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Government Regulations and Power Advantage Shifting in Buyer-Supplier Exchange Relation: The Case of the Shisha Industry in Singapore

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ABSTRACT

Government regulations can have a direct impact on the power advantages enjoyed by buyers and/or suppliers in exchange interaction. Exchange power can be defined as a function of the relative utility and relative scarcity of the resources brought to the transaction by each of the parties involved (Cox et al., 2000). The state can play a central role in creating and sustaining situations of resource scarcity through its ability to grant property rights and through regulations. This scarcity can create a power advantage in buyer-supplier relation. Sanderson (2001) referred to government as simply a creator and guarantor of resource scarcity as *creative regulation,* and referred to government role in containing or removing an existing power advantage as *disruptive regulation.* We argue there is another form of regulation effect called *disruptive-creative regulation.* We present a case study of the shisha industry in Singapore where regulations alter the supplier-buyer power advantage and illustrates a situation where licenses in a competitive market are revoked (disruptive regulation) that creates an oligopoly; albeit a temporary one. The case study also illustrates how competition in the shisha industry has led to *price-stagnation war* and kinked demand. Regulations shifted the power advantage in a competitive market to the suppliers; however the case study illustrates how by suppliers not taking advantage of the resource scarcity have led to suppliers returning the power advantage to buyers. The paper adds to the theoretical understanding of government regulation interfering in supplier-buyer exchange relations in competitive markets, shifting power advantages and highlights how, as was the case in the case study, suppliers at times are not able to view resource scarcity as a power advantage to them due

to game playing. Four decades ago, in 1974, Professor Henry G. Manne testified before the Senate Subcommittee on Anti-Trust and Monopoly and his closing remarks were "*Now with a fearful sense that there may in fact be no one left to listen or to act, I would still urge this Committee to forcefully reject any new regulatory gimmicks, and to get down to the much more serious task of freeing (American) competition from its single most serious opponent, the (US) government.*" (Barron's National Business and Financial Weekly, May 20, 1974 Editorial Commentary : 'Myth of Monopoly: Only the Government Can Hobble Competition").

INTRODUCTION

Monopolies are created by government regulations and licensing requirements; where these regulations and/or licenses act as barriers to entry to the market. Though licensing requirements might be seen as anti-competitive, they are, by and large, necessary for a regulatory framework and orderly management and control of businesses. The licensing requirements in most cases are not anti-competitive as obtaining a license is a fair process that on level playing field. All firms are allowed to apply for the permit/license and all have (reasonably) equal chance of obtaining it. In certain industries or certain scenarios, there might be a limit on the number of permits issued, hence creating a resource scarcity. The New York Cab medallion system is such a case. The limit on the issued permits (a barrier to entry) and resulting resource scarcity creates a monopoly.

At times, due to market size or high initial investments in infrastructure or public interest, it is deemed necessary to limit the entrants to the market for greater efficiency and society benefit. The regulatory created monopolies are evident, for example, in the pharmaceutical industry where patents are given for new medicines. This enables the pharmaceuticals to recoup their research investments. If these monopolies were not allowed the investment in (private sector sponsored) medical research in search for new-cure medicines will drastically descent. The patent created monopoly and the status as first entrant market leader (after the patent period) makes the research investment cost attractive. The licensing monopolies are also apparent in industries requiring huge investments such as telecommunications and utilities. Occasionally there are rules and regulations to control the pricing in an attempt to avoid monopoly pricing.

Simpson (2010) argues that there are two concepts of monopoly; Economic Monopoly and Political Monopoly. Monopolies under the economic concept arise from free competition markets and Simpson is of the view they are not monopolies. The political concept says as long as a firm is being protected from competition from the government then the firm has monopoly irrespective of the firm size. Simpson argues that monopoly is a concept used to identify situations where competition is absent or restricted; one cannot use it to identify situations that arose as a result of competition. Monopolies are not created by free market, they are created only by government interference into the free market. They are created when government gives some firms special privileges over others through the initiation of physical force (regulations). Only government protection permits monopolies to persist.

The normal market process is that a new industry might emerge from entrepreneur initiative and starts as a monopoly. New entrants enter the market converting the monopoly to oligopoly then competitive market. At the oligopoly stage of the market, at times the market incumbents organise themselves to create (sometimes artificial) barriers to entry and form lobby groups, associations or even cartels.

There are instances where government intervention reverses the normal evolution of the market structure. Regulators, through new regulations, might create barriers to new entrants or even reduce the incumbent market players. The new imposed requirements might, at times, be too cumbersome for the incumbent market players. We saw this in Singapore for example with the *centre of excellence* program by the football clubs. The Football Association of Singapore changed the regulations with more cumbersome requirements to qualify for permit to be a *centre of excellence* as a football academy that obtains funding from the football association. This reduced the clubs by half. There are also common where the urban planning authorities stop issuing permits for food & beverage outlets in certain areas (thus creating an advantage for the incumbents).

Another scenario is regulators transforming a competitive market into a political monopoly. This was the case for the shisha-café industry in Singapore. Licenses of a number of shisha cafes were revoked (at the same time) effectively reducing the number of competitive firms in the market. The café that had their licenses revoked were predominately the market leaders. Almost simultaneously with the “mass” revocation, new regulations were announced banning the sale of shisha in Singapore; however the ban only takes effect after a 2 year transitional period and no new licenses were to be issued during the transitional period. This created *transitional (temporal) monopoly* for two years, as it created resource scarcity and shifted the buyer-supplier exchange relation power advantage.

Resource scarcity and Power Advantage in Buyer-supplier exchange relation, and Government regulations

Government regulations can have a direct impact on the power advantages enjoyed by buyers and/or suppliers in exchange interaction. Exchange power can be defined as a function of the relative utility and relative scarcity of the resources brought to the transaction by each of the parties involved (Cox et al 2000).

Resource scarcity is a function of the ability to imitate the resource and/or its substitution. The degree by which a firm’s competitive advantage is threatened by substitutes is a key part of Porter (1980) five forces model. A large part of the literature had focused on the issue of resource imitability (Yao, 1988; Dierickx and Cool, 1989). Rumelt (1984, 1987) developed the concept of “isolating mechanism” to refer to factors that impede imitative competition and thereby ensuring that a particular resource remains relatively scarce. Rumelt (1987) described two main types of ‘isolating mechanisms as (a) exclusive property rights granted by the state and (b) various forms of first-mover advantages. The revoking of the licenses of the market leaders in the shisha café industry was in essence removing first-mover advantages.

The state can play a central role in creating and sustaining situations of resource scarcity through its ability to grant property rights and through regulations. This scarcity can create a power advantage in buyer-supplier relation. Sanderson (2001) referred to government as simply a creator and guarantor of resource scarcity as *creative regulation,* and referred to government role in containing or removing an existing power advantage as *disruptive regulation.*

Essentially Sanderson (2001) argues that creative regulation leads to or protects a position of monopoly (from suppliers perspective); while disruptive regulation (from suppliers perspective) constitute those actions that substantially erode, remove or prevent a situation of monopoly. Sanderson (2001) gives examples of disruptive regulation where monopolistic licenses are removed hence allowing competition and reducing scarcity of resources. Sanderson (2001) refers to regulations either as creating monopolies or disrupting monopolies. In this paper we present a case study where regulation has been used to create a monopoly from a competitive market. Licenses were removed not to disrupt a monopoly, but to <u>create</u> a monopoly. This form of regulation effect we can name as *disruptive-creative regulation.*

The Case Study: Shisha Industry in Singapore

3.1 Background

Shisha-smoking is a water based form of smoking, also known as *hookah* or *Argieleh*. It is a very popular leisure activity in the Middle East; with shisha cafes widely spread in most cities in Middle East. Shisha tobacco is essentially tobacco mixed with molasses and is fruit flavoured. One session of smoking a single serving of shisha can last over one hour.

The shisha cafes in Singapore started in 2001 by Café Le Caire (CLC) of Arab Street. The founder and director of Café Le Caire (hereafter referred to as AT)[1] had a vision of reviving the Arabic Quarters of Singapore and advocating an alternative alcohol-free night life. To achieve the vision, Café le Caire viewed shisha as an integral part of the business model, and Arab Street as the only possible location for the premises. As shisha was a tobacco product, it was regulated by the tobacco control unit of the Health Science Authorities (HSA). AT went to meet the director of the tobacco control unit in HSA to enquire about getting a license for shisha to be told it was

[1] The founder and director of Café Le Caire is Ameen Talib, the author of this paper. The narrations are therefore first party and the insights into the shisha industry are not merely perceptions.

'not allowed' in Singapore. There was no Act that explicitly (or implicit) disallowed shisha. After persisting, AT was asked to make written representation to present his case of why shisha should be allowed; which he did. A couple of months after submitting the representation, sometime in September 2001, Café Le Caire received a reply from HSA that to serve shisha in the café the only requirement was the standard tobacco retail license, which CLC had already obtained. This narration serves two points; the first is shisha tobacco is regulated in the same manner as cigarettes, and the second point is HSA appear not to be in favour of allowing shisha from the offset.

CLC commenced shisha operation as a monopoly; being the sole supplier. The resource scarcity meant that the power advantage in the supplier-buyer exchange relation was with the supplier. This however was not that simple. There were no barriers to entry for competition, except the uncertainty of market demand. The product was new to the market and there was demand scarcity; particularly as there was a sharp drop in tourist numbers from Middle East due to visa restrictions imposed immediately after Sept 11, 2001. CLC had to create 'local' demand shifting the power advantage to the buyers; thus pricing were set not at high levels. CLC generated demand and Shisha cafes after that *mushroomed* in the Arab Street area of Singapore. The area; which is a historical conservation area, flourished as an alternative night life.

3.2 Prohibition of Smoking in Public Places

In July 2006 the *Prohibition of Smoking in Public Places Act* came into effect. The new Act prohibited indoor smoking and allowed only 20% of the outdoor refreshment area (ORA) to be designated as 'smoking area'. AT had formed a business association in 2005 called *kampong Gelam Business Association (KGBa)* to promote the kampong Gelam area and represent the interest of its stakeholders (Arab Street was a core area of kampong Gelam). KGBa made a written representation to the Ministry of Environment (the relevant ministry overseeing the new Act) to exempt shisha from the *prohibition of smoking in public places act.* The request was denied.

The shisha cafes in the Arab Street area submitted their area plan drawings identifying the ORA and the 20% smoking area. However, many shisha cafes took the position that 80% of the ORA and the licensed premises indoor was prohibited from allowing patrons to smoke. Therefore the 20% designated smoking area was allowed for smoking **as well as** any area outside of the ORA and the licensed premises. Some cafes leased premises adjoining their licensed premises and allowed indoor smoking in them as they did not register those premises as part of the café. They were fined continuously for using unlicensed premises. The majority of the cafes put tables outside their registered ORA and allowed smoking as it was outside the 'no smoking' 80% zone. They would also put tables on the road and were being fined by the land Transport Authority (LTA). Many were also fined for allowing patrons to smoke outside the designated smoking area. As it was merely a fine; no café challenged the charge.

The new regulation placed a constraint on the sale-generating space, effectively limiting (quantity) sales. Prior to the Act the shisha cafes were able to serve shisha indoors and anywhere outdoors; thus 100% of their space was shisha revenue generator. Most of the cafes had a small outdoor area, even with 'creative' extension into the (retail) neighbour's shop fronts. The retail shops in the area mostly closed by 6pm; allowing the shisha cafes to expand their outdoor area by placing tables on these shop-front walkways. Shisha became a popular night activity in the area.

If we even *exaggerate* and assume that the café's ORA was equal to the indoor seating capacity, it will translate to "the post-Act" space generating shisha revenue as being only 10% of total capacity. Sales would be expected to drastically drop as now the cafes would not be able to accommodate the customers (buyers). Resource scarcity was thus created and the power advantage in the buyer-supplier exchange relation shifted to the supplier. The theoretical expectation was for prices to go up. The behaviour displayed by the shisha café market was not as expected and makes a case for studying. The suppliers in this instance had (collectively) foregone their power advantage. Instead of benefitting from the created monopoly by the resource scarcity, the market handed back the power advantage to the buyers and increased resource supply by non-compliance with the new regulations. This had a penalty cost and eventually antagonising the authorities to take severe actions against the industry.

The market displayed irrational behaviour. The rational behaviour would have been to comply with the regulation and increase prices; as the resource scarcity shifted the power advantage in buyer-supplier exchange relation to the supplier. The business would have been unattractive to new entrants unless prices rose to a very high level. So why did market players reacted to the Act in a fashion detrimental to their long term interest?

Prior to the Act restricting the space allowed for smoking, there was a kinked demand situation with a price stagnation for a long period. New entrants in the market would undercut prices to attract customers. The market leaders did not enter the price war but found themselves not able to increase prices significantly. The new entrants mainly were selling at around $10-$12 per serving while the market leaders were selling around $15/- per serving. Market segmentation developed. The price stagnation resulted in the cafes hesitant to increase prices after implementation of the new regulation limiting the smoking area; hence handing the power advantage back to buyers.

The control of smoking in public places act effectively reduced the sales capacity of the shisha cafes. The cafes went from being able to serve indoors and 100% of ORA to only 20% of ORA. In many instances this effectively translated to having less than 10% of your previous 'sales area' being currently revenue generating for shisha. This was particularly relevant as the consumption of shisha required customers to be sited with the shisha apparatus next to them and one session could last for one hour. The shisha industry was a competitive market and due to the fact that most cafes were in Arab street area, customers were 'shopping for lower prices'. Most cafes were selling at the same price more or less. Any increase in prices above the market average would be accompanied with a reduction in customers. Many customers would choose café based on pricing. The buyers had the power advantage. It was classic example of a kinked demand. The regulation of allowing smoking ONLY in designated smoking corner altered the power dimensions in the supplier-buyer relationship. A competitive product through regulation was made into a scarce resource! The only means of increasing the resource supply would have been through new café entrants or incumbents increasing their ORA. The cost of renting premises required was not justifiable under the regulation and prevailing market price for shisha. The market now had the power advantage with the suppliers. The product became a scarce resource. The suppliers could have chosen to abide by the regulation and increase prices to accommodate the drop in quantity sales arising from the regulation. That was probably the regulators intentions. If the prices were increased substantially making excessive monopoly profits it could induce new entrants into the market. The long term optimal strategy would have been to increase prices to compensate for the lower (quantity) sales without making huge margins to maintain the monopoly created by the resource scarcity as a result of the new regulations. That strategy would have led to incumbents with small ORA to exit the market strengthening the monopolistic power of those who remain. Such a strategy would have required cohesion between the café operators, however there was a level of mistrust and lack of cooperation. Even where a number of cafes agreed to increase prices there were those who did not comply or gave discounts on the prices. The operators decided to continue serving outside the designated area and those who complied with the regulation were at a disadvantage as they were not able to increase prices and maintain customers.

One factor for the irrational behaviour was also because a number of the cafes relied heavily on shisha sales. They would not have been able to survive if they complied with the new regulation. Their behaviour had directly influenced the other cafes to also not comply; as compliance would have resulted in a disadvantaged position. CLC was operating as a restaurant/café and was one of the more popular places for food in Arab Street and had lower (direct) reliance on shisha sales. CLC shisha sales on average constituted about 20% of total revenue, however there was a direct correlation between shisha sales and sales of food and beverages. Though some operators recognised the power advantage they had, they could not exercise it as, by the other cafes not complying, the resource scarcity vanished and power advantage handed back to buyers.

3.3 The revoking of licenses

Sometime in 2010 The National Environment Agency (NEA), which was the enforcing agency for the prohibition of smoking in public places, issued warning letters that any infringement of the prohibition of smoking in public places act would lead to rescinding the smoking corner. After that warning letter the cafes ceased serving in the no-smoking zone though some of them continued serving outside the outdoor recreational area (ORA).

In March 2012 the NEA rescinded the smoking corner of Café le Caire and a few other cafes, for offences under the Act. The rescinding was for 3 year period and took effect immediate before the charge was heard in court. Café le Caire challenged the charge and pleaded not guilty and appealed. The charge for café le Caire was not shisha related. Unfortunately, a customer smoked a cigarette in a no-smoking area during an inspection by the (NEA) enforcement officers. Café Le Caire felt it was not equitable to be heavily charged for an offence not committed by them. NEA withdrew the charge against Café le Caire and issued them another letter rescinding the smoking corner based on previous charges that were prior to the warning letter. Café le Caire ceased serving in the smoking corner but continued serving outside the ORA and in an adjoining 'unlicensed' premises and continued appealing with NEA. At that point the HSA contacted Café Le Caire to withdraw the tobacco retail license. CLC argued that the tobacco retail license does not have a requirement for a smoking corner, as was the case for convenience stores selling cigarettes. CLC were also selling cigarettes and retail pre-pack shisha tobacco. HSA did not pursue the cancellation of the license back then in 2012.

In December 2013 HSA issued a letter to Café le Caire cancelling their tobacco retail license. Many other cafes also suffered the same fate, particularly the popular cafes. CLC appealed unsuccessfully; they even requested that they sell cigarettes and pre-pack shisha tobacco without serving shisha but was not successful. The representations and appeals were ongoing when in November 2014 it was announced that sale of shisha will be banned in Singapore. The ban takes place from August 2016; giving the licensed cafes two years to operate without new competition.

The de-licensing of the main market players in early 2014 allowed the ones that kept their licenses to enjoy a period of no major competition and created a monopoly of a small number of firms. The prices more than doubled. The government has created a monopolistic market structure by removing players in the competitive market by de-licensing them.

Concluding Remarks

The state can play a central role in creating and sustaining situations of resource scarcity through its ability to grant property rights and through regulations. This scarcity can create a power advantage in buyer-supplier relation. Sanderson (2001) referred to government as simply a creator and guarantor of resource scarcity as *creative regulation*, and referred to government role in containing or removing an existing power advantage as *disruptive regulation.* We argue there is another form of regulation effect that we call *disruptive-creative regulation.* We presented a case study of the shisha industry in Singapore where regulations altered the power advantage in the supplier-buyer exchange relation and illustrated a situation where licenses in a competitive market are revoked (disruptive regulation) that creates a monopoly market; albeit a temporary one.

The case study also illustrates how competition in the shisha industry suppliers had led to *price-stagnation war*. New Regulations shifted the power advantage in a competitive market to the suppliers; however the case study illustrates how by suppliers not taking advantage of the resource scarcity have led to suppliers returning the power advantage to buyers.

The paper adds to the theoretical understanding of government regulation interfering in supplier-buyer exchange relations in competitive markets, shifting power advantages and highlights how , as was the case in the case study, suppliers at times are not able to view resource scarcity as a power advantage to them due to game playing by the market players. The paper also highlights a case study where a temporal monopoly was created by regulations and the removing licenses of some incumbents in market. The irrational behaviour of the shisha café operators, by non-compliance of the new regulation provides lessons for entrepreneurs faced with similar situation. The case can also be a basis of s future study in game theory or effect of regulation on competition capabilities.

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