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Edexcel GCE

Economics

Advanced

Unit 3: Business Economics and Economic Efficiency

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|--|------------------------------------|
| Wednesday 23 June 2010 – Morning 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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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 use diagrams in your answers.

1 Intel is the world's largest microchip manufacturer, supplying over 75% of the market. In May 2009 it was fined \$1.44bn by the European Commission. It claimed that Intel gave secret payments to computer makers to use only Intel chips and paid a major retailer to stock only computers with its microchips. The most likely justification for this fine is that:

(1)

- A it ensured Intel would make a loss
- B the market for microchips is contestable
- C it would increase Intel's producer surplus
- D Intel was abusing its market power
- E the market for microchips has a low concentration ratio.

Answer

Explanation

(3)

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(Total for Question 1 = 4 marks)



- 2 In May 2009, British Airways (BA) quoted the following prices for a flight from London to Toronto, Canada:

| Date of flight | Price |
|----------------|-------|
| 1 August 2009 | £407 |
| 1 October 2009 | £204 |

Source: www.britishairways.com/travel/fx/public/en

The most likely explanation of this pricing strategy is:

(1)

- A more spare capacity on BA's planes on 1 August 2009
- B higher costs of flying planes in October than in August
- C that there is a difference in price elasticity of demand in August and October
- D the expectation that some airlines will go bankrupt between August and October 2009
- E an expectation that the world recession will be over by October 2009.

Answer

Explanation

(3)

(Total for Question 2 = 4 marks)



3 Amtrak is the sole provider of long-distance rail passenger travel in the US. The most likely reason why Amtrak has no competition is that:

(1)

- A sunk costs are low
- B there are falling long run average costs in the US rail passenger industry
- C demand for rail travel is increasing
- D x-inefficiency is high
- E consumers' surplus is always higher when there is a sole provider of a product or service.

Answer

Explanation

(3)

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(Total for Question 3 = 4 marks)



4 A firm engaged in 'satisficing' behaviour is most likely to:

(1)

- A maximise profits
- B maximise revenue
- C maximise sales
- D minimise costs
- E produce at an output different to that of a profit maximising firm.

Answer

Explanation

(3)

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(Total for Question 4 = 4 marks)



- 5 A firm might aim to maximise sales rather than profits in the short run because: (1)
- A it knows its marginal cost and marginal revenue
 - B it is in a market with no other competitors
 - C it wishes to deter the entry of new firms
 - D supplies of raw materials are limited
 - E there are substantial barriers to entry in this industry.

Answer

Explanation (3)

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(Total for Question 5 = 4 marks)



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| Year (July) | Making a call (€ per minute) | Receiving a call (€ per minute) |
|-------------|---------------------------------|------------------------------------|
| 2009 | 0.46 | 0.22 |
| 2010 | 0.43 | 0.19 |
| 2011 | 0.34 | 0.11 |

Source: *The Guardian*, 'EC wants price caps to prevent mobile phone bill shock', 24 September 2008

The table shows the maximum prices for making and receiving mobile phone calls permitted by the European Competition Commission. The most likely reason for these price caps is that the Commission believes that in this industry:

(1)

- A contestability is too high
- B excessive profits are being made
- C consumer surplus is too high
- D it is unnecessary to intervene since sufficient price competition exists between mobile phone companies
- E investment needs to be encouraged.

Answer

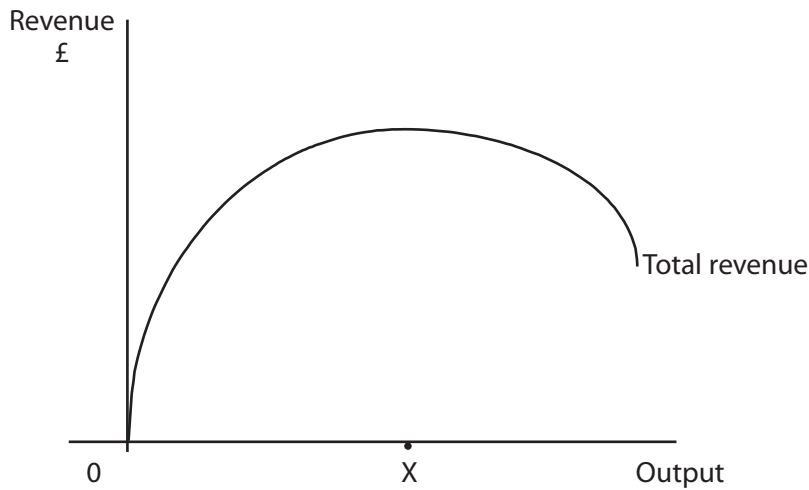
Explanation

(3)

(Total for Question 6 = 4 marks)



7



The diagram shows the total revenue curve of a firm. It can be deduced that: (1)

- A average revenue and marginal revenue will be upward sloping as output increases
- B average revenue will be equal to marginal revenue as output increases
- C average cost will be falling as output increases
- D the firm will be making maximum profit at output 0X
- E average revenue and marginal revenue will both be falling as output increases.

Answer

Explanation

(3)

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(Total for Question 7 = 4 marks)

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8 A profit-maximising firm will produce at the productively and allocatively efficient level of output in which of the following market conditions?

(1)

- A Perfect competition in the long run
- B Monopoly
- C Perfect competition in the short run
- D Monopolistic competition in the long run
- E Oligopoly.

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 18.

You should spend 55 minutes on this section.

9 The German Electricity Market

Extract 1 Electricity prices in Germany

On 22 April 2009, just days after Germany's competition regulator said it had started an investigation into electricity generating companies, RWE, Germany's second largest electricity generating company, predicted that its profits are likely to go up in 2010 and 2011. The regulator is trying to work out why energy prices in Germany are high, and in some cases rising, even though oil and gas prices have fallen sharply. It suspects electricity generating companies may have been keeping prices artificially high by, for instance, shutting power stations simultaneously to limit supplies. Finding evidence of anti-competitive behaviour may be difficult, and proving it even more so. However, it will be clear to the regulator that Germany's electricity market is not working efficiently. An attempt to liberalise the market over the past decade seems only to have worsened many of its problems.

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The first sign that the market is not working is in Germany's electricity prices, which are among the highest in Europe, even though it has an abundance of cheap coal. Moreover, Germany's electricity prices have remained persistently high even at a time when they would be expected to fall. Analysts at Credit Suisse, an investment bank, estimate that the slowing economy should reduce electricity demand by about 5%. Coal prices have dropped by 50% from 2008. Yet there is little sign that either falling demand or lower input costs are leading to cheaper electricity.

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The main reason Germany's electricity market is not working well is the lack of competition. The biggest four electricity generating companies in Germany produce more than 80% of its electricity. The top two, E.ON and RWE, produce more than 60%. Liberalisation has, if anything, reduced competition. Germany had eight big generating companies in 1997, but that number has since fallen to four because of mergers and acquisitions.

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A second problem is that Germany's biggest electricity generating companies also own the networks that distribute electricity. Critics argue that this gives them a huge advantage over smaller electricity generating companies, which may struggle to gain fair access to the networks or market information.

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Change is, however, coming for two reasons. The first is that regulators in Germany have come to realise that the electricity market is not competitive. They have the power to impose very heavy fines for anti-competitive practices. The European Commission is also having some success in forcing firms to sell off their distribution networks. For example, at the end of 2008, E.ON agreed to sell its long-distance distribution network after being investigated by the European Commission.

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Over the long run, there are ambitious plans to increase the share of electricity from renewable sources, which have high start-up costs. This may reduce the dominance of the country's four biggest electricity generating companies. Germany hopes to get as much as 30% of its electricity from renewable sources by 2020. However, despite increased competition from renewable energy providers, Germany's electricity prices are likely to keep on rising.

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Source: The Economist, 25 April 2009 'Power to the people (at a price)'

- (a) Briefly explain the form of integration described in lines 25–26. (4)
- (b) Assess the evidence that the electricity generating companies in Germany are operating as a cartel. (8)
- *(c) Apart from operating as a cartel, discuss the ways in which firms might compete in the German electricity generating market. Refer to game theory in your answer. (12)
- *(d) With reference to the last two paragraphs, evaluate the factors which might reduce the profits of Germany's electricity generating companies. (16)



M 3 6 9 8 9 A 0 1 1 2 8

(a) Briefly explain the form of integration described in lines 25–26.

(4)

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*(c) Apart from operating as a cartel, discuss the ways in which firms might compete in the German electricity generating market. Refer to game theory in your answer.

(12)

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Handwriting practice area with 25 horizontal dotted lines.



*(d) With reference to the last two paragraphs, evaluate the factors which might reduce the profits of Germany's electricity generating companies.

(16)

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(Total for Question 9 = 40 marks)



If you answer question 10 put a cross in this box .

10 The market for instant coffee

Figure 1: UK Instant coffee market shares, 2007–8

| Coffee brand | Market share (%) |
|--|------------------|
| Nescafé | 51 |
| <i>of which</i> Nescafé original | 25 |
| Nescafé Gold Blend | 13 |
| other Nescafé | 10 |
| Nescafé Decaffeinated | 3 |
| Kenco | 17 |
| <i>of which</i> other Kenco | 6 |
| Kenco Really Smooth | 4 |
| Kenco Really Rich | 4 |
| Kenco Decaffeinated | 3 |
| Douwe Egberts | 5 |
| Carte Noire | 3 |
| Others (including supermarket own label brands) | 24 |

Source: <http://www.brandrepublic.com/InDepth/Features/790070-Insight-Coffee---Inst>

Extract 1 Changing Tastes

The rise of the coffee shop has brought urban café culture to the UK. While consumers are connoisseurs of brewed and filter coffee on the high street, they are, however, opting for convenience at home, where instant coffee still dominates.

Amongst instant coffees, there is a growing willingness among consumers to trade up to premium and speciality varieties. Growing awareness of health, wellbeing and ethical trading are also affecting consumers' purchasing decisions, and, therefore, the market.

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Instant coffee accounts for more than 80% of the total UK market for coffee. Nescafé leads the field, and last year announced a £17 million promotional investment in its instant range.

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Source: [Ahttp://www.brandrepublic.com/InDepth/Features/790070-Insight-Coffee---Inst](http://www.brandrepublic.com/InDepth/Features/790070-Insight-Coffee---Inst)



Extract 2 Can instant coffee give Starbucks a boost?

In the US, instant coffee is regarded as being cheap and tasteless. The global instant coffee market is worth \$17.7 billion, just \$700 million of which is sold in America. Instead, Americans drink brewed and filter coffee – 65 billion cups of it a year.

Starbucks, best known as ‘the home of the \$4 latte’, is gambling its luxury image by entering the instant coffee market with a new brand called Via, which can be sold through supermarkets and other outlets. At first, Via will come in packets of twelve individual servings, costing less than \$1 per cup. This is much more than other instant coffees, but much less than a cup of coffee at one of Starbucks’ cafés. As John Quelch, a Harvard Business school professor said: “Instant, soluble coffee has long been an unspeakable wasteland. Conventional wisdom would be that no premium brand should go near it”.

But Howard Shultz, the chief executive of Starbucks, believes that with a superior instant coffee, he can take a share of the consumers who currently drink brewed and filter coffee at home. Starbucks says it has patents that should prevent competitors from quickly copying Via, which will go on sale in the US in June 2009. The opportunity may, however, be biggest in other countries: in the UK over 80% of the coffee sold is instant, compared with just 10% in America.

Mr Shultz insisted that the Via instant coffee brand was an innovation Starbucks had been working on for almost 20 years. It was just fortunate that the creation was perfected in time for the economic downturn. However, Starbucks also faces increased competition. For example, McDonald’s is heavily promoting its McCafé espresso-based drinks.

(Source: Adapted from *The Times Online*, 17 February 2009 (<http://business.timesonline.co.uk/tol/business/industry>) and *The Economist*, 21st February 2009.

- (a) Briefly explain the market structure which best describes the UK instant coffee market. (4)
- *(b) Assess the likely reasons why Starbucks is charging a lower price for Via instant coffee than for filter coffee sold in its cafés. (12)
- (c) To what extent is the UK market for instant coffee contestable? (8)
- *(d) Assess the methods by which the manufacturers of instant coffee might compete with each other in both the UK and the US. (16)



(a) Briefly explain the market structure which best describes the UK instant coffee market.

(4)

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*(b) Assess the likely reasons why Starbucks is charging a lower price for Via instant coffee than for filter coffee sold in its cafés.

(12)

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(c) To what extent is the UK market for instant coffee contestable?

(8)

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*(d) Assess the methods by which the manufacturers of instant coffee might compete with each other in both the UK and the US.

(16)

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(Total for Question 10 = 40 marks)

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

