Model Answers Unit 3 January 2010

9) A) What does the information provided suggest is the market structure of the airport industry in London? Explain your answer. (4)

BAA own London's three largest airports in Heathrow, Gatwick and Stansted (extract 1) ***(KAA 1 mark)***. Because BAA is a dominant firm it could be argued that it is a monopoly, it has at least 25% market share ***(KAA 2 marks)***. Also, the Competition Commission, who investigate monopolies, are forcing BAA to sell an airport (extract 1), further indicating it is a monopoly ***(KAA 1 mark)***.

***B) Assess the case for increased competition in the airport industry. (14)**

More competition means there will be more firms ***(KAA 1 mark)***. A benefit to airline passengers will be lower ticket prices. More firms in the airline industry means more competition, firms must compete by lowering their costs and ultimately lowering their ticket prices to attract passengers from rivals. Airlines will be more allocatively efficient (P=MC). So consumer surplus rises ***(KAA 2 marks)***. Additionally, passengers will benefit from a more efficient service. Airlines must become more efficient to compete which should mean quicker flights, less delays, less bags lost and a better airline experience for passengers ***(KAA 2 marks)***. Also, the government/economy will benefit because there should be more international flights to and from London so exports should rise ***(KAA 2 marks)***.

Although, if the airline industry is a natural monopoly then more competition means a wasteful duplication of resources. More airports may need to be built for more airlines. This is very costly and may cause resources to be diverted from more beneficial uses ***(E 2 marks)***. Moreover, more firms means less profits and thus less incentives for airlines to invest. This will cause inefficiencies such as delayed flights in the future ***(E 2 marks)***. Furthermore, more competition means more rivals so airlines must spend more on advertising. This could drive up airline firms' costs and cause some airlines to make a loss and go bust ***(E 1 mark)***. Finally, after more competition has entered the airline market it may become an oligopoly and thus have the potential for collusion and high prices. So consumer surplus may fall ***(E 2 marks)***.

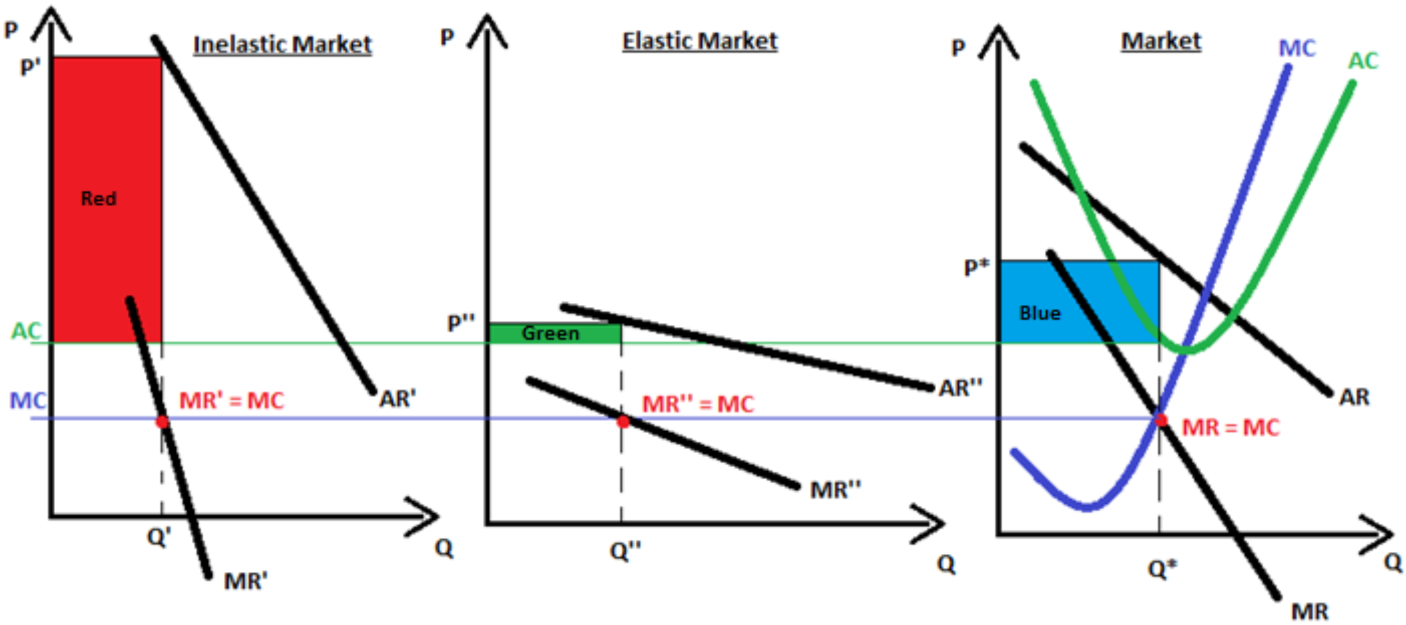
C) Discuss the effectiveness of the Competition Commission in regulating industries such as the airport industry. (8)

The Competition Commission (CC) investigates monopolies suspected of abusing their market power and potential mergers that will result in a monopoly. Any merger that results in the firm owning at least 25% of the market can be blocked by the CC. The CC may allow a merger even if it results in a firm becoming a monopoly so long as the monopoly acts in the interest of the consumer by, for example, investing in R&D ***(KAA 2 marks)***. The CC could force a firm to sell some assets as it did in the airline industry by forcing BAA to sell Gatwick airport (extract 1) ***(KAA 2 marks)***.

However, regulatory capture could reduce the effectiveness of the CC. Regulatory capture occurs when a regulator makes decisions that benefit the regulated firm instead of consumers. Regulatory capture could occur if the CC believes inaccurate information given to them by BAA ***(E 2 marks)***. Also, time delays may cause the CC to be ineffective. The airline industry regulator must first pass on the case to the CC who, in turn, must then investigate. The longer this takes, the less effective the CC's powers will be ***(E 2 marks)***.

***D) BAA charge more for landings at Heathrow than at other airports. Evaluate the reasons for and consequences of such a policy. (14)**

BAA may be doing this because it has monopoly power to raise prices for some particular services to earn higher profits ***(KAA 2 marks)***. BAA are basically price discriminating. Price discrimination occurs when a firm charges different prices to different consumers for the same good. Landing at Heathrow is, essentially, the same service as landing at other London airports. Because airlines' demand for landing at Heathrow is more price inelastic than demand for landing at other airports, BAA can charge airlines a higher price for landing at Heathrow ***(KAA 2 marks)***.



A high price P' is charged to those with an inelastic demand and a low price P'' is charged to those with an elastic demand. Both market segments earn BAA super-normal profit. As long as the red and green super-normal profits sum up to more than the blue super-normal profit, BAA earns more profit than charging a single price P* ***(KAA 2 marks)***. Another consequence is that consumer surplus will fall because those with an inelastic demand are charged a higher price than before ***(KAA 2 marks)***.

However, because landing at Heathrow is not exactly the same as landing at other airports, this is not technically price discrimination but product differentiation. BAA are likely, and within their rights, to charge different prices for these different services ***(E 2 marks)***. If BAA are earning extremely high super-normal profits by charging airlines these different prices then the Competition Commission may investigate them as they are potentially acting against public interests ***(E 2 marks)***. A more important impact on the costs of airlines may be fuel or wage costs rather than what airlines pay BAA to use airports ***(E 2 marks)***. In the long-run, if more competition enters the market then BAA may not be able to do this any longer ***(E 1 mark)***.

10) A) What does the information provided suggest is the market structure of the pharmaceutical industry? Explain your answer. (4)

It could be argued that the pharmaceutical industry is an oligopoly, that is, there are a few large dominant firms, interdependency and high entry barriers ***(KAA 2 marks)***. The pharmaceutical industry is dominated by large firms such as Roche, Pfizer, Novartis and Merck (figure 1) ***(KAA 2 marks)***.

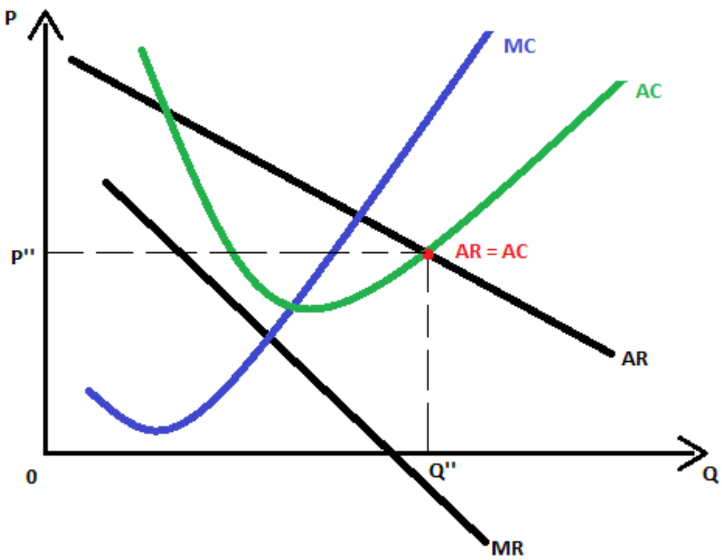
***B) Discuss the benefits that Merck might expect to gain through the takeover of Schering-Plough. (12)**

A first benefit to Merck is an increase in market share. A takeover of Schering-Plough means less competition, higher market share, more market power and thus the ability to set higher prices and earn higher profits ***(KAA 2 marks)***. A second benefit to Merck is economies of scale. A firm experiences economies of scale if its long-run average costs fall as output rises. A takeover will mean Merck can benefit from financial economies, it will be a larger firm so it is deemed less risky by creditors and can obtain larger loans at lower interest rates ***(KAA 2 marks)***. A third benefit to Merck is that it will break into new markets and thus diversify and reduce risk. Merck's sales outside of the US will increase because 70% of Schering-Plough's revenue comes from outside of America (extract 1) ***(KAA 2 marks)***.

However, Merck may suffer from diseconomies of scale. A firm experiences diseconomies of scale if its long-run average costs rise as output rises. The takeover may result in managerial diseconomies if Merck's managers take on too many responsibilities running the larger firm ***(E 2 marks)***. Also, the takeover may result in an investigation by the Federal Trade Commission. The larger firm may exploit its increased market power to raise prices, this is not in the public's interests and thus the takeover may be blocked ***(E 2 marks)***. Furthermore, the takeover may not succeed Merck have preferred to grow internally by making new products in their own laboratories (extract 1) ***(E 2 marks)***.

C) Evaluate one pricing and one non-pricing strategy that Merck could adopt to increase sales. (12)

A pricing strategy Merck could use is sales maximization. Merck maximizes sales at $AR = AC$. At $AR = AC$ Merck sells all the output it can without making a loss. Merck earns normal profit only ***(KAA 3 marks)***.



A non-pricing strategy Merck could use is advertising. Advertising will create a brand image and help Merck to keep its current consumers whilst attracting consumers away from rival firms and thus increase sales. If Merck's advertising is informative, Merck will be telling people about the full benefits of its drugs and consequently consumers should buy more from Merck ***(KAA 3 marks)***.

However, sales maximization may involve cutting prices and this may lead to a price war. Maybe, because Merck steals rival firms' consumers by cutting its prices, Merck's rivals respond by cutting their prices and thus all firms in the pharmaceutical industry are worse off because they are charging lower prices than before with no significant increase in sales ***(E 2 marks)***. Moreover, Merck would only aim to maximize sales in the short-run because Merck only makes normal profit by maximizing sales. In the long-run Merck must profit maximize at MR=MC ***(E 2 marks)***. Also, advertising may be very costly, Merck may not be able to afford a large enough advertising campaign to make a difference to its sales ***(E 2 marks)***.

***D) To what extent would further mergers and takeovers in the pharmaceutical industry be in the best interests of consumers and employees? (12)**

A benefit to consumers is lower prices. If Merck takes over Schering-Plough, the larger firm may experience economies of scale. Long-run average costs fall so the larger firm can lower prices. This means consumer surplus increases. Also, the larger firm has more profit and thus the ability to invest more in R&D. This means new and better drugs for consumers in the future ***(KAA 3 marks)***. A benefit to employers is increased job security. A larger firm makes more profit so it may not need to fire any workers to reduce costs. Additionally, if the larger firm earns higher profits then wages may rise ***(KAA 3 marks)***.

However, consumers may suffer higher prices. A larger firm could suffer diseconomies of scale. Long-run average costs will rise and thus the firm must increase prices. Monopoly power and collusion may also mean higher prices. So consumer surplus falls ***(E 2 marks)***. Moreover, if there are more mergers and takeovers then there are less firms, less competition and less incentives for larger firms to invest in R&D. This means there will be less choice and quality for consumers ***(E 2 marks)***. Furthermore, more mergers and takeovers may mean further job cuts because the larger firm will fire workers if they already have someone who does their job. One merger could result in thousands of employee redundancies (extract 2) ***(E 2 marks)***.

Model Answers Unit 3 June 2010

9) A) Briefly explain the form of integration described in lines 25–26. (4)

RWE owning the distribution networks is forward vertical integration because both firms are in the electricity industry but at different stages of production ***(KAA 2 marks)***. RWE generates and supplies electricity to the distribution networks who then sell electricity to consumers (extract 1) ***(KAA 2 marks)***.

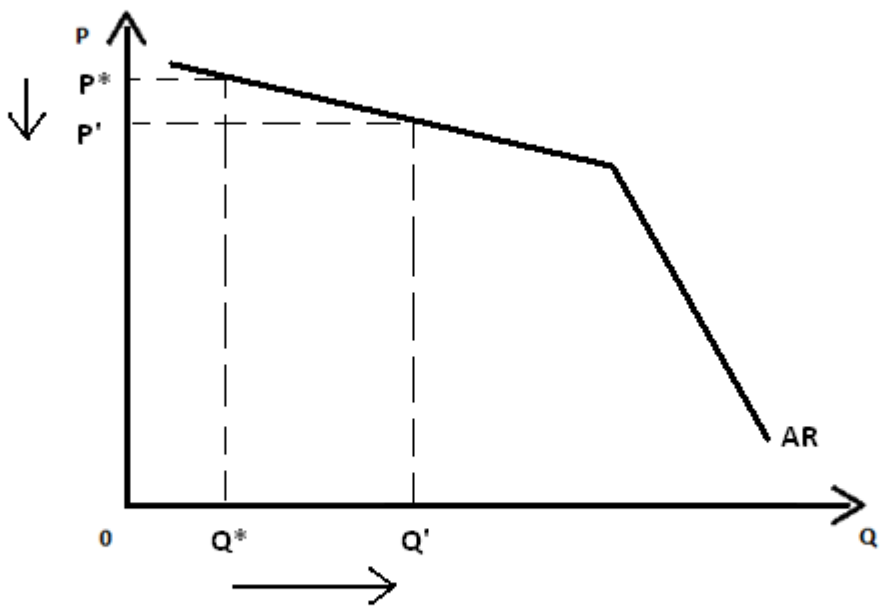
B) Assess the evidence that the electricity generating companies in Germany are operating as a cartel. (8)

A cartel occurs when a group of firms come together to act as if they were a monopoly to restrict output and raise prices ***(KAA 2 marks)***. Firstly, Germany's electricity prices are the highest in Europe (extract 1). Prices are rising despite coal prices dropping by 50% so the high prices are arguably not due to rising costs. Maybe the large dominant electricity firms have agreed to price-fix and charge higher prices ***(KAA 2 marks)***. Secondly, RWE and E.ON are Germany's most dominant firms with a combined market share of 60% (extract 1). With only two large dominant firms it would be relatively easy to form a cartel and price-fix ***(KAA 2 marks)***.

However, RWE and E.ON may be tacitly colluding rather than acting as a cartel. There may only be an informal agreement between the two firms to price-fix rather than a formal agreement because drawing up contracts for price-fixing is illegal ***(E 2 marks)***. Also, RWE and E.ON's prices may simply be too high because they are X-inefficient. Maybe, because they face little competition, their workers are slacking and their costs are high so their prices are high ***(E 2 marks)***.

***C) Apart from operating as a cartel, discuss the ways in which firms might compete in the German electricity generating market. Refer to game theory in your answer. (12)**

RWE could decrease electricity prices. RWE is a large firm in an oligopoly so it faces a kinked demand curve. If the demand curve is elastic, RWE could decrease electricity prices to gain a lot of sales and increase profits because rivals will not react by lowering prices too ***(KAA 2 marks)***.



Alternatively, RWE could collude with E.ON. RWE and E.ON may both agree to charge high electricity prices so that they both have roughly the same market share as before but are now each making higher profits ***(KAA 2 marks)***. RWE could instead engage in non-price competition to increase its profits. Maybe RWE could embark on an advertising campaign with celebrities to strengthen its brand and attract consumers from rivals ***(KAA 2 marks)***.

However, if the kinked demand curve is inelastic, when RWE decrease their price they will not gain many extra sales because rivals will react by lowering their prices too ***(E 2 marks)***. Moreover, collusion is illegal. If the European Commission discovers that RWE and E.ON were colluding then the firms may be fined and suffer bad publicity from the media ***(E 2 marks)***. Also, advertising may be very costly, RWE may not be able to afford a large enough advertising campaign to make a difference to its sales and profits. Advertising is also very risky as there is no guarantee that it will boost sales ***(E 2 marks)***.

***D) With reference to the last two paragraphs, evaluate the factors which might reduce the profits of Germany's electricity generating companies. (16)**

Maybe RWE and E.ON's profits will fall because of fines from the European Commission (extract 1). If RWE and E.ON are caught acting anti-competitively or against the public's interests by, for example, colluding or engaging in predatory pricing, then they will be heavily fined ***(KAA 2 marks)***. Additionally, the European Commission may impose price caps on RWE and E.ON (extract 1). Maybe an RPI-X price cap will be imposed on RWE and E.ON, this basically means their prices must fall in real terms because their prices may only rise by a maximum of RPI minus the cost-savings the regulator believes they can make ***(KAA 2 marks)***. Furthermore, the European Commission may force RWE and E.ON to sell off some distribution companies (extract 1). If RWE and E.ON own less distribution companies then they will sell less electricity to consumers, make less revenue and less profit ***(KAA 2 marks)***. Moreover, RWE and E.ON may make a loss because of increased competition from renewable energy firms. More domestic or foreign competition may emerge to sell electricity to German consumers and take away some of RWE and E.ON's sales, revenue and profit ***(KAA 2 marks)***.

However, the magnitude of the European Commission's fines must be significant to reduce RWE and E.ON's profits. A small fine of say €10 million will have little effect on profits of say €2 billion ***(E 2 marks)***. Also, regulatory capture may occur. Maybe the European Commission's regulatory officials become too friendly with RWE's officials and make regulatory decisions that benefit RWE more than public interests ***(E 2 marks)***. Maybe the European Commission only forces RWE and E.ON to sell off small distribution networks. This means RWE and E.ON's revenue and thus profit will not fall by a significant amount ***(E 2 marks)***. Lastly, RWE and E.ON may invest in R&D, develop better renewable energy sources, out-compete any potential rival firm and continue to dominate Germany's electricity market and earn high super-normal profits in the future ***(E 2 marks)***.

10) A) Briefly explain the market structure which best describes the UK instant coffee market. (4)

It could be argued that the coffee market is an oligopoly, that is, there are a few large dominant firms, interdependency and high entry barriers ***(KAA 2 marks)***. The coffee market is dominated by large firms such as Nescafé and Kenco with these two making up a two firm concentration ratio of 68% (figure 1) ***(KAA 2 marks)***.

***B) Assess the likely reasons why Starbucks is charging a lower price for Via instant coffee than for filter coffee sold in its cafés. (12)**

Maybe Starbucks faces lower production costs for Via. Via instant coffee may be made from cheap low quality coffee beans, it may be cheaper to produce Via than filtered coffee so Starbucks charges a lower price for Via ***(KAA 2 marks)***. Additionally, demand for Via instant coffee may be price elastic so a lower price must be charged for Via whereas demand for filtered coffee in cafés may be price inelastic so a higher price can be charged ***(KAA 2 marks)***. Also, Starbucks just created its Via brand so it may be pricing Via low so as to establish its brand and compete with rivals such as McDonald's McCafé ***(KAA 2 marks)***.

However, missing information in the extracts means it is difficult to tell why the price of Via is low. There are no cost comparisons for Starbucks' Via instant coffee and filtered coffee ***(E 2 marks)***. As the economy begins to boom, incomes will rise, demand for normal goods like coffee will rise and the price of Via may eventually rise ***(E 2 marks)***. Maybe Starbucks are only charging a low price for Via in the short-run to compete with Nescafé and McDonald's. In the long-run, Starbucks may weaken its competition and then raise the price of Via ***(E 2 marks)***.

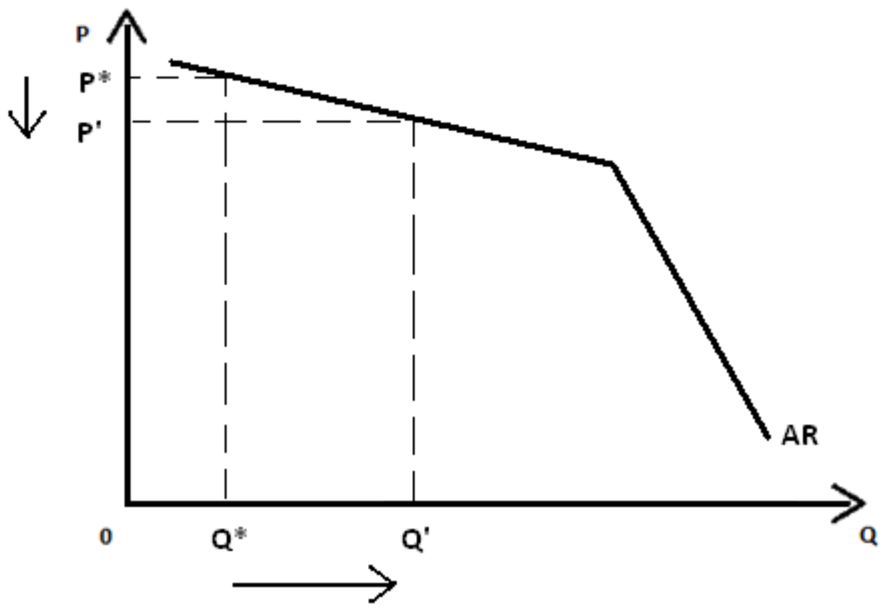
C) To what extent is the UK market for instant coffee contestable? (8)

A contestable market has low entry barriers, low sunk costs and thus a lot of potential competition ***(KAA 1 mark)***. The instant coffee market may be contestable because there are many new firms/products entering. For example, Starbucks created a new brand with its Via instant coffee and McDonald's created its brand McCafé (extract 2) ***(KAA 2 marks)***. Also, the instant coffee market may be contestable because the market is growing, especially with consumers willing to trade up to premium variants (extract 1) so it is easier for new firms to enter and possibly set up in a niche market ***(KAA 2 marks)***.

However, the market is highly concentrated. Nescafé and Kenco make up a two firm concentration ratio of 68%, these large dominant firms may engage in predatory pricing to deter rivals ***(E 2 marks)***. Moreover, an entry barrier exists in terms of advertising. Nescafé spent £17 million on advertising (extract 1), a new firm may not be able to afford this much advertising expenditure ***(E 2 marks)***.

***D) Assess the methods by which the manufacturers of instant coffee might compete with each other in both the UK and the US. (16)**

Nescafé could decrease instant coffee prices. Nescafé is a large firm in an oligopoly so it faces a kinked demand curve. If the demand curve is elastic, Nescafé could decrease instant coffee prices to gain a lot of sales and increase profits because rivals will not react by lowering prices too ***(KAA 2 marks)***.



Alternatively, Nescafé could collude with Kenco. Nescafé and Kenco may both agree to charge high instant coffee prices so that they both have roughly the same market share as before but are now each making higher profits ***(KAA 2 marks)***. Nescafé could instead engage in non-price competition to increase its profits. Maybe Nescafé could embark on an advertising campaign with celebrities to strengthen its brand and attract consumers from rivals ***(KAA 2 marks)***. Also, Nescafé could invest in R&D to develop a new instant coffee and attract consumers from rival instant coffee firms ***(KAA 2 marks)***.

However, if the kinked demand curve is inelastic, when Nescafé decrease their price they will not gain many extra sales because rivals will react by lowering their prices too ***(E 2 marks)***. Moreover, collusion is illegal. If the competition authorities discover that Nescafé and Kenco were colluding then the firms may be fined and suffer bad publicity from the media ***(E 2 marks)***. Also, advertising may be very costly, Nescafé may not be able to afford a large enough advertising campaign to make a difference to its sales and profits. Advertising is also very risky as there is no guarantee that it will boost sales ***(E 2 marks)***. Furthermore, investing in R&D is costly and it may take some time before the new instant coffee is developed because it has to be researched and tested first ***(E 2 marks)***.

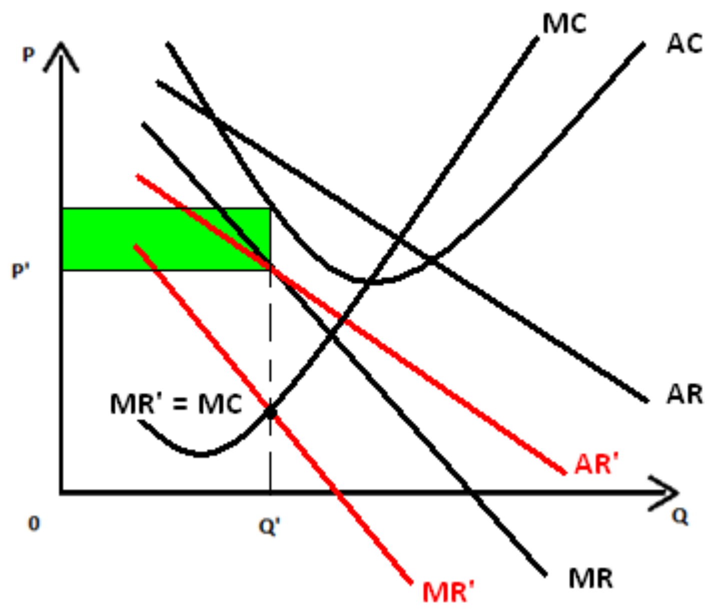
Model Answers Unit 3 January 2011

9) A) Using the evidence, explain the type of integration involved in the agreed merger between BA and Iberia. (4)

A merger between BA and Iberia is a horizontal merger because they are both airline firms in the same industry and at the same stage of production ***(KAA 2 marks)***. Both firms offer commercial flights and a merger would result in economies of scale for example, they could cut overlapping routes and reduce costs (extract 1) ***(KAA 2 marks)***.

B) Examine the likely reasons why Iberia made a loss during 'the usually profitable summer months' (Extract 1, line 7). Use a diagram to support your answer. (8)

Iberia made a loss because demand fell. Because of the global financial crisis (extract 1), global incomes fell and, since holidays are a luxury good, demand for holidays and flights fell ***(KAA 2 marks)***.



AR and MR shifts left, at the price P' a loss is made equal to the shaded area ***(KAA 2 marks)***.

However, in the long-run, as global economies move out of a recession, world incomes will rise and demand for holidays and flights will increase so Iberia may begin to make a profit again ***(E 2 marks)***. Also, the problem is not unique to Iberia, the losses are affecting the entire airline industry, airline firms must wait until the industry becomes profitable again ***(E 2 marks)***.

***C) Assess the likely impact on contestability of the airline industry resulting from the mergers and agreements referred to in the evidence. (12)**

A contestable market is a market with low entry/exit barriers, low sunk costs and thus a lot of potential competition ***(KAA 1 mark)***. A merger between BA and Iberia (extract 1) may decrease the airline industry's contestability because the larger firm would have a larger market share, more market power, a stronger brand and the ability to outcompete rivals ***(KAA 2 marks)***. Moreover, the larger firm may benefit from economies of scale. BA and Iberia could benefit from technical economies as they may use specialist planes like the Airbus to transport a larger quantity of passengers. This means the larger firm's costs fall so it is harder for rivals to compete ***(KAA 2 marks)***. Also, entry barriers will rise because rivals will have to spend even more on advertising to compete with the larger firm ***(KAA 2 marks)***.

However, the competition authorities may block the merger. If BA and Iberia merge they may become a monopoly and act against the interests of consumers by raising prices ***(E 2 marks)***. Furthermore, the larger firm may suffer diseconomies of scale. Maybe the larger firm suffers managerial diseconomies as the managers cannot efficiently deal with all the tasks of BA and Iberia together. This means the larger firm's costs rise so it is easier for rivals to compete ***(E 2 marks)***. Lastly, the airline industry may be highly incontestable anyway. Airline firms must rent out a runway, buy airplanes and hire specialist pilots. Even without the larger firm the entry barriers may be too high for potential rivals to enter ***(E 2 marks)***.

***D) Evaluate the likely benefits of the agreed merger between BA and Iberia. (16)**

A benefit to BA and Iberia is higher profits. A larger firm means a higher market share, more market power and the ability to raise prices to increase profits. ***(KAA 2 marks)***. Another benefit to BA and Iberia is economies of scale. A firm experiences economies of scale if its long-run average costs fall as output rises. BA and Iberia may benefit from marketing economies, as a larger firm it has monopsony power to negotiate lower prices for Airbus and Boeing airplanes (extract 1) ***(KAA 2 marks)***. A benefit to consumers is lower prices. The larger firm may experience economies of scale, so its long-run average costs fall, prices fall and consumer surplus increases. Also, there may be less strikes and a more efficient airline experience ***(KAA 2 marks)***. Workers may also benefit. A larger firm means higher profits so BA and Iberia's workers may receive higher wages and benefit from increased job security ***(KAA 2 marks)***.

However, the takeover may result in an investigation by the competition authorities. BA and Iberia may exploit their increased market power to raise prices, this is not in the public's interests and thus the takeover may be blocked ***(E 2 marks)***. Furthermore, the larger firm may suffer diseconomies of scale. Maybe the larger firm suffers managerial diseconomies as the managers cannot efficiently deal with all the tasks of BA and Iberia together. This means the larger firm's costs rise and profits fall ***(E 2 marks)***. Moreover, consumers may suffer from higher prices. A larger firm could suffer diseconomies of scale. Long-run average costs will rise and thus the firm must increase prices. Monopoly power and collusion may also mean higher prices. So consumer surplus falls ***(E 2 marks)***. Lastly, some of BA and Iberia's workers may be fired as the larger firm will not need multiple workers for one position ***(E 2 marks)***.

10) A) Explain one possible reason for the trend in newspaper sales as shown in Figure 2. (4)

Between 2001-2009, there was a falling trend for The Financial Times as daily sales fell from 478,161 to 426,676 (figure 2) ***(KAA 2 marks)***. Sales of the newspaper may have fallen because of the 2007/08 global recession causing incomes to fall and demand for goods to fall ***(KAA 2 marks)***.

B) Assess the possibility of some printed newspapers shutting down as a result of the trend in newspaper sales. (8)

As newspaper sales have fallen, newspaper prices may be so low that newspaper firms make a loss and leave the industry. Maybe newspaper firms leave the industry straight away due to the shutdown rule P<AVC. If newspaper firms cannot cover their variable costs then staying in business means their losses rise ***(KAA 2 marks)***. Maybe new technology like the Kindle means printed newspaper firms go bust as they are replaced by online newspapers ***(KAA 2 marks)***.

However, in the long-run, as the global economy recovers from the 2007/08 recession, incomes will rise and demand for newspapers may rise, making newspaper firms profitable again ***(E 2 marks)***. Also, declining sales may not affect newspaper firms that much as a lot of their revenue may come from advertising revenues (extract 1) ***(E 2 marks)***.

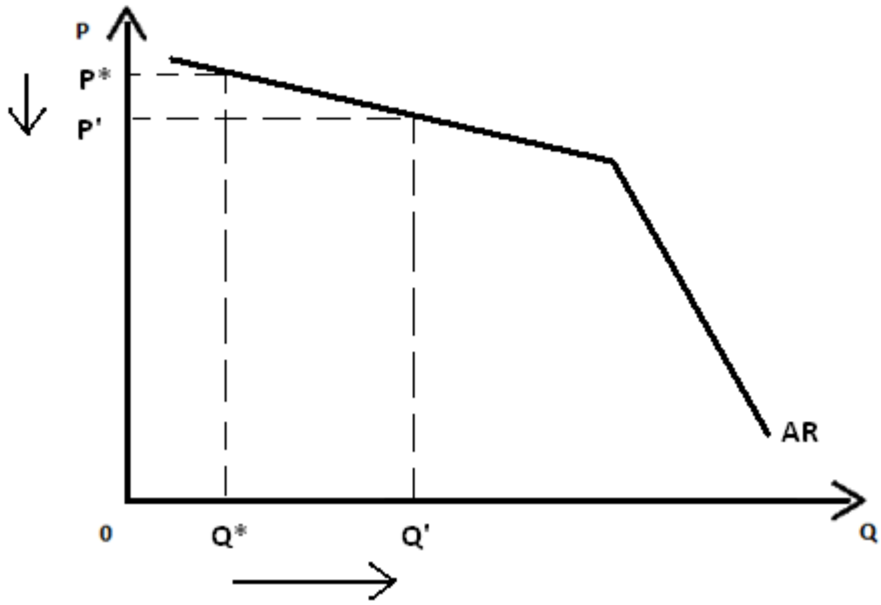
***C) To what extent might the contestability of the markets for online news and printed newspapers differ? (12)**

A contestable market is a market with low entry/exit barriers, low sunk costs and thus a lot of potential competition ***(KAA 1 mark)***. The market for online news may be more contestable as there should be lower entry barriers. For example, printed newspapers may require costly printing machines whereas online news only requires computers so the start-up costs for online news should be relatively low ***(KAA 2 marks)***. Moreover, the market for online news may be more contestable as there may be many 'hit and run' firms. Many small firms may be quickly entering and exiting the market to earn a quick profit ***(KAA 2 marks)***. Also, the market for printed newspapers is less contestable because it is highly concentrated. In 2001, the concentration ratio for the top 2 firms The Sun and The Telegraph was roughly 30% (figure 2) ***(KAA 2 marks)***.

However, it may not cost that much for printing machines. There are many local newspapers in circulation, implying low start-up costs for printed newspapers ***(E 2 marks)***. Furthermore, the market for online news may be incontestable because there are some large dominant firms. For example, the BBC and Daily Telegraph have a combined market share of 24% (figure 1) ***(E 2 marks)***. Lastly, online news may be incontestable depending on agents' search engine. As most web users use Google, online news may be incontestable if Google help promote certain online news firms with links and adverts ***(E 2 marks)***.

***D) Evaluate price and non-price strategies newspaper organisations may pursue to increase profitability. (16)**

A newspaper firm like The Financial Times (FT) could decrease newspaper prices. The FT is a large firm in an oligopoly so it faces a kinked demand curve. If the demand curve is elastic, The FT could decrease newspaper prices to gain a lot of sales and increase profits because rivals will not react by lowering prices too ***(KAA 2 marks)***.



Alternatively, The FT could collude with The Sun. The FT and The Sun may both agree to charge high newspaper prices so that they both have roughly the same market share as before but are now each making higher profits ***(KAA 2 marks)***. The FT could instead engage in non-price competition to increase its profits. Maybe The FT could embark on an advertising campaign with celebrities to strengthen its brand and attract consumers from rivals ***(KAA 2 marks)***. Additionally, The FT could invest in R&D, develop new ideas, designs or apps for online news, attract more consumers, increase sales and increase profits ***(KAA 2 marks)***.

However, if the kinked demand curve is inelastic, when The FT decrease their price they will not gain many extra sales because rivals will react by lowering their prices too ***(E 2 marks)***. Moreover, collusion is illegal. If the OFT discover that The FT and The Sun were colluding then the firms could be fined up to 10% of their turnover and individuals involved may be jailed for up to 5 years and face an unlimited fine ***(E 2 marks)***. Also, advertising may be very costly, The FT may not be able to afford a large enough advertising campaign to make a difference to its sales and profits ***(E 2 marks)***. Lastly, R&D is risky as it may cost a lot to research plus there is no guarantee the new design or app will attract more consumers ***(E 2 marks)***.

Model Answers Unit 3 June 2011

9) A) With reference to Extract 1, explain why governments allow patents to be granted. (4)

A patent gives a firm legal protection by the government to be the exclusive producer of a good/idea for a number of years. It acts as an entry barrier because only the patent holder can produce the patented good/idea ***(KAA 2 marks)***. Giving RB a patent will incentivize RB to invest in R&D, innovate and produce a new drug without the risk of rival firms producing RB's new drugs and stealing RB's profits (extract 1) ***(KAA 2 marks)***.

B) Assess the economic effects on consumers of increased competition from generic (unbranded) products within the healthcare market. (8)

A benefit to consumers is lower drug prices. More drugs in the healthcare market means more competition, firms must compete by lowering their drug prices to attract consumers from rivals. Pharmaceutical firms will be more allocatively efficient (P=MC) and consumer surplus rises ***(KAA 2 marks)***. Also, consumers will benefit from new drugs. Pharmaceutical firms may react by investing in R&D, innovating and producing new and better drugs to gain a competitive advantage over rivals. Consumers then benefit from more choice and quality ***(KAA 2 marks)***.

However, more competition may mean less profits for pharmaceutical firms. This means firms have less to invest in R&D so they may not be able to innovate and develop new drugs. Ultimately the consumer suffers from less choice and quality ***(E 2 marks)***. Moreover, more competition may mean pharmaceutical firms go bust. Some firms may not be able to compete with all the additional drugs, these firms will make a loss and leave the healthcare market. This means less choice for consumers ***(E 2 marks)***.

***C) With reference to the information provided and your own knowledge, to what extent is the government's competition policy successful in promoting competition between firms? (12)**

Competition policy aims to make markets more competitive to benefit consumers with lower prices, increased consumer surplus and more choice ***(KAA 1 mark)***. Any firm that the OFT discovers has abused its market power will be punished. The OFT can fine firms up to 10% of their turnover if they are breaking competition laws by, for example, predatory pricing. Ultimately, the fines should act as a deterrent to firms and prevent them from breaking competition laws ***(KAA 2 marks)***. Additionally, a firm may be deterred from breaking competition laws to avoid bad publicity. A firm that is being investigated by the OFT may receive bad publicity by the media. Bad publicity means consumers demand less of that firm's good and switch to buying rival goods ***(KAA 2 marks)***. Furthermore, firms may be deterred from colluding to avoid jail time. The 2002 Enterprise Act means it is a criminal offence to collude, anyone found guilty could face up to 5 years in jail plus an unlimited fine ***(KAA 2 marks)***

However, regulatory capture could occur and make completion policy fail. Regulatory capture occurs when the regulator makes decisions that benefit the regulated firm rather than consumers. Maybe, due to asymmetric information, the OFT believes false information given to it by a firm and thus does not punish the firm when it should ***(E 2 marks)***. Also, a firm may have such a strong brand that bad publicity does not affect it. Coca Cola for example, if the media reports that it broke competition laws then it may not lose many consumers. So Coca Cola breaks competition laws as the OFT's punishment seems weak ***(E 2 marks)***. Moreover, the OFT may lack the information to enforce competition policy. Administration costs may prevent the OFT from discovering enough information to build a case against firms who abuse their market power ***(E 2 marks)***.

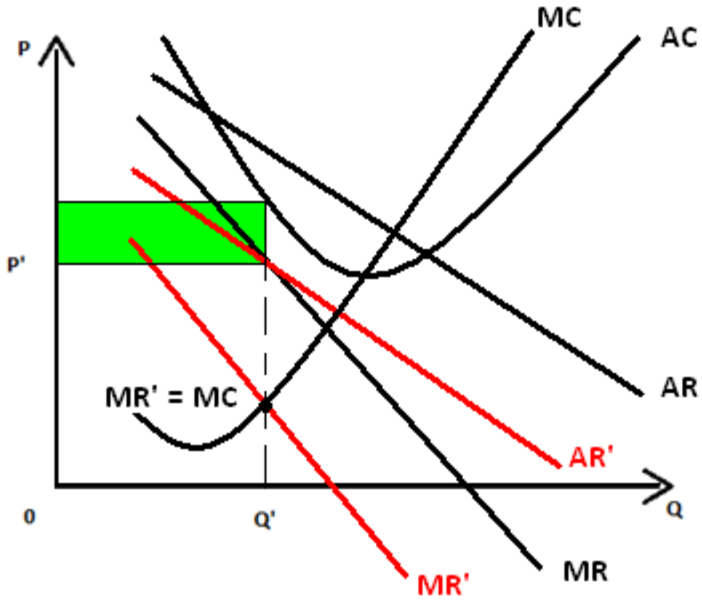
***D) To what extent does the threat of competition affect a firm's behaviour? Answer either with reference to the healthcare product industry or to an industry of your choice. (16)**

A market is more contestable if there are lower entry/exit barriers, lower sunk costs and thus more potential competition ***(KAA 1 mark)***. A first effect may be firms lowering prices. More potential competition in the healthcare market means large incumbent firms like RB must lower their prices to make less profit to disincentivize new firms from entering the market. This could spark a price war as all incumbent firms begin to lower their prices to compete with both current and potential competition ***(KAA 2 marks)***. Also, large firms like RB may engage in predatory pricing to destroy new rivals. RB may price below their AC curve so that both they and their rivals make a loss. Because RB is a large firm it can afford to do this whilst new smaller rivals may not have the required funds and thus make a loss and leave the market ***(KAA 2 marks)***. Additionally, firms may respond by cutting costs and increasing efficiency. More competition means less profit so firms may decrease costs to become more productively efficient and X-efficient to raise their profits again ***(KAA 2 marks)***. Alternatively, firms may respond by advertising. Large firms like RB may embark on an advertising campaign to strengthen their brand and attract consumers from rival firms ***(KAA 2 marks)***.

The response of firms depends on the magnitude of the rise in the threat of competition. A small rise in the threat of competition may not cause a response by large incumbent firms like RB because the extra risk of new firms entering the market and stealing RB's profits is low. Also, if the firms threatening to enter the healthcare industry are really small then RB may not respond because small firms will not really affect their profit ***(E 2 marks)***. Furthermore, there may be patents in the healthcare industry so an extra threat of competition may have no effect. A firm like RB may have patents on many of its drugs, this prevents rival firms from producing RB's patented drugs so RB may not need to respond unless new rivals produce something innovative ***(E 2 marks)***. Moreover, the industry may behave competitively anyway. Maybe the OFT are enforcing rules like price capping on the industry, any increase in competition is unlikely to make the market much more competitive ***(E 2 marks)***. Finally, more firms mean less profits, so there may be less investment in R&D, less innovation and ultimately less quality and choice for consumers ***(E 2 marks)***.

10) A) Using an appropriate cost and revenue diagram, show why 'Thorntons usually records a loss in the second half of the year' (Extract 1, lines 8–9). (4)

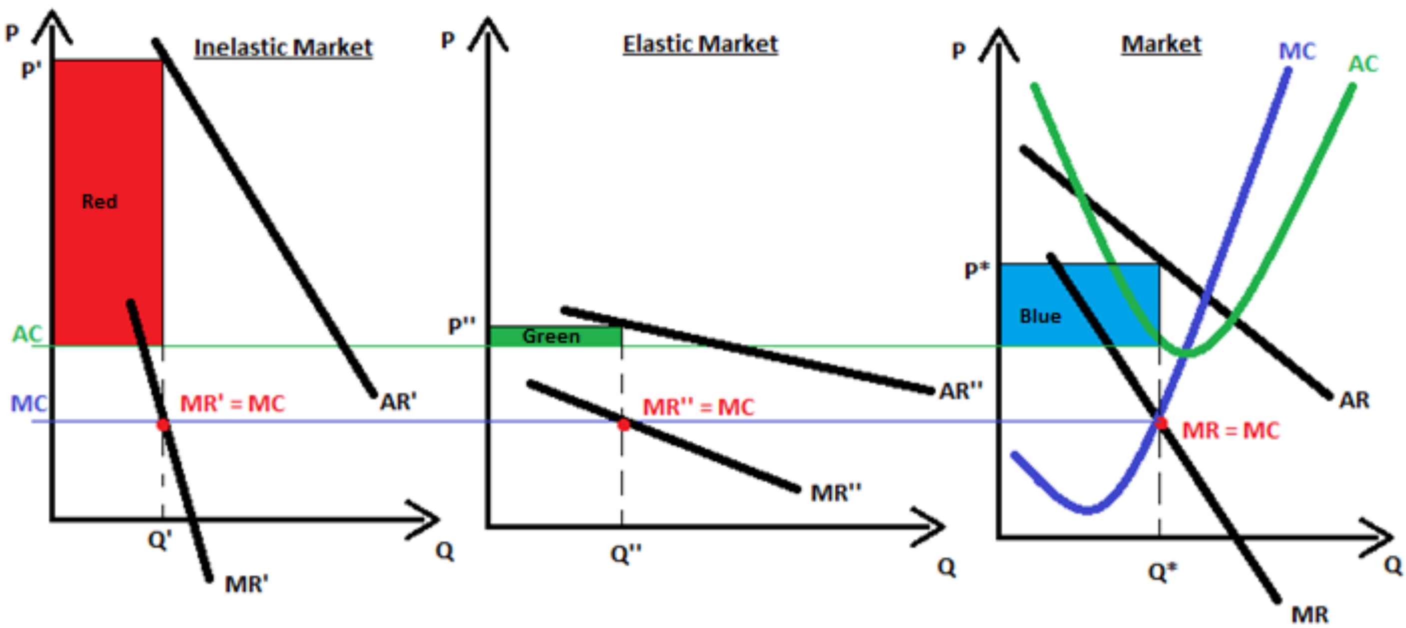
Thorntons records a loss because demand falls. During the summer period, consumers demand less chocolate as the weather is too hot (extract 1) ***(KAA 2 marks)***.



AR and MR shifts left, at the price P' a loss is made equal to the shaded area ***(KAA 2 marks)***.

B) Examine one reason why Thorntons is likely to sell its chocolates at a higher price in its retail shops than through its website. (8)

Thorntons may be doing this to price discriminate. Price discrimination occurs when a firm charges different prices to different consumers for the same good. Thorntons can charge a higher price in-store rather than online because those who buy chocolate in-store may have a more inelastic demand than those who buy online ***(KAA 2 marks)***.

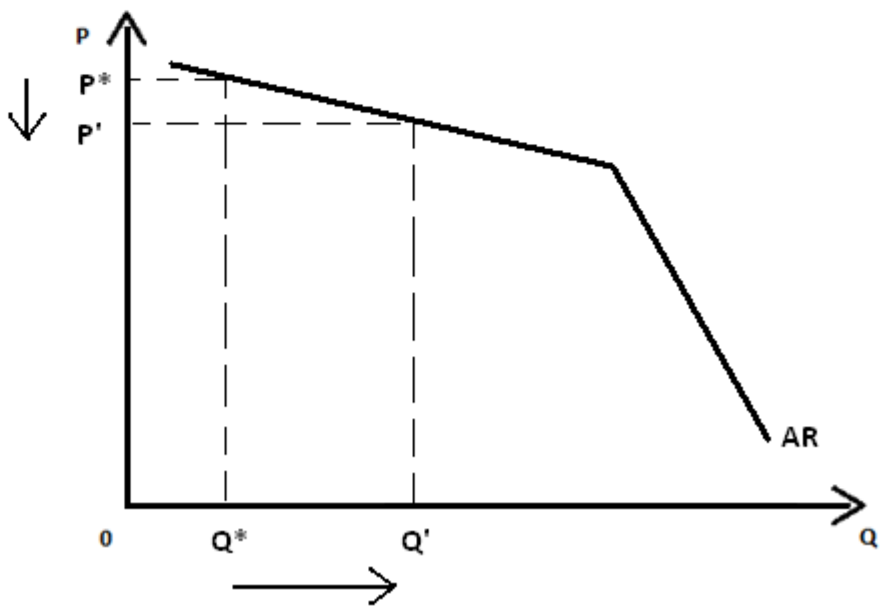


A high price P' is charged to those with an inelastic demand and a low price P'' is charged to those with an elastic demand. Both market segments earn Thorntons super-normal profit. As long as the red and green super-normal profits sum up to more than the blue super-normal profit, Thorntons earns more profit than charging a single price P* ***(KAA 2 marks)***.

However, as Thorntons is price discriminating, consumers with an inelastic demand will be worse off because they pay a higher price so their consumer surplus falls ***(E 2 marks)***. Consumers may eventually begin to buy chocolate online at the low price and sell to consumers with an inelastic demand. This means arbitrage becomes easier so price discrimination may no longer be possible ***(E 2 marks)***.

***C) Assess how the newly combined Kraft and Cadbury food company could increase its share of the chocolate market in competition with Mars. Refer to game theory in your answer. (12)**

Kraft/Cadbury could decrease chocolate prices. Large firms in an oligopoly face a kinked demand curve because they produce close substitutes. If the curve is elastic, Kraft/Cadbury could decrease prices to gain a lot of sales because Mars will not react by lowering prices too ***(KAA 2 marks)***.



Alternatively, Kraft/Cadbury could collude with Mars. Kraft/Cadbury and Mars may both agree to charge high chocolate prices so that they both have roughly the same market share as before but are now each making higher profits ***(KAA 2 marks)***. Kraft/Cadbury could instead engage in non-price competition to increase its market share. Maybe Kraft/Cadbury could embark on an advertising campaign to strengthen their brand and attract consumers from Mars ***(KAA 2 marks)***.

However, if the kinked demand curve is inelastic then when Kraft/Cadbury decrease their price they will not gain many extra sales because Mars will react by lowering their prices too ***(E 2 marks)***. Additionally, collusion is illegal. If the OFT discover that Kraft/Cadbury were colluding then the firms could be fined up to 10% of its turnover and individuals involved may be jailed for up to 5 years and face an unlimited fine ***(E 2 marks)***. Also, advertising may be very costly, Kraft/Cadbury may not be able to afford a large enough advertising campaign to make a difference to its sales and market share ***(E 2 marks)***.

***D) With reference to the information provided, evaluate whether Kraft's takeover of Cadbury is likely to increase economic efficiency. (16)**

Allocative efficiency means P=MC, the firm produces what consumers want and in the desired quantities. Productive efficiency means the firm produces on the lowest point of its AC curve. Kraft's takeover of Cadbury will increase efficiency because the larger firm will experience economies of scale. A firm experiences economies of scale if its long-run average costs fall as output rises. Kraft will benefit from technical economies. As Kraft is larger it can buy specialist machinery to use in its production process to produce a large quantity at a low average cost ***(KAA 2 marks)***. Also, Kraft will benefit from financial economies. Kraft will be a larger firm so it is deemed less risky by creditors and can obtain larger loans at lower interest rates ***(KAA 2 marks)***. Moreover, Kraft will experience managerial economies. A larger firm can employ specialist staff to increase efficiency. Managers can be employed to manage, motivate and/or supervise workers to increase labour productivity and lower unit labour cost (extract 2) ***(KAA 2 marks)***. Furthermore, Kraft will benefit from marketing economies. A larger firm can spread its advertising costs over its larger output. Additionally, the larger firm may gain some monopsony power to be able to bulk purchase and negotiate discounted prices for its inputs ***(KAA 2 marks)***.

However, Kraft may suffer from diseconomies of scale. A firm experiences diseconomies of scale if its long-run average costs rise as output rises. The takeover may result in managerial diseconomies if Kraft's managers take on too many responsibilities running the larger firm ***(E 2 marks)***. Also, the takeover may result in an investigation by the Competition Commission. The larger firm may exploit its increased market power to raise prices, this is not in the public's interests and thus the takeover may be blocked ***(E 2 marks)***. Additionally, Kraft may not need to takeover Cadbury because it may be efficient enough already. Kraft's management has reduced costs significantly by off-shoring (extract 2) ***(E 2 marks)***. Finally, Kraft may become X-inefficient. Kraft may become so big that it has little competition. Kraft's workers will relax more at work and put in less effort because they know Kraft will not go bankrupt if they do not minimize costs because profits are high ***(E 2 marks)***.

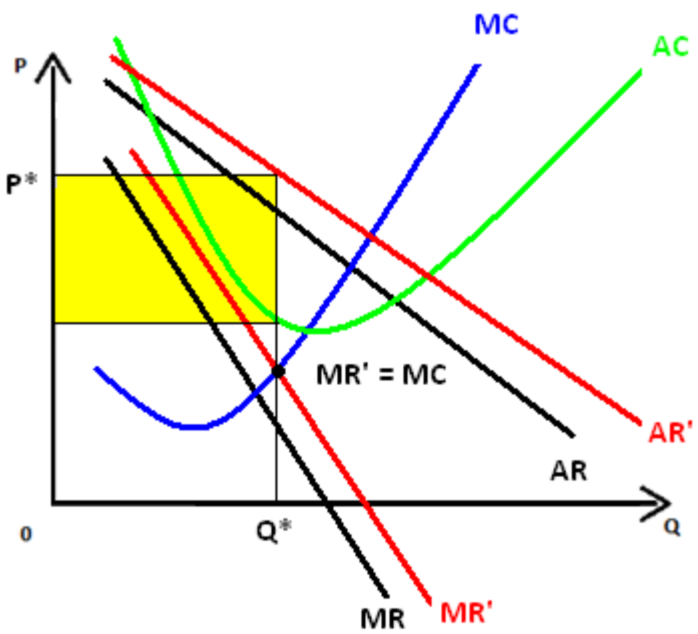
Model Answers Unit 3 January 2012

9) A) With reference to Extract 1, what is meant by anti-competitive behaviour (Extract 1 line 3)? (4)

Anti-competitive behaviour is when firms break competition laws such as the 2002 Enterprise Act ***(KAA 1 mark)*** by colluding ***(KAA 1 mark)*** or engaging in predatory pricing ***(KAA 1 mark)***. UK banks were price-fixing with bank loans and sharing information on the loan market (extract 1) ***(KAA 2 marks)***.

B) Using an appropriate cost and revenue diagram, assess one likely reason why banks' profits rose in the UK in 2010 (Extract 2 paragraph 1). (8)

UK banks' profits rose because demand rose. After the 2007/08 credit crisis there was an increase in consumer confidence and an increase in demand for bank loans ***(KAA 2 marks)***.



AR and MR shifts right, at the price P' a profit is made equal to the shaded area ***(KAA 2 marks)***.

However, banks may have increased their profits by charging small and medium size firms a higher interest rate than the BoE's base rate (extract 2) ***(E 2 marks)***. Also, in the long-run, banks may have to hire more workers as the banking sector makes a full recovery from the credit crisis, causing banks' costs to rise and profits to fall ***(E 2 marks)***.

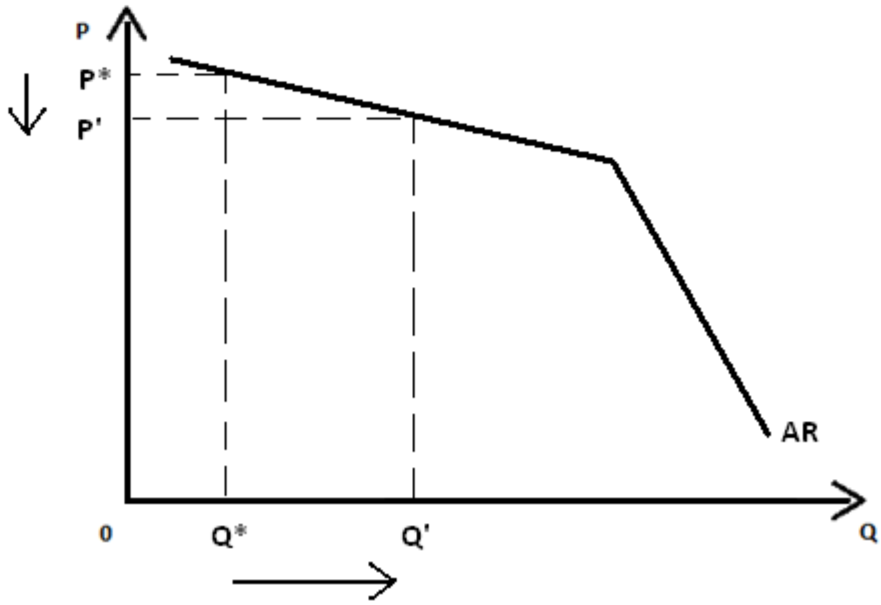
***C) Assess the likely impact on economic efficiency in the UK banking industry of increased regulation of UK banks. (12)**

Allocative efficiency means P=MC. Productive efficiency means banks produce on the lowest point of their AC curve. X-inefficiency occurs when a bank faces no current or potential competition so its workers slack and the bank's costs rise. Regulators could impose an RPI-X price cap on banks. This means banks must raise their prices by no more than the RPI rate of inflation minus the cost-savings that the regulator believes banks can make. This means banks' prices fall in real terms and moves closer towards P=MC so consumer surplus rises and banks are more allocatively efficient ***(KAA 2 marks)***. Moreover, because banks must increase their efficiency to reduce their costs by X they move closer towards the minimum point of their AC curve and become more productively efficient and less X-inefficient ***(KAA 2 marks)***. Furthermore, regulators could set a target for banks. For example, regulators could set a minimum level of investment for banks so that banks lower their costs in the future and become more productively efficient and less X-inefficient ***(KAA 2 marks)***.

However, regulators may accidently set X too low in the RPI-X formula if they lack information on banks' cost structures. If X is too low, banks costs remain high, prices may not fall much and banks do not become much more allocatively and productively efficient ***(E 2 marks)***. Also, regulatory capture could occur and make regulation fail. Regulatory capture occurs when the regulator makes decisions that benefit the regulated firm rather than consumers. Maybe, due to asymmetric information, the OFT believes false information given to it by banks and does not set a high enough target for investment ***(E 2 marks)***. Additionally, more regulations may increase entry barriers and reduce contestability. This means less potential competition for banks, bank workers may become more slack, banks' costs rise and banks become more productively inefficient and more X-inefficient ***(E 2 marks)***.

***D) With reference to Extract 1, assess reasons for Barclays' changing behaviour. Refer to game theory in your answer. (16)**

Barclays were using price information on bank loans shared by other banks but Barclays eventually reported it (extract 1) ***(KAA 2 marks)***. Barclays may have wanted to decrease the prices of its loans to increase its market share. Barclays are in an oligopoly and face a kinked demand curve. Maybe the curve was elastic so Barclays decreased their loan prices to gain a lot of sales because rivals would not have reacted by lowering their loan prices too ***(KAA 2 marks)***.



Barclays may also have been trying to damage RBS' profits and image. RBS were fined £28 million, decreasing their profits. By revealing that RBS had colluded, the OFT investigated and attracted bad publicity for RBS, meaning less demand and less profits for RBS ***(KAA 2 marks)***. Moreover, Barclays may have revealed this information to avoid severe punishment from the OFT. As a reward for acting as an informant, no action was taken against Barclays (extract 1) ***(KAA 2 marks)***. Additionally, Barclays may have revealed this information for 'first mover advantage'. Being the bank that revealed the collusion and by admitting they did wrong, Barclays may be seen in a more sympathetic light by consumers. Maybe Barclays thought consumers would think that RBS forced Barclays to collude. Maybe Barclays moved first because it thought that RBS was ready to report it. ***(KAA 2 marks)***.

But, because Barclays broke the collusive agreement, it is less likely that collusion will occur in the future. RBS may not trust Barclays in any future rounds of collusive negotiation ***(E 2 marks)***. As well as damaging RBS' profits and image, Barclays inevitably damaged its own. Maybe Barclays believed that it can sustain such bad publicity because its brand image is really strong whilst RBS' brand is weaker ***(E 2 marks)***. Furthermore, as RBS was only fined £28 million, it is unlikely that Barclays changed their behaviour to avoid such a small fine. Compared to Barclays' billions of pounds of profits, £28 million is insignificant and not likely to have affected Barclays' behaviour unless, of course, Barclays expected a much larger fine ***(E 2 marks)***. Maybe this was Barclays' plan all along. Collude, make more profits initially, reveal collusion, avoid the fine (or pay the insignificant fine) and damage RBS ***(E 2 marks)***.

10) A) Using the information provided, explain the market structure in the supply of yogurt. (4)

It could be argued that the yogurt industry is an oligopoly, that is, there are a few large dominant firms, interdependency and high entry barriers ***(KAA 2 marks)***. The Yogurt industry is dominated by large firms such as Yoplait and Danone (extract 1) and there is heavy advertising as firms pay search engines for marketing (extract 2) ***(KAA 2 marks)***.

B) Discuss two reasons why the French government may intervene to prevent the acquisition of Yoplait by an overseas firm. (8)

The French government may intervene and prevent the takeover to protect consumers. An overseas takeover of Yoplait may result in a monopoly with the power to restrict output and raise prices. Consumers will be worse off because there is less choice and consumer surplus falls ***(KAA 2 marks)***. Additionally, an overseas takeover of Yoplait may mean that Yoplait's investments and profits leave France in the future. The French government may prevent the takeover so that Yoplait continues to keep its investments and profits in France ***(KAA 2 marks)***.

However, maybe Yoplait is inefficient and requires another firm to buy it and make it efficient. An inefficient Yoplait would not be in the interests of consumers because it means Yoplait's costs and prices are high so consumer surplus is low ***(E 2 marks)***. Also, an overseas firm buying Yoplait does not necessarily mean Yoplait's investments and profits will leave France in the future, in fact, the overseas buyer may intend to make even more investments in France ***(E 2 marks)***.

***C) Assume Yoplait is taken over by PepsiCo. Assess the possible benefits to PepsiCo and consumers of this acquisition. (12)**

A benefit to PepsiCo if it takes over Yoplait is economies of scale. A firm experiences economies of scale if its long-run average costs fall as output rises. A takeover will mean PepsiCo can benefit from financial economies, it will be a larger firm so it is deemed less risky by creditors and can obtain larger loans at lower interest rates ***(KAA 2 marks)***. A second benefit to PepsiCo is that it will break into a new market. PepsiCo would be able to use Yoplait to help expand its range of healthy products (extract 1) ***(KAA 2 marks)***. A benefit to consumers is lower prices. If PepsiCo takes over Yoplait, the larger firm may experience economies of scale. Long-run average costs fall so the larger firm can lower prices and consumer surplus increases. Also, the larger firm has more profit and thus the ability to invest more in R&D, meaning new and better goods for consumers in the future ***(KAA 2 marks)***.

However, the takeover may result in an investigation by the competition authorities. The larger firm may exploit its increased market power to raise prices, this is not in the public's interests and thus the takeover may be blocked ***(E 2 marks)***. Also, PepsiCo will only be buying 50% of Yoplait (extract 1) so PepsiCo would not be gaining complete control. Resultantly, PepsiCo may not benefit much from the takeover as it may not be able to affect all the decisions of Yoplait ***(E 2 marks)***. Moreover, consumers may suffer from higher prices. A larger firm could suffer diseconomies of scale. Long-run average costs will rise and thus the firm must increase prices. Monopoly power and collusion may also mean higher prices. So consumer surplus falls ***(E 2 marks)***.

***D) With reference to Extract 2, discuss how the launch of the new product Yoplait Greek yogurt may influence the behaviour of rival firms. (16)**

Maybe rival yogurt firms will react by increasing their output and reducing prices. Yoplait's new product may steal consumers away from rival firms so rival firms must attract them back by reducing their prices ***(KAA 2 marks)***. Rival firm Danone may react by adopting predatory pricing. Danone may use predatory pricing to price below their own AC curve so that both they and Yoplait make a loss. Danone would hope to drive Yoplait, or at least Yoplait's new product, out of business ***(KAA 2 marks)***. Furthermore, Danone could react by developing a new good. Danone could invest in R&D, innovate and invent a new yogurt to compete with Yoplait's new Greek yogurt and attract more consumers ***(KAA 2 marks)***. Greek Gods may react with an advertising campaign to increase the number of visits to their website from the roughly 3,000 they had between January-March 2010 (figure 1) ***(KAA 2 marks)***.

Assuming the yogurt industry is an oligopoly, rival firms may react with a price war. Large firms in an oligopoly face a kinked demand curve and, if they are on the inelastic part of the curve, a price reduction by one firm will spark rival firms to retaliate and reduce prices ***(E 2 marks)***. Additionally, Danone may not use predatory pricing as it is illegal to make a loss on purpose to make rivals suffer losses. Danone would then be punished by competition authorities ***(E 2 marks)***. Moreover, rivals may not react if they believe Yoplait will soon leave the industry. Because Yoplait only recently entered the Yogurt industry in March 2010 (extract 2), rival firms may believe Yoplait is a 'hit and run' firm looking to take advantage of low entry and exit barriers to quickly enter and exit the industry to make a quick profit ***(E 2 marks)***. Finally, some rivals may go bust due to the shutdown rule (P<AVC). Yoplait's rival firms may suffer such heavy losses that they cannot even cover their average variable costs so they must leave the industry immediately ***(E 2 marks)***.