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Pearson Edexcel

Level 3 GCE

Centre Number

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Economics B

Advanced

Paper 1: Markets and how they work

Tuesday 6 June 2017 – Afternoon Time: 2 hours	Paper Reference 9EB0/01
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You do not need any other materials.

Total Marks

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Instructions

- Use **black** ink or ball-point pen.
- **Fill in the boxes** at the top of this page with your name, centre number and candidate number.
- Answer **all** questions.
- Answer the questions in the spaces provided
– *there may be more space than you need.*

Information

- The total mark for this paper is 100.
- The marks for **each** question are shown in brackets
– *use this as a guide as to how much time to spend on each question.*
- Calculators may be used.

Advice

- Read each question carefully before you start to answer it.
- Try to answer every question.
- Check your answers if you have time at the end.

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Turn over ►


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Answer ALL questions.

SECTION A

Read the following extracts (A to D) before answering Question 1.

Write your answers in the spaces provided.

Extract A

Bright future for coffee shops

In 2014 the branded coffee chain segment recorded £2.9bn turnover from 5,781 outlets, with impressive sales growth of 11.9%. The number of branded coffee shops grew by 4.9%, with 271 stores added during the year.

Costa Coffee, Starbucks Coffee Company and Caffè Nero remain the UK's leading brands by outlet numbers. Market leader, *Costa*, added 151 UK outlets in 2014 and increased revenue from £807m in 2013 to £951m in 2014. Operating profits increased by 20% in 2014 from a figure of £110m in 2013.

Increasing competition provides consumers with more choice of quality coffee at home, at work and a wider variety from the non-specialist sector, such as public houses, fast food operators, supermarkets, garden centres and bookshops. Consumer choice is driven by more criteria than ever before, including: habit, coffee shop brand, loyalty scheme and brand of coffee offered. Coffee shops increasingly play an important role, contributing to the social vibrancy of a community as well as being a large contributor to UK employment and the economy.

Independent coffee shops are becoming far more wide spread and successful than ever before. Some of these independents are now expanding, following the success of leading small chains such as *Taylor St Baristas* and *Timberyard*.

(Sources: adapted from Coffee shops key to growth in market spend, Kathy Bowry at Catering Insight © Promedia Publishing Ltd; Allegra announces 2014 European Coffee Award winners in Istanbul © lunchbusiness.co.uk; and whitbread.co.uk)

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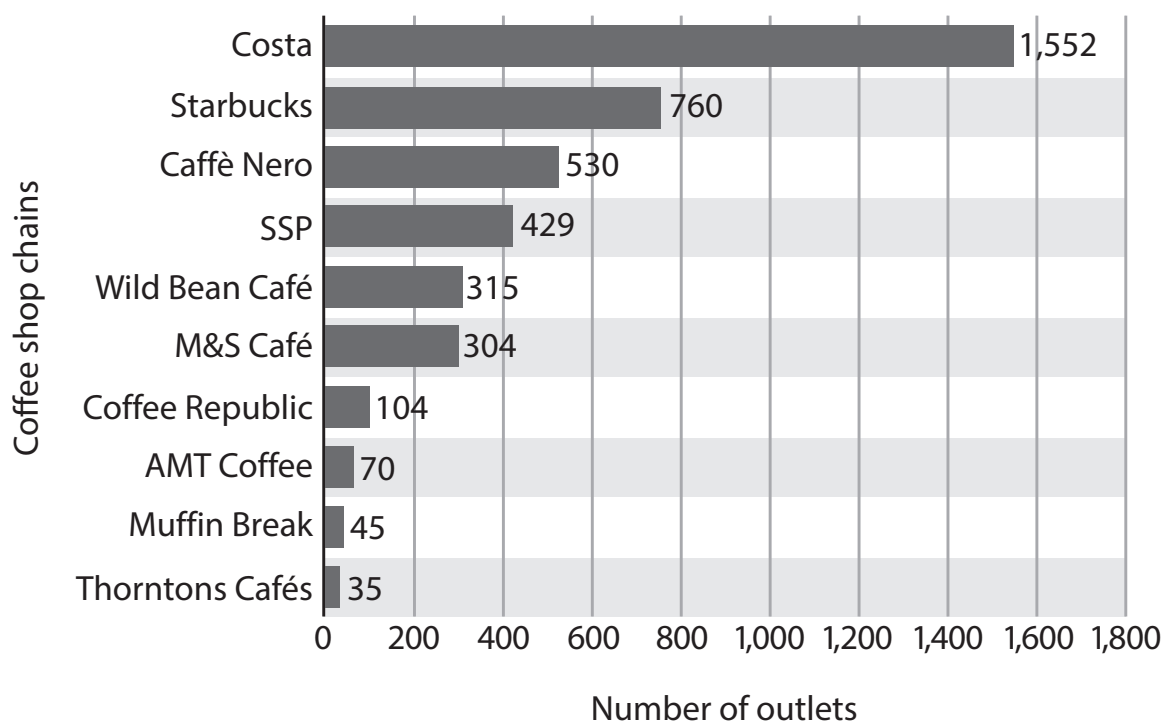
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Extract B

Leading 10 coffee shop chains ranked by number of outlets in the UK in 2014



(Source: adapted from <http://www.statista.com/statistics/297863/leading-coffee-shop-chains-in-the-united-kingdom-uk-store-number/>)

Extract C

Tea, Coffee, Work and Play. Reimagined

Timberyard is a dynamic, independent creative workspace fused with speciality tea and coffee. A challenge to the traditional coffee shop, we are a new and exciting environment that aims to provide products and services that are conducive to the evolving needs of life in London.

We encourage creative people to come together for a variety of reasons and provide a place in which they are comfortable to stay as long as they like. With our range of food and drink from high quality local producers changing daily, it's easy to keep yourself fuelled all day long.

At the 2014 European Coffee Awards, *Timberyard* was announced as 'Best Independent Coffee Shop in Europe'.

Timberyard Soho

Timberyard Soho provides a new creative hub in the heart of London. In an area known for colourful ingenuity and innovation, this new space welcomes our familiar speciality tea and coffee coupled with vibrant workspace. The members' floor offers a beautiful central brew bar plus 104 seats in 2,000 square feet of open plan workspace.

(Source: adapted from <https://tyuk.com/>)



P 5 2 1 3 9 A 0 3 2 4

Extract D**Wholesale Coffee prices, US cents per pound of coffee, October 2014 to September 2015**

Month	Price	Change
Oct 2014	109.39	–
Nov 2014	106.81	–2.36%
Dec 2014	103.51	–3.09%
Jan 2015	102.33	–1.14%
Feb 2015	103.74	1.38%
Mar 2015	98.07	–5.47%
Apr 2015	98.73	0.67%
May 2015	94.35	–4.44%
Jun 2015	96.89	2.69%
July 2015	92.71	–4.31%
Aug 2015	91.94	–0.83%
Sep 2015	87.98	–4.31%

(Source: adapted from <http://www.indexmundi.com/commodities>)

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- 1 (a) Using Extract A, calculate to 2 decimal places the operating profit margin for Costa for 2014. You are advised to show your working.

(4)

$$\text{Operating profit margin} = (\text{operating profit} \div \text{revenue}) \times 100$$

$$\text{Operating profit 2014} = £110\text{m} \times 120\% = £110\text{m} \times 1.2 = £132\text{m}$$

$$\text{Revenue 2014} = £951\text{m}$$

$$\text{Operating profit margin} = (132 \div 951) \times 100 = 13.880\ldots\%$$

$$\text{Operating profit margin for Costa in 2014} = 13.88\%$$



P 5 2 1 3 9 A 0 5 2 4

- (b) Using Extract D, calculate to 2 decimal places the percentage change in the coffee price from October 2014 to September 2015. You are advised to show your working.

(4)

$$\text{Percentage change} = (\text{new price} - \text{original price}) \div \text{original price} \times 100$$

$$\text{Difference} = 87.98 - 109.39 = -21.41 \text{ US cents per pound}$$

$$\text{Percentage change} = (-21.41 \div 109.39) \times 100 = -19.572\ldots\%$$

$$\text{Percentage change in the coffee price} = -19.57\% \text{ (a fall of 19.57\%)}$$

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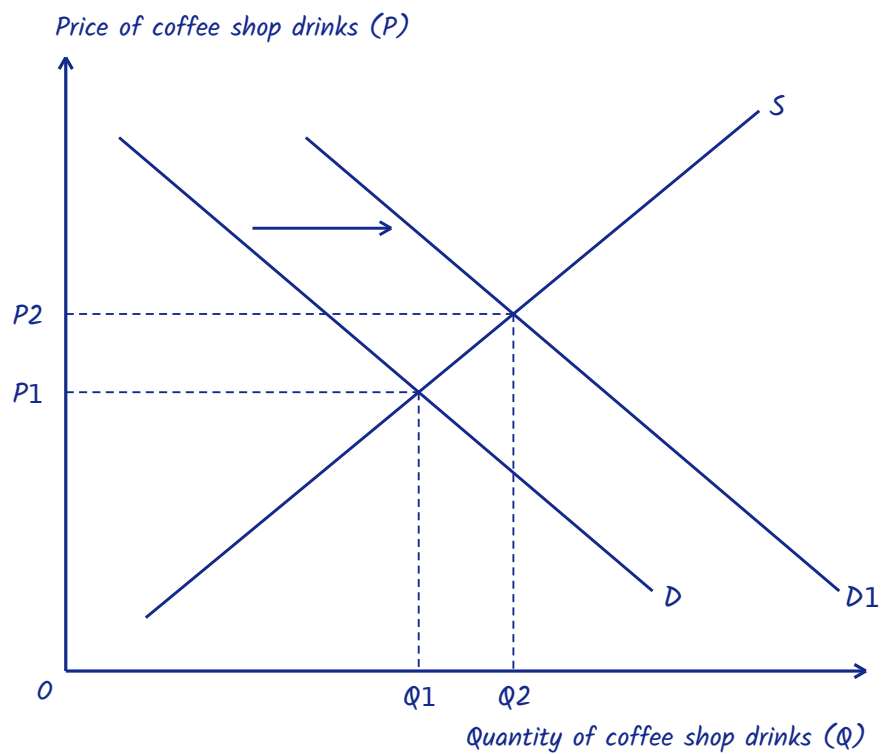
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- (c) Using a supply and demand diagram, illustrate the impact on the coffee shop market of the change in taste and fashion. (Extracts A and C)

(4)



Change in taste and fashion towards coffee shop culture (Extract A: sales up 11.9%; Extract C: workspace cafés) shifts demand right from D to D_1 , so price rises from P_1 to P_2 and quantity rises from Q_1 to Q_2 .



P 5 2 1 3 9 A 0 7 2 4

- (d) Costa Coffee, Starbucks Coffee Company and Caffè Nero are the UK's leading coffee shop chains. (Extract B)

Analyse **one** possible impact of the market structure on the pricing strategy of these firms.

(6)

The UK coffee shop market is an oligopoly, a market dominated by a few large firms. In 2014 Costa (1,552), Starbucks (760) and Caffè Nero (530) had 2,842 of the 5,781 branded outlets, so the three firms held about 49% of the market (Extracts A and B).

Because there are only a few dominant firms, they are interdependent: each must consider how its rivals will react before changing its price. If Costa cut the price of a latte, Starbucks and Nero would be likely to match the cut to protect their market share, so Costa would gain few customers, lose revenue and risk a price war. If Costa raised its price, rivals would probably not follow and it would lose customers to them. As a result, oligopolies tend not to compete on price, so the pricing strategy of these firms is likely to be competitive pricing, setting prices very similar to their rivals, which gives price stability (as the kinked demand curve model predicts). They compete through non-price methods such as loyalty schemes, branding and new outlets instead.



- (e) Discuss whether market share is the most important business objective to a coffee shop chain, such as Timberyard.

(8)

Market share is the percentage of total market sales held by one firm. It is a relative measure against external benchmarks, so it lets Timberyard measure how it is performing against Starbucks or other independents, and helps it judge the effectiveness of its marketing campaigns.

A larger market share can be important because it drives the market's perception of a brand, which is a prerequisite for growth. It also brings economies of scale, such as bulk buying of coffee and spreading management and advertising costs over more outlets, lowering average costs, as Costa does with 1,552 outlets.

However, for a small independent like Timberyard other objectives may be more important. In a very competitive oligopoly dominated by Costa, Starbucks and Nero, survival may be the key aim, as it faces established branded chains, new independents and non-specialists such as supermarkets and pubs entering the market.

Timberyard's Soho venture aims to satisfy a niche segment, creative Londoners wanting workspace, rather than to pursue market share, so customer satisfaction and loyalty may matter more. Ethical objectives, such as supporting high quality local producers, are part of its brand. The Soho site, 2,000 square feet in central London, will be costly, so return on investment and payback may be crucial.

Overall, market share is unlikely to be the most important objective for Timberyard. It depends on the size of the firm: for a market leader like Costa share is vital, but for a niche independent, survival, profit and customer loyalty matter more, at least until it grows into a small chain.



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(f) Extract D shows a fall in the wholesale price of coffee during 2015.

Assess the impact this might have on prices charged in coffee shops.

(10)

Extract D shows the wholesale price of coffee fell from 109.39 to 87.98 US cents per pound between October 2014 and September 2015, a fall of about 20%. Coffee is an input, so lower input costs should reduce the cost of each cup of coffee to retailers.

This shifts the supply curve of coffee shop drinks to the right, from S to S_1 in my diagram, so price could fall from P_1 to P_2 and quantity rise from Q_1 to Q_2 .

If the cost savings are passed on, prices in coffee shops should fall and consumers benefit. The price is more likely to fall if coffee shops are competing heavily on price, as non-specialists such as supermarkets and fast food outlets do, and if demand is price elastic, since a price cut would then raise total revenue.

However, coffee may be only a small element of the overall cost of a cup. Most costs are barista wages, rent and the high fixed costs of high street sites such as Timberyard's Soho premises, so a 20% fall in coffee prices may cut the total cost of a cup by only a few pence.

Consumers may also not be affected in the short term, because chains buy on fixed or forward contracts with farmers. The data also show wholesale prices fluctuating, rising in February, April and June 2015, so retailers facing uncertainty may prefer price stability and take no action short term.

If consumers are loyal to brands such as Costa, demand is price inelastic, and in an oligopoly firms avoid price cuts that could start a price war, so retailers may maintain current prices and enjoy higher profit margins instead.

Overall, the fall in wholesale prices is likely to have only a small effect on coffee shop prices, especially in the short run. Any fall is more likely among price-competitive non-specialists, while branded chains keep prices stable and widen their margins.

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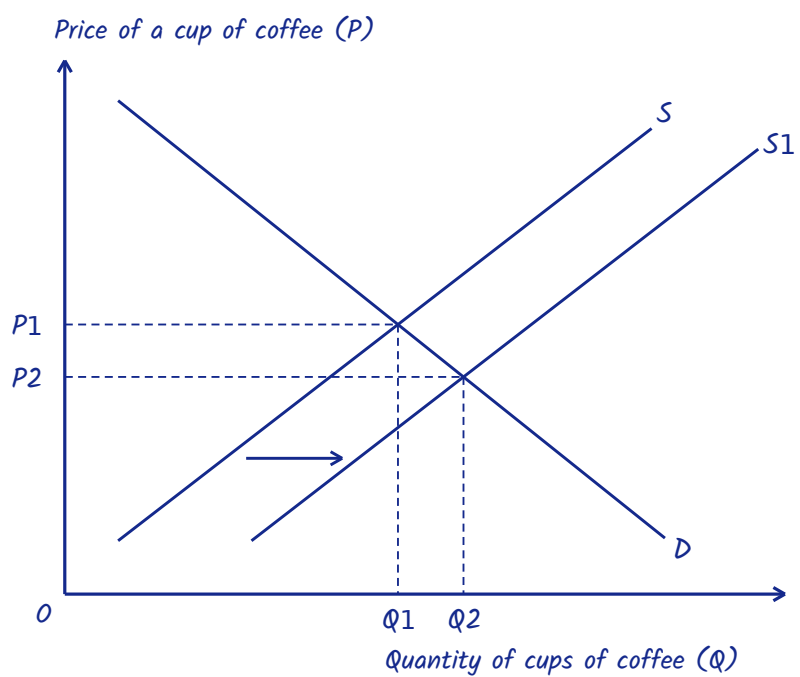
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Lower wholesale coffee price cuts costs: S shifts to S_1



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(g) Assess the importance of non-price competition in the UK coffee market.

(12)

Non-price competition is when firms try to increase demand by means other than price, such as branding, quality, service, location and loyalty schemes. It occurs in imperfect competition, where products are not homogeneous, and is especially important in an oligopoly like the UK coffee market, where Costa, Starbucks and Nero hold about 49% of branded outlets.

Differentiation of drinks attracts customers interested in speciality coffees, which makes demand more price inelastic and allows premium pricing. Timberyard offers speciality tea and coffee and food from high quality local producers, and its award as 'Best Independent Coffee Shop in Europe' strengthens its reputation.

Level of service is also key. Timberyard aims to meet the 'evolving needs of life in London' with vibrant workspace, 104 seats on its members' floor, where customers can stay as long as they like, responding to social trends to increase sales.

Loyalty schemes such as loyalty cards encourage repeat purchase and build brand loyalty, and Extract A says consumer choice is driven by habit, brand and loyalty schemes. Location matters too: growth of chains in major cities builds brand awareness as independents become small chains, and prime sites such as Soho attract footfall.

As it is a growing market, with sales up 11.9% in 2014, non-price factors may be more important than price. Discounted prices may lead to a perception of lower quality, discouraging some consumers. In an oligopoly there is relative price stability, so customer loyalty is built on location, differentiation and service.

However, price may still be important. Firms may use discount pricing, price discrimination, BOGOF offers or predatory pricing to attract greater footfall. This risks a price war: game theory suggests that if one firm cuts its price rivals will follow, leaving all with lower profits, cost cutting and lower levels of service for customers.

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Price matters most to price sensitive consumers, and is more evident among non-specialist providers such as supermarkets and pubs than in speciality coffee retailers.

Overall, non-price competition is very important in the UK coffee market, as consumers choose on brand, location, service and experience. However, its importance depends on the segment: it is crucial for speciality chains and independents like Timberyard, while price remains significant in the non-specialist sector.



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(h) Assess whether the UK coffee shop market could be considered contestable.

(12)

A contestable market is one with freedom of entry and exit and low sunk costs, so the threat of new entrants forces existing firms to keep prices and profits near normal levels, whatever the number of firms.

There is evidence of contestability. New firms such as Taylor St Baristas and Timberyard are entering the market and winning awards, bringing out new coffees, niche products and services such as workspaces. Extract A says independents are more widespread and successful than ever, and 271 branded stores were added in 2014, growth of 4.9%.

There is also entry from the non-speciality sector, such as garden centres, bookshops, supermarkets and garages providing coffee shops or concessions, showing access to the coffee market is easy. An economic upturn in the UK encourages dining out and café culture, attracting new entrants to a growing market.

There is little evidence of high sunk costs, high technology levels or collusion that would prevent entry: a shop can be leased and an espresso machine resold on exit.

However, high investment costs in premium high street London locations such as Soho, plus coffee machinery and fit-out costs, may prevent new entrants. Contestability may also be low due to economies of scale gained by large branded retailers such as Costa, which opened 151 new outlets in 2014 with revenue of £951m, so it can buy coffee and advertise more cheaply per unit. Large retailers are likely to have contracts or vertical integration with coffee growers, giving cost advantages over new entrants.

There is limited evidence that new entrants will survive. Due to brand loyalty, Costa and Starbucks are now household names, and Costa's operating profit of £132m suggests supernormal profit, which would be competed away in a perfectly contestable market.

Overall, the market is fairly contestable at the independent and niche end, where entry

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and exit costs are low, but the branded chain segment is much less contestable because of economies of scale, brand loyalty and the sunk costs of prime sites. So it is contestable only to a degree.

(Total for Question 1 = 60 marks)

TOTAL FOR SECTION A = 60 MARKS



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SECTION B

Read the following extract (E) and Figures 1 and 2 before answering Question 2.

Write your answer in the space provided.

Extract E

Trends and Fluctuations in fuel prices

Fluctuations in fuel prices are a common occurrence. For the most part an upward change in the price of petrol, diesel and other fuels is caused by a variety of factors, such as market forces, global events and new technology.

Changes in the oil industry have significant effects all around the world. Crude oil, which is refined to form different fuels and many other products, including plastics, fertilisers and man-made fabrics, is the world's most actively traded commodity.

The UK Fuel Industry

The UK's fuel industry is home to some of the world's biggest fuel companies such as *BP* and *Shell* whose products and services are used around the globe. As such the importation and refining of crude oil and its production into petroleum and other petrochemicals are a major part of the fuel industry in the UK.

Hydraulic fracturing or fracking has made America increasingly energy independent and has broken its reliance on the volatile Middle East. Experts have warned that a rush to start fracking for oil across Britain may already be over before it has even begun. The slump in global crude oil prices makes this controversial method look increasingly uneconomic.

(Source: adapted from UK fracking faces bust amid Opec oil price war, Andrew Critchlow
© Telegraph Media Group Limited)

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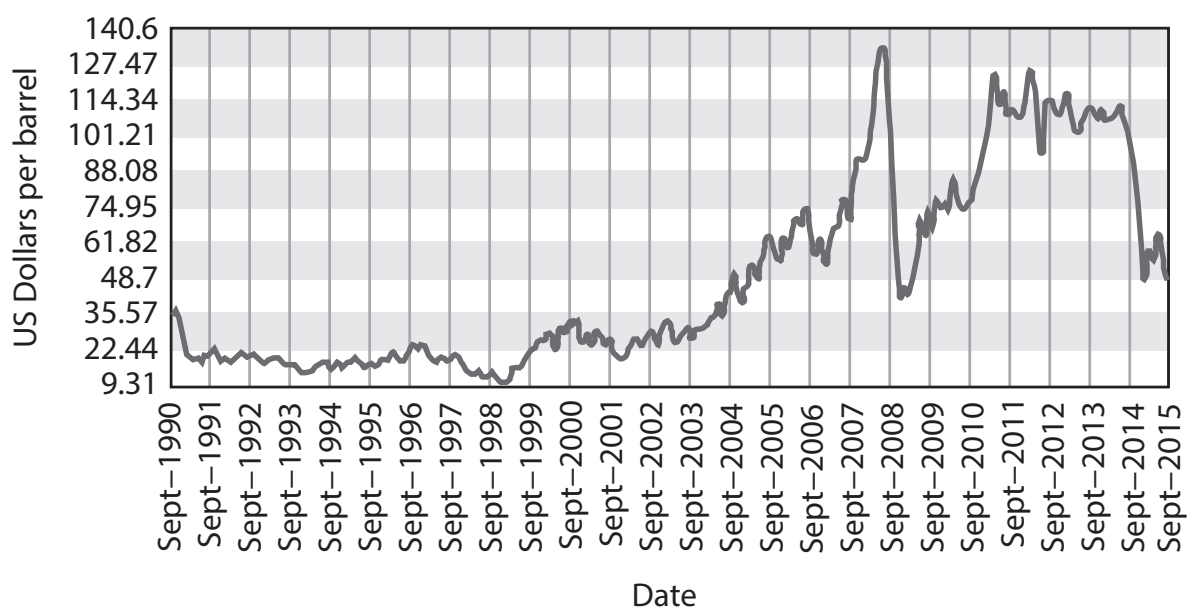
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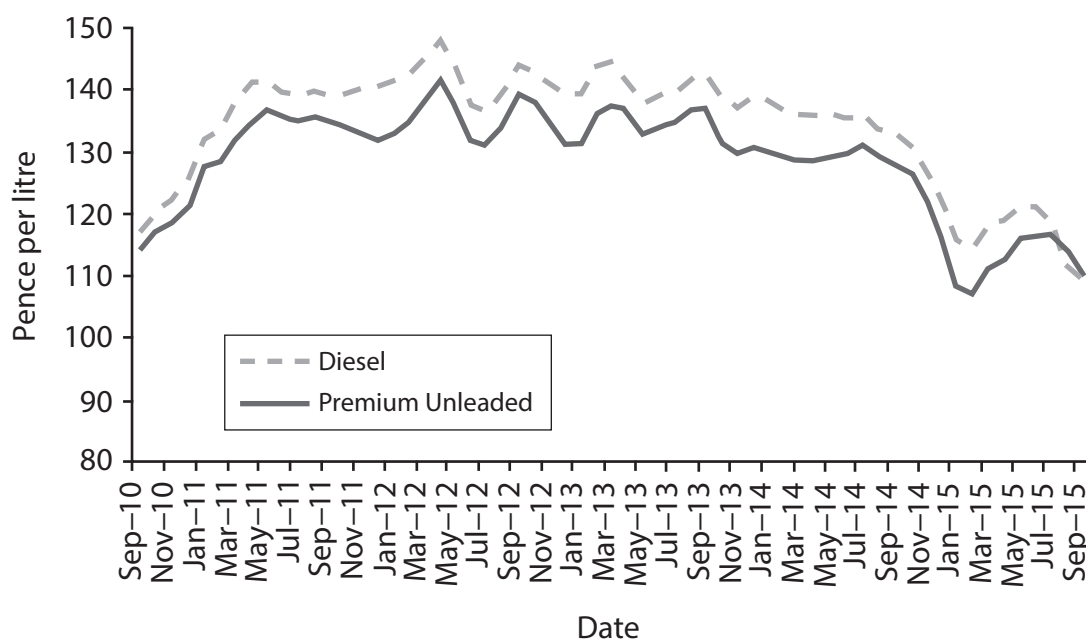
Crude oil prices – US Dollars per barrel (Sept 1990 to Sept 2015)



(Source: adapted from © Crown copyright)

Figure 1

UK Retail prices of Diesel and unleaded petrol (Sept 2010–Sept 2015)



(Source: adapted from © Crown copyright)

Figure 2



- 2 Using Extract E, evaluate the likely impact of falling crude oil prices on the UK economy.

(20)

Crude oil is refined into fuels and many other products such as plastics, fertilisers and man-made fabrics, and is the world's most actively traded commodity (Extract E).

Figure 1 shows crude oil prices fell from about \$110 a barrel in mid 2014 to below \$50 in 2015, more than halving, and Figure 2 shows UK retail prices of premium unleaded fell from about 130p to around 107p to 110p per litre.

Falling oil prices are likely to lead to falling prices elsewhere in the economy, because oil is an important part of the cost of production and transport. This shifts SRAS to the right, from SRAS to SRAS1 in my diagram, so the price level falls from P1 to P2 and real output rises from Y1 to Y2. Oil related products such as plastics and man-made fabrics will fall in cost and price, reducing inflationary pressures.

Savings made from lower petrol prices allow households to increase spending elsewhere, thus increasing AD. Falling costs of production raise firms' profits and may lead them to increase investment, further increasing AD and AS and real income, which could lead to a fall in unemployment. As economic activity grows, government tax revenues from corporate and personal income taxes may rise, perhaps offsetting declining revenues from the oil sector.

The value of oil imports will drop, reducing the current account deficit. It may also reduce income inequality, as low income earners spend a high proportion of income on fuel and so gain a real saving.

However, Extract E says the slump makes fracking look increasingly uneconomic, so falling oil prices could delay investment in fracking and in 'greener' energy such as electric cars. Cheaper fuel could increase car usage, leading to more traffic congestion and environmental costs of petrol use. UK oil firms such as BP and Shell, a major part of the UK fuel industry, will earn lower revenues, which may cut jobs and investment.

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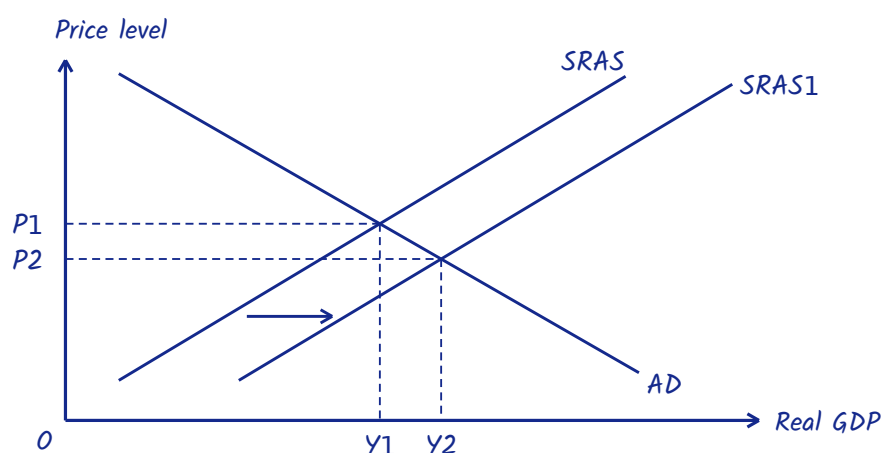
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Rather than helping increase spending, falling oil prices are pushing down the inflation rate and making deflation a real possibility, which could lead consumers to delay purchases.

The size of the impact is uncertain. Figures 1 and 2 show oil and fuel prices fluctuate, for example crude collapsed in 2008 and then recovered to over \$110, so the fall may be temporary and industry may be reluctant to invest. Retail fuel prices fell by much less than crude, because fuel duty and VAT are a large share of the pump price, so some consumers may not feel much better off. Cost savings may not be passed on immediately, and supply chains and fixed price contracts delay the benefit.



Effects differ by industry: transport firms and manufacturers gain, while oil producers lose, as a falling oil price reduces the value of oil exports. The UK is currently a small net importer of oil, so the impact on the current account will be limited, and dependency on oil is falling as the UK becomes a more service based economy using more renewable energy.

In conclusion, falling crude oil prices are likely to benefit the UK economy overall in the short run, through lower inflation, higher real incomes and higher AD, with low income households and transport intensive firms gaining most. However, the size of the benefit depends on how long the fall lasts and how much is passed on, and it is partly offset by losses in the oil and fracking industries and by environmental costs.



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(Total for Question 2 = 20 marks)

TOTAL FOR SECTION B = 20 MARKS



SECTION C

Read the following extracts (F and G) before answering Question 3.

Write your answer in the space provided.

Extract F

Banking Regulations and fines

The Financial Conduct Authority (FCA) fined the *Royal Bank of Scotland plc*, *National Westminster Bank plc* and *Ulster Bank Ltd* £42m for IT failures which meant that their customers could not access banking services.

The IT failure affected over 6.5 million customers in the UK for several weeks. Over the course of that period customers could not use online banking facilities to access their accounts or obtain accurate account balances from ATMs; customers were unable to make mortgage payments; customers were left without cash in foreign countries. The three banks applied incorrect credit and debit interest to customers' accounts and produced inaccurate bank statements. Some organisations were unable to meet their payroll commitments or finalise their audited accounts.

5

10

The FCA has also published new remuneration rules aimed at further aligning risk and reward in the banking sector. The rules, on pay and bonus payments for banking staff, are intended to discourage irresponsible risk-taking and short-termism, and to encourage more effective risk management.

(Sources: adapted from FCA fines RBS, NatWest and Ulster Bank Ltd £42 million for IT failures © FCA and FCA and PRA publish new remuneration rules © 2015 Compliancy Services Ltd)

Extract G

Too big to fail

If the financial crisis (2008) had a catchphrase, it was "too big to fail".

September 2008 saw the collapse of *Lehman Brothers*, the original "too big to fail" event that highlighted to the world exactly what the failure of a major financial institution would entail. Since *Lehman's* bankruptcy, reforms have been put in place aimed at making big banks safer.

5

The financial crisis had an unprecedented impact on the financial system. A number of firms that were considered "too big to fail" were bailed out by the state. This resulted in a perception that such firms in effect benefit from a state guarantee.

At EU level, new rules allow governments and regulators in Europe to intervene when financial institutions have not prepared appropriately for potential failure. The initiative aims to minimise the need for tax payer bailouts when financial institutions face difficulties.

10

(Sources: adapted from Banks will carry on being 'too big to fail' © The Telegraph 2014)



P 5 2 1 3 9 A 0 2 1 2 4

3 Evaluate the likely impact on the UK of increased regulation of the UK banking industry.

(20)

Regulation is rules set by government or agencies, such as the Financial Conduct Authority (FCA), to control the behaviour of firms. In banking it aims to correct market failures such as information asymmetry and moral hazard, protecting customers and the wider economy.

Customers are protected from market imperfections and failures and should see improved service. Extract F shows IT failures at RBS, NatWest and Ulster Bank affected over 6.5 million customers for several weeks: they could not use online banking, get accurate balances from ATMs or make mortgage payments, and some organisations could not meet payroll commitments. The £42m fine gives banks an incentive to invest in reliable systems, which gives customers confidence as information asymmetry is reduced.

Another important role of regulation is to set minimum standards and remove failing banks from the market, so banks maintain standards and participate actively in the market. If financial services operate effectively, savings and investment are encouraged, supporting growth, which should also positively affect shareholders' returns.

The FCA's new remuneration rules on pay and bonuses aim to discourage irresponsible risk taking and short-termism and encourage more effective risk management. Business customers may see a reduction in charges if bankers are regulated in terms of salaries and bonuses awarded.

Most importantly, regulation tackles the 'too big to fail' problem. Extract G explains that after the collapse of Lehman Brothers in 2008 several banks were bailed out by the state, creating a perception that such firms benefit from a state guarantee. Without changes to this concept moral hazard increases: with a view that depositors are protected, banks are induced to take more risk and can hold lower levels of capital because of deposit insurance, while consumers are less careful in choosing a bank. This

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could lead to a collapse like Northern Rock with taxpayers bailing banks out. Stronger regulation, such as the EU rules allowing regulators to intervene before failure, prevents UK taxpayers from being forced to pay if big banks collapse in another financial crisis, freeing government funds for other spending.

However, regulation costs are high, as is the cost of fines, and these increase costs to customers and potentially reduce dividends to shareholders. Fining RBS, which the taxpayer partly owned after its bailout, partly takes money from the public. Bank employees may not be rewarded sufficiently for their efforts if remuneration is capped, so banks may lose their best managers to other industries or overseas, causing skills gaps. Banks themselves may move abroad, reducing UK jobs, tax revenue and London's role as a financial centre.

Unless banks can earn returns that are sufficiently attractive to private investors to draw in capital, they will suffer a slow decline. That could choke off credit to companies and households, reducing investment and consumption, damaging the economy and diminishing growth. There is also a risk of regulatory failure if rules are too complex or cannot keep pace with innovation, and some argue banks could self-regulate more cheaply.

The overall impact depends on the type and degree of regulation. Rules that improve service and reduce systemic risk, like those in Extracts F and G, have large long run benefits, while heavy caps on pay or lending carry larger costs. It also depends on whether other countries regulate too, as UK-only rules encourage banks to relocate.

In conclusion, increased regulation is likely to have a positive overall impact on the UK, because the cost of another crisis like 2008 is far greater than the costs of compliance, with customers and taxpayers gaining most. However, regulation must be proportionate and phased in, as in the short run it may raise costs and reduce lending to firms and households.



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(Total for Question 3 = 20 marks)

TOTAL FOR SECTION C = 20 MARKS

TOTAL FOR PAPER = 100 MARKS

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