Mark Scheme (Results)
Summer 2007

GCE

GCE Economics (6354) Paper 1

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6354 Mark Scheme June 2007
Section A

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

- Candidates can be rewarded up to a maximum of two marks for correct explanation even if they have the wrong key.
- Candidates can be rewarded a maximum of two marks for identifying and explaining incorrect options.

Question 1: D
Vertical integration is when firms in the same industry but at different stages of production merge (**1**).

Reference to vertical forward integration (**1**).

Any benefits to Coca-Cola, for example barriers of entry / raising profits / control over sales / greater market knowledge (**1+1**).

Question 2: E
Correct calculations of both AR and MR (**2**)
If one set of calculation (**1**)

Output of Boats	Total Revenue £	**Average Revenue £**	**Marginal Revenue £**
0	0	**0**	**0**
1	20,000	**20,000**	**20,000**
2	38,000	**19,000**	**18,000**
3	54,000	**18,000**	**16,000**
4	68,000	**17,000**	**14,000**
5	80,000	**16,000**	**12,000**

Also award correct definition or formula of AR or MR (**1**)
Accept diagram of falling AR and MR curves / or explanation e.g. to sell more firm has to cut price.(**1**)

Question 3: E
RPI is a measure of inflation (**1**).
The permissible price increase of season tickets is 3.9% whereas the rate of inflation is 2.9% **or** K is set at +1% above the rate of inflation (**1**).
The purpose of a real increase in price is to allow train operating companies to secure additional revenue / profit for improving service / investing in services (**1**).
Also award for reference to price controls protecting consumers (**1**).

Question 4: D
Definition / explanation of oligopoly (e.g. few sellers, many buyers / market dominated by a few large firms) (**1**).
Calculation of concentration ratio (**1**).
Example of interdependency e.g. If IBM cuts price / increases output of computer servers the other firms may follow for fear of losing market share / possibility of collusion (**1**).

Also award:
IBM or Hewlett Packard have more than 25% market share and so may be regarded as having monopoly power (**1**).
Also accept duopoly (**1**).

Award a maximum of 2 marks for explanation of market structure.

Question 5: E
Short-run since supernormal profits are being made by the firm (**1**) (this may be shown on the diagram) (**1**).
Productive efficiency is not achieved since firm is **not** producing where MC=AC (**1**).
Allocative efficiency is achieved since firm is producing where MC=Price or MC=AR (**1**).

Also award:
Correct annotation of diagram showing allocative efficiency, productive efficiency and supernormal profits for short run perfectly competitive firm (**3**).
Note: If candidate selects option D and explains how supernormal profits are competed away, award up to 2 marks.

Question 6: A
The role of competition commission in protecting consumer interests (accept public interest) (**1**).
The takeover still leaves HMV with less than 25% market share which is the legal definition of a monopoly (**1**).
Competition should ensure consumer choice/competitive prices/product quality (**1**).

Also award for recognition of market entry by supermarkets and internet book suppliers (**1**).

Question 7: E
Definition / characteristic of a firm in monopolistic competition (**1**).
Application of product differentiation to Estate Agents (**1**).
The firm is not productively efficient where MC=AC (**1**).

Also award:
Correct diagram of a firm in long-run monopolistic competition (**1**).

Question 8: C
Correct calculations of both AC and MC (**2**)
If one set of calculation (**1**)

Total Output of furniture	Total Costs	**Average Cost**	**Marginal Cost**
0	£1,000	**-------**	**-------**
1	£1,400	**£1,400**	**£400**
2	£1,700	**£850**	**£300**
3	£1,900	**£633**	**£200**

Also award correct formula or definition of MC or AC (**1**).
Accept explanation or diagram of falling AC and MC curves (**1**).

Question 9: B
Definition of 'contestable markets' in terms of low sunk costs or low entry and low exit costs / threat of competition is high (**1**).

Application / characteristics of painting and decorating firms - this may include low start-up costs / low technology / accessible skills / hit and run competition. (**up to 2**)

Note: A maximum of 2 explanation marks can be achieved if no application to painting and decorating firms.

Question 10: A
Definition of price discrimination **(1)**
Any conditions of price discrimination (e.g. Market power, different price elasticity of demand, and separation of markets) (**1**).
Consumers gain through increased market knowledge and so can buy a good from a firm at the lowest price offered **(1)**.

Section B

Question 11

(a) (i) Outline the type of integration involved in Morrisons takeover of Safeway. **(2)**

- Horizontal (**1**)
- A merger / takeover between firms who are at the same stage of production (**1**).

(a) (ii) Analyse two likely motives for Morrisons takeover of Safeway. **(6)**
(3+3 or 2+4)

Identification (**1+1**):

- Increase profits
- Increase market share to become a national player in supermarket sector.
- Increase efficiency e.g. gain economies of scale.
- To protect against takeover.

Analysis (**2+2**):
If only discussing economies of scale award a **maximum of 4 marks**. Be prepared to accept an analysis of two types of economies of scale as two separate motives e.g. purchasing, financial, technical, managerial and marketing. (**2+2**).

(b) Examine two factors which may have caused Morrisons to make a loss in 2005. Illustrate your answer with a diagram. (10)

- The takeover (**up to 2marks**):
  - One-off costs in purchasing Safeways
  - Diseconomies of scale e.g. delay in combining two head offices into one / lack of managerial expertise / supply chain difficulties.
  - Sale of so many stores – were all the sales necessary?
  - Movement away from its core food business
  - Culture clash in two companies combining.

- Falling market share (**up to 2 marks**):
  - Market share fell from 14.4% to 12.2%
  - Fall in revenues

- The price war (**up to 2 marks**):

  - Morrisons engaged in a price war which have reduced revenues. The greater financial backing and economies of scale available to Tesco and Walmart (Asda) mean they may eventually gain from a price war.
  - The difficulty involved in ending price war.

- Relevant diagram which shows a firm making a loss, costs rising, revenue falling, imperfect competition (**up to 4 marks**).

Note: a **maximum of 6 marks** is available for application and analysis.

Evaluation (2+2)

- Prioritise the factors – the most important is the takeover since the exceptional costs alone were £271 million.
- Magnitude of the takeover - taking over a company four times its size could lead to financial difficulties in raising funds and expose it to high debt burden.
- The demand for groceries is likely to be price-inelastic and so total revenue is likely to fall in a price war.
- Tesco and Walmart are much larger companies than Morrisons and so are likely to be able to sustain a price war for longer.

(c) Discuss why a firm such as Morrisons might continue in operation despite making a loss. (6)

Candidates may offer various responses which can be viewed as valid:

- Most of the loss was due to one-off costs (**1**) relating to the takeover (£271 million out of £312 million) (data reference) (**1**).
- The graph shows substantial profits were made before this which could help pay for any losses (**2**).
- The company forecasts a return to profits in 2006 ranging between £50 million and £150 million. (**2**).
- The company has assets to cover losses (**2**)

Note: a **maximum of 4 marks** available from the above points.

Evaluation - Any one point (**2**)

- The standard textbook argument is that a firm just needs to ensure its total revenue covers its total variable costs in the short run as fixed costs are already sunk into the business.
- Diagram showing price above average variable cost.
- The fixed costs only need to be covered in the long run.

(d) Apart from mergers and takeovers, examine two non-pricing measures Morrisons could implement to increase its profits. (8)

Several measures could be used from prompts in the extract (**3+3 or 4+2**) for example:
(Application 1+1, analysis = 2+2 or 1+3)

- Rationalisation programme – focusing on cutting costs and increasing efficiency. This might involve combining the head offices into one and rationalising the supply chain.
- Concentrating on the core food business which Morrisons knows best and so compete more effectively. This implies a reduction of focus on non-food items.
- Sale of unprofitable stores – Morrisons appear keen to sell a further 75 outlets.

Other measures include:

- Bring in a new chairman and managers to turn the company around.
- Make efforts to end the supermarket price war without falling foul of the competition authorities.
- Introduce a loyalty card.
- Increase (or decrease) advertising expenditure.
- Celebrity endorsements.
- Pay cuts or productivity bonuses for staff.

Evaluation - Any one point (**2)**

- Prioritise
- Short run v long run
- Magnitude
- Sale of stores may be a false economy as it will reduce market share and scope for economies of scale.
- Rationalisation e.g. reduce number of employees or customer choice may lead to worse customer services.
- Advertising campaign is very expensive.

(e) To what extent is the market for food retailing contestable?

(8)

Three factors required (**2+2+2)**
The supermarket sector of Food retailing is not contestable since:

- High entry barriers & exit barriers, for example
- High start up costs
- Difficulty in gaining planning permission for new sites especially for large stores. (Control of market outlets by existing supermarkets).
- Advertising costs
- Brand loyalty of rival supermarkets
- Massive economies of scale of incumbent firms enable them to keep unit costs down and prices low for customers. (Control of supply chain by existing supermarkets).
- Current price war
- Limit pricing

Note: Also accept correct definition / understanding of a contestable market (**1**).

Accept alternative view that it is contestable since:

- Walmart entry via purchase of Asda stores; also European discount stores have entered too e.g. Lidl, Aldi & Netto.
- It may be possible to enter at a localised level
- Competition authorities keen to see competition at localised level

Note: If no reference to food retailing award a **maximum of 6 marks**.

Evaluation (2+1 marks)

- At a local level Food retailing is likely to be contestable (small stores)
- Magnitude of factors
- Prioritise which factor(s) make it non-contestable / contestable
- Consideration of both arguments

Question 12

(a) (i) With reference to the information provided, explain why the regulator Ofcom forced BT to restructure its business. (6)

- Reference to figure 1 which shows BT has over 56% of domestic land line customers (**1**).
- The role of the regulator in promoting competition / protecting consumer interest / increase choice and lower prices / increase consumer surplus (**up to 2**).
- To reduce the dominant market position / monopoly power of BT / to reduce the power of the vertically integrated BT (**up to 3**).
- To increase competition and encourage new entrants / develop new products e.g. super-fast broadband, internet phone calls and video (**up to 4**).
  (3+3 or 4+2)

Note: If no reference to figure 1 which shows BT has 56% of domestic landline customers a mark cap of 5 applies.

(a) (ii) Why might BT's rivals still need some convincing that the restructuring will operate in their interests? *(lines 17 & 18)* **(4)**

- Ownership issue - the division responsible for the telephone land line network is still owned by BT / and so there is a possibility that BT retail's business will be given preferential treatment over its rivals in access to the network (**2**).
- Track record – for many years BT has abused its monopoly position / obstructed competition (**2**).

(b) Discuss the likely impact on BT's profits of price capping its line rentals (6)

- Understanding of how price capping works (this may be implicit)**(1)**.
- Price capping is likely to reduce BT's profits / development of this **(1+1).**
- Data reference (£81.85 is less than £105.09) **(1)**.

Evaluation - Any one point **(2)**

- It depends upon BT's ability to increase efficiency to compensate for the lower prices of its line rental services.
- It depends on how many extra customers BT might obtain from lower line rental fees.
- BT's rivals have lower line rental fees / lower costs and so may compete more effectively. BT's profits are likely to fall.

(c) Discuss how the price and output decisions of BT might have changed following privatisation. Illustrate your answers with a diagram

(10)

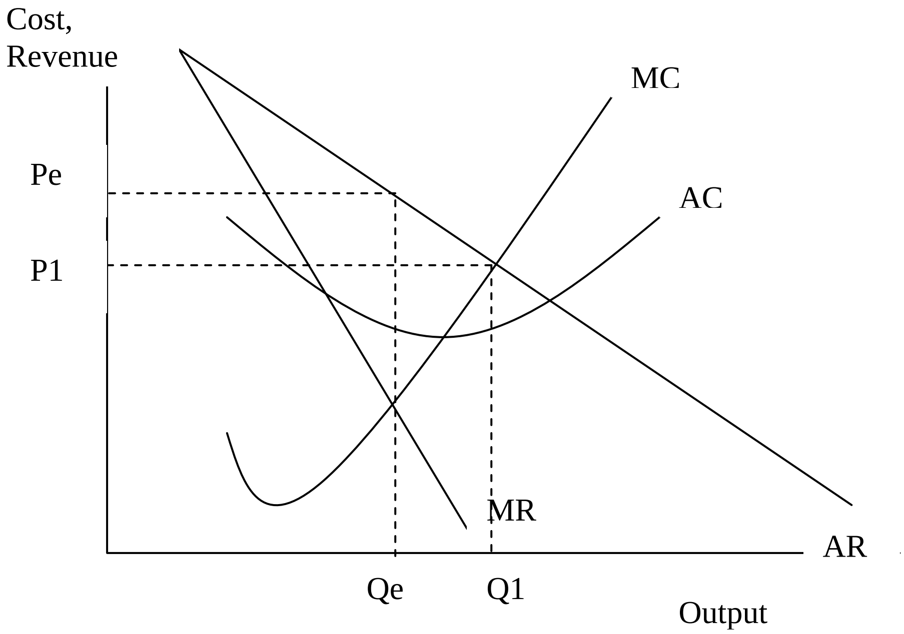

Diagram – (up to 4 marks)

- Identify profit maximisation where MC=MR (**1**) and allocative efficiency where MC=P (**1**).
- Identify profit maximising price Pe **(1)** and allocative efficiency price P1 **(1)**.

Also award illustration of different profit areas (**1+1**).
Also award for other pricing policies BT may have adopted (e.g., revenue maximization, sales maximization, cost plus pricing, limit pricing).

Note: award a **maximum of 6 marks** if no diagram.

- Explanation of profit maximisation as a better position for the firm – profits are greater (**1**) and price is higher & output lower **(1).**

Evaluation (2+2)

- As a nationalised firm the government may have instructed BT to set price for allocative efficiency to maximise society's welfare (**1**) via joint maximisation of consumer & producer surplus (**1**)
- By switching to profit maximisation the firm captures consumer surplus / is able to increase investment/increase shareholder dividends / increase directors' salaries (**2**).
- BT was able to raise price and gain more profits since it had monopoly power (**2**).
- The role of the regulator limiting BT's profits (**2**).
- The price and output decisions following privatisation depend upon the aims of BT. It may not seek profit maximisation due to divorce of ownership from control. Alternately BT may seek profit satisficing (**2**).

(d) Assess the likely effectiveness of mergers by rival companies as a means of challenging BT's dominance. (8)

- Reference to NTL takeover of Virgin Mobile or another merger depicted in Figure 1 (**1**).
- Mergers might be necessary to enable rivals to gain economies of scale / explanation of two or more scale economies e.g. technical, purchasing, marketing, risk bearing, managerial, R&D, rationalisation (**up to 3**).
- Mergers are a fast way of increasing market share / reduce competition for rival firms enabling them to concentrate upon competing with BT (**up to 3**).

Evaluation (**2 + 1**)

- Largest rival (NTL) only has 11% market share compared to BT's 56%.
- There may be limited scope from economies of scale through mergers.
- BT still has control over the landline operator 'Openreach'.
- Mergers could take time to work.
- Strong brand loyalty to BT makes it difficult for a rival merger to be successful.

(e) To what extent might a reduction in the number of telephone companies be against the interest of telephone customers. (6)

- Against consumer interests since:
    - Less competition
    - Less consumer choice
    - Higher price of telephone service / less consumer surplus
    - Lower quality goods and services
    - Less incentive for product innovation
    - Greater risk of collusion

(1+1+1+1 marks)

Evaluation (2 marks)

- Discussion of for and against fewer companies in the marketplace
- Magnitude of reduction in telephone companies
- Short run v long run
- Not against consumer interests since it could lead to more effective competition against BT by a bigger rival firm.
- Not against consumer interests if profits used for R&D
- Fewer companies may lead to increased economies of scale