WELSH JOINT EDUCATION COMMITTEE
General Certificate of Education
Advanced

CYD-BWYLLGOR ADDYSG CYMRU
Tystysgrif Addysg Gyffredinol
Uwch

374/01

ECONOMICS EC4

A.M. WEDNESDAY, 13 June 2007

(1¼ hours)

ADDITIONAL MATERIALS

In addition to this examination paper, you will need a 12 page answer book.

INSTRUCTIONS TO CANDIDATES

Answer **one** of the questions.

INFORMATION FOR CANDIDATES

The number of marks is given in brackets at the end of each question.

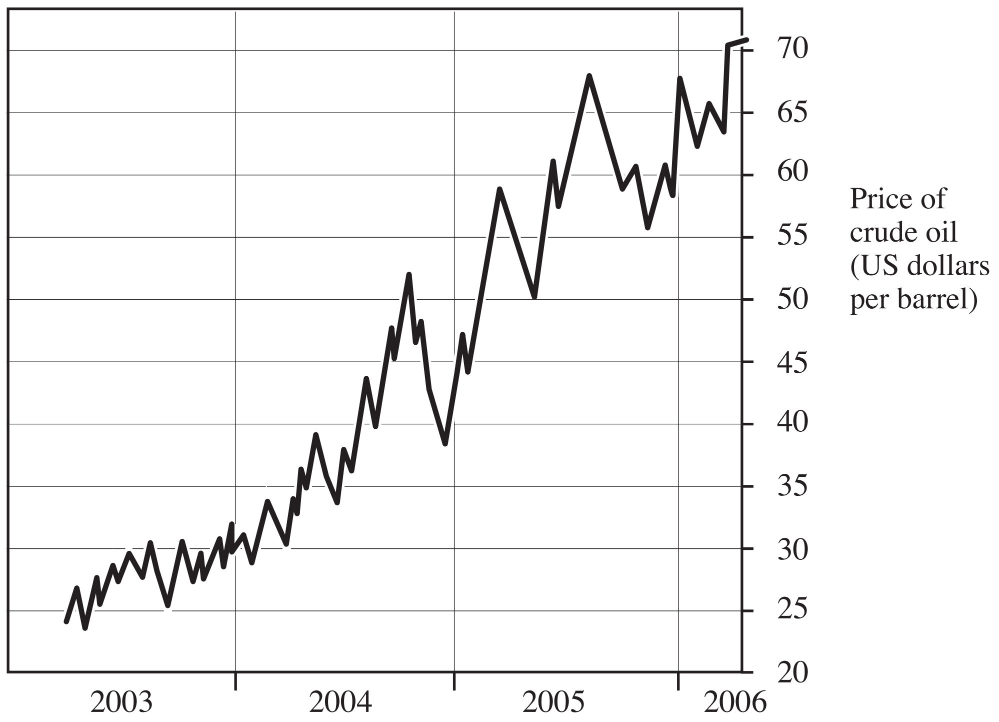
You are reminded of the necessity for good written communication and orderly presentation in your answers.

Answer **one** *question.*

1. Study the following information and then answer the questions that follow.

Oil giants can't drill fast enough

Investment in new fields is being hit by shortages of skills and equipment.



Colin Manson and a colleague set up Xodus in Aberdeen five months ago. Since then Xodus has taken on more than 30 people and plans to grow to a workforce of 250 in the next three years. Xodus, which helps oil companies to assess the economics of new fields, is one of the growing number of support-services companies helping the world's oil producers to record profits.

Last week, Exxon Mobil, the world's largest oil company, announced a profit of $36 billion, the biggest in the history of America. On Thursday, Shell set a new record for a British company - $23 billion. The bumper figures are due to the rise in the price of oil and gas, which do not seem to have significantly reduced demand in the developed economies. At the same time rapid economic growth in economies such as those of India and China has contributed to a large increase in world demand for oil.

The support-services sector – from contractors who carry out oil-finding surveys to consultants and oil-rig providers – is booming as the oil giants' profits trickle down the industry. Many firms are reporting that revenue has doubled in a year.

Jeff Corray, UK senior oil and gas partner at consultant KPMG, said the support services sector was now beginning to feel the benefits of investment by major oil companies. He said: "Profit margins have been slim for years. Oil companies were reaping the benefit of the high oil price but not investing in new equipment. Now service companies are reaping the rewards".

Owners of offshore drilling platforms are among the first to profit during an oil-industry upturn. The most sophisticated deep-water drilling rigs cost up to $500,000 a day to hire, compared with $150,000 two years ago. The going rate for hiring a floating rig is $250,000 a day. Two years ago it was $50,000 a day. With the world fleet of such rigs numbering less than 100, demand far outstrips supply.

The oil giants' recent profits may be huge, but they cannot spend the money as quickly as they would like on new developments. The sector is suffering from a lack of support services, equipment and skilled workers. Work in the industry is seen as dirty and arduous and this puts people off. Last year, only 200 petrochemical engineers graduated from American universities compared with thousands in the industry's 1970s heyday. Britain produced 88 from three or four universities.

Stats UK, a specialist oil-engineering firm in Aberdeen, was forced to search for workers in Poland because the skills shortage in the British oil industry has become so acute. The oil industry stopped taking on large numbers of graduates after the sharp downturn in 1986. It is now paying the price – the average age of an American oil worker is over 50.

Exxon pledged last week to invest its bumper fourth-quarter profits – more than $10 billion on revenues of $100 billion – in new refineries and exploration. BP, the leading British company, expects to spend $15 billion this year. With oil prices high, companies have been returning to reserves that were uneconomical to extract during the years of low prices. However, each $1 billion of new investment carries with it $1 billion of new overheads.

Oil firms are having to push into increasingly inhospitable terrain to find deposits, drilling to record depths to bolster production in older fields and exploring far-flung reaches of the globe in search of new reserves. Exxon said that deep-water exploration, at present a very small proportion of exploration, will account for 20% of the oil it produces by 2010.

President George Bush said last week that Americans were addicted to oil. It appears that the oil industry, grown used to low levels of investment for 10 years, is addicted to its profits and has been keeping them for shareholders rather than reinvesting.

The oil companies have to overcome outdated attitudes to investment. They have been wary ever since the oil-price slump of the 1990s, when they cut back drastically on investment. Even after prices began to rise again, they were reluctant to increase investment. Far from spending less, experts believe the oil industry should be spending more on investment in new oil fields.

Infuriated by the massive increase in the oil producers' profits, some commentators are calling for a 'windfall tax' – a special tax on oil company profits for this year only. They say that this is justified because the companies have done nothing to deserve their extra profits, which are solely due to the sudden rise in oil prices.

Adapted from The Sunday Times, 5 February 2006

(a) Explain, with the aid of a diagram, the effect of rising oil prices on oil companies such as Exxon and Shell. [8]

(b) What does the article suggest about the effect of rising oil prices upon the supply of support services to the major oil companies? [8]

(c) Discuss the case for the Government placing a 'windfall tax' (line 52) on the increased profits of oil companies such as Shell and BP. [12]

(d) To what extent are rising oil prices necessarily bad for UK firms **and** the UK economy? [12]

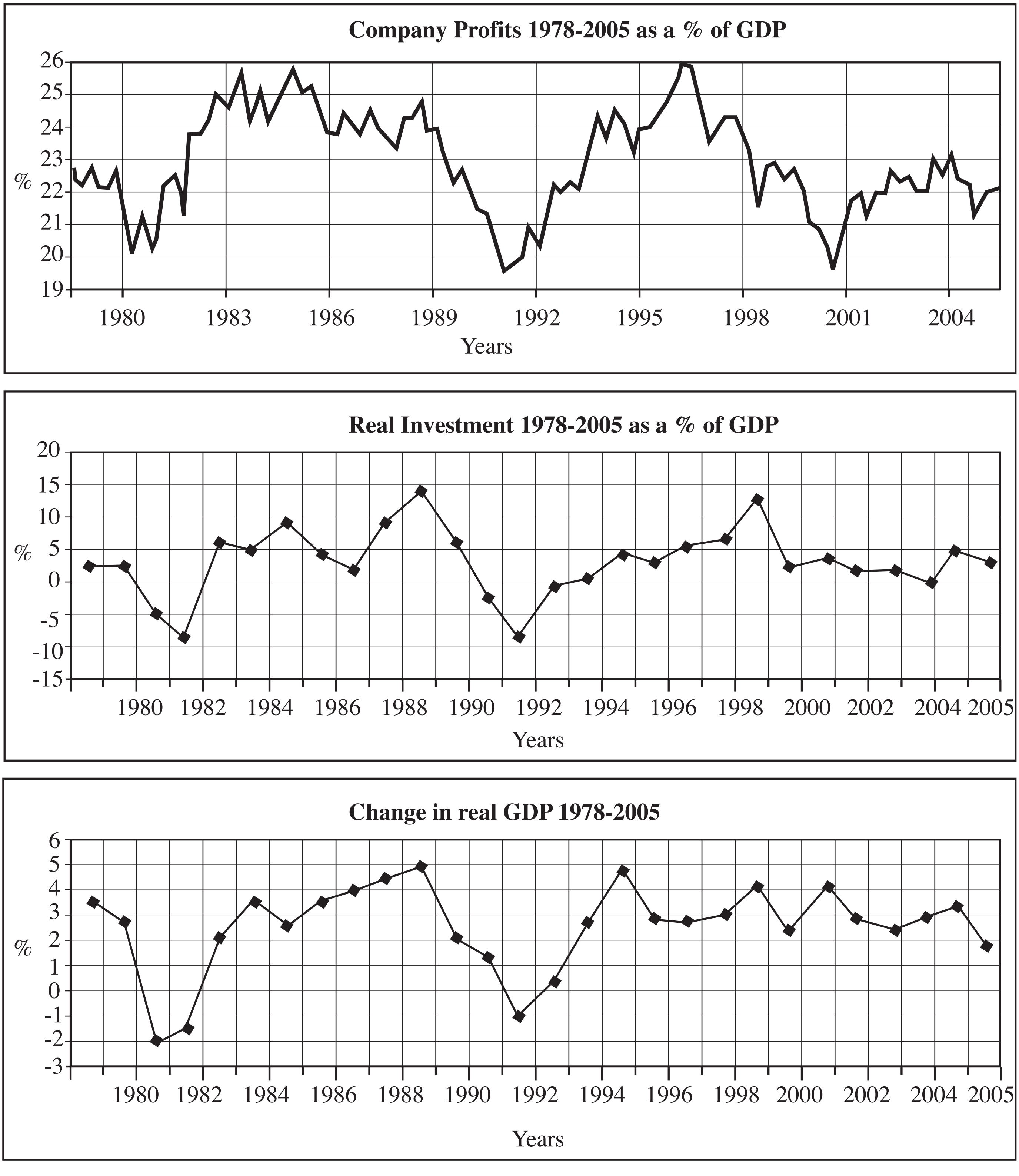
2. Study the following information and then answer the questions that follow.

CBI Recommendations for the 2006 Budget

Submission to HM Treasury - March 2006

The Confederation of British Industry (CBI) is the UK's leading business organisation, speaking on behalf of some 240,000 businesses that together employ around a third of the private sector workforce. This report sets out the CBI's recommendations for the Spring 2006 Budget.

Figure 1 - UK Profits, investment and economic growth 1978-2005



Problems for UK businesses

UK business has become less competitive. Business investment as a proportion of GDP is at an all time low and firms' profitability is under pressure. In 2005 real business investment, 'a key creator of long-term economic growth', grew by just 1.6%.

Much of this is due to intense global competition, rising input costs and the slowdown in the UK economy, but it has been made worse by domestic policy changes which have increased business costs.

Increased global demand for inputs, driven by the rise of India and China, has created an environment of strong input prices - notably of commodities and oil. For UK firms this has been compounded by domestic gas and electricity price rises.

At the same time, more intense global competition has reduced firms' pricing power, with import and export prices down by 15% compared with 1996. The net impact has been to squeeze profit margins and in turn profitability. In this environment any government-imposed cost and tax rises cannot simply be passed on to the final customer either at home or abroad.

Since 1997 Budget measures have created £50bn extra business taxes. By 2010 the extra tax burden will reach £80bn.

Figure 2 – UK's tax burden

Country	US	Germany	France	Ireland	Holland	UK	Average
Total basic business taxes (as % of GDP)	6.9	9.0	12.4	7.4	8.6	8.5	8.8
All taxes as % of GDP	25.4	34.6	43.7	30.2	39.3	36.1	34.9

CBI recommendations for the 2006 Budget

1. **Reduce the business tax burden**. The priority of the 2006 Budget and future Budgets must be to improve business competitiveness and stimulate investment by halting the rise in the business tax burden and starting to reduce it. This reduction in the general business tax burden should be focused on an across-the-board reduction in a main business tax e.g. corporation tax or employer national insurance contributions. The Government should also ensure that there is no rise in the Uniform Business Rate on business premises.

2. **Cut public spending.** The reduction in taxes can be financed by restraining the growth of public spending over the next two years to a rate in line with the growth of the economy as a whole. Increasing spending by 10%, rather than the 12% planned, would yield £10bn in cost savings. Such savings would allow the health of the public finances to be reinforced, while reducing the business tax burden by £5.5bn, without raising other taxes.

3. **Cash grants to potential high-growth small and medium-sized enterprises (SME's).** The government should put in place this year targeted measures to support enterprise, particularly in science and industries producing new products.

4. **A reduction in the amount of rules and regulations that SME's have to obey.** The rules that small firms have to follow, such as reporting information to Government Departments, require too much staff time. The Government should aim to reduce by 25% the amount of administration required from SME's.

Adapted from CBI 2006

(a) Explain the relationship between investment and profits, as shown in Figure 1. [8]

(b) Using Figure 1 explain, with the aid of a diagram, why investment may be 'a key creator of long-term economic growth' (lines 8-9). [8]

(c) Discuss how far the UK's 'tax burden' (Figure 2) might be responsible for the low profitability of UK firms. [12]

(d) Apart from cutting taxes, discuss how far the CBI's recommended policies are likely to improve the competitiveness of UK businesses. [12]