GCE

Edexcel GCE

Economics (6354)

Summer 2005

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Mark Scheme (Results)

Edexcel GCE
Economics (6354)

6354/01 MARK SCHEME
June 2005

Question	Scheme	Marks
(1)	**A**	**1**
	Definition of marginal revenue (1) and average revenue (1) explanation that both are constant and equal – i.e. the firm is a price taker (1) • Also accept diagram showing horizontal AR and MR curve (1) and written explanation i.e. perfect competition (1). • Also award for recognition of constant total revenue gradient (1).	**3**
(2)	**B**	**1**
	Explanation of RPI (1) and X in terms of efficiency improvements imposed by the regulator (1) which could mean consumers gain through lower prices (1). In this case the graph shows positive X factor throughout the period. (1) • Also accept numerical application of RPI-X formula to Telecommunications. • Also accept real price of telephone calls falling (1).	**3**
(3)	**E**	**1**
	Explanation that move will require switch from MR=MC (1) to MR=0 (1) Diagram showing reduc equivalent written explanati	
(4)	**E**	**1**
	Firms in a dominant market position are likely to be few in number or the industry has a high concentration ratio (1). Sharing future price information is collusion (1). • Also accept reference to disadvantage of collusion e.g. prices will rise (1). • Also accept explanation of role of OFT (1).	**3**
(5)	**B**	**1**
	• Diagram of firm in monopolistic competition long-run equilibrium up to 2 marks. • Recognition of allocative efficiency as price equals marginal cost (1) and the firm is not allocatively efficient as price exceeds marginal cost (1). • Explanation of downward sloping demand curve (1).	**3**

(6)	**C**		**1**
	Definition of conglomerate integration (1). Application to example (1). Also accept explanation of one or more advantages of conglomerate integration (up to 2 marks).		**3**
(7)	**B**		**1**
	Definition of fixed costs as those independent of the level of output (1) and application to computer security (up to 2 marks). • Also award for distinguishing fixed costs from variable costs by explanation or example of variable cost (1). • Also award diagram of total fixed cost (1).		**3**
(8)	**A**		**1**
	Definition of oligopoly (1). Explanation of tacit collusion (1). • Analysis of kinked demand curve or game theory (up to 2 marks). • Recognition that tacit collusion may be difficult to prove (1).		**3**
(9)	**B**		**1**
	Recognition that 25% market share is a monopoly (1). Impact of reduced competition on the monopoly or consumers in terms of price, quality of service, range of choice and innovation (up to 3 marks). • Also award for explanation of work of competition authorities in terms of promoting competition / public interest(up to 2 marks).		**3**
(10)	**D**		**1**
	Definition of monopoly (1). Definition of limit pricing: ➢ Setting price below average cost of new entrants (2) ➢ Setting price low enough to deter new entrants (1) • Also award diagram of limit pricing (up to 2 marks). • Also award effects of limit pricing e.g. reduced S-R profits, higher L-R profits and less consumer choice (up to 2 marks).		**3**

Total Marks: 40

Q. 11

(a) (i) **Explain three of the assumptions behind the 'model of perfect competition.' (lines 1-2).**

Identification (1) and explanation of significance (1) of any three assumptions of the model of perfect competition: many buyers and sellers so no firm/consumer has market power, perfect information so consumers always know where the product is cheapest, no barriers to entry or exit so supernormal profits will be competed away, homogeneous good so consumers interested in price only. Price taking.

Allow explanation in the form of a diagram (up to 2 marks). **6**

(a) (ii) **Using your own knowledge, identify one product for which price discrimination has become harder following increased internet usage. Justify your answer.**

For example the CD industry where prices used to vary considerably across countries. It is now possible to buy CDs from the US and Europe online, thus tending to limit price differences to transport costs and taxes. Other examples would include cars, books, contact lenses etc.

Identification of product (1) and implicit definition of price discrimination (1).

<u>Evaluation</u> (2)

- Improved market knowledge for customers and firms **4**
- Increase in internet firms selling CDs

(b)(i) **With reference to the passage, examine why price discrimination may be more likely in the airline industry than in the market for medicinal drugs.**

Any two conditions for successful price discrimination (2).
eg market power; no resale; low costs of separating markets; different PED. Accept any two conditions.
Application to air travel and medicinal drugs (3) e.g. impossible to resell airline tickets; airlines can use internet to vary prices over time to fill each flight; medicinal drugs can be resold so secondary markets emerge.

<u>Evaluation</u> (up to 3 marks for any one point)

- Government intervention may prevent medicinal drugs firms from price discrimination. **8**
- Patents on medicinal drugs may give firm absolute monopoly power.
- The internet may be creating conditions more favourable for price discrimination in medicinal drugs.
- Significance of factors.

(b) (ii) **Using an appropriate diagram(s), examine why a firm that can identify two sets of consumers with different price elasticities of demand may find it profitable to price discriminate.**

Standard two markets+firm diagram (4), explanation of MR1=MR2=MC condition for profit maximization. Explanation of different prices relative to PEDs (2).

Evaluation (2).

- The cost of splitting the market should not exceed additional revenue gained.
- Derivation of constant MC curve from the industry diagram.

Award up to 2 marks for a diagram of first degree price discrimination (2). **8**

(b) (iii) **Outline two possible advantages of price discrimination to consumers.**

Accept any two advantages, for example:

Advantage One: Price of the good may be reduced in one market, enabling some consumers who were previously unable to afford the good now to purchase it. This could also increase consumer surplus.

Advantage Two: A firm may increase its profits and then re-invest, helping to improve product quality or reduce production costs and prices in the future.

(3+3 or 4+2).

6

(c) **Assess the impact on market contestability of increased use of the internet.**

Definition of contestability in terms of low entry and exit barriers (low sunk costs)(2).

The internet may have made markets more contestable since:

- Lower marketing costs and greater access to potential customers eg hotels, restaurants and theatres.
- Improved market knowledge for potential entrants eg prices charged and services provided by existing firms in industry.
- Lower start-up costs eg less premises and shops for many firms eg Dell computers and Amazon books, air travel and banking.
- Lower sunk costs on exit since less marketing expenditure, premises etc.
- Over time customers are more likely to use the internet.

Also accept view the internet may have made some markets less contestable if reasoned argument made. **8**

- Technical difficulty in creating websites or financial cost involved
- The ability of existing firms to extend their knowledge of customers and so impose barriers to new entrants eg limit pricing.
- Some customers may not have access to the internet.
- There are transport costs associated with delivery of products.
- Security issues.

At least two points, well evaluated, required for full marks (2+4).
e.g. Discussion of both views and weighing up their relative merits.
e.g. short-term versus long-term effect on contestability.

Q.12

(a) **Outline one reason why a small company such as Elizabeth Shaw might seek to expand its market share.**

A reason may include:

- Increase market power and thus gain some control over pricing in pursuit of supernormal profit.
- Increase efficiency by using up spare capacity in the firm (reduce short-run average costs).
- Achieve greater security by having more market share, leading to long-term survival.
- Achieve economies of scale (reduce long-run average costs). **4**

(2 marks for identification, 2 marks for explanation).

(b) **With reference to the extract, assess the extent to which the UK chocolate industry is a contestable market.**

Definition of contestable market in terms of low entry and exit barriers (low sunk costs). (2)

Chocolate industry may be contestable:

- Opportunity to expand overseas *(line 22)*
- Opportunity to increase sales in run up to Christmas *(lines 20-22)*
- Availability of information in production methods
- Possible development of niche market.

Chocolate industry may not be contestable:

- Brand loyalty such as that of Cadbury *(line 25)*
- Heavy advertising by well known companies
- Difficulty of achieving shelf space in supermarkets *(line 18)*
- Static chocolate market *(line 17)*

Application / Analysis 5 marks
Evaluation 3 marks
At least three points should be raised to achieve maximum marks.

10

(c) **Using an appropriate diagram, examine how a 'programme of advertising and promotions' (lines 7 and 8) might have contributed to an increase in Elizabeth Shaw's profits.**

Diagram showing: AR shift to right (1)
MR shift to right (1)
New equilibrium positions (1)
Increased supernormal profits (1)

Explanation that advertising and promotion leading to increased customer knowledge and brand loyalty (up to 4 marks)

Evaluation (2)

- Award diagram which shows an increase in average costs due to advertising/promotions or a written explanation (2). **10**
- The extent of the increase in profits will depend on the success of the advertising campaign.
- Impact of advertising on PED.

(d) **To what extent is a company owned by its directors following a management buyout likely to pursue different objectives than a large public limited company such as Nestlé.**

Owner-led firms may seek profit maximisation or cost minimisation or profit satisficing objectives.
plcs may seek revenue maximisation or sales growth or sales maximisation objectives.
Award any two credible objectives (2+2).

Evaluation (2)

- Recognition of separation of ownership from control in plcs.
- The objectives of plcs and owner-led firms may not reflect the above stereotypes.
- The extract suggests growth maximisation for Elizabeth Shaw, lines 11 and 21.
- Shareholders are getting more interventionist.
- Differences in short-run and long-run objectives. **6**

(e) **Examine two possible reasons why small chocolate companies such as Elizabeth Shaw find it difficult to expand when faced with large multinational rivals.**

Award two reasons five marks each.
Identification (1+1), explanation (2+2), evaluation (2+2).

Reasons may include:

- Problems faced by small companies in obtaining shelf space in supermarkets.
- Lack of distribution networks for small firms seeking to expand overseas compared with large firms.
- Small advertising budgets compared to large firms.
- Massive economies of scale enjoyed by large firms eg purchasing, financial, managerial and technical. Note, discussion of two separate economies of scale are acceptable as two separate reasons.
- Cross-subsidisation of different activities in large multinational corporations, so they can compete very effectively over price against small firms. Accept argument of predatory pricing. **10**
- Small companies may become trapped in the nîche market.

<u>Evaluation</u> (4)

- Prioritising most important obstacle to expansion
- Critical assessment of obstacles – can they be overcome?
- Fear of how large multinational companies might respond to expansion of small firms.
- The magnitude of the difference in size between small companies and global rivals.

Assessment Objectives Grid

Question	Knowledge	Application	Analysis	Evaluation	Total
Section A					
Qu.1	2	1	1		4
Qu.2	1	1	1	1	4
Qu.3	2	1	1		4
Qu.4	1	1	1	1	4
Qu.5	1	1	1	1	4
Qu.6	2	1	1		4
Qu.7	2	1	1		4
Qu.8	1	1	1	1	4
Qu.9	1	1	1	1	4
Qu.10	2	1	1		4
Total	15	10	10	5	40
Section B					
Qu.11 (ai)	3		3		6
Qu.11 (aii)		1	1	2	4
Qu.11 (bi)		3	2	3	8
Qu.11 (bii)		4	2	2	8
Qu.11 (biii)		2	4		6
Qu.11 (c)	2		2	4	8
Total	5	10	14	11	40
Qu.12 (a)	1	1	2		4
Qu.12 (b)	2	2	3	3	10
Qu.12 (c)		4	4	2	10
Qu.12 (d)		1	3	2	6
Qu.12 (e)	2	2	2	4	10
Total	5	10	14	11	40
Grand Total A+B	20	20	24	16	80