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ECON DEPARTMENT OF ECONOMICS

SEMINAR

"Vertical price restraints in two landmark cases: *State Oil v. Khan* and *Rainbow v. Johnson & Johnson*"

By Prof. Travis NG
Associate Professor
Department of Economics (CUHK)

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ABSTRACT:

A manufacturer sells a product that doesn't quite rely on downstream services. Why would it still restrict its dealers' price? *State Oil v. Khan* and *Rainbow v. Johnson & Johnson* give us two hints. The former concerns a vertical price ceiling on the gas price at self-served stations, while the latter case a vertical price floor on suturing products that are standardized medical consumables hospitals frequently buy. Intra-brand competition is absent in both cases, rendering Telser's (1960) free-riding explanation inapplicable. I offer a theoretical model with two variants.

The product in the first variant brings an opportunity for the dealers to cross-sell customers another product. While selling the manufacturer's product requires no downstream services, cross-selling another product requires ervices that are subject to free-riding among dealers. Using a two-part tariff contract, the manufacturer would find its dealers' prices too high and cross-selling services insufficient. Imposing a vertical price ceiling to suppress their prices is profitable for the manufacturer as it would elicit more cross-selling services from the dealers. I argue that this first variant explains *State Oil v. Khan*.

The second variant features no cross-selling. The customers the dealers sell to ain't end-users but are agents making buying decisions on behalf of their principals. While no downstream services are needed, the dealers compete with other brands using kickbacks. Because the buying decisions can be influenced, the agents are subject to audits. The more a principal pays for a product in excess of what other principals pay, the more likely will an audit happens. Using a two-part tariff contract, the manufacturer would find its dealers' prices too low. Imposing a vertical price floor to raise their prices is profitable for the manufacturer as it would decrease the minimum kickbacks needed for the dealers to sell at a particular price. I argue that this second variant explains *Rainbow v. Johnson & Johnson*.

BIOGRAPHY:

Travis Ng is a teacher of the Department of Economics of the Chinese University of Hong Kong. He teaches industrial organization and law and economics. His research interest is competition. He does both theoretical and empirical research.

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Enquiry: 2616 7384 (Ceci)