
A Profitable Pricing Strategy for Tie In Sales: A Look *Webkinz*

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This article discusses the economic principles behind the ability of a dominant firm to leverage its market power over one product into another market using a tying arrangement like that described in the ongoing *Webkinz Antitrust Litigation*.¹ In a standard tying arrangement, a seller conditions the sale of one product (the tying product) on the buyer's purchase of a second product (the tied product).

In *Webkinz*, on October 20, 2010, the California District Court (N.D. Cal.) denied Defendant Ganz's motion to dismiss the antitrust claim against it.² This allowed a putative class of retailers to proceed with their claim that Ganz unfairly conditioned the sale of its successful *Webkinz* products on Plaintiffs' purchases of unrelated items sold by Ganz (so-called "core line products"). Plaintiffs' arguments in *Webkinz* focus on the anti-competitive effects that could be associated with tying arrangements, such as reduced competition in the market for the tied product, as well as Plaintiffs paying a higher price for the tied products but-for the tie. While there are well established "efficiency" reasons for a dominant firm to engage in tied sales (e.g., price discrimination, cost-savings, quality control),³ Plaintiffs in *Webkinz* focus on market-power motives related to leverage and foreclosure.⁴

A simple example is presented to illustrate that under certain conditions, a profitable pricing strategy can exist for a dominant firm under the

tying arrangement as described in *Webkinz*. The intuition is that if customers derive enough benefit (or "consumer surplus") from the purchase of the tying product (i.e., *Webkinz* products), they will accept a higher price for the tied good as long as the gain in consumer surplus from buying the tying product exceeds the loss in consumer surplus from having to buy the tied good at an elevated price.⁵

The "standard" Leverage Theory of tying and *Webkinz*

Plaintiffs' arguments in *Webkinz* rely on the "standard" leverage theory and anti-competitive effect of tie-in sales. For example, Plaintiffs state, "Ganz was exploiting its control over the sale of *Webkinz* to force retailer-customers...into purchasing its line of [unwanted] tied core products"⁶ even though the "[d]emand for the two products is separate."⁷ Moreover, but-for the tying arrangement, Plaintiffs would "rather have purchased [the tied products] on the open market for more competitive terms."⁸ Plaintiffs further state that the effect of Ganz's sales policy is to "appreciably restrain competition in the market in

¹ See, *In re Webkinz Antitrust Litigation* 582 F.Supp.2d 1380 (MDL No. 1987); and *In re Webkinz Antitrust Litigation*, 2010-2 CCH Trade Cases (N.D. Cal.)

² Available at <http://www.scribd.com/doc/40045591/In-Re-Webkinz-Antitrust-Lit-MTD>.

³ See, e.g., Margaret E. Slade, "The Leverage Theory of Tying Revisited: Evidence from Newspaper Advertising," *Southern Economic Journal*, 65(2), October 1998, 204-222. These three justifications for tying generally are recognized not to present antitrust problems.

⁴ The actual competitive effects of any given tying arrangement will depend on the specific facts of the matter, as well as on the exact nature of the challenged conduct.

⁵ Or, as stated by Lambert (2011), "As long as a buyer's expected consumer surplus from her purchases of tying products at the monopoly (or supracompetitive) price is likely to exceed the surplus she expects to lose from having to buy the tied product from the monopolist, the buyer will accept the tie-in and thereby transfer some of her surplus to the seller." Lambert, Thomas A., "Appropriate Liability Rules for Tying and Bundled Discounting: A Response to Professor Elhauge" (July 09, 2011). *Ohio State Law Journal*, Forthcoming; University of Missouri School of Law Legal Studies Research Paper No. 2011-04. Available at SSRN: <http://ssrn.com/abstract=1781130>.

⁶ *Comstock v. Ganz, Inc., Class Action Complaint* (N.D. Ill, E.D.), July 22, 2008, at ¶23 and ¶18. "The core line consists of Ganz products unrelated to *Webkinz*, including lip gloss, magnets, and stuffed and rubber animals." (Plaintiff Nut for Candy's Notice for Motion and Motion for Appointment of Interim Lead Counsel, N.D. Cal., August 22, 2008, at 3). Available at <http://www.cpmlegal.com/pdf/Webkinz-Ntc of Mtn & Mtn for Lead.pdf>.

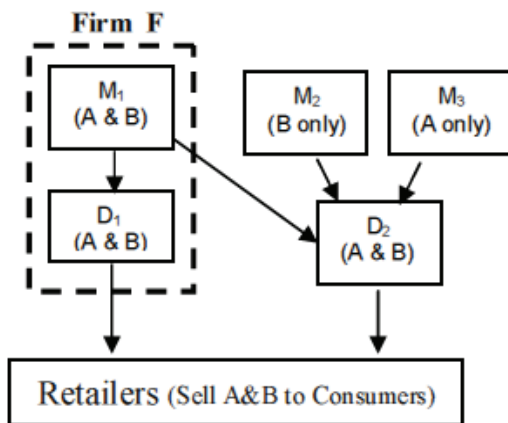
⁷ *Id.* at ¶69.

⁸ *Freetown Trading Post v. Ganz, Inc., Plaintiff's First Complaint* (D. Mass.), July 11, 2008, at ¶18.

which the tied Ganz products compete.”⁹ As a result of “using its power in the relevant product market to restrict competition in the markets for the tied products, GANZ artificially increased its revenues and profits from the tied GANZ core-product.”¹⁰ The example below illustrates how these claims fit within the economic analysis of how such a tying arrangement not only can enhance Ganz’s profits, but also lead to potential foreclosure in the market for the tied good.

Figure 1 presents a simplified representation of an industry producing two goods, A & B. In this industry, Firm F is a vertically integrated producer and distributor of goods A & B, with upstream manufacturer M1 and downstream distributor D1. Good A is a product over which M1 has substantial market power; good B represents other products that are produced under strong competitive conditions. M1 distributes goods A & B directly to retailers through its own distributor D1 because of the value-added services D1 provides. M1 also supplies retailers through independent downstream distributors such as D2 that compete directly with D1. Manufacturers M2 and M3 represent upstream producers of good B and good A, respectively, that supply independent downstream distributors such as D2.

Figure 1



Suppose that Firm F implements a tying arrangement where it requires M1’s “outside”

customers (such as independent distributor D2) that purchase good A from M1 to also purchase good B from M1. A concern is that the dominance of M1 in the market of the tying product (good A) provides a strong incentive for a customer not to refuse the tying arrangement. As a result, manufacturer M2 (a producer of good B) might be “foreclosed” because independent downstream distributors like D2 will now purchase goods A & B from M1. If, as a result, independent upstream suppliers of good B (such as M2) are unable to attract a sufficient number of customers to survive in the marketplace, competition in the production and sale of good B might be diminished. By tying the purchase of good B to good A, M1 (the dominant firm in the market for good A) might reduce the sales of its competitors (such as M2) in the tied market (good B) while expanding its own sales of good B. In the extreme, as a result of being foreclosed from the market for good B, competitors to M1 (such as M2) may find their profitability falling below a level that would allow them to survive.

This “standard” leverage theory concerning the anti-competitive nature of a tying arrangement is that a dominant firm over good A could extend its market power from market A to market B. While this would increase such a firm’s profits, it also would lessen competition due to the foreclosure in the market for the tied product, as well as decrease consumer surplus. Focusing on the strategic (as opposed to profit-maximizing) motives, by tying the sale of good B to good A, the dominant producer of good A (firm M1) can “disable” its competition by reducing the size of the market available to rival producers of good B (firm M2).¹¹ As noted by Areeda and Hovenkamp (2002),

The principle evil of tying arrangements is that they make it harder for rivals to obtain access to the tied-up market, costing them sales and profits, and in more extreme cases driving them

⁹ *Comstock v. Ganz, Inc.*, Class Action Complaint (N.D. Ill, E.D.), July 22, 2008, at ¶27.

¹⁰ *Freetown Trading Post v. Ganz, Inc.*, Plaintiff’s First Complaint (D. Mass.), July 11, 2008, at ¶62.

¹¹ A discussion concerning the strategic effect of tie-in sales based upon foreclosure can be found in Dennis Carlton and Jeffrey Perloff. Modern Industrial Organization, 3rd ed., (Addison-Wesley, 2000), at 371-372; and, Michael D. Whinston, “Tying, Foreclosure, and Exclusion,” American Economic Review, 80, 837-59 (1990).

out of the market altogether or preventing new firms from entering the market. The impact of such exclusion is higher prices that result from output reductions in the tied-up market.¹²

What About the “One-Monopoly Rent Theory”?

Contrary to this standard view, it has been argued – notably by those associated with the Chicago School – that such foreclosure was unlikely to occur based upon the notion that a dominant firm (in the extreme, a monopolist) can extract its monopoly rents only once, and therefore cannot leverage its market power profitably into other markets. That is, to the extent Firm F already possesses significant market power in good A, and that the tied product (good B) is competitively produced (and whose demand is independent of that for good A), Firm F cannot increase its profits by tying these two products. The reasoning behind this view can be summarized as follows:¹³ Suppose that consumers value goods A and B at reservation values v_a and v_b , the unit costs of making the two goods are c_a and c_b , and that $v_a > c_a$ and $v_b > c_b$. Assume that Firm F is dominant in the production and sale of good A but that the market for good B is more competitive. Firm F informs its customers that if they want good A, they also must purchase good B from it. However, the most Firm F can charge for the bundle is v_a (consumers’ maximum willingness-to-pay for a unit of good A) plus c_b . Since market B is competitive, the firm charges a price equal to cost and makes zero economic profit on the sale of B. This yields total profit to Firm F from the bundle of $v_a - c_a$, exactly identical to Firm F’s profit when it does not tie and just sells good A. Therefore, tying will not increase Firm F’s overall profits.

Under this reasoning, to the extent that Ganz already possessed significant market power (or even monopoly power) in the production and sale of Webkinz, and that the tied products are

competitively produced whose demand is independent of that for Webkinz, Ganz would not find it profitable to tie these two products. Accordingly, the “one-monopoly-rent theory” would have Ganz obtaining all the profit related to its market power in Webkinz by simply charging an appropriately high price for them. There is no need for tie-in-sales to affect this outcome.

Pricing Incentives to Engage in Tie-In Sales

The above view argues that foreclosure due to tie-in sales is unlikely because a monopolist can extract its monopoly rents only once, and cannot leverage them profitably into other markets. The recognized “weak link” in this view (which is illustrated below) is the implicit assumption that all consumer surplus can be extracted by Firm F in market A by charging a single, uniform price to all customers.¹⁴ It is the existence of this unexploited consumer surplus in market A that provides a rationale for tying to increase profits – even when the two goods are unrelated in demand. Consider the diagrams in Figure 2.¹⁵

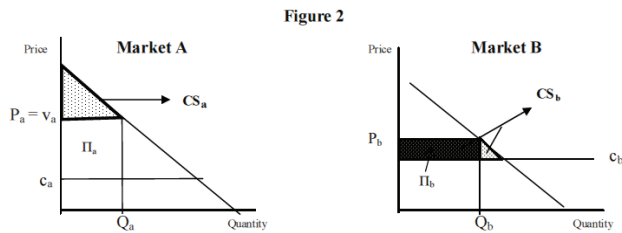
In this paradigm, without tying, suppose Firm F has a monopoly over good A. At the monopoly price of P_a , the remaining consumer surplus in market A equals CS_a . Because market B is assumed competitive, its equilibrium price is set at cost (equal to c_b) and there is no economic profit (i.e., $P_b = c_b$). With tying, however, suppose Firm F quotes two prices to potential customers, P_a and P_b as in Figure 2.

¹² Phillip Areeda and Herbert Hovenkamp. Antitrust Law. (Aspen Law & Business, 2002 Supplement), at 342.

¹³ See, e.g., Jeffrey Church and Roger Ware. Industrial Organization: A Strategic Approach. (Irwin McGraw-Hill, 2000), at 697.

¹⁴ It is usually the case that the single price charged by a monopolist leaves some consumer surplus remaining. See, e.g., Nicholas Economides, “Tying, Bundling, and Loyalty/Requirement Rebates,” NYU Law and Economics Working Paper, February 2011, at 6-9.

¹⁵ This discussion can be found in Jeffrey Church and Roger Ware. Industrial Organization: A Strategic Approach. (Irwin McGraw-Hill, 2000), at 697-698. For a detailed repudiation of the Chicago-School theory of tying, see Einer Elhauge, “Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory,” 123 Harv. L. Rev. 397 (Dec. 2009).



In order to increase profits, the Firm F will have to price above cost in market B (i.e., $P_b > c_b$).¹⁶ This causes a loss in consumer surplus in market B equal to CS_b for those who buy the tied good. However, consumers will opt for the tying contract provided that the loss of consumer surplus in market B is less than the surplus they can still obtain from purchasing good A – that is, as long as $CS_a > CS_b$.¹⁷ In this setup, M1’s “outside” customers – independent distributors (such as D2) – are willing to incur some “cost” in the market for good B (i.e., pay a price $P_b > c_b$) to be able to continue to obtain their surplus in the market for good A (CS_a). As a result, Firm F’s profits increase to $\Pi_a + \Pi_b$ with the tying arrangement compared to Π_a absent the tie, consumer surplus falls in market B by CS_b , and suppliers of good B (such as M2) might be foreclosed from selling to independent distributors (such as D2) who opt for M1’s tying arrangement.¹⁸



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¹⁶ Here, it is assumed that the price of good A is unchanged. However, the optimal price may involve a reduction in P_a under the tying arrangement.

¹⁷ This will be true for small increases in the price of good B above c_b .

¹⁸ This does not account for any additional gain to Firm F should M1’s competitors be foreclosed from the market for good B.