Write your name here

Surname	Other names

Edexcel GCE

Centre Number	Candidate Number

Economics

Advanced
Unit 3: Business Economics and Economic Efficiency

Tuesday 12 June 2012 – Afternoon
Time: 1 hour 30 minutes

Paper Reference
6EC03/01

You do not need any other materials.

Total Marks

Instructions

- Use **black** ink or ball-point pen.
- **Fill in the boxes** at the top of this page with your name, centre number and candidate number.
- Answer **all** the questions in Section A and **one** question from Section B.
- Answer the questions in the spaces provided – *there may be more space than you need.*

Information

- The total mark for this paper is 72.
- The marks for **each** question are shown in brackets – *use this as a guide as to how much time to spend on each question.*
- Questions labelled with an **asterisk** (*****) are ones where the quality of your written communication will be assessed – *you should take particular care on these questions with your spelling, punctuation and grammar, as well as the clarity of expression.*
- Calculators may be used.

Advice

- Read each question carefully before you start to answer it.
- Keep an eye on the time.
- Check your answers if you have time at the end.

Turn over ▶

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PEARSON

Section A: Answer all the questions in this section.

You should spend 35 minutes on this section. Use the data to support your answers where relevant. You may annotate and include diagrams in your answers.

1 In 2010 the assets of ROK, a building maintenance firm, were acquired by Balfour Beatty, which also maintains buildings as part of its operations. This type of integration of business assets is:

(1)

A Satisficing

B Privatisation

C Backwards vertical

D Forwards vertical

E Horizontal

Answer

Explanation

(3)

(Total for Question 1 = 4 marks)

2 A firm operating under conditions of perfect competition is making supernormal profits. What is likely to happen to this firm in the long run?

(1)

A The price of its product will rise

B It will leave the industry

C Both its output and price will fall

D Its output and price will remain unchanged

E Its output will rise and its price will fall

Answer

Explanation

(3)

(Total for Question 2 = 4 marks)

3 In a review in March 2011 Ofgem, the energy regulator, reported that it had concerns over the vertically integrated energy markets. The figure below shows the UK market share of the largest vertically integrated energy firms:

	Percentage of UK market (volume of sales)
EDF Energy	24%
E.ON	12%
RWE npower	10%
SSE	10%
ScottishPower	9%
Centrica	6%

(Source: © Crown Copyright)

The most likely reason for Ofgem's concerns is:

(1)

A There is a low level of producer surplus

B Vertical integration tends to decrease the concentration ratio

C Centrica is too small to achieve economies of scale

D Vertical integration can create a barrier to entry

E EDF Energy is a legal monopoly

Answer ☐

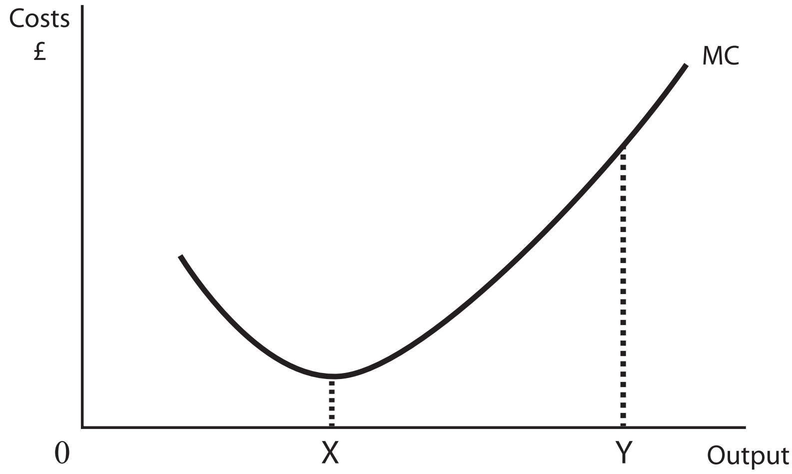
Explanation

(3)

(Total for Question 3 = 4 marks)

4 Which of the following best explains the shape of the short run marginal cost curve between X and Y?

(1)



A The law of diminishing marginal returns

B The law of increasing marginal product

C Average costs are rising

D Average variable costs are rising

E Economies of scale

Answer

Explanation

(3)

(Total for Question 4 = 4 marks)

5 Lizzie runs a hairdressing shop and the following table shows her costs and revenues in a fixed time period when she changes her prices for a haircut. Some parts of the table are left blank for your own calculations.

Quantity	**Price (£)**			**Total costs (£)**	**Marginal costs (£)**
0	11			5	–
1	10				4
2	9				5
3	8				6
4	7				8
5	6				10

At what range of output would Lizzie achieve profit maximisation?

(1)

A 0 – 1

B 1 – 2

C 2 – 3

D 4 – 5

E She cannot make supernormal profits at any output.

Answer ☐

Explanation

(3)

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(Total for Question 5 = 4 marks)

6 In January 2010 the Office of Fair Trading (OFT) referred the UK's local bus services to the Competition Commission over concerns about pricing. It had received complaints about the "predatory behaviour" of existing firms, designed to exclude new entrants from the market. Which characteristic was likely to have been observed?

(1)

A Prices equal to marginal cost

B High prices in the short run

C Prices set above average costs in the short and long run

D Revenue maximisation pricing

E Prices set below average variable costs in the short run

Answer ☐

Explanation

(3)

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(Total for Question 6 = 4 marks)

7 Game theory can be used to explain the breakdown of a cartel. Which of the following is the most likely cause of such a breakdown?

(1)

A A possibility of an individual member gaining short term profits

B An aim of reaching long term equilibrium

C Economies of scale

D Satisficing behaviour

E Reduced risk of collusive behaviour being investigated

Answer

Explanation

(3)

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(Total for Question 7 = 4 marks)

8 In 2009 a 30-year private finance contract for widening and maintaining the M25 motorway was agreed. The contract was valued at £6.2 billion, with penalties if the consortium of companies did not achieve completion on time.

The main reason that the government used a private finance contract was likely to be because it:

(1)

A wanted to manage the project within the public sector

B cannot use performance targets in the public sector

C has limited experience of road building

D wanted to increase producer surplus

E wanted to commence a major project without raising the finance at the initial stage

Answer ☐

Explanation

(3)

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(Total for Question 8 = 4 marks)

TOTAL FOR SECTION A = 32 MARKS

Section B: Answer either Question 9 or Question 10.

If you answer Question 9 put a cross in this box ☒ .

Question 10 starts on page 22.

You should spend 55 minutes on this section.

9 Food manufacturing and retailing

Extract 1 Northern Foods struggles to meet supermarket power

Food manufacturing is a brutal industry. A fresh burst of commodity inflation has raised input costs and the buying power of the big supermarkets makes it hard for food manufacturing firms to pass these extra costs on. The grocers' influence is a benefit to consumers: though dominated by a handful of big chains, Britain's retailing industry is competitive, and the margins squeezed from manufacturers are shared with shoppers. That buyer power is not such a blessing for suppliers, who struggle to hold on to any cost savings they make. Multinational firms, such as Nestlé or Unilever, possess the strength and the famous brands to fight back. Small suppliers seem powerless.

Northern Foods isn't small (it has almost 9,500 employees) and owns some sizeable brands, such as Fox's Biscuits; but the core of its business is supplying prepared foods to which supermarkets then attach their own labels. The firm led the way in chilled prepared meals, partnering with Marks & Spencer (M&S) in the 1980s. But as others caught up, Northern Foods found itself struggling against retailers who could quickly change suppliers if they wanted to pay less.

Northern Foods' response to its declining fortunes and slumping share price was to seek a merger. In November 2010 there was a proposed merger with Greencore, a Dublin-based food manufacturer. It would have yielded the merged company £40m a year, around 2% of joint sales, through cost and tax savings, and better terms with its own suppliers. Behind the push for a merger was a belief that a bigger, more diversified firm would not be so easily bullied by retailers.

Yet it is far from clear that Northern Foods' main problem is insufficient scale. Other food manufacturers have thrived despite pressures on profit margins. Cranswick, a supplier of upmarket pork products to supermarkets, has a bigger stockmarket value than Northern Foods' with less than half the staff. Its revenues and share price have grown quickly in the past decade, as have those of Kerry Group, an Irish firm supplying the upmarket City Kitchen line of prepared meals for Tesco. The firm works closely with retailers to provide good service and improved products and is very disciplined in controlling costs.

The key to a good bargaining position for food manufacturing firms, it seems, is to make it costly for retailers to change suppliers. The more reliable the supply, the better the goods and the more tailored the service, the harder it is for retailers to switch. This requires constant effort: a firm that stands still is a target for the cost-cutting chains.

(Source: adapted from © *The Economist* Newspaper, 10 February 2011)

PMT

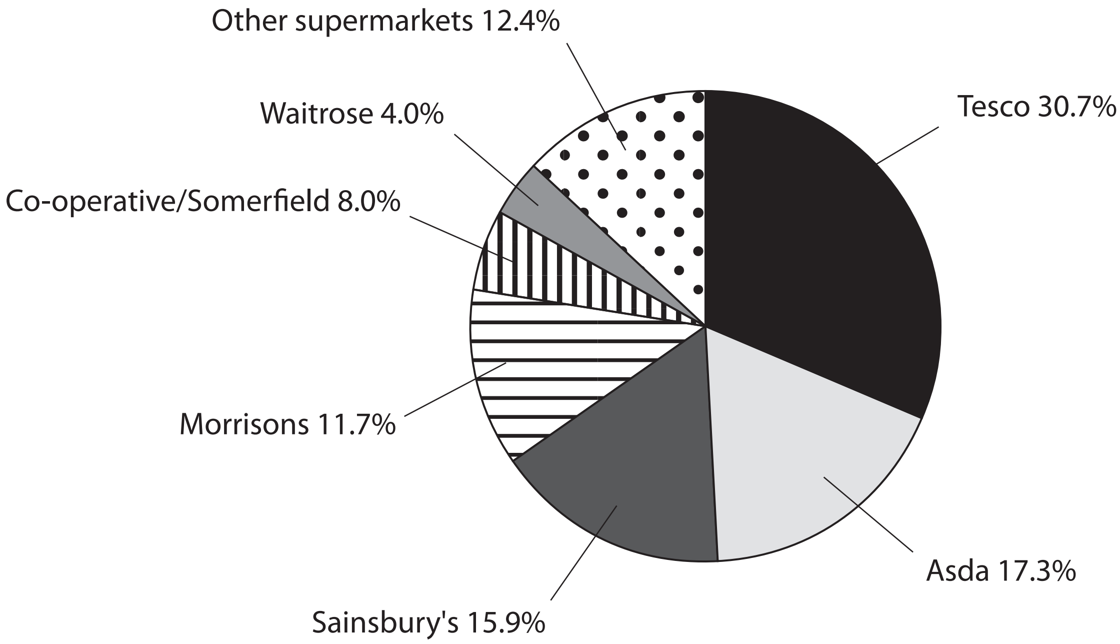
Extract 2 Tesco pushes into northern California

In 2007 Tesco began its move into the United States by opening a chain of small-format grocery stores on the West Coast of the United States (Arizona, California and Nevada) under the brand name Fresh & Easy. Tesco has now begun its expansion into northern California, with the opening of its first two stores in the San Francisco Bay area, indicating the continued expansion of its loss-making US venture under new group chief executive Philip Clarke. A further 10 standard stores are set to open by April 2011. Fresh & Easy, which has more than 160 stores, is to open about two stores a week this year. The initial planned capital expenditure was up to £250 million per year. One of the key decisions for Mr Clarke will be deciding whether to continue with the Fresh & Easy chain, which made a loss of £165m last year, but is expected to break even by 2013, and turn losses into profits by 2015.

Tesco is planning to extend Fresh & Easy into smaller sized stores with the aim of attracting customers from larger out of town stores owned by competitors. Opening the northern California stores demonstrates that Mr Clarke is pushing ahead with expansion, despite the highly unusual decision last October to close 13 loss-making stores, primarily in Arizona and Nevada. These states have been hit by the US housing market downturn, shrinking populations, the high percentage of house repossessions and high unemployment rates.

(Source: adapted from © The Financial Times Limited, 3 March 2011)

Figure 1 UK supermarket market shares by revenue, 2009



(Source: © Kantar Worldpanel)

Extract 3 Tesco's purchase of 77 One Stop stores angers rivals

One Stop, a chain of 598 convenience stores in the UK, was bought by Tesco in 2002 as part of its £377m acquisition of T&S Stores. Tesco has been forced to defend itself against allegations of high prices – despite its general claims that its huge scale means consumers benefit from the retailer offering the same prices nationwide. A spokesperson for Tesco said "The ranges are quite different in One Stop. It is a separate business with a different supply chain and a separate business model with stores that are typically smaller than those running under the Tesco Express name". In clearing the original merger, the OFT said "Tesco has said that the transaction will bring consumer benefits as its Express store prices are lower than those of One Stop." There are currently 1,183 Tesco Express stores, and Tesco controls 3.5% of the convenience store market. Tesco is the world's third largest retailer by revenue, after Walmart and Carrefour, and the second largest after Walmart by profit.

(Source: adapted from © Guardian News & Media Ltd 2010 16 December 2010)

(a) Using the evidence, explain one potential benefit to Greencore of the proposed merger with Northern Foods (Extract 1 lines 17–21).

(4)

(b) Using an appropriate diagram, discuss **one** reason why new 'Fresh & Easy' stores set up in the United States are likely to 'turn losses into profits by 2015' (Extract 2 line 11).

(8)

*(c) Using examples from the Extracts, assess the degree of **monopsony** power in the groceries market.

(12)

*(d) With reference to supermarkets or another industry of your choice, assess reasons why some firms become very large and others remain small.

(16)

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(16)

(Total for Question 9 = 40 marks)

If you answer Question 10 put a cross in this box ☒ .

10 A crowded car industry

Figure 1 US car market, % market share 2010

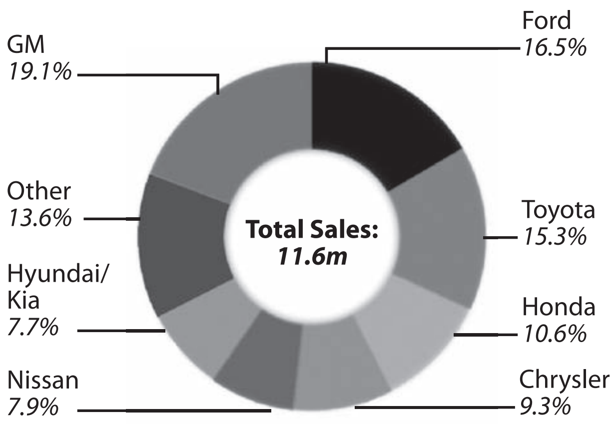
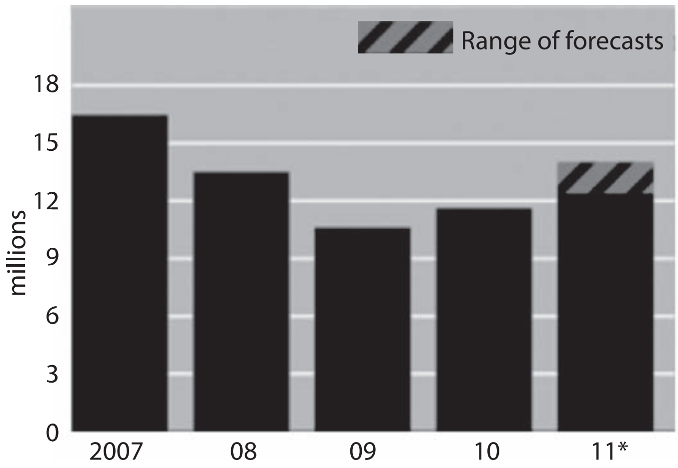


Figure 2 US car market, units sold (millions)



Extract 1 United States carmakers are back. Tough competition is waiting for them

Every year at the Detroit Motor Show there is a major display used by the main manufacturers of cars to bring new models to the US market. For the past two years it been a dismal affair, but this year the parties were in full swing again. Helped by government bail-outs and with debt burdens lightened by bankruptcy, Chrysler and General Motors (GM) are back on their feet. Ford, the other member of Detroit's Big Three, is thriving.

The biggest impact on the opening day was made by a Volkswagen saloon, which is to be built in a new factory in Tennessee. This is causing some concern for local manufacturers. Europe's market-leading carmaker is taking aim at the heart of the American market for the first time in over 20 years. Its bold move is just one sign of breakup in a market once dominated by the Big Three and a small collection of Japanese rivals.

The recession sent car sales in America falling from 16.5 million in 2007 to just over 10 million in 2009 (see Figure 2). Since then, sales have risen. Sales in December 2010 were equivalent to an annual rate of 12.7 million cars, the best performance since 2008, with a predicted 10% rise in 2011. Analysts point to an improvement in the creditworthiness of buyers which increases the willingness of banks to lend. Americans are buying big, expensive vehicles again.

The 2008 crash allowed Chrysler, GM and Ford to strengthen management and push through changes that had long been blocked by unions. Capacity was cut drastically: Ford closed 17 factories and reduced employee numbers by over 40%. GM abandoned brands such as Hummer and Saturn to focus on Chevrolet, Buick and Cadillac, while Ford got rid of all brands except Ford and Lincoln. Health care for company pensioners, for a long time a problem for the firms' owners, was transferred to union-run trusts. New workers can now be hired at lower rates of pay than those forced up by the United Auto Workers (Union) during the boom years. Ford's chief executive says his company can compete on price with factories opened in weakly unionised southern states by Japanese, South Korean and German carmakers. Ford may have made as much as $10 billion in profit last year.

For the Big Three now read the Magnificent Seven. Toyota, Honda and Nissan have been joined by Hyundai and its sister brand Kia in a fragmented market where seven manufacturers each have more than 5% of the market (see chart). And Volkswagen is trying to join the club. Volkswagen and its Audi offshoot sold 358,500 cars in the United States last year. The firm aims to triple sales by 2018 and plans to spend $3 billion on marketing and opening more dealerships.

Competition is particularly fierce in the "mid-range" market, where Toyota's Camry, Nissan's Altima and Honda's Accord have long dominated. Since petrol prices first rose above $3 a gallon in 2005 Detroit has been trying to reconquer the mid-range car market instead of relying on sales of expensive gas-guzzlers. Ford is bringing in slightly Americanised versions of saloon cars that have been successful in Europe, while GM plans to do the same with versions of its German-designed Opels. Chrysler will import Italian technology from Fiat as the ties between the two companies strengthen.

They will face an old adversary. Quality problems at Toyota led to $48.8m in government fines and a recall of 4 million vehicles in America alone. Toyota's embattled chief executive, Akio Toyoda, making his first visit to the Detroit show, admitted that the firm "did receive damage". But it would be foolish to underestimate the ability of the world's biggest carmaker to put its house in order: it still has the most efficient system for product development and manufacturing, even if it must focus for the moment on quality control. For the first time it is offering customers discounts to increase sales.

The Japanese firm could learn a good deal from Hyundai and Kia. The South Korean firms suffered from reputations for poor quality when they entered the American market and relied largely on bargain prices to sell their vehicles. Under pressure from consumer magazines they gradually improved their quality and have won recognition from critics and customers. That jump in quality, as well as heavy marketing, has turned them into serious competitors. A glimpse of the next challenger came from BYD, a Chinese car manufacturer, which showed off an innovative, compact battery-powered car.

(Source for Figures and Extract: © *The Economist* Newspaper, *The Economist*, 13 Jan 2011)

(a) With reference to Figure 1, briefly explain the market structure in the US car market.

(4)

(b) Using an appropriate diagram, discuss **one** reason why General Motors and Ford have been able to turn losses in 2008 to profits in 2010.

(8)

*(c) To what extent does the evidence suggest that the US car market is contestable?

(12)

*(d) Using evidence from a range of manufacturers referred to in Extract 1, assess pricing and non-pricing strategies car manufacturers might use to increase total revenue, when petrol prices are rising sharply.

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(Total for Question 10 = 40 marks)

TOTAL FOR SECTION B = 40 MARKS
TOTAL FOR PAPER = 72 MARKS