Mark Scheme (Final)
January 2009

GCE

GCE Economics (6354/01)

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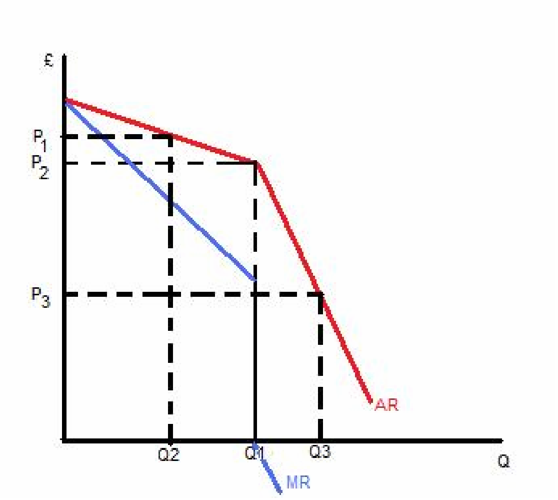
General Marking Guidance

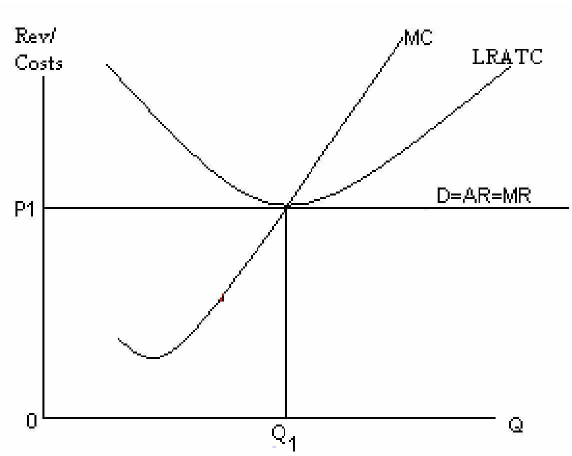
- All candidates must receive the same treatment. Examiners must mark the first candidate in exactly the same way as they mark the last.
- Mark schemes should be applied positively. Candidates must be rewarded for what they have shown they can do rather than penalised for omissions.
- Examiners should mark according to the mark scheme not according to their perception of where the grade boundaries may lie.
- There is no ceiling on achievement. All marks on the mark scheme should be used appropriately.
- All the marks on the mark scheme are designed to be awarded. Examiners should always award full marks if deserved, i.e. if the answer matches the mark scheme. Examiners should also be prepared to award zero marks if the candidate's response is not worthy of credit according to the mark scheme.
- Where some judgement is required, mark schemes will provide the principles by which marks will be awarded and exemplification may be limited.
- When examiners are in doubt regarding the application of the mark scheme to a candidate's response, the team leader must be consulted.
- Crossed out work should be marked UNLESS the candidate has replaced it with an alternative response.

Question Number	Answer	Mark
	Notes for Section A: • Candidates can be awarded up to a maximum of two marks for correct explanation if the wrong key is selected. • Candidates can be awarded a maximum of two marks for identifying and explaining up to two incorrect options.	

Question Number	Answer	Mark
1	**B** • Identification of economies of scale (**1**) • Diagram showing falling long-run average cost (**1**) • Application and analysis to road haulage: technical economy of scale (volume based or increased dimensions) (**1**) means lower cost per ton of goods transported / savings on wage costs / fuels costs / tax disc / increased capacity (identification of concept **1** + explanation **1**)	**(1)** **(3)**

Question Number	Answer	Mark
2	**C** • Definition of contestability (or non-contestability): low sunk costs / low entry and exit barriers (**1**). • Application and analysis: Total advertising expenditure by the four supermarkets has increased (**1**); advertising expenditure is a sunk cost / entry barrier which reduces contestability (**1**). Also award: advertising expenditure may create more brand loyalty and so act as a barrier to entry for new firms (**1**).	**(1)** **(3)**

Question Number	Answer	Mark
3	**A** • Characteristic of oligopoly (few sellers, many buyers/large scale industry, dominated by a few firms, price rigidity) (**1**) • Since demand is inelastic, a price cut will cause total revenue to fall (**1**). • A price cut would result in a price war and hence demand is inelastic **(1)** • Diagram of kinked-demand curve, depicting a fall in revenue as price is cut (**1**).  • Example of non-price competition **(1)**	**(1)** **(3)**

Question Number	Answer	Mark
4	**C** • Definition of productive efficiency (the most output for the least inputs or lowest point on the average cost curve or minimum efficient scale) or identifying it as output where AC=MC (**1**) • Definition of allocative efficiency or identifying it is output position where MC=AR or price=MC (**1**) • Diagrammatic analysis of firm in long run perfect competition **(1)** indicating productive **(1)** and allocative **(1)** efficiency at an output of Q1  	**(1)** **(3)**

Question Number	Answer	Mark
5	**E** • Explanation of concentration ratio (the combined market share of the x largest firms) (**1**). • Identification that market structure is oligopoly (**1**). • Application to data, for example, four-firm concentration ratio increased from 66% in 1998 to 76% in 2008 (**1+1**) **OR** calculation of increase in market concentration of 10% (**1**).	**(1)** **(3)**

Question Number	Answer	Mark
6	**D** • Definition of privatisation (sale of state assets to the private sector) (**1**). • Identification of two benefits from privatisation (**1+1**) **or** identification of one benefit explained **(1+1)**(improve government finances / increase efficiency / competition / increase share ownership).	**(1)** **(3)**

Question Number	Answer	Mark
7	**D** • Definition of marginal revenue i.e. $\frac{\Delta TR}{\Delta Q}$ (**1**). • Marginal revenue is zero at point X (**1**). • Annotation of diagram, showing total revenue at a maximum above position X (**1**). • Explanation of why revenue maximisation occurs at MR=0 (marginal analysis to the left of X MR is positive and to the right MR is negative) **(1).**	**(1)** **(3)**

Question Number	Answer	Mark
8	**A** • Definition of diseconomies of scale (long-run average costs rise as output increases) (**1**). • Diagram depicting diseconomies of scale (**1**). • Explanation of management co-ordination problems due to the huge range of products sold by the company (**1 + 1**).	**(1)** **(3)**

Question Number	Answer	Mark
9	**B** • Identification and explanation of illegal restrictive practices, for example collusion / price fixing / predatory pricing / limit pricing (**1+1**). • Identification of the role of the OFT in reducing these illegal practices or promoting competition or protecting consumer interests or promoting the public interest **(1).** • Advantage of increased competition e.g. consumer choice / competitive prices / product quality / investment in an industry / public interest (**1**). • Also award for reference to whistle blowing which makes it harder for firms to engage in illegal anti-competitive practices (**1**).	**(1)** **(3)**

Question Number	Answer	Mark
10	**D** • Any three characteristics of monopolistic competition, at least one applied to window cleaning services for full marks for example (**1+1+1**): ➢ Low entry and exit barriers – just need bucket, sponge, car shampoo. ➢ Supernormal profits in short-run but only normal profits in long-run. ➢ Many producers and consumers acting independently. ➢ Product differentiation – location / hours opening / type of cleaning fluids / dress of personnel. ➢ Downward sloping AR curve, so some ability to influence market price. Also award a diagram of monopolistically competitive firm in short-run or long-run equilibrium (**1**). Note: there must be application to window cleaning for full explanation marks.	**(1)** **(3)**

Question Number	Answer	Mark
11(a)(i)	• Identification of oligopoly (**1**), and definition (few sellers or large scale industry or strategic interdependence) (**1**). • Application to the data, for example: three-firm concentration ratio is 64%; four-firm is 78%; five-firm is 89%; six-firm is 100%. (**2**)	**(4)**

Question Number	Answer	Mark
11(a)(ii)	• Identification of two motives (**1+1**) and their analysis (**2+2**). ➢ Recognition of horizontal integration ➢ Increase market share / sale revenue / increased profits / reduced competition / increase barriers to entry / increased economies of scale (accept two types of scale economies as two alternative motives). • **Evaluation (2)** ➢ Discussion on eligibility of Competition Commission investigation and possible blocking of merger (since 27% market share which exceeds the 25% market share definition of a firm which may exhibit the properties of a monopoly). ➢ Prioritisation of the motives – perhaps economies of scale are more important than increased market power / share (especially since an even larger company exists – British Gas with 32% market share). ➢ Demand for British Gas or other rivals may be price inelastic in demand reducing the possibility that the new firm will be able to poach consumers. ➢ Discussion of diseconomies of scale arising from an overexpansion of the business ➢ Discussion of the possibility that the merger may not succeed or cost significant amounts to fully integrate the business	**(8)**

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<tr><th>Question Number</th><th>Answer</th><th>Mark</th></tr>
<tr><td>11(b)</td><td>

Understanding of collusion / tacit collusion (firms restricting competition between themselves in order to increase profits, or, firms acting as if they have made an agreement despite no contact) (2).
Collusion may have taken place due to: (2+2+1 or 3+2)

Claims made by Mr Asher of Energywatch / similar energy prices charged as shown in Figure 2.
Energy firms raise prices by similar amounts and at similar time
Oligopolistic market structure / reference to Figure 1 / significant barriers to entry.
High profits gained e.g. British Gas / Ofgem investigation into the high profits.

• Evaluation (2+1 or 1+1+1)
Developing alternative view: collusion unlikely since:

Figure 1 shows different prices of energy bills by firm
Firms have different costs structure – so less incentive to collude
Firms may have similar cost structures hence price changes are similar
Severe penalties exist for collusion, for example, fines up to 10% of annual sales revenue / prosecution of directors (with jail sentences) / whistle blowing encouraged.
5.1 million gas and electricity customers have switched supplier alone in 2007, suggesting healthy price competition.
No evidence of collusion so will be hard to prove
Firms have just been reacting to changes in the wholesale market

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Question Number	Answer	Mark
11(c)	• High profits are / are not justified; award up to 6 marks for one view and 2 marks for the alternative view. • High profits are justified since: (**2+2+2 or 3+3**) ➢ Energy companies need high profits to invest in renewable energy sources, such as wind and wave power. ➢ The profits will ensure long-term energy supplies to the UK. ➢ Profits can be used to improve product quality / safety, benefiting consumers. ➢ Energy companies are very large with large assets and sales revenue; British Gas has 8.8% profits to sales revenue. ➢ Price volatility in the wholesale energy market – firms may have to cover possible big rises in purchasing their energy supplies, by setting high gas and electricity prices for households. ➢ Profits are a reward to risk taking. Shareholders should receive higher dividends too. ➢ Profits act as a signal for new entrants / increasing supply. In the long-run profits may fall to much lower levels. • **Evaluation:** High profits are not justified since: (**2**) ➢ Large price rise of 15% in one year (Extract 2, line 4). ➢ High profits may reflect collusive practices / barriers to entry / little chance of competing them away. ➢ Profits are a result of external factors such as increased demand due to a cold winter Discussion of whether these profits are normal or supernormal.	**(8)**

Question Number	Answer	Mark
11(d)	• An understanding regulatory price controls, for example, the RPI-X or RPI+K formula (**1**). • An understanding of 'consumer interest', for example, price / quality / consumer choice / customer service / innovation (**1**). • Application and analysis of price controls to consumer interest: (**2+2**) ➢ Price controls may limit price increases (or reduce prices) and so protect consumer surplus. ➢ Price controls may encourage efficiency in the industry which lead to lower unit costs / prices. ➢ Price controls mean firms may have to find other ways of competing, for example, customer service and product quality and innovation. • **Evaluation (2+2**) ➢ Price controls may be too harsh, so reducing company profits and leading to less investment / less efficiency. This could damage consumer interests in the long run. ➢ Price controls may be too generous, so increasing profits. This is associated with regulatory capture or an inability to access accurate information from the firm. Consumer interests are not protected. ➢ Time span of price controls; it may be hard to predict technological change in the industry over a five year period. ➢ Discussion on why price controls were removed in the first place, for example, had they been a success or failure or is there sufficient competition in the industry? ➢ Firms need to make high profits to reinvest and therefore best approach is RPI + K or equivalent	**(10)**

Question Number	Answer	Mark
12(a)	• Identification of a loss between 2006 and 2008 (**1**). • Reference to Figure 1 which shows a falling number of letter deliveries (**1**) / due to growth of substitute forms of communication, for example, the internet (**1**). • Deregulation has allowed competition in letter delivery market (**1**) / reference to TNT or nineteen firms compete and have gained significant share of business mail (**1**).	**(5)**

Question Number	Answer	Mark
12(b)	• Identification of two **non-price** strategies (**1+1**) and their analysis (**2+2**). Strategies may include: ➢ Further increases in efficiency, for example, cuts in wages, longer hours, flexible working, change to pension scheme, reduce staffing levels. ➢ Reduction in services, for example, Saturday deliveries. ➢ Investment into new technology to increase productivity. ➢ Improve product quality. ➢ Marketing campaign to win business customers. ➢ Advertising ➢ Promotion through other means ➢ Diversify into internet services. ➢ **Buy One Get One Free is a pricing strategy, and therefore unacceptable.** • **Evaluation (2+2)** A range of ideas could be developed, for example: ➢ It may be harder to make further increases in efficiency; postal workers are likely to strike over attempts to worsen working conditions. ➢ 50,000 postal jobs already cut by Royal Mail – so hard to find scope for further redundancies. ➢ Investment is expensive and there is no guarantee of success. ➢ Improving product quality is expensive. ➢ Marketing is expensive and no guarantee of success.	**(10)**

Question Number	Answer	Mark
12(c)	• Definition of a monopoly in terms of single seller / few close substitutes (**1**). • Legal definition: firm with 25 per cent or more market share (**1**). • Evidence from extract suggests the Royal mail is still a monopoly, with 80 per cent of overall mail market / 60 per cent of business mail market (**1**). • Regional monopoly in certain rural areas **(1)** or monopoly in post boxes **(1)** • **Evaluation (1)** ➢ Royal Mail no longer considered a natural monopoly or virtual monopoly instead can be considered an oligopoly since genuine competition exists. ➢ Royal Mail's monopoly is under threat, especially in the business mail market. Eighteen other firms have entered letter delivery market. Over time its market share is likely to fall further.	**(4)**

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- Definition of price discrimination (**1**). The sale of the same good to at least two different markets at different prices.

- Identification of second-degree or third-degree price discrimination **(1) Do not accept first degree price discrimination.**

- Identification and explanation of the conditions necessary for price discrimination to be effective (**1+1+1**)

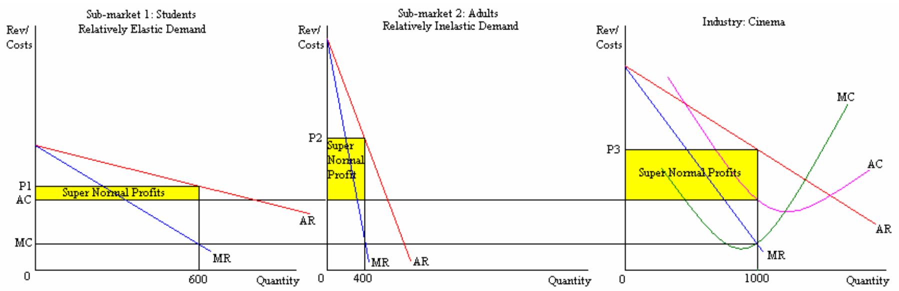
  - ➢ A degree of monopoly or market power / customers faced with higher prices cannot go elsewhere.
  - ➢ Ability to separate customers into different markets / prevent leakage between them.
  - ➢ Different price elasticities of demand between markets / different prices can be charged in order to increase revenues or profits.

- Application of price discrimination to reducing losses in Royal Mail's letter delivery service **(1)**

- Diagrammatic or written analysis showing (**4**)

  - ➢ Different elasticities of demand (different AR & MR gradients) (1)
  - ➢ Different prices shown – with a higher price where demand is inelastic (1).
  - ➢ Marginal cost or average cost line shown (1).
  - ➢ Areas of profit shown (1).

  Accept any appropriate price discrimination diagram including:



- **Evaluation (2+2)**
  - ➢ Although Royal Mail has a large share of the letter delivery market, there are eighteen other companies who could capture more customers if prices are set too high.
  - ➢ A cost involved in separating customers into different markets – however, this might be achieved easily if just two different prices set: small and large users of the service.
  - ➢ Demand may be price elastic for some consumers and small

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	businesses due to development of alternative forms of communication (internet email / mobile phone / text messaging). This means Royal Mail may struggle to increase prices for these customers. ➢ The overall letter delivery market is in decline, so it is harder for price discrimination to work in reducing losses. ➢ Postcomm may limit the price increases that Royal Mail seeks to reduce losses.	**(12)**

Question Number	Answer	Mark
12(e)	• Candidate can take either view (**3+2+2 or 4+3):** consumers / businesses may lose out since: **Candidates must discuss both consumer and business interests to obtain full marks otherwise a maximum of 5 marks** ➢ Higher prices for letters / leads to a fall in consumer surplus. ➢ Quality of service may diminish if universal delivery service at uniform price is scrapped or Saturday service scrapped. ➢ Royal Mail losses mean less funds to invest in service improvements. ➢ Loss of economies of scale for Royal Mail. • **Evaluation (2)** ➢ Even if price of letters go up – still a relatively insignificant cost to consumers and producers. ➢ More choice for consumers. ➢ More choice for consumers may cause confusion ➢ Large bulk business users have gained significantly via lower prices. ➢ New entrants have led to increased investment. ➢ Competition is forcing Royal Mail to increase efficiency as shown by cost cutting. X-inefficiency should fall. ➢ The market is in decline – increased competition necessary to find ways of reducing this decline. ➢ Strong brand loyalty for Royal Mail will reduce the effectiveness of competition	**(9)**