

GCE

Edexcel GCE

Economics (6354/01)

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Mark Scheme (Results)

## 6354: Industrial Economics

### Mark scheme

#### Section A

#### Key to answers

1	2	3	4	5	6	7	8	9	10
C	A	E	E	E	A	C	B	B	A

Award up to 2 marks for elimination of incorrect keys.

#### Q1 Answer C

Definition of horizontal merger (allow merger at same stage of production or increase in market share)(1)

Correct definition of scale economies (must include **average** costs)(1)

Application of scale economy to supermarkets (1)

Impact of cost cutting on the level of profit, or other illustration of the motive (1)

#### Q2 Answer A

Definition of oligopoly (e.g. a few large firms in the industry).(1)

Correct definition of concentration ratio (e.g. a reference to market domination) (1)

Calculation of a 3 (53%) or 4 (64%) or 5 (75%) firm concentration ratio for the digital camera market (1) or other use of relevant data (1).

#### Q3 Answer E

Numerical calculation or diagram of marginal cost from data (1) and AR (1)

Connection between gradient of AR and imperfect competition (1)

Correct definition of marginal cost (1)

No marks for MR calculation or abstract market structure diagram.

#### Q4 Answer E

Explanation that in the short run only variable costs have to be covered, i.e. short run equilibrium (2)

Application of variable costs to rail travel (1)

This is not a long run position, or other evaluative point (1)

Correct definition of price discrimination (1) and explanation up to (2) marks.

#### Q5 Answer E

Correct definition of AVC (must have sense of per unit) - or formula (1)

Correct calculation shown ( $\pounds 5000 \div 5000 = \pounds 1$ ) or other use of data (2)

Also award annotation of diagram (1)

Distinguishing between TFC and TVC (or AFC and AVC) (1).

#### Q6 Answer A

Correct explanation of limit pricing: allow one mark for illustration that the firm sets price just below the predicted average costs of production of a new entrant (1); 1 mark for prohibiting entry (1); 1 mark for disincentive (1).

Also accept valid diagram showing limit pricing, if cost differences are illustrated. (1)

Outline of effect of a patent right expiring i.e. opening up of competition. (1)

Application to pharmaceuticals industry (1)

**Q7 Answer C**

Definition of sunk costs (unrecoverable costs) (1)

An example of a sunk cost e.g. advertising, specialised machinery (1)

Award explanation that there is a reduction in contestability (1)

Application to the computer games market e.g. the need for computer games to play on the handheld computers (1)

**Q8 Answer B**

Definition of oligopoly or non-price competition (1)

Explanation of a price fall when demand is price-inelastic will lead to a fall in total revenue (2)

Example of non-price competition applied to soap powder (1)

**Q9 Answer B**

Explanation of revenue maximisation ( $MR=0$ ) (1)

Explanation of super-normal profits as  $OKLZ - ONMZ$  or as profit per unit  $LM$  multiplied by total output  $MN$  (2)

Also award for shading in of super-normal profits on diagram (1)

Diagram showing  $TR$  in line with  $MR=0$  (2)

**Q10 Answer A**

Aims of Competition Commission - increasing competition, and allow public interest arguments (1). The merger threatened to reduce competition (1) in an already highly concentrated market (1)

Reference to one advantage or disadvantage to consumers e.g. consumer choice, higher price, service quality etc in context of the music industry (1)

Question 11            The Low Cost European Airline Market

(a) Explain why a low cost airline company such as Easy Jet 'typically generates all its profits' in the second half of the year (line 6).

(4)

- The demand for air travel is seasonal with the greatest number of customers in the summer months. Higher demand means higher revenues as firms can raise prices and achieve higher profits. Also accept the reverse argument for off peak periods.
- Airlines may have high fixed costs which have to be met all year round whether revenue is high or low.
- Fuel costs fall in the summer months, hence profits can increase as costs fall.

(2 x 2 marks or up to 1 x 4)

(b) With the aid of an appropriate cost and revenue diagram, analyse the reasons that might explain Alitalia's 'large financial losses' (line 8).

(8)

- Diagram of average cost and average revenue, depicting a loss making position for a firm. Also accept diagram of total costs & total revenue, depicting a loss making situation. (4)
- Analysis of a falling average revenue curve for Alitalia due to increased competition (2)
- Analysis of rising average cost curve, leading to a financial loss which might include rising fuel costs shown in figure 2 (2).

(c) Examine the extent to which the low cost airline market has achieved economic efficiency.

(8)

- Understanding of productive efficiency (2) and allocative efficiency (2) or other.
- Productive efficiency has not been reached since spare capacity exists in the industry (*line 16*) (1).
- Allocative efficiency may have been achieved since there is much consumer choice & low prices (1).

Award a maximum of 5 marks in this section.

Evaluation - up to 3 marks for any one point, or award two points

- Falling airline prices act as an incentive for firms to cut production costs and so the market is heading towards productive efficiency.

- Closure of some firms suggests an inability to meet customer requirements so allocative efficiency not achieved.
- The entry of new firms suggests scope still exists to achieve allocative efficiency.

- (d) Examine the ability of Easy Jet and Ryanair to survive the pressures of 'lower air fares and increased competition' (line 17).

(10)

The extract mentions three factors, namely: economies of scale, strong branding and established networks. Explanation of each strategy (1+1+1) and application to airline industry (1+1+1). Allow other factors, such as price discrimination.

Evaluation - up to 4 marks (2 x 2 points or 4 x 1 point)

- Danger of diseconomies of scale.
- Price may be more important than branding for many travellers.
- An established network implies high start-up costs and high fixed costs.
- Also accept reference to Figure 1 which shows a strong increase in passenger numbers for the two airlines.
- Prioritise the factors with justification.

- (e) Assess the extent to which the European airline industry is contestable.

(10)

Award (3 x 2 marks) or (2 x 3 marks) for factors explaining either:

Contestable Market

- The extract refers to firms exiting the industry (*lines 8-11*), suggesting market contestability.
- Firms are poised to enter the market (*line 11*) suggesting a threat of potential competition for incumbents and hence market contestability.
- Falling profit levels and even losses for existing airlines.
- Expansion of EU (*lines 12-13*) has increased opportunities for air firms.
- Possibility of leasing planes to reduce start-up costs.
- Use of internet bookings to reduce fixed costs.
- Strong second hand market in airplanes.

Non-Contestable Market

- Economies of scale for market leaders Easy Jet & Ryanair. They are likely to win any price war.
- Strong branding, implying high marketing costs (sunk costs).
- Established network e.g. air routes, flight slots, staffing, planes.

Evaluation - up to 4 marks (2 + 2 points)

- Critical distance
- Prioritise the factors with justification.

- Questioning the validity of factors explained
- Short-run suggests market contestability but if consolidation continues then in the long-run the market may become less contestable.
- Inadequacy of information provided?



Question 12      The Regulation of Royal Mail

(a) (i) Using a diagram, explain the concept of monopoly. (4)

- Definition of monopoly (some sense of market dominance and one other comment) (2). If just definition of monopoly in terms of 25% or more market share (1). Allow natural monopoly with appropriate analysis.
- Diagram (one mark reserved for  $MC=MR$ ) (2)

(a) (ii) To what extent is the Royal Mail letter delivery service a monopoly? (6)

- Royal Mail appears to have a monopoly due to powerful entry barriers - particularly economies of scale (2).
- Despite one year of exposure to competition the Royal Mail retains almost 100% market share (1) (*lines 15 & 16*)
- Accept an alternative argument that Royal Mail no longer has a pure monopoly in urban areas due to opening up of competition. Award a maximum of 3 marks in this section

**Evaluation** - up to 3 marks for any one point.

- However, Royal Mail's monopoly position is under threat since it is being forced by Postcomm to allow incoming firms access to its distribution network
- Also award for alternative forms of evaluation e.g. prioritising the most important entry barrier or the threat posed by new technology.
- Brand recognition and customer inertia are not completely insurmountable barriers to entry.
- Is it a *natural* monopoly - i.e. competition would involve duplication of network/delivery?

(b) (i) Royal Mail charges different prices to bulk mailers and small users of the letter delivery service. Analyse *two* possible objectives of this policy.

(6)

3 marks per valid objective.

- Profit maximisation - costs may be lower for bulk users.
- Retain major customers and hence market share (may include elasticities).
- Increase profits in the short or long run (price discrimination model may be used).
- Compete effectively against incoming firms (limit pricing or other valid model may be used).

(b) (ii) Outline the conditions necessary for Royal Mail to undertake successful price discrimination.

(6)

3 factors with relevant 2 marks each, or 2 factors developed to 3 marks each

- Different price elasticities of demand in sub-markets
- Some degree of monopoly power
- Ability to prevent arbitrage between markets

- (c) Examine the likely impact of 'price-capping' (line 4) and 'performance targets' (line 11) on the efficiency of the UK's postal services.

(10)

**Price capping (3 marks):** Regulator has set a reduction in real price of Royal Mail services between 2001-2006 (1).

- Royal Mail may seek to increase productive efficiency in order to achieve profits. Responses could refer to production costs, investment and employment levels.
- Royal mail may become less allocative efficient due to emphasis on cutting unit costs to maintain profits. (Note recent scrapping of Royal Mail post trains and second day deliveries).
- Price control acts as a surrogate for competition  
Up to 2 marks for development

**Performance targets (3 marks):** Regulator attempting to improve standards of customer service; next day delivery target for 1<sup>st</sup> class mail of 92.5%, or other performance targets e.g. reduction in percentage of missing mail (1).

- To achieve performance targets, Royal Mail may need to increase investment and / or change working practices.
- Royal Mail need to sacrifice profits and productive efficiency in order to achieve allocative efficiency i.e. improving customer service will require extra spending.  
Up to 2 marks for development.

**Evaluation up to 4 marks.** Factors might include:

- Discussion of most effective regulatory measure, e.g. contrast with deregulation or increased competition
- Regulatory capture
- Asymmetric information arguments
- Information transaction costs (overload of information is a cost when making decisions)
- Regulatory failure (e.g. inappropriate price caps) might make the services *less* efficient or have inappropriate impact on investment levels, or if the company is fined this might have an adverse effect on performance
- Natural monopoly argument used as critical distance

- (d) Assess the extent to which Postcomm's decision to open up the letter delivery market to competition is in the interests of consumers.

(8)

Competition may bring the standard benefits to consumers e.g. greater choice, lower prices, increased consumer surplus, improved quality (2+2).

Evaluation up to 4 marks. Evaluation might include:

- Prioritising the most important benefit to consumers
- The extent of the competition e.g. the extract reveals the whole market will be opened up by 2007 and powerful firms waiting to enter
- Choice may lead to confusion for consumers over prices and postal services on offer
- Royal Mail may be unable to cross-subsidise its rural delivery services; either price is increased or a reduction in services are undertaken. This brings into question the universal delivery service and uniform price
- Will bulk users benefit more than small users of letter delivery services?
- Changing forms of communication will change the nature of the market in the long run

### Unit 4 Assessment Objectives Grid

Question	Knowledge	Application	Analysis	Evaluation	Total
<b>Section A</b>					
Q1	2	1	1		4
Q2	2	1	1		4
Q3	1	1	1	1	4
Q4	1	1	1	1	4
Q5	2	1	1		4
Q6	1	1	1	1	4
Q7	1	1	1	1	4
Q8	2	1	1		4
Q9	2	1	1		4
Q10	1	1	1	1	4
<b>Total</b>	<b>15</b>	<b>10</b>	<b>10</b>	<b>5</b>	<b>40</b>
<b>Section B</b>					
Q11 (a)		2	2		4
Q11 (b)		4	4		8
Q11 (c)	2	1	2	3	8
Q11 (d)		3	3	4	10
Q11 (e)	3		3	4	10
<b>Total</b>	<b>5</b>	<b>10</b>	<b>14</b>	<b>11</b>	<b>40</b>
Q12 (ai)	1	2	1		4
Q12 (aii)		2	1	3	6
Q12 (bi)	3	3			6
Q12 (bii)		2	4		6
Q12 (c)	1	1	4	4	10
Q12 (d)				4	8
<b>Total</b>	<b>5</b>	<b>10</b>	<b>14</b>	<b>11</b>	<b>40</b>
<b>Overall Total</b>	<b>20</b>	<b>20</b>	<b>24</b>	<b>16</b>	<b>80</b>