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Mark Scheme (Results)

January 2011

GCE

GCE Economics (6EC03/01)
Paper 01

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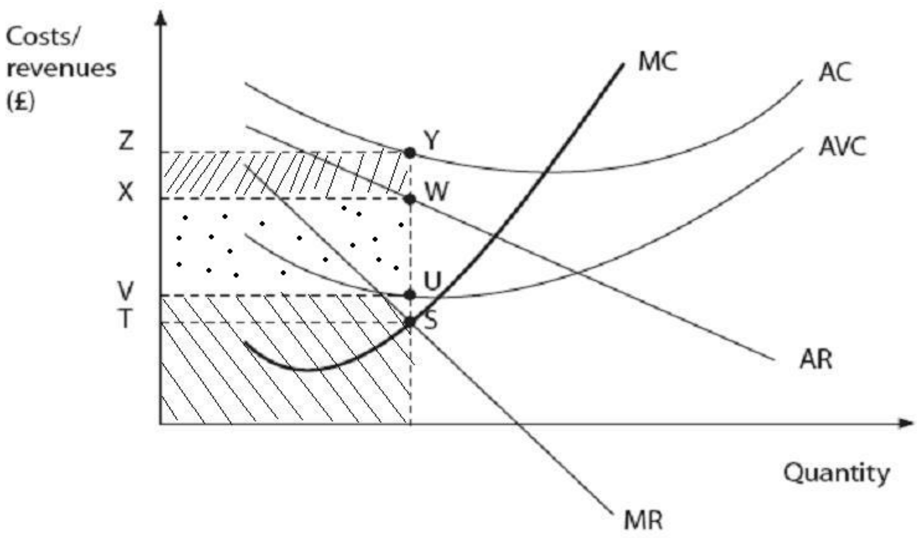
If the incorrect key has been chosen, the explanation is unlikely to score more than **two** marks. The exception is where the key is not written, or not written clearly.
Incorrect options can be knocked out, but the letter of the knocked out key must be given, along with relevant economic reasoning. If more than one key is knocked out for the same reason, this will earn one mark. Up to two knock out marks can be awarded for each Supported Choice Question.

Question Number	Answer	Mark
1	**B** Definition of monopoly power (either legal definition 25%, or 100% of market share), or dominance, market power is high, one seller in the market **(1 mark)** Role of the Competition Commission (e.g. to increase the level of competition) **(1 mark)** Application e.g. airlines buying slots at airports **(1 mark)** Adverse effects on airlines **(1 mark)** and therefore on consumers **(1 mark)** and/or competition (higher prices, less choice, reduced consumer surplus) **(1 mark)** Benefits of the decision, e.g. on consumers (lower prices), the level of competition **(1 mark) or** contestability **(1 mark)** increased efficiency **(1 mark)**	**(4)**

Question Number	Answer	Mark
2	**D** 	**(4)**

	MC=MR is the objective of the firm **(1 mark)** Identification that the firm is a loss minimising firm OR it is making a loss OR AC>AR **(1 mark)** which may be shown ZYWX **(1 mark)** The firm is covering its average variable costs **(1 mark)** which may be shaded **(1 mark)** For an answer that shows area XWUV shaded or otherwise indicated **(1 mark)** as the **contribution** towards fixed costs, or other explanation that it will reduce the fixed costs, which have to be paid anyway **(1 mark)** In the long run all costs are variable or other description of long run impact (can't just repeat the key which refers to the long run), for example if nothing changes in the long run the firm would go out of business, or AC = AR **(1 mark)**	

Question Number	Answer	Mark
3	**C** Identification of revenue maximisation as MR=0 or diagram showing MR crossing horizontal axis **(1 mark)** Diagram showing TR max at MR = 0 **(1 mark)** The flowers are going to be discarded the cost is effectively zero **(1 mark)** The firm makes as much money as possible ignoring the costs since the costs are no longer recoverable **(1 mark)** If flowers are sold there is additional revenue or if flowers are not sold revenue from them is zero **(1 mark)** Therefore by selling flowers that would otherwise be discarded, profits are made or losses reduced. **(1 mark)** Demand is relatively elastic **(1 mark)** Reference to second-degree price discrimation is allowed (but not required for this specification) **(1 mark)** It will cost money to dispose of wasted stock **(1 mark)** Alternative approach: the firm is profit maximising **(1 mark)**, but MC = 0 **(1 mark)**, and if MC = MR then MR = 0 **(1 mark).**	**(4)**

Question Number	Answer	Mark
4	**D** Definition of profit: difference between revenues and costs, AR>AC, or profit above normal profit, or reward to entrepreneur (normal profit) **(1 mark)** Alternatively the definition of profit can be awarded for the accurate labelling of a diagram showing AR>AC. Costs have fallen **(1 mark)** more than revenue has fallen or more than 4% **(1 mark)** **OR** a diagram showing revenue falling **(1 mark)** or costs falling AC and MC or just AC **(1 mark)** and new larger profit area **(1 mark)** Increased workloads **(1 mark)** and/or mechanisation/investment in technology **(1 mark)** has increased output per postal worker and/or productivity or efficiency **(1 mark)**	**(4)**

Question Number	Answer	Mark
5	**E** Role of Ofwat, e.g. to promote consumer interests or promote competition **(1 mark)** Private utilities are natural monopolies in local markets **(1 mark)** Cutting the permitted price increase is a price cap, e.g. RPI - X **(1 mark)** RPI – X + K allows for investment in the water industry **(1 mark)** Powers of Ofwat, e.g levy fines **(1 mark)** Increased investment is likely to make the firms more efficient (cut costs); this may be shown by a falling costs diagram **(1 mark)** Consumer welfare improves, e.g. better quality service or reduced water loss **(1 mark)** Producer profits fall if inefficiency continues, or firm has to cut costs to maintain profitability **(1 mark)**	**(4)**

Question Number	Answer	Mark
6	**E** Definition of market share **(1 mark)** (e.g. percentage of market sales controlled by a firm) Role of the European Competition Commission or competition authorities generally, to promote competition **(1 mark)** Calculation of concentration ratio, e.g. 2 firm 90.4%, 3 firm 94.7% etc, or comment that IE has a legal monopoly with 62% of the market **(1 mark)**	

	Increased contestability, or reduced barriers to entry e.g. removing the pre-installation of the software will mean that more firms will be able to enter the market **(1 mark)** Existing firms will be able to increase their market share/greater competition **(1 mark)** Benefits to consumer, e.g. increased speed of browser, more choice **(1 mark)** Comment on the magnitude of the fine, to show the estimated impact of the damage to the market **(1 mark)**	**(4)**

Question Number	Answer	Mark
7	**D** Tacit collusion definition, e.g. that firms co-operate but not formally, or price leadership, or quiet or implied co-operation, secret, unspoken **(1 mark)** Explanation that oligopoly involves interdependence or other characteristics, e.g. a few firms dominate the market. **(1 mark)** Game theory: workable pay-off matrix **(1 mark)** initially with increased prices **(1 mark)** may be used to explain short term gains, e.g. one firm makes profit at the expense of another **(1 mark)** but long term further adjustment, or other use of prisoners' dilemma e.g. both have low prices, collusion breaks down, or Nash equilibrium **(1 mark)** n.b. Nash equilibrium is not required for full marks Alternative approach: Kinked-demand curve analysis or price leadership may be used **(up to 3 marks**, of which, 1 mark for diagram, 1 mark for impact of increased prices described, 1 mark for impact of decreased prices described**)**	**(4)**

Question Number	Answer	Mark
8	**E** PFI or PPPs defined as a **means of obtaining** private funds for public sector projects **(1 mark)** Use of data or other knowledge that prices charged are often high **(1 mark)** Identification of reasons for higher prices (e.g. lack of competitive tendering, extortion by owners of finance) **(1 mark)** Reasons why government continues with PFI despite costs, e.g.: • Enables projects e.g. hospitals/schools to be built earlier or at all than would otherwise be possible. **(1 mark)** • Private sector might be seen to be more efficient than public sector **(1 mark);** • defers payments for expensive projects **(1 mark)** • by paying rents or by leasing **(1 mark)** • lowering borrowing costs **(1 mark)** • consideration of opportunity cost, e.g. the government's money can be used for other things **(1 mark)**	

	Example of knock-out mark: Not A because it is hard to predict future costs for major public sector investment projects because there are unknown costs **(1 mark)**	**(4)**

Question Number	Answer	Mark
9(a)	**Theory (2 marks):** identification that this is horizontal (1 mark) with explanation that the firms are at the same stage of the production process (1 mark) gaining economies of scale/combined market share (1 mark) **Application (2 marks):** that they both offer commercial flights (1 marks); application of economies of scale e.g. cut overlapping routes (1 mark); can combine office functions (1 mark); increased buying power when buying planes (1 mark); 'national flag carriers' Ext 1 lines 14-16 (1 mark) with associated landing rights (1 mark), substantial cost savings (1 mark).	**(4)**

Question Number	Answer	Mark
9(b)	KAA: 4 marks Award 2 reasons (1+1). Award a maximum of 2 marks for the reasons – a diagram is required in question Costs have risen: e.g. rising fuel costs, wage costs, Iberia has become x-inefficient, other cost issues Demand has fallen: e.g. fall in demand due to financial crisis, recession, and other confidence issues, other airlines scooping up the market. Diagram (up to 2 marks): showing leftward shift in AR and MR (1 mark) and new equilibrium MC=MR and sub-normal profit (i.e. loss) (1 mark) **or** rising costs (AC and/or MC rises)**(1 mark)** n.b. cost diagram does not need to show a shift in MC and new equilibrium MC=MR and sub-normal profit (i.e. loss) (1 mark) Diagram does not need to show a profit before the shift. NB these sketches are not intended to be fully labelled diagrams,	

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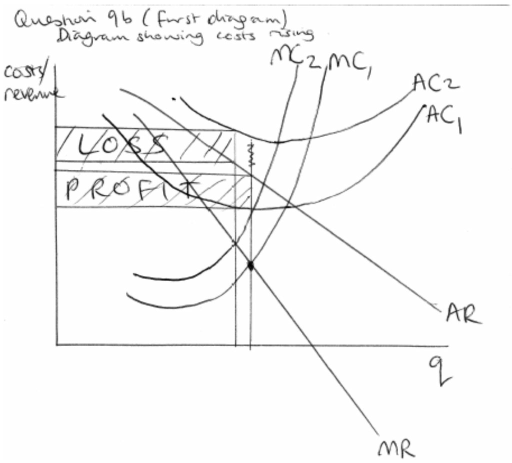
but merely indicate profit areas.



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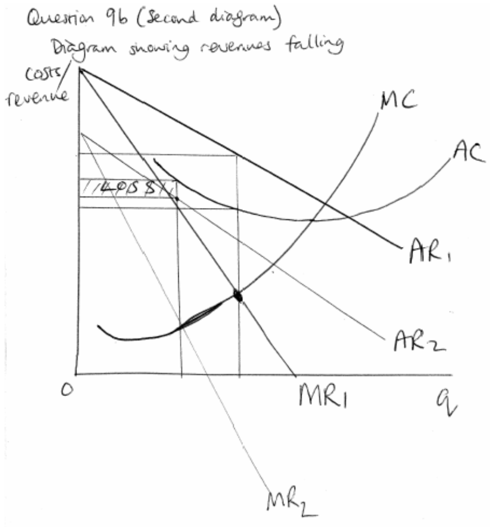

Evaluation 4 marks (2+2 or 3+1 or 4+0)

Factors might include:

- This might improve as the economy recovers (time lag)
- Other airlines have experienced similar problems, so not unique to Iberia
- Speculation has exacerbated the problems
- State governments might intervene
- Prioritisation – which reasons for loss are most significant
- Consideration of elasticities in short and long run
- Questioning of the meaning of profit.
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Question Number	Answer	Mark
9(c)	KAA 6 marks, award up to 3 factors (2 x 3 marks or 3 x 2 marks or 3 + 2 + 1) Can be argued for increased or decreased contestability. Definition of contestability (may be implicit) e.g. low or no sunk costs, low or no barriers to entry/exit (1 mark) with application that this causes barriers to entry or exit for new firms (limit pricing might occur); use of data to support argument that markets will be less contestable. Factors suggesting lower contestability might include: • Increased barriers to entry and exit • Firm can cross-subsidise routes and effectively use a limit price strategy in contestable markets • Economies of scale (can be developed as separate points) • Concentration ratio might increase • Increased market power • Price fixing or collusion might be more likely • After the merger there will be more profits which is a sign of decreased contestability Evaluation: Award up to 6 marks (2x3 or 3x2 marks) • Counterargument: Can be argued for increased or decreased contestability • Barriers to entry might be the only way that companies can survive, so in the long run are beneficial to consumers and stops the market becoming even more concentrated • Suppliers have monopoly power, so bilateral powers are levelled out • Depends on the degree of monopsony – might strangle suppliers • Many agreements against the law if they are anti-competitive • Will make little difference as airline industry was highly incontestable before the merger? • EU powerless in global market (Ext 1 lines 34 – 35) • Lack of profitability suggests that the industry is contestable • Low cost and emerging economies' airlines are entering, which is a sign of high contestability • With the strikes (Extract 2) brand loyalty might diminish, and consumers might be more willing	**(12)**

	to shift • Diseconomies of scale/lack of synergies might mean new entrants find it easier to compete • Ext 1 Line 30 More landing slots might become available, increasing contestability • Other things are not equal. Contestability might change for other reason, e.g. internet bookings, more planes available to lease	

Question Number	Answer	Mark
9(d)	KAA: 8 marks, award as (2x4 or 4x2 marks or 3+2+2+1 etc). Award up to four points. Benefits might include: • Economies of scale (more than one can count as separate points) • Increased market share • Rationalisation: 'within five years the new group will save some €400m ($595m) a year by cutting overlapping routes, and by combining maintenance, office functions and business-class lounges. • Benefits to consumers e.g. consolidation means fewer strikes/airlines going out of business, which is better for the consumer in the short run (don't get holidays cancelled) and long run (more choice, competitiveness, better service) • Could protect and even create jobs • Benefits to the government in terms of tax revenue and spending • Increased buying power, or monopsony power, enabling purchasing economies of scale. The pair may also have more buying power when it comes to negotiations to buy new planes from Boeing and Airbus' • Merger will provide finance for investment, e.g., in environmentally friendly technology • Benefits to shareholders – increased market capitalisation and dividends Evaluation (costs): 8 marks (2x4 marks or 4x2 marks or 3+2+2+1 etc). Points might include: • De-industrialisation problems, unemployment, • Less choice and/or higher prices for consumers; fall in consumer surplus • Higher risk and/or prices for consumers; fall in consumer surplus • Higher risk for firm/over-specialisation ('all the eggs in one basket') • Diseconomies of scale • Clash of cultures, and/or loss of synergy	**(16)**

	• Costs of redundancies • Lower morale of workers • Marketing problems • Allow other forms evaluation, e.g. short/long run distinction • Risk of investigation by competition authorities • Legal, admin and negative publicity costs should the merger fail to go through • Other airlines might retaliate by merging • Loss of benefits of specialisation in domestic markets.	

Question Number	Answer	Mark
10(a)	Award 1 reason (2 marks) • Increased availability and quality of substitutes, e.g. internet news providers or free newspapers (1 mark) which are cheaper (1 mark) • Credit crisis (from 2007), recession from 2008 • Allow reasons for slowing rate of fall or even rise (FT sales 2005-09) e.g. fears about the economy make people want to buy newspapers • Fewer bulk purchases by train/flight operators and hotels Application (2 marks) • Falling trend (or rising trend for FT) 1 mark • Use of data to explain trends, up to 1+1 • More people check their news online – must give reference to (Extract 2) • Readers are disloyal • Use of FT figures as bucking the trend, using observations from data, up to 1 + 1	**(4)**

Question Number	Answer	Mark
10(b)	KAA: 4 marks (4 + 0 marks) or (2 + 2 marks) or (3 + 1 marks). KAA for they will leave (can be argued the opposite way around) • If firms do not make a profit (i.e. if demand is falling) they will go out of business in the long run • Price (AR) must cover AVC or AC in the long run • Diagram (up to 2 marks): showing leftward shift in AR and MR (1 mark) and price below AVC (i.e. shut down price) (1 mark) • New technology makes printed matter obsolete which means eventually they will shut down • Declining advertising revenues increase the likelihood of shut-down, Extract 1 lines 7-8 – online advertising is cheaper and more effective • Use of Figure 1 to support disloyalty argument Evaluation: 4 marks (4 + 0 marks) or (2 + 2 marks) or (3 + 1 marks) Evaluation marks are awarded for saying firms will stay in business (or counterargument to the above) AND other evaluative comments. Points might include: • Newspaper sales are not the only form of income for the firms. Many newspapers are profitable even with a free cover price – other revenue streams are more important e.g. apps, advertising revenue is likely to increase as adverts can be targeted to readers' profiles (Ext 1 line 8) • If firms can cover AVCs then they may stay in business and try to drive down costs • Market is fairly contestable (low sunk costs) and other firms may enter the market to provide services • If firms can survive the downturn, AR is likely to rise in a recovery and the firm will return to profit • Some newspapers are part of a conglomerate, so losses can be cross-subsidised, e.g. by SKY Sports, and the firms stay in business • Diagram (up to 2 marks): showing leftward shift in AR and MR (1 mark) and price above AVC (i.e. they do NOT shut down in the short	**(8)**

	run) (1 mark) • Insufficient data provided to make a judgement • Depends whether they can cut costs • Depends whether they can increase market share • Depends whether the trend is long run – if this continues the firm will shut down • Unlikely in that '24' hour news is likely to reduce demand for newspapers as newspapers offer depth of insight and evaluative comment • Some people cannot or do not want to access other forms of news so the market will remain in the long term • Extent of competition • Depends on the costs of exit	

Question Number	Answer	Mark
10(c)	KAA: 6 marks (2x3 marks or 3x2 marks) or (3 + 2 + 1) KAA might be argued for or against a difference in contestability Definition of contestability (may be implicit) e.g. low or no sunk costs, low or no barriers to entry/exit (1 mark) Points might include: • Online news is a highly competitive market with a high level of contestability. Brand loyalty is low. Use of data in Fig 1 to support argument. • Online news has low sunk costs, easy to set up. • Print set up costs are high, needing high levels of equipment • Print edition news is less contestable. Use of Figure 2 for evidence of concentration. • Comment on related demand for advertising: advertisers have more choice about where to place the online adverts (higher price elasticity of demand) and they view customers of the newspapers as being more disloyal online so the expected returns are lower. • Lack of profitability suggests that the industry is contestable • There may be more hit-and-run in the online market **If the answer is referring to only one kind of market for news or for newspapers in general, then cap KAA at 4/6 marks** Evaluation: 6 marks (2 x 3 marks or 3 x 2 marks or 3+2+1). Points might include: • Counterarguments to above points, e.g. that there is **not** a significant difference in contestability. • Online set up costs are in fact very high • Printing set up costs might be low e.g. because the technology already exists • Contestability of both markets increasing as internet is used more widely for reading news (also 24 hour TV news) • Some newspapers are starting to charge for or	**(12)**

	limit online news (Google and Times) but we do not yet know impact on demand (Fig 2 and own knowledge) • Increased contestability may worsen the quality of news reporting – negative impact will be wider than just on the firms • Newspapers have become more contestable particularly local newspapers, as a result of new technology. • Fig 1 shows BBC dominance, therefore online news is not contestable • Websites might seem contestable but they are not, because of network effects of readers and path-dependency of search engines	

Question Number	Answer	Mark
10(d)	KAA 8 marks award as (4x2 or 3+2+2+1) Award up to four strategies Allow any valid price strategies IF LINKED TO INCREASED PROFITABILITY albeit in the long run: • Limit pricing if linked to increased profitability • Revenue maximisation/sales max can only be awarded if linked to increased profitability, e.g. in the long run **Do not award identification marks for the above unless linked to profitability, because the strategies aim to lower profits.** • Predatory pricing • Collusion/price wars • Other game theory pricing strategies • Price discrimination • Cost-plus pricing • Penetration pricing • Allow profit maximisation as a pricing strategy Allow any valid non price strategies • Marketing/advertising e.g. celebrity endorsement (may be awarded as more than one factor) • Improved service e.g. delivery networks • Customer interface and apps • Mergers and acquisitions • Product re-design • Loyalty schemes • Free gifts • Other game theory non-pricing strategies • Lowering costs/increasing efficiency	**(16)**

	If only one type of strategy then award a maximum of 6/8 marks Evaluation 8 marks. Award as (4x2 marks or 2x4 marks or 3+2+2+1 etc). Factors might include: • The Times is already charging for use of articles and is a success/is not a success • It is too early to say, certainly with The Times. • Difficult to know outcomes in game theory, or other game theory critique, e.g. kinked demand curve to show sticky prices • Award game theory responses as more than one point, e.g. price war • Depends on changing income in a recession • Global competition issues • Discussion of relative merits of pricing and non-pricing strategies • Possible intervention by the Competition Authorities • Costs involved in redesigning and marketing the non-price strategies might outweigh benefits • Advertising as a **sunk** cost	

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