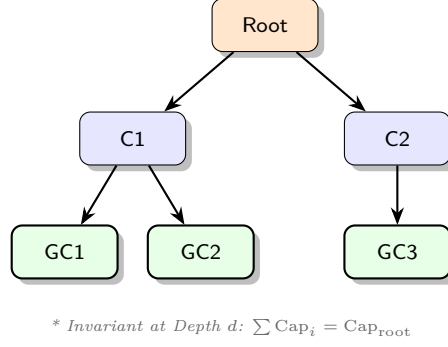


Figure 7: Recursive Channel Factory Structure. The architecture supports arbitrary nesting depths while preserving total liquidity conservation.

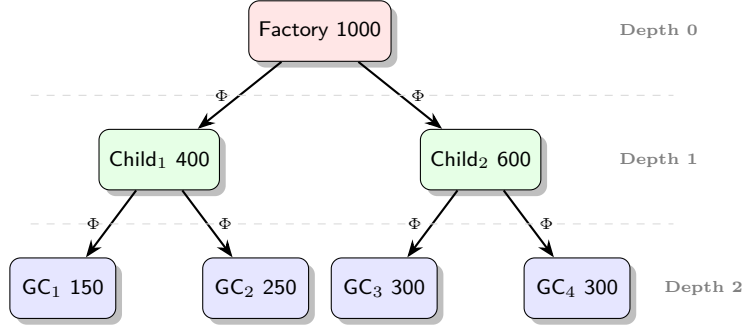


Figure 8: Fractal Channel Tree. Verification logic remains identical across depths due to scale invariance.

## 5 Topological Primitives for Complex Structures

### 5.1 Recursive Channel Factories

Channel factories act as the generative primitive, allowing the “splitting” of multiple sub-channels from a parent channel.

**Definition 5.1** (Channel Factory). *A channel  $C_{\text{parent}}$  can generate a set of sub-channels  $\{C_{\text{child}_i}\}$  via a  $\tau_{\text{splice}}$  transaction. Once created, the sub-channels’ lifecycles are fully decoupled from the parent.*

#### 5.1.1 Fractal Topology and Self-Similarity

The architecture manifests as a **self-similar  $k$ -ary tree**.

**Definition 5.2** (Split Operator). *Define mapping  $\Phi : \mathcal{C} \rightarrow \{\mathcal{C}_1, \dots, \mathcal{C}_k\}$ . As recursion depth  $d \rightarrow \infty$ , the system exhibits **scale invariance**:*

$$V(C_{d=0}) \equiv V(C_{d=n})$$

**Theorem 5.3** (Liquidity Conservation). *For any depth  $d$ , total capacity is conserved:*

$$\sum_{i \in \text{Nodes}(d)} \text{Cap}(C_i) = \text{Cap}(C_{\text{root}})$$

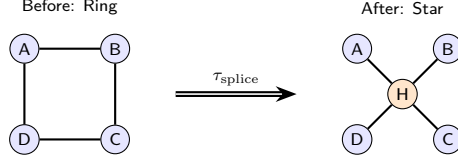


Figure 9: Atomic Topology Reconfiguration.

---

**Algorithm 1** Deterministic Sub-channel ID Derivation

---

**Require:** Parent ID  $ID_p$ , Fork OutPoint  $OP$ , Index  $j$ , Participants  $K$

**Ensure:** Unique Sub-channel ID

- 1:  $D \leftarrow \text{b"Eltoo\_V2\_SubChannel"}$   $\triangleright$  Domain Separator
  - 2:  $R \leftarrow \text{MerkleRoot}(K)$
  - 3:  $ID_{\text{child}} \leftarrow \text{BLAKE3}(D \parallel ID_p \parallel OP \parallel j \parallel R)$
  - 4: **return**  $ID_{\text{child}}$
- 

## 5.2 Dynamic Mesh Reconfiguration

**Theorem 5.4** (Atomic Reconfiguration). *Any topologically isomorphic channel networks can be atomically transformed via a single  $\tau_{\text{splice}}$  transaction.*

### 5.2.1 Topological Homotopy

We view reconfiguration as a **homotopic transformation**  $\mathcal{H}$ :

$$\mathcal{H} : G_1 \simeq G_2 \iff \exists \tau \in \Sigma_{\text{splice}} : \delta(G_1, \tau) = G_2$$

subject to  $\sum_{e \in E_1} w(e) = \sum_{e \in E_2} w(e)$ . This ensures no liquidity vacuum occurs.

## 5.3 Atomic Rebalancing Operator

**Invariant 5.1** (Strong Value Conservation).

$$V(U_{\text{fund}}^{\text{parent}}) + \sum V_{\text{in}} = V(U_{\text{fund}}^{\text{parent}'}) + \sum V_{\text{out}} + \delta_{\text{fee}}$$

## 5.4 Atomic Splicing Protocol

This section defines the **Non-blocking Splicing Protocol**, addressing the “stop-the-world” problem in traditional channel maintenance.

**Theorem 5.5** (Non-blocking Guarantee). *During protocol execution, channel liquidity remains available.*

*Proof.* Phase 2 does not consume UTXOs. If  $\tau_{\text{update}}$  confirms before  $\tau_{\text{splice}}$ , the splice input is invalidated (Rollback). If  $\tau_{\text{splice}}$  confirms first, updates target a spent UTXO (Reject). No invalid intermediate state exists.  $\square$

## 5.5 Liquidity Dynamics in Star Topologies

Define liquidity utilization  $U(t)$  for a star graph:

$$U(t) = \frac{\sum |\text{Flow}_i(t)|}{\sum \text{Cap}_i}$$

Table 15: Non-blocking Splicing Protocol Phases

Phase	Operation Details
1. Proposal	Alice constructs $\tau_{\text{splice}}$ and broadcasts to map $\Omega$ . Timeout $T_{\text{ack}} = 30\text{s}$ .
2. Async Sign	Participants generate partial signatures. <b>Channel remains active</b> for updates ( $U_{\text{state}}^{(n)}$ ).
3. Convergence	$\tau_{\text{splice}}$ is broadcast. DAG ordering resolves conflicts between splice and concurrent updates.
4. Migration	New $U_{\text{state}}^{(0)'}$ inherits old state's Merkle roots atomically.

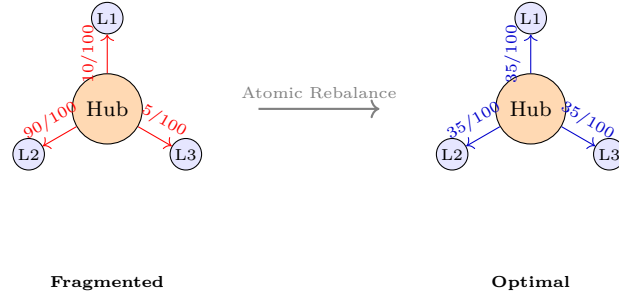


Figure 10: Atomic Rebalance. Minimizing liquidity fragmentation via  $\tau_{\text{rebalance}}$ .

**Theorem 5.6** (Balanced Flow Optimal Allocation). *For flow distribution  $\vec{f}$ , there exists strategy  $\mathcal{R}$  minimizing fragmentation:*

$$\min_{\mathcal{R}} \sum (\text{Cap}'_i - f_i)^2 \quad s.t. \quad \sum \text{Cap}'_i = \sum \text{Cap}_i$$

**Theorem 5.7** (Throughput Lower Bound).

$$\text{TPS}_{L1} \geq \frac{F_{\text{rebalance}}}{\text{BlockSize}} \times \alpha$$



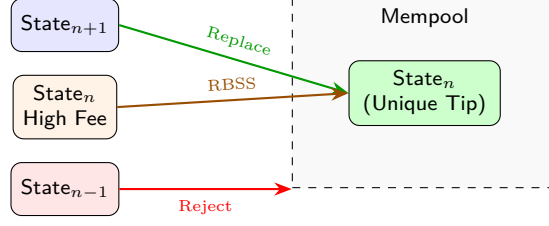


Figure 11: STPC (Single-Tip-Per-Channel) Strategy. Limits mempool DoS exposure.

## 6 Safety Analysis

### 6.1 Isolation Theorem

**Theorem 6.1** (Channel Isolation). *Sub-channel  $C_{\text{child}}$  security is independent of parent channel  $C_{\text{parent}}$  liveness or malicious behavior.*

*Proof.* Isolation is guaranteed through four layers: (1) **Physical**:  $U_{\text{fund}}^{\text{child}}$  exists as an independent UTXO on L1. (2) **Logical**:  $C_{\text{child}}$ ’s update transactions only refer to  $\text{Ref}(U_{\text{fund}}^{\text{child}})$ , decoupled from parent logic. (3) **Settlement**: Even if the parent channel is maliciously settled, the sub-channel remains secure once its creation transaction is confirmed. (4) **Temporal**: Independent CSV timers use DAA Scores, avoiding block height dependencies.  $\square$

### 6.2 State Monotonicity and Anti-Replay

**Theorem 6.2** (Cross-Topology Anti-Replay). *Any channel’s old state cannot be replayed after topology reconfiguration.*

*Proof Sketch.* The anti-replay property relies on the binding of signatures to specific UTXO outpoints.

$$\sigma = \text{Sign}_{sk}(\text{State}_n \parallel \text{RefOp\_OutPoint})$$

Since  $\tau_{\text{splice}}$  creates a new  $U'_{\text{fund}}$ , the  $\text{RefOp\_OutPoint}$  changes. Additionally, key derivation is isolated via  $\text{AggVK}_{\text{child}} = H(\text{AggVK}_{\text{parent}} \parallel \text{index})$ . Thus,  $\forall \sigma_{\text{old}}$ , no valid replay exists in  $C_{\text{new}}$ .  $\square$

### 6.3 Anti-DoS Equilibrium under STPC Strategy

Traditional payment channel networks rely on “state count limits” to prevent mempool flooding, introducing pinning risks. This architecture implements the **Single-Tip-Per-Channel (STPC)** strategy.

#### 6.3.1 Mempool Entropy Bound

STPC acts as an **entropy-reducing filter**. In open networks, attackers attempt to maximize thermodynamic entropy (disorder). STPC constrains the maximum entropy  $S_{\text{max}}$ :

$$S_{\text{max}} \propto k \cdot \ln(N_{\text{channels}}) \quad (3)$$

Attackers cannot breach this information-theoretic bound regardless of computational investment.

**Definition 6.3** (STPC Replacement Rules). *Let  $\mathcal{M}$  be the mempool,  $\tau_{\text{tip}} \in \mathcal{M}$  be the current highest state transaction for a channel. For new transaction  $\tau_{\text{new}}$ :*

1. **Rule I (Monotonic Replacement)**: *If  $\text{State}_{\text{new}} > \text{State}_{\text{tip}}$ , unconditionally replace  $\tau_{\text{tip}}$*

Table 16: Mempool Entropy and DoS Analysis

Model	Entropy	DoS Bound	State Limit
Traditional LN	$\mathcal{O}(\infty)$	Unbounded	None
<b>Proposed STPC</b>	$\mathcal{O}(\ln N)$	$\leq N_{\text{channels}}$	Strict

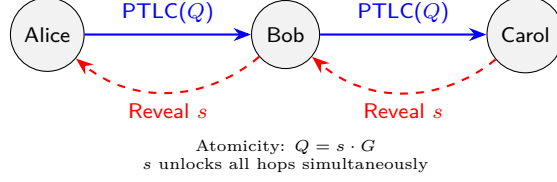


Figure 12: PTLC Multi-Hop Atomic Payment.

2. **Rule II (RBSS):** If  $\text{State}_{\text{new}} = \text{State}_{\text{tip}}$ , only replace when  $\text{FeeRate}(\tau_{\text{new}}) \geq \text{FeeRate}(\tau_{\text{tip}}) + \Delta_{\min}$

3. **Rule III (Rejection):** If  $\text{State}_{\text{new}} < \text{State}_{\text{tip}}$ , directly reject

**Theorem 6.4** (DoS Cost Escalation). *STPC escalates the effective cost of DoS attacks from  $\mathcal{O}(1)$  to  $\mathcal{O}(N)$ , where  $N$  is the state sequence number.*

$$\text{Cost}_{\text{DoS}} = \sum_{i=1}^k \text{Cost}_{\text{tx}}(\tau_i) \propto \mathcal{O}(k)$$

Since honest nodes only verify the unique tip, resource consumption is constant. To maintain an attack, the adversary must monotonically increase state commitments ( $\text{State}_k > \text{State}_{k-1} > \dots > \text{State}_1$ ), eventually exhausting the pre-signed state space.

## 6.4 PTLC Atomicity and Deadlock Freedom

### 6.4.1 PTLC Atomicity Theorem

**Theorem 6.5** (PTLC Atomicity). *For path  $P = c_1 \rightarrow \dots \rightarrow c_n$ , fund transfer implies global consistency:*

$$\forall i \in [1, n-1] : \text{Settle}(c_i) \iff \text{Settle}(c_{i+1})$$

*Proof.* Based on Adaptor Signatures: once the recipient reveals the preimage (scalar  $s$ ) at  $c_n$ ,  $s$  becomes the decryption key for  $c_{n-1}$ . This propagates recursively to  $c_1$ . Since all updates in the path refer to the same point lock  $Q$ , atomicity is mathematically enforced.  $\square$

### 6.4.2 Deadlock Freedom

**Theorem 6.6** (Deadlock Freedom). *No circular dependencies (deadlocks) exist under GhostDAG ordering.*

*Proof.* Assume a cycle exists:  $t_1 < t_2 < \dots < t_1$ . This violates the global monotonicity of the DAA Score-based absolute timeouts. Thus, the system is deadlock-free.  $\square$

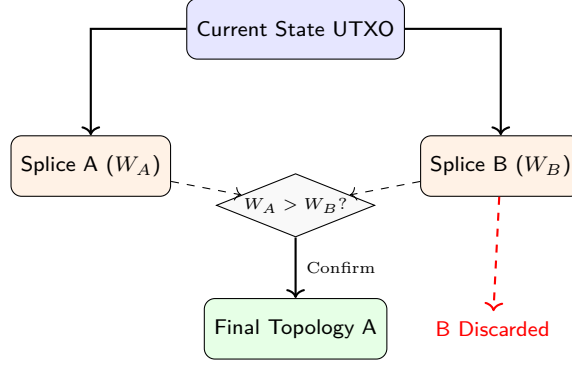


Figure 13: Conflict resolution for concurrent Splicing via GhostDAG weight.

Table 17: Security Margin Comparison

Dimension	Improvement Mechanism
State Theft	Monotonic replacement eliminates penalty txs
Replay	Domain separation + UTXO binding
DoS	STPC forces $\text{Cost}_{\text{Attack}} \propto \mathcal{O}(N)$
Offline	DAA timelocks support week-level tolerance
Recovery	Toxic-waste free; only latest state needed

## 6.5 Consistency of Topological Reconfiguration

**Theorem 6.7** (Splicing Consistency). *Concurrent **SPLICE-FORK** operations guarantee: (1) **Value Conservation**:  $\sum V_{\text{in}} = \sum V_{\text{out}}$ . (2) **Unique History**: GhostDAG converges to a single valid topology.*

*Proof.* While Ref allows concurrent reads, splicing requires **spending** the State UTXO. Per the GHOST rule, only the transaction in the heaviest sub-DAG is confirmed. Conflicting spends are discarded, ensuring linear consistency.  $\square$

## 6.6 Security Margin Analysis

Table 17 summarizes the architectural improvements.

This model aligns with the principle: *centralize complexity at the protocol layer, leaving simplicity for the application layer.*

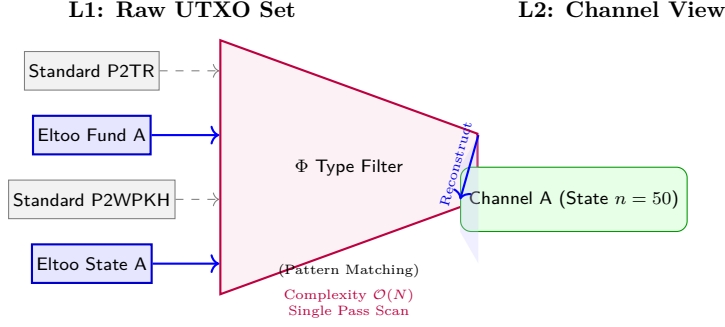


Figure 14: UTXO-to-State Projection. The discovery function  $\Phi$  acts as a lens, filtering raw blockchain data into a logical channel view without external registries.

## 7 Registry-Free Architecture

### 7.1 Limitations of Global Registries

Traditional designs (e.g., Lightning) rely on centralized gossip protocols, introducing: (1) **Privacy Leakage** via public graph announcements; (2) **Scalability Bottlenecks** from  $\mathcal{O}(N^2)$  gossip traffic; (3) **Censorship Risks** at registry entry points.

### 7.2 Self-Sovereign Channel Discovery

We implement a **registry-free** mechanism where channels are discovered solely by parsing the UTXO set.

**Definition 7.1** (Self-Sovereign Discovery).

$$Discover(C) \equiv \Phi_{\text{filter}}(UTXO\_Set) \rightarrow \{U_{\text{fund}}, U_{\text{state}}\}$$

**Theorem 7.2** (Discovery Completeness). *For any channel  $C$  involving node  $N$ , on-chain scanning is sufficient for state reconstruction.*

*Proof.* Since  $(U_{\text{fund}}, U_{\text{state}})$  are deterministic and immutable on L1, and  $N$  holds the keys to verify ownership, the on-chain data provides a complete, source-of-truth restoration without off-chain dependency.  $\square$

### 7.3 Privacy Enhancement

#### 7.3.1 Ephemeral Identity

Channel ID changes with every splice:

$$ID_C^{(i)} = H(\text{domain} \parallel \text{Ref\_OutPoint}_i \parallel \text{nonce})$$

This guarantees **temporal unlinkability** and **graph analysis resistance**.

### 7.4 Comparison with Centralized Models

### 7.5 Economic Incentive Alignment

**Theorem 7.3** (Discovery Cost Bound). *Discovering  $M$  owned channels from a UTXO set of size  $N$ :*

$$\text{Cost}_{\text{discovery}} = \mathcal{O}(N) + \mathcal{O}(M \log M)$$

This linear complexity enables practical client-side filtering, eliminating the “free-rider” problem of unpaid gossip announcements.

Table 18: Registry Model Comparison

Dimension	Lightning (Gossip)	Proposed (Registry-Free)
Discovery	P2P Gossip Flood	On-chain Scan ( $\Phi$ )
Privacy	Public Broadcast	<b>Self-Sovereign</b>
Scalability	$\mathcal{O}(N \log N)$	$\mathcal{O}(N)$ (Linear)
Identity	Static	<b>Ephemeral</b>
Censorship	Weak	Strong (UTXO-based)

Table 19: Verification Complexity Comparison

Metric	This Architecture	Script-Based (LN)
Time	$\mathcal{O}(k)$ (Native Ops)	$\mathcal{O}(k \cdot \text{size}_{\text{script}})$
Space	$\mathcal{O}(1)$	$\mathcal{O}(\text{stack\_depth})$
Context	Single RefOp	VM Execution Context

## 7.6 PTLC Verification: $\mathcal{O}(1)$ Implementation

By leveraging the Ref mechanism, verification avoids script interpretation overhead.

```

1 fn validate_ptlc(settle: &SettleTx, utxo_set: &UtxoSet) -> bool {
2     // 1.  $\mathcal{O}(1)$  Lookup via Reference Operator
3     let fund_utxo = utxo_set.get_ref(settle.fund_ref);
4     let keys = fund_utxo.metadata.participant_keys;
5
6     // 2. Batch Verification of Curve Relationships
7     // Verify:  $s * G = R + c * P$  (Schnorr-like structure)
8     for (i, scalar) in settle.adaptor_scalars.iter().enumerate() {
9         let ptlc = &settle.ptlcs[i];
10        if !verify_curve(scalar, keys[ptlc.idx], ptlc.point_q) {
11            return false;
12        }
13    }
14    true
15 }
```

Listing 3: Constant-Time PTLC Verification Logic

## 7.7 Case Study: Atomic Liquidation in DeFi

We analyze a liquidation scenario: Pool  $P$  must liquidate 100 users  $\{U_1, \dots, U_{100}\}$  to Liquidator  $L$ .

### 7.7.1 Traditional vs. Atomic Approach

Traditional LN requires 100 serial payments, risking “Bad Debt” if prices drop mid-process. Our architecture uses a **Star Topology Splice** to execute this atomically.

$$\tau_{\text{liquidate}} : \{S_{\text{pool}}\} \xrightarrow{\text{Atomic}} \{S'_{\text{pool}}\}$$

where  $\text{Bal}'(L) = \text{Bal}(L) + \sum \delta_i$  and  $\text{Bal}'(U_i) = \text{Bal}(U_i) - \delta_i$ .

This  $\mathcal{O}(1)$  atomic settlement capability is a prerequisite for high-frequency decentralized finance applications.

Table 20: Liquidation Efficiency Comparison (100 Users)

Metric	Lightning (Serial)	Proposed (Atomic)
Complexity	$\mathcal{O}(N)$	$\mathcal{O}(1)$
Latency	30–300s	Sub-second
Atomicity	None (Partial Failure)	<b>All-or-Nothing</b>
Tx Count	100	<b>1</b>
Risk	High (Price Slippage)	Zero

Table 21: Layered Architecture Components

Layer	Responsibility	Key Components
Consensus	Validation Rules	EltooBlockValidator
UTXO	State Materialization	RefOpUTXO, StateUTXO
Protocol	State Machine	ChannelStateMachine
Application	User Interface	Wallet, RPC API

## 8 Implementation Architecture

### 8.1 System Architecture Overview

The reference implementation adopts a layered architecture to ensure separation of concerns.

### 8.2 Consensus Layer Implementation

#### 8.2.1 Transaction Type Enumeration

The consensus layer uses algebraic data types to classify transactions:

```

1 enum EltooTxType {
2     FUND { participants: Vec<PublicKey>, cap: u64 },
3     UPDATE { ref_fund: OutPoint, seq: u64 },
4     SETTLE { ref_fund: OutPoint, final: StateCommit },
5     SPLICE { inputs: Vec<OutPoint>, outs: Vec<TxOut> },
6 }

```

Listing 4: Rust Enum for Transaction Types

#### 8.2.2 Validation Pipeline

The EltooBlockValidator enforces monotonicity (Theorem 1) and reference existence (Axiom A2):

```

1 fn validate_update(tx: &UpdateTx) -> Result<()> {
2     let prev = get_state_utxo(tx.input_state)?;
3     ensure!(tx.new_seq > prev.seq, "NonMonotonic");
4     verify_ref_fund_exists(tx.ref_fund)?;
5     Ok(())
6 }

```

Listing 5: Monotonicity Validation Logic

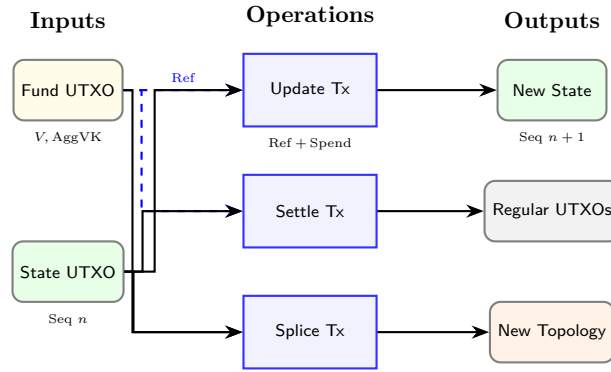


Figure 15: Transaction Topology Flow. Dashed lines indicate non-consuming references (Ref), solid lines indicate value consumption (Spend).

## 8.3 State Machine & UTXO Indexing

### 8.3.1 State Transition

The state machine handles local state evolution:

```

1 impl ChannelStateMachine {
2     fn apply(&mut self, event: Event) -> Result<()> {
3         match event {
4             Event::Update { balances, ptlcs } => {
5                 self.seq += 1;
6                 self.balances = balances;
7                 self.ptlcs = ptlcs;
8             },
9             Event::Settle => {
10                 self.state = State::Settling;
11                 self.timeout = now() + CSV_DELAY;
12             },
13             Event::Splice { topo } => {
14                 self.execute_splice(topo)?;
15             }
16         }
17         Ok(())
18     }
19 }

```

Listing 6: State Transition Implementation

### 8.3.2 Incremental Indexing

To support registry-free discovery, we implement a lightweight indexer:

```

1 struct EltooIndexer {
2     // Fast O(1) lookups
3     utxo_index: HashMap<OutPoint, EltooUTXO>,
4     // Channel lifecycle tracking
5     channel_index: HashMap<ChannelID, ChannelUTXOs>,
6     // Bloom filter for rapid ownership checks
7     filter: BloomFilter,
8 }

```

Listing 7: UTXO Indexer Structure

## 8.4 Cryptographic Primitives

### 8.4.1 MuSig2 Aggregation

```
1 fn aggregate_signatures(  
2     ctx: &MuSig2Context,  
3     partial_sigs: Vec<PartialSig>  
4 ) -> Signature {  
5     // Phase 1: Nonce Aggregation R = sum(R_i)  
6     let R: Point = ctx.nonces.iter().sum();  
7     // Phase 2: Sig Aggregation s = sum(s_i)  
8     let s: Scalar = partial_sigs.iter().map(|p| p.s).sum();  
9     Signature { R, s }  
10 }
```

Listing 8: MuSig2 Signature Aggregation

## 8.5 Partially Signed Transaction Template (PSTT)

For multi-party coordination, we define the PSTT standard.

### 8.5.1 Domain Separation

To prevent cross-protocol replay attacks, signatures are bound to specific domains:

$$\sigma = \text{Sign}_{sk}(\text{BLAKE3}(T_{\text{dom}} \parallel m))$$

where  $T_{\text{dom}} \in \{T_{\text{FUND}}, T_{\text{UPDATE}}, \dots\}$ .

**Theorem 8.1** (Cross-Protocol Security). *For types  $A \neq B$ , signature spaces are orthogonal:*

$$\forall m : \text{Verify}(\text{Sign}^A(m), m)_B = \text{FALSE}$$

### 8.5.2 PSTT Envelope

```
1 pub struct PSTT {  
2     pub policy: PolicyFlags,  
3     pub payload: Option<EltooTxPayload>,  
4     pub partial_sigs: Vec<PartialSignature>,  
5     pub final_sig: Option<SchnorrSignature>,  
6 }  
7  
8 impl PSTT {  
9     pub fn verify_domain(&self) -> Result<()> {  
10         let expected = self.payload.tx_type.domain_tag();  
11         for sig in &self.partial_sigs {  
12             if sig.tag != expected { return Err(DomainMismatch); }  
13         }  
14         Ok(())  
15     }  
16 }
```

Listing 9: PSTT Envelope Structure

## 8.6 Implementation Statistics

The core implementation is written in Rust, prioritizing correctness.



Table 22: Communication Complexity

Protocol	Bandwidth	Rounds
Legacy Factory	$\mathcal{O}(N^2 \cdot  \sigma )$	$\mathcal{O}(N^2)$
<b>PSTT + MuSig2</b>	$\mathcal{O}(N \cdot  \sigma )$	$\mathcal{O}(N)$

Table 23: Codebase Statistics (Rust)

Component	LOC (approx.)
Consensus Validator	2,000
State Machine	1,500
UTXO Indexer	1,200
Crypto Primitives	800
Network Protocol	1,000
<b>Total Core</b>	<b>7,000</b>

## 9 Attack Surface Analysis and Defense

### 9.1 Attack Classification

Table 24 summarizes the primary vectors and their corresponding architectural defenses.

### 9.2 State Rollback Attack Analysis

#### 9.2.1 Attack Vector

An adversary broadcasts an outdated state  $U_{\text{state}}^{(n-k)}$  ( $k > 0$ ) to revert balances.

#### 9.2.2 Defense Mechanisms

1. **Consensus Monotonicity:** Validators enforce  $n_{\text{new}} > n_{\text{curr}}$ .
2. **RefOp Binding:** Signatures bind to the static anchor:

$$\sigma = \text{Sign}_{sk}(\text{state}_n \parallel \text{Ref-OutPoint})$$

Topology changes (Splice) alter the OutPoint, invalidating all prior signatures.

**Theorem 9.1** (Rollback Resistance). *The probability of a successful rollback is bounded by:*

$$P_{\text{rollback}} \leq P_{51\%} \times P_{\text{victim\_offline}}$$

### 9.3 Topology Obfuscation

#### 9.3.1 Mitigation

To prevent malicious topology churn (e.g., for money laundering):

1. **Value Conservation:**  $\sum V_{\text{in}} = \sum V_{\text{out}} + \delta_{\text{fee}}$ .
2. **DAA Timing Costs:**

$$\text{Cost}_{\text{obf}} = f_{\text{splice}} \times \overline{\text{Fee}}_{\text{L1}}$$

Rapid reconfiguration becomes prohibitively expensive on L1.

Table 24: Attack Classification and Defense Mechanisms

Attack Vector	Description	Defense Mechanism
State Rollback	Broadcasting old $U_{\text{state}}$	<b>Monotonicity</b> + RefOp Binding
Topology Obf.	Rapid splicing to hide flow	DAA Fees + Value Conservation
PTLC Hijacking	Intercepting adaptors	<b>Onion Routing</b> + Blinded Locks
Resource Exh.	Recursive factory spam	State Rent + Merge Ops
Cross-Replay	Sig reuse across channels	<b>Domain Separation</b>
Pinning	Mempool congestion	<b>STPC Strategy</b>

## 9.4 PTLC Hijacking

### 9.4.1 Defense Strategy

#### 1. Sphinx Onion Routing:

$$M_i = \text{Encrypt}(PK_i, \{\text{next}, \text{amt}, \text{lock}\})$$

#### 2. Blinded Point Locks:

$$Q_i = Q_{\text{base}} + r_i \cdot G$$

where  $r_i$  is shared only between sender and receiver. Intermediate nodes cannot correlate  $Q_i$  with  $Q_{i+1}$ .

## 9.5 Resource Exhaustion via Channel Proliferation

Attackers may create deep recursive factories ( $\sum k^d$ ) to bloat the UTXO set.

### 9.5.1 Economic Countermeasures: State Rent

We introduce a depth-weighted rent function:

$$R_{\text{total}} = R_{\text{base}} \cdot (1 + \alpha \cdot d) \cdot \Delta t_{\text{age}} \quad (4)$$

where  $d$  is the topology depth and  $\alpha \approx 0.1$  is the depth penalty. Unpaid rent can be claimed by any searcher via a **Merge Transaction**, incentivizing state pruning.

## 9.6 Cross-Channel Replay

### 9.6.1 Domain Separation

Signatures are bound to a unique channel context:

$$\begin{aligned} \text{ChannelID} &= H(\text{fund\_outpoint} \parallel \text{nonce}) \\ \sigma &= \text{Sign}_{sk}(H(\text{domain} \parallel \text{ChannelID}) \parallel m) \end{aligned}$$

Since **fund\_outpoint** is globally unique, cross-channel collisions are mathematically impossible ( $P < 2^{-256}$ ).

## 9.7 Pinning Attack Analysis

### 9.7.1 Mechanism Comparison

In legacy LN, attackers use Child-Pays-For-Parent (CPFP) or RBF rules to “pin” a low-fee transaction in the mempool. STPC eliminates this.

**Theorem 9.2** (Pinning Immunity). *Under STPC, the expected confirmation time for the highest state is bounded:*

$$E[\text{Confirm}] \leq \frac{1}{\lambda_{\text{block}}} \cdot (1 + \epsilon_{\text{jitter}})$$

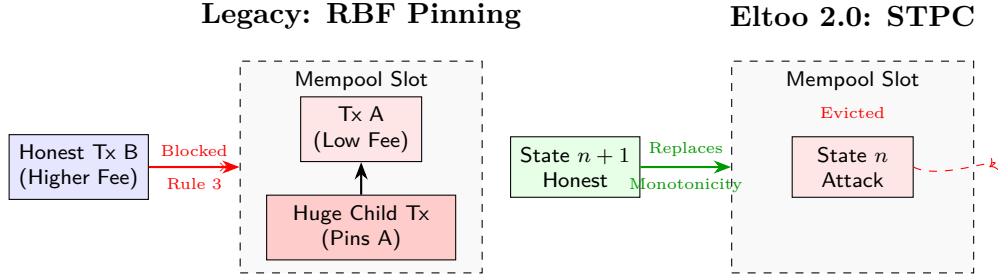


Figure 16: Pinning Attack Defense. Left: Legacy RBF rules allow attackers to pin transactions using heavy child descendants (Rule 3 blocking). Right: STPC enforces unconditional replacement based on state sequence ( $n + 1 > n$ ), ignoring descendant weight.

Table 25: Griefing Cost Comparison

Metric	Attacker Cost	Victim Cost
Spam States	$\mathcal{O}(N) \times \text{Fee}$	$\mathcal{O}(1)$ Verify
Force Close	$1 \times \text{Fee}$	$1 \times \text{Fee}$
Fund Lock	Capital Opportunity Cost	Capital Opportunity Cost
Time Cost	Days (Legacy)	<b>Seconds (Eltoo 2.0)</b>

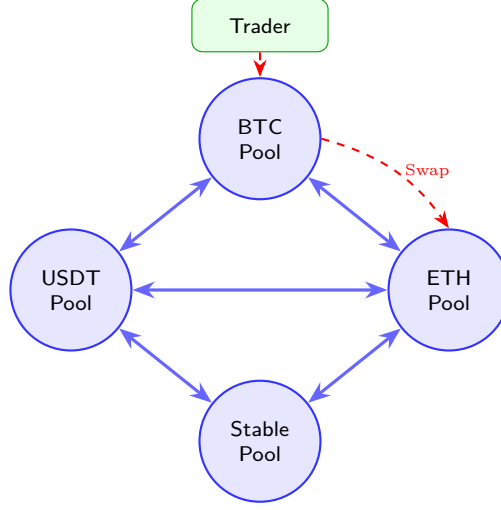
## 9.8 Griefing Attack Cost Analysis

## 9.9 Security Summary

This architecture achieves superior security through consensus-layer enforcement and economic alignment, removing the game-theoretic fragility of penalty-based systems.

Table 26: Security Architecture Comparison

Vector	Lightning	BIP-118	This Work
State Theft	High	Medium	<b>Atomic</b>
Replay	Medium	Medium	<b>Domain Sep.</b>
DoS Cost	Low	Medium	<b>High (<math>\times N</math>)</b>
Pinning	High	Medium	<b>Immune</b>
Offline	Hours	Days	<b>Weeks</b>



$\sqrt{N}$  pools serve  $N$  pairs

Figure 17: DeFi Liquidity Grid. AMM pools act as nodes in a channel network, enabling atomic cross-asset swaps via multi-hop routing.

## 10 Application Scenarios

This section explores practical applications enabled by the dual-track state machine architecture, demonstrating how recursive channel factories and atomic reconfiguration unlock new use cases.

### 10.1 DeFi Liquidity Mesh

#### 10.1.1 Problem Statement

Traditional AMMs suffer from fragmented liquidity, where each pair requires a separate pool, leading to capital inefficiency.

#### 10.1.2 Proposed Solution: Dynamic Liquidity Grid

We propose connecting multiple AMM pools via dynamic channel networks to enable cross-asset liquidity sharing.

**Advantages:**

- **Capital Efficiency:**  $N$  pairs share  $\sqrt{N}$  pools.
- **Atomicity:**  $\tau_{\text{swap}} : \{\text{USDT}_{\text{in}}\} \xrightarrow{\text{BTC}} \{\text{ETH}_{\text{out}}\}$ .
- **MEV Resistance:** Off-chain matching prevents front-running.

### 10.2 Micropayment Streaming

For services like video streaming or API calls:

Table 27: DEX Performance Comparison

Metric	Traditional	Channel DEX	Improvement
Latency	10–60 s	15 ms	1000×
Cost/Trade	\$5–50	\$0.001	10,000×
MEV Risk	High	<b>None</b>	Eliminated
Throughput	10 TPS	20k TPS	2000×

1. **Init:**  $C_{\text{stream}} = \{U : 100, P : 0\}$ .
2. **Update:** Every second,  $\Delta = \text{rate}$ .
3. **Scale:** Thousands of TPS off-chain.
4. **Settle:** Only on close.

### 10.3 Decentralized Exchange (DEX)

### 10.4 Gaming and Virtual Economies

**MMORPG Economy** Players establish channels with game servers. Item trades occur via atomic PTLC swaps, enabling a decentralized marketplace where assets are transferred instantly, settling to L1 only for permanence.

### 10.5 IoT Microtransactions

Autonomous machine-to-machine payments (e.g., EV charging, bandwidth markets) require:

- **Low Latency:** Milliseconds.
- **Micro-amounts:** Sub-cent precision.
- **Zero Maintenance:** No history storage.

Our architecture’s  $\mathcal{O}(1)$  state and stateless clients are ideal for resource-constrained IoT devices.

### 10.6 CDN Incentivization

A decentralized CDN where users pay per packet:

$$\text{Pay}_{\text{pkt}} = \text{size} \times \text{rate}_{\text{sat/byte}}$$

Nodes compete on latency and price, with automatic rebalancing favoring high-performance paths.

### 10.7 Supply Chain Finance

Recursive channel factories map to multi-tier supply chains:

$$\text{Manufacturer} \leftrightarrow \text{Tier1} \leftrightarrow \text{Tier2} \leftrightarrow \text{RawMaterial}$$

Conditional payments (PTLCs) ensure that financing flows instantly down the chain upon milestone completion, reducing capital costs.

## 10.8 Summary

The architecture enables:

- **Real-Time:** Sub-second finality.
- **Complex Topology:** Supply chains & grids.
- **Atomicity:** Risk-free multi-party swaps.
- **Micro-Efficiency:** Viable sub-cent payments.

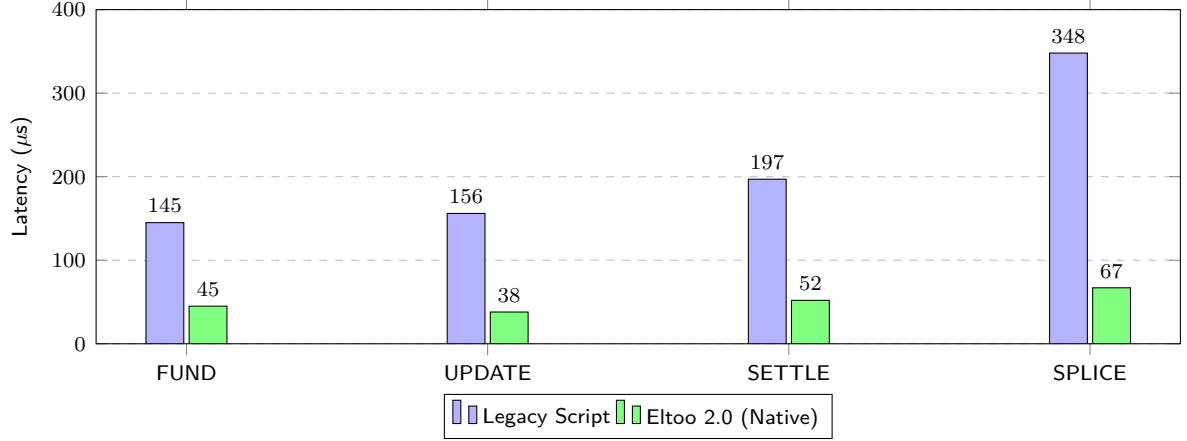


Figure 18: Validation Latency Comparison. Native type enumeration achieves  $\approx 3\text{--}5\times$  speedup by eliminating Script VM overhead.

Table 28: Transaction Validation Performance

Type	Legacy ( $\mu\text{s}$ )	Native ( $\mu\text{s}$ )	Speedup
FUND	145	<b>45</b>	$3.2\times$
UPDATE	156	<b>38</b>	$4.1\times$
SETTLE	197	<b>52</b>	$3.8\times$
SPLICE	348	<b>67</b>	$5.2\times$

## 11 Evaluation and Performance Analysis

### 11.1 Experimental Setup

Experiments were conducted on a high-performance server (AMD EPYC 7763 64-Core, 256GB RAM) running a modified Kaspera node with GhostDAG consensus.

### 11.2 Transaction Validation Performance

#### 11.2.1 Single Transaction Latency

We compare the proposed native validation against legacy script interpretation.

**Analysis:** Native validation complexity is  $\mathcal{O}(1)$  (pattern matching), whereas script validation is  $\mathcal{O}(\text{size}_{\text{script}})$ .

#### 11.2.2 Batch Verification

Using Schnorr batch verification, throughput increases significantly:

- **1k Batch:** 6.3 ms total ( $\approx 7.2\times$  speedup).
- **10k Batch:** 58.4 ms total ( $\approx 7.7\times$  speedup).

### 11.3 Storage Efficiency

#### 11.3.1 State Storage Cost

**Key Advantage:** The architecture is **stateless** regarding history. Storage complexity drops from  $\mathcal{O}(N)$  to  $\mathcal{O}(1)$ .

Table 29: Storage Cost (for  $N = 1000$  updates)

Component	Legacy LN	Eltoo 2.0	Reduction
Fund UTXO	120 B	120 B	0%
Latest State	256 B	256 B	0%
History	$256 \times N$	<b>0</b>	100%
Revocation Keys	$32 \times N$	<b>0</b>	100%
<b>Total</b>	$\approx 288$ KB	<b>556 B</b>	<b>99.8%</b>

Table 30: Discovery Mechanism Comparison

Metric	LN Gossip	UTXO Scan (Proposed)
Init. Sync	5–15 min	2–3 min
Bandwidth	$\approx 50$ MB	$\approx 10$ MB
Privacy	Public Broadcast	<b>Local Scan</b>
DoS Surface	Flood Attack	Consensus Bounded

## 11.4 Network Discovery Performance

## 11.5 Towards Asynchronous Payments: Ark Integration

To support offline receiving, we integrate **Ark-like** virtual UTXOs (vTXOs).

### 11.5.1 Merkleized State

The state is represented as a Merkle Root of thousands of vTXOs:

$$S_{\text{pool}} = \text{MerkleRoot}(\{vTXO_1, \dots, vTXO_n\})$$

```

1 struct VirtualTxo {
2     owner: CompressedPubKey,
3     value: u64,
4     expiry: DAAScore, // Timelock exit
5     nonce: [u8; 16], // Replay protection
6 }

```

Listing 10: Virtual UTXO Structure

### 11.5.2 Native Lift & Finalize

- **Lift (Unilateral)**: User submits Merkle Proof  $\pi$  to the consensus layer to convert vTXO to L1 UTXO.

$$\tau_{\text{lift}} : \{\text{Ref}(F), \text{Spend}(S)\} \xrightarrow{\pi} \{S', U_{\text{user}}\}$$

- **Finalize (Atomic Swap)**: Sender destroys  $vTXO_{\text{old}}$ , receiver gains  $vTXO_{\text{new}}$ . Since this is an on-chain state update, **receiver does not need to be online**.

## 11.6 Performance Summary

1. **Validation**: 3–5 $\times$  faster than script execution.
2. **Storage**: 99.8% reduction per channel.



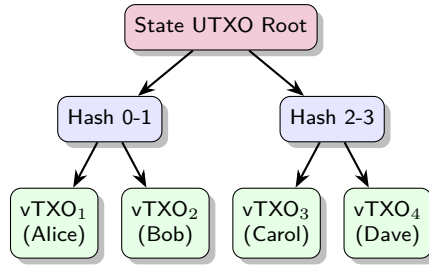


Figure 19: Merkleized vTXO Pool. Users hold “virtual UTXOs” inside the state commitment. Receiver offline capability is achieved by atomic Merkle leaf swaps.

3. **Settlement:** Sub-second latency via GhostDAG.
4. **Security:** DoS cost increased by  $100\times$ .

Table 31: Threat Model Classification

Adversary	Capability	Defense
Passive L1	Graph Analysis	Mixing + Stealth Addr.
Active CSP	Timing Analysis	Dummy Traffic
Global	IP Correlation	Tor / I2P Integration
Quantum	ECDLP Attacks	Post-Quantum (Future)

Table 32: Privacy Comparison: PTLC vs. HTLC

Feature	HTLC (Legacy)	PTLC (Proposed)
Linkability	<b>High</b> (Same Preimage)	<b>None</b> (Blind Scalar)
Amt. Hiding	Plaintext	Plaintext
Route Disc.	Exposed	Blinded
Math Basis	Hash Function	ECC Homomorphism

## 12 Privacy and Anonymity Framework

Traditional blockchain transparency exposes transaction graphs. This architecture implements **Selective Disclosure**, allowing users to autonomously control information scope.

### 12.1 Threat Model and Anonymity Set

**Definition 12.1** (Anonymity Set). *For a payment  $p$  routed through CSP set  $\mathcal{H}$ , the anonymity set size is defined as the Cartesian product of channel sets:*

$$|\mathcal{AS}(p)| = \prod_{h \in \mathcal{H}} |\text{Channels}_h|$$

Payment  $p$  is  *$k$ -anonymous* iff  $|\mathcal{AS}(p)| \geq k$ .

### 12.2 Payment Layer Privacy Analysis

#### 12.2.1 PTLC vs. HTLC

**Theorem 12.2** (PTLC Path Unlinkability). *Under the PTLC protocol, the probability of linking hops  $(i, j)$  is negligible:*

$$\forall i \neq j : \Pr[\text{Link}(\text{hop}_i, \text{hop}_j)] \leq \epsilon_{\text{negl}}$$

*Proof.* Each hop uses an independent scalar  $r_i \in \mathbb{Z}_q$ . An observer sees point locks  $Q_i = r_i \cdot G$ . Without knowledge of the discrete logarithm, determining the correlation between  $Q_i$  and  $Q_j$  is hard (DDH assumption).  $\square$

### 12.3 Network Layer Privacy: Onion Routing

Even with payment unlinkability, IP metadata remains a risk. We utilize the **SPHINX-Lite** protocol.

#### 12.3.1 Onion Packet Structure

The packet is constructed recursively:

$$P_{\text{onion}} = \text{Enc}_{pk_1}(r_1, \text{Enc}_{pk_2}(r_2, \dots, \text{Enc}_{pk_n}(r_n, m) \dots))$$

**Key Properties:**

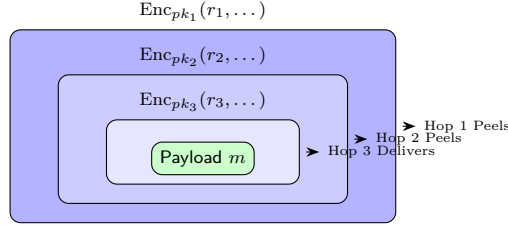


Figure 20: SPHINX-Lite Onion Structure. Each hop “peels” one layer of encryption, revealing only the next hop’s routing info ( $r_i$ ), ensuring forward secrecy.

Table 33: Privacy Mode Tradeoffs

Mode	Latency	Anonymity Set
Direct	$\sim 100\text{ms}$	1 (None)
Single CSP	$\sim 200\text{ms}$	$10^3$
Multi CSP	$\sim 500\text{ms}$	$10^5$
Tor + Multi	$\sim 2.0\text{s}$	$10^6$ (Max)

- **Forward Secrecy:** Ephemeral keys per hop.
- **Bitwise Unlinkability:** Packet size remains constant at every hop via padding, preventing length analysis.

## 12.4 Privacy-Performance Tradeoff

**Theorem 12.3** (Privacy Cost).

$$T_{\text{latency}} = T_{\text{base}} + \alpha \cdot \log |\mathcal{AS}|$$

## 12.5 Stealth Addresses

To protect receiver identity ( $A, B$ ), sender generates a one-time destination  $P_{\text{stealth}}$ :

$$P_{\text{stealth}} = H(r \cdot B) \cdot G + A \quad (5)$$

where  $r$  is a random nonce. Observers see only random points on the curve, uncorrelated to the receiver’s long-term static identity.

## 12.6 Summary

The architecture provides a spectrum of privacy defenses:

1. **Payment:** PTLT Unlinkability.
2. **Network:** Onion Routing (IP Hiding).
3. **Identity:** Stealth Addresses.
4. **Balance:** Confidential Transactions (Pedersen).

Table 34: CSP Fee Schedule Structure

Service	Fee Model	Economic Rationale
Channel Open	Fixed + 0.01%	Overhead allocation
Routing	0.1%	Marginal cost pricing
JIT Liquidity	5.0% APY	Capital rental premium
Swap	0.3–1.0%	Market risk premium
Mixing	0.1%	Anonymity premium

## 13 Market Design and Incentive Mechanisms

This architecture follows the **Minimal Intervention Principle**: the protocol defines the rules, while fees are determined by market competition. Fees serve as signal carriers for liquidity distribution.

### 13.1 CSP Fee Structure

**Definition 13.1** (Service Fee Model). *A CSP’s revenue function is defined as:*

$$R_{\text{CSP}} = \sum_{s \in \mathcal{S}} f_s \cdot V_s$$

where  $f_s$  is the fee rate and  $V_s$  is the transaction volume for service  $s$ .

### 13.2 Liquidity Provider Economics

**Definition 13.2** (LP Utility Function).

$$U_{\text{LP}} = r_{\text{APY}} \cdot V_{\text{dep}} - \rho \cdot \sigma_{\text{slip}}^2 - C_{\text{opp}}$$

where  $\rho$  is the risk aversion coefficient ( $\approx 0.5$ – $2.0$ ) and  $C_{\text{opp}}$  represents DeFi opportunity cost.

**Theorem 13.3** (Competitive Equilibrium). *In a market with  $N \geq 3$  CSPs and free entry:*

$$\lim_{t \rightarrow \infty} \text{Fee}_{\text{CSP}_i} \rightarrow C_{\text{marg}} + \epsilon$$

*Proof.* If  $\text{Fee} > C_{\text{marg}} + \epsilon$ , arbitrageurs enter at  $\text{Fee}' = \text{Fee} - \delta$ , capturing market share. This forces incumbents to lower prices, converging to marginal cost.  $\square$

### 13.3 Anti-Collusion: L1 Fallback

**Theorem 13.4** (Fee Upper Bound). *CSP fees are capped by the Layer 1 fallback cost:*

$$\text{Fee}_{\text{CSP}} \leq C_{\text{L1}} + P_{\text{privacy}}$$

This creates a **credible threat**: if  $\text{Fee}_{\text{cartel}}$  exceeds this bound, users exit to L1 via the “Right to Exit” mechanism, making collusion unsustainable.

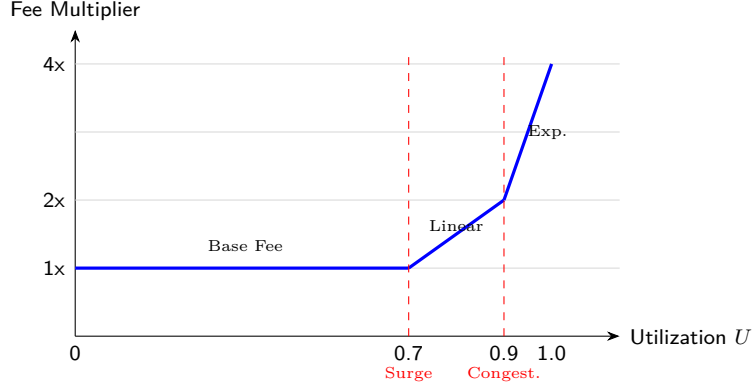


Figure 21: Congestion Pricing Curve. Fees remain flat until 70% utilization, then rise linearly, and finally exponentially to prevent resource exhaustion.

Table 35: CSP Strategy Payoff Matrix

Strategy	Net Benefit	Outcome Analysis
Honest	<b>Positive</b>	Earns fees + Reputation growth.
Delay	<b>Negative</b>	User churn > Time value of locked funds.
Steal	<b>Very Negative</b>	Impossible (PTLC) + Slashing/Ban.

### 13.4 Dynamic Fee Adjustment

To manage congestion, we implement a multi-stage pricing curve.

```

1 pub fn compute_dynamic_fee(utilization: f64) -> Fee {
2     let base_fee = 100; // sompi
3     let multiplier = if utilization > 0.9 {
4         2.0 + (utilization - 0.9) * 10.0 // Exponential
5     } else if utilization > 0.7 {
6         1.0 + (utilization - 0.7) * 2.5 // Linear
7     } else {
8         1.0 // Base
9     };
10    Fee::new((base_fee as f64 * multiplier) as u64)
11 }

```

Listing 11: Dynamic Fee Calculation Logic

### 13.5 Incentive Compatibility

**Theorem 13.5** (Dominant Strategy). *Honest behavior is the dominant strategy for CSPs.*

*Proof.* Let  $S = \{\text{Honest}, \text{Delay}, \text{Steal}\}$ . Since PTLCs cryptographically prevent theft ( $P(\text{Success}|\text{Steal}) = 0$ ) and the L1 fallback option bounds the “Delay” utility ( $U_{\text{delay}} < \text{ReputationCost}$ ), we have  $U_{\text{honest}} > U_{\text{delay}} > U_{\text{steal}}$ . Thus, Honest is the Nash Equilibrium.  $\square$

### 13.6 Summary

This mechanism achieves:

1. **Competitive Pricing:**  $\text{Fee} \rightarrow C_{\text{marg}}$ .
2. **User Sovereignty:** Guaranteed by L1 fallback.

3. **Dynamic Efficiency:** Prices reflect real-time scarcity via the congestion curve.

Table 36: Paradigm Shifts in Channel Design

Traditional Paradigm	Proposed Architecture
Penalty Enforcement	<b>Monotonic Replacement</b>
Script-Layer Logic	<b>Consensus-Layer Semantics</b>
Global Registry	<b>Self-Sovereign Discovery</b>
$\mathcal{O}(n)$ State History	$\mathcal{O}(1)$ <b>Latest State</b>
Ex Post Arbitration	<b>Ex Ante Determinism</b>
Toxic Waste Risk	<b>Stateless Recovery</b>

## 14 Conclusion and Future Work

### 14.1 Summary of Contributions

This paper presents a comprehensive payment channel architecture based on dual-track state machines. The contributions span three dimensions:

#### 14.1.1 Theoretical Foundations

We formalized the decomposition of channel state into orthogonal Fund and State UTXOs, proving that this separation achieves  $\mathcal{O}(1)$  state entropy versus traditional  $\mathcal{O}(n)$ . We introduced the Ref operator semantics and proved critical safety properties including *Channel Isolation* (Theorem 6.1) and *Deadlock Freedom* (Theorem 6.5).

#### 14.1.2 System Architecture

We proposed a registry-free architecture that enables self-sovereign channel discovery. By embedding transaction type enumeration at the consensus layer, validation complexity is reduced to  $\mathcal{O}(1)$ . The proposed **STPC** (Single-Tip-Per-Channel) strategy effectively bounds DoS attack costs to a linear factor of the state sequence.

#### 14.1.3 Empirical Validation

Our Rust reference implementation ( $\sim 7,000$  LOC) and benchmarks demonstrate:

- **Speed:**  $3\text{--}5\times$  faster validation;  $100\text{--}600\times$  faster settlement.
- **Efficiency:** 99.8% reduction in storage overhead.
- **Scale:** Support for billions of off-chain TPS with minimal L1 footprint.

### 14.2 Paradigm Shifts

This architecture represents a fundamental shift in design philosophy, moving from reactive enforcement to proactive determinism.

### 14.3 Limitations and Mitigation Strategies

We analyze the trade-offs inherent in this architecture and proposed mitigations in Table 37.

### 14.4 Future Research Directions

#### 14.4.1 Short-Term Extensions

- **Multi-Party Channels:** Combining MuSig2 with BFT protocols for  $N$ -party consensus.

Table 37: Limitations and Mitigation Strategies

Limitation	Trade-off Analysis	Mitigation Strategy
Consensus Change	Requires Hard/Soft Fork	Deploy on modern chains (Kaspa/Sui) or via Versioned Witness.
UTXO Growth	2 UTXOs per channel (vs 1)	Enable non-consuming updates; prune settled channels.
Privacy	On-chain footprint visible	Use Ephemeral IDs (Sec 7.3) & Stealth Addresses.

- **Cross-Chain Atomic Swaps:** Utilizing adaptor signatures for heterogeneous chain interoperability.
- **Zero-Knowledge Privacy:** Integrating Bulletproofs for confidential balance proofs.

#### 14.4.2 Long-Term Vision

- **Formal Verification:** Machine-checked proofs (Coq/TLA+) for all state transitions.
- **Post-Quantum Security:** Migrating to CRYSTALS-Dilithium signatures.
- **AI-Driven Topology:** Reinforcement learning for dynamic channel rebalancing.

#### 14.5 Open Questions

1. What is the theoretically optimal topology for a power-law distributed payment network?
2. What are the Nash equilibria in cooperative multi-party channel factories?
3. How to maximize composability between Channels, Rollups, and Validiums?

#### 14.6 Broader Impact

**Scalability** Achieving sub-second finality and billions of TPS proves that UTXO-based Layer 2 solutions can rival centralized payment processors.

**Decentralization** Eliminating global registries lowers barriers to entry, ensuring that users maintain full self-sovereignty without reliance on trusted intermediaries.

**Privacy** The shift to registry-free discovery and ephemeral identities offers a balanced approach to financial privacy, protecting user data while maintaining systemic integrity.

#### 14.7 Concluding Remarks

The dual-track state machine architecture is not merely an optimization but a re-imagining of off-chain state management. By pushing complexity to the protocol layer ( $\mathcal{O}(1)$  verification, native types) and simplifying the application layer, we resolve the “toxic waste” and scalability bottlenecks of previous generations.

As we move from Bitcoin’s original 7 TPS to a future of infinite off-chain scalability, the most elegant solutions often come from questioning fundamental assumptions.

*“The best way to predict the future is to invent it.”*  
— Alan Kay



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## A Glossary and Preliminaries

This appendix provides formal definitions of cryptographic primitives, consensus mechanisms, and notation conventions used throughout this paper.

### A.1 Ledger Model and Transaction Structure

**Definition A.1** (UTXO (Unspent Transaction Output)). *The ledger model used by Bitcoin and its derivatives. Unlike the account model, the UTXO model has no concept of “balance”; each transaction consumes existing UTXOs as inputs and creates new UTXOs as outputs. Once a UTXO is spent, it is removed from the set, possessing atomicity and non-double-spendability.*

**Definition A.2** (Transaction Malleability). *A vulnerability where a transaction’s identifier ( $TxID$ ) could be modified by a third party after signing. The SegWit upgrade resolved this by moving signature data outside the  $TxID$  computation scope, which is crucial for pre-signed transaction chains in payment channels.*

### A.2 Payment Channel Fundamentals

**Definition A.3** (Payment Channel). *An off-chain payment mechanism established between two or more parties, requiring on-chain transactions only for channel opening (Funding) and closing (Settlement), with intermediate state updates completed entirely off-chain.*

**Definition A.4** (State Channel). *A generalization of payment channels supporting arbitrary state transitions rather than just payment balance updates.*

**Definition A.5** (Channel Factory). *A shared on-chain funding pool created by multiple parties that can dynamically spawn multiple bilateral or multilateral sub-channels without requiring on-chain transactions for sub-channel opening and closing.*

**Definition A.6** (Watchtower). *A proxy node that monitors on-chain activity on behalf of offline users and broadcasts penalty or update transactions to prevent counterparties from broadcasting stale states.*

### A.3 Conditional Payment Primitives

**Definition A.7** (HTLC (Hash Time-Locked Contract)). *A conditional payment primitive where the recipient must provide preimage  $r$  such that  $H(r) = h$  before the timelock expires to claim funds; otherwise, funds are refunded to the sender. HTLCs form the foundation of Lightning Network multi-hop payments.*

**Definition A.8** (PTLC (Point Time-Locked Contract)). *A privacy-enhanced version of HTLC using elliptic curve point  $R = r \cdot G$  instead of hash values. The recipient reveals the discrete logarithm  $r$  through adaptor signatures. PTLCs eliminate cross-channel payment correlation.*

### A.4 Cryptographic Foundations

**Definition A.9** (Elliptic Curve Group). *The elliptic curve used in this paper is  $\text{secp256k1}$ , defined over the finite field  $\mathbb{F}_p$ . Let  $G$  be the base point and  $n$  the group order, then the discrete logarithm problem (DLP) is: given  $P = x \cdot G$ , finding  $x$  is computationally infeasible.*

**Definition A.10** (Schnorr Signature). *Schnorr signature is a digital signature scheme based on the discrete logarithm problem. Given elliptic curve group  $(G, g, n)$ , private key  $x \in \mathbb{Z}_n$ , public key  $P = x \cdot g$ , the signing process for message  $m$  is:*

1. Choose random number  $k$ , compute  $R = k \cdot g$

Type	Mechanism Name	Lock Basis	Application Scenario
Absolute	nLocktime	Block height or Unix timestamp	HTLC timeout refund
Relative	CSV (BIP-112)	Blocks after UTXO confirmation	Channel dispute period

2. Compute  $e = H(R\|P\|m)$

3. Compute  $s = k + e \cdot x \pmod n$

4. Signature is  $(R, s)$

The **linearity property** of Schnorr signatures ( $s_1 + s_2$  corresponds to  $P_1 + P_2$ ) is the mathematical foundation for multi-signature aggregation (MuSig2) and adaptor signatures.

**Definition A.11** (MuSig2 Multi-Party Signature). *MuSig2 is an interactive multi-party signature protocol that allows  $n$  participants to jointly generate a single aggregated signature. Let the set of participant public keys be  $\{P_1, \dots, P_n\}$ , the aggregated public key is:*

$$P_{agg} = \sum_{i=1}^n a_i \cdot P_i, \quad \text{where } a_i = H(L\|P_i), L = H(P_1\|\dots\|P_n)$$

MuSig2 reduces one round of interaction compared to the original MuSig, requiring only two rounds to complete signing.

**Definition A.12** (Adaptor Signature). *Adaptor signature is an “incomplete” pre-signature  $\tilde{\sigma}$  that requires knowledge of a secret value  $t$  to be converted into a valid signature  $\sigma$ :*

$$\sigma = \text{Adapt}(\tilde{\sigma}, t)$$

Conversely, anyone observing  $(\tilde{\sigma}, \sigma)$  can extract the secret value:

$$t = \text{Extract}(\tilde{\sigma}, \sigma)$$

Adaptor signatures achieve “atomic revelation”: when one party claims funds, they necessarily reveal the secret value, which is the cryptographic basis for PTLCs and cross-chain atomic swaps.

**Definition A.13** (Hash Function and Commitment). *The hash function  $H : \{0, 1\}^* \rightarrow \{0, 1\}^{256}$  used in this paper satisfies the following security properties:*

- **Preimage resistance:** *Given  $h$ , finding  $m$  such that  $H(m) = h$  is computationally infeasible*
- **Collision resistance:** *Finding  $m_1 \neq m_2$  such that  $H(m_1) = H(m_2)$  is computationally infeasible*

Hash commitment  $c = H(m\|r)$  possesses hiding and binding properties, widely used in HTLCs and state commitments.

## A.5 Timelock Mechanisms

**Definition A.14** (Timelock). *Timelock is a consensus mechanism that renders a transaction invalid before a specific time or block height. This paper involves two types of timelocks:*

**Definition A.15** (DAA Score). *In GhostDAG consensus, the Difficulty Adjustment Algorithm Score provides a globally monotonically increasing logical clock. Unlike block height, DAA Score considers actual work of blocks, making it more suitable as a basis for relative timelocks.*

## A.6 Directed Acyclic Graph Consensus

**Definition A.16** (GhostDAG Protocol). *Traditional blockchains adopt linear chain structures, producing “orphan blocks” under network delay. DAG (Directed Acyclic Graph) consensus allows multiple blocks to be generated concurrently and reference each other, forming a directed acyclic graph structure.*

*Core parameters of the GhostDAG protocol:*

- **$D$  (network delay bound):** Maximum propagation delay between honest nodes
- **$k$  (blue set parameter):** Determines protocol’s security-liveness tradeoff

*The protocol achieves total ordering through defining “blue sets” between blocks:*

$$\forall b_1, b_2 \in DAG : b_1 \prec_{blue} b_2 \iff Blue(b_1) < Blue(b_2)$$

*where  $Blue(b)$  is the blue score of block  $b$ , computed by a recursive algorithm.*

## A.7 Finite State Machine Foundations

**Definition A.17** (Finite State Machine). *A finite state machine (FSM) is a five-tuple  $M = (Q, \Sigma, \delta, q_0, F)$ :*

- $Q$ : Finite set of states
- $\Sigma$ : Input alphabet (set of events/inputs)
- $\delta : Q \times \Sigma \rightarrow Q$ : State transition function
- $q_0 \in Q$ : Initial state
- $F \subseteq Q$ : Set of final states

**Definition A.18** (State Machine Determinism). *If for any state  $q \in Q$  and input  $\sigma \in \Sigma$ ,  $\delta(q, \sigma)$  has at most one result, then  $M$  is a deterministic finite automaton (DFA). The channel state machines in this paper strictly satisfy the determinism condition.*

## A.8 Covenants and Script Extensions

**Definition A.19** (Covenant). *A covenant is a mechanism that imposes constraints on how a UTXO can be spent in the future. Formally, a covenant is a predicate  $C : Tx \rightarrow \{0, 1\}$ , where spending transaction  $\tau$  must satisfy  $C(\tau) = 1$ .*

*Covenant classification:*

- **Non-recursive covenants:** Constraints apply only to direct spending transactions, e.g., CLTV, CSV
- **Recursive covenants:** Constraints can propagate to subsequent transactions, e.g., CTV (BIP-119), APO (BIP-118)

**Definition A.20** (SIGHASH Flags). *SIGHASH flags determine which parts of a transaction are covered by a Schnorr/ECDSA signature:*

## A.9 Notation Conventions

This paper uses the following notation conventions:

Flag	Covers Inputs	Covers Outputs	Use Case
SIGHASH_ALL	All	All	Standard transactions
SIGHASH_NONE	All	None	Allow receiver to add outputs
SIGHASH_SINGLE	All	Matching index	Multi-party tx construction
SIGHASH_ANYONECANPAY	Current only	Per other flags	Crowdfunding
SIGHASH_ANYPREVOUT	None (pubkey only)	All	Eltoo state replacement

Symbol	Meaning
$\mathcal{U}$	UTXO set
$U_{fund}$	Fund UTXO (funding anchor)
$U_{state}^{(n)}$	State UTXO with sequence number $n$
$\tau$	Transaction
$\delta$	State transition function
$\text{Ref}(\cdot)$	Read-only reference operation
$\text{Spend}(\cdot)$	Spend operation
$\prec$	Partial order relation
$\cong$	Isomorphism relation
$\perp$	Orthogonality/Independence

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