

Please check the examination details below before entering your candidate information

Candidate surname <i>StemUp Model Solution</i>		Other names											
Pearson Edexcel Level 3 GCE		Centre Number <table border="1"><tr><td></td><td></td><td></td><td></td><td></td></tr></table>						Candidate Number <table border="1"><tr><td></td><td></td><td></td><td></td><td></td></tr></table>					
Monday 18 May 2020													
Morning (Time: 2 hours)		Paper Reference 9EB0/01											
Economics B Advanced Paper 1: Markets and how they work													
You do not need any other materials.			Total Marks										

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.

Turn over ►

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Answer ALL questions.

SECTION A

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

Write your answers in the spaces provided.

Extract A

How *British Airways (BA)* is turning itself into a low-cost airline

BA's efforts to compete with budget airlines such as *EasyJet* and *Ryanair* on short-haul flights has led to a number of changes that have been criticised by loyal customers and created bad publicity for the long-established business. BA took the decisions to scrap free meals on all short-haul flights and reconfigure aircraft to add more seats, resulting in reduced legroom on some aircraft. 5

The reinvention of BA is continuing with the carrier planning to launch the option of no-frills fares on its long-haul flights. The cheaper tickets, which do not include the cost of luggage or seat selection, will help BA compete with the likes of low-cost long-haul rival *Norwegian* on key routes to America. 10

BA faced further bad publicity when news broke it had been fined €104m (£90m) by the European Commission in 2017 for its role in a major price-fixing scandal. Eleven airlines were fined a total of €776m for their role in a cartel to fix fuel and security charges on flights within the European Economic Area.

Despite the bad publicity the business is performing well financially. In 2017 BA generated sales revenue of £12.30bn, which was a 7.3% increase on the previous year. In 2017 the profit for the year increased from £1.28bn to £1.4bn. 15

(Sources: adapted from <https://www.telegraph.co.uk/travel/comment/british-airways-is-going-budget-on-long-haul-flights/>,
<https://www.statista.com/statistics/264296/british-airways-worldwide-revenues-since-2006/>,
<http://www.cityam.com/261156/eu-slaps-eur776-million-fine-air-cargo-cartel>)

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Extract B**Government sets out its vision for UK aviation**

In 2017 the UK Government launched its initial plans to develop a new aviation strategy to help shape the future of the aviation industry to 2050 and beyond. It looks at how the government can support future growth in an industry which directly supports 240,000 jobs and contributes around £22bn to the UK economy each year. The plan recognises that larger airports help to attract more investment and visitors and connects UK firms to trading opportunities overseas. 5

The strategy was announced at the launch of a £1bn project to double the size of Manchester Airport's Terminal 2. The project will create 1,500 jobs, allow for more international destinations, and grow passenger numbers from 27 million to 45 million a year. 10

In addition, it was announced that families flying on holiday will no longer have to pay air passenger duty (APD) for children under the age of 16. APD was introduced in 1994 as an indirect tax to pay for the environmental costs of air travel and is levied against each passenger on flights departing from the UK. 15

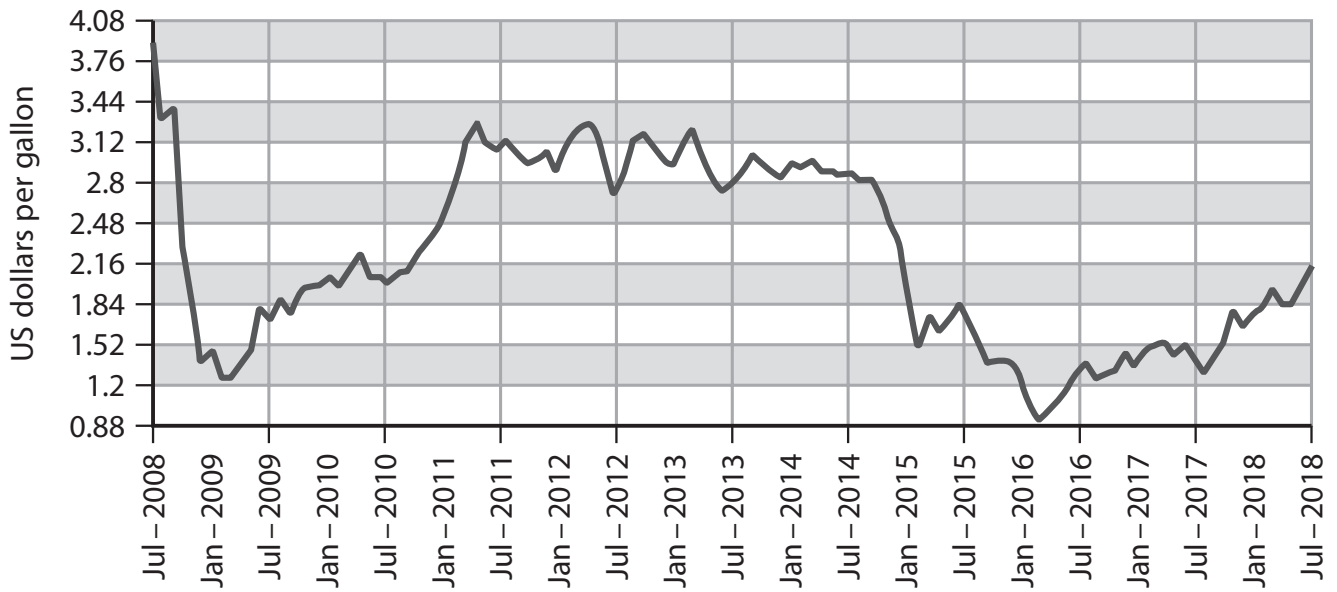
(Sources: adapted from <http://www.thisismoney.co.uk/money/holidays/article-2859186/Flight-taxes-children-abolished-cut-hundreds-pounds-cost-family-holidays.html>,
<https://www.gov.uk/government/news/government-sets-out-vision-for-future-of-uk-aviation>)



Extract C

For the airline industry, jet fuel represents one of the largest expenses.

Jet fuel prices (US dollars per gallon)



(Source: adapted from <https://www.indexmundi.com/commodities/?commodity=jet-fuel&months=120>)

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1 In July 2008 the jet fuel price per gallon was \$3.89. In January 2018 it was \$1.95.

- (a) Calculate, to two decimal places, the percentage decrease in the price of jet fuel between July 2008 and January 2018. You are advised to show your working.

(4)

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

$$\text{Change in price} = \$3.89 - \$1.95 = \$1.94$$

$$(\$1.94 \div \$3.89) \times 100 = 49.871\ldots\%$$

$$\text{Percentage decrease} = 49.87\%$$



A company that refits aircraft for airlines was charging a price of £300 000 to refit an aircraft and demand was six refits per year. When the company reduced its price to £298 000 per aircraft the demand increased to seven aircraft per year.

- (b) Calculate the marginal revenue gained from the decrease in price for refitting an aircraft.

(4)

Marginal revenue = change in total revenue $\div$ change in quantity

Original total revenue = £300 000 $\times$ 6 = £1 800 000

New total revenue = £298 000 $\times$ 7 = £2 086 000

Change in total revenue = £2 086 000 - £1 800 000 = £286 000

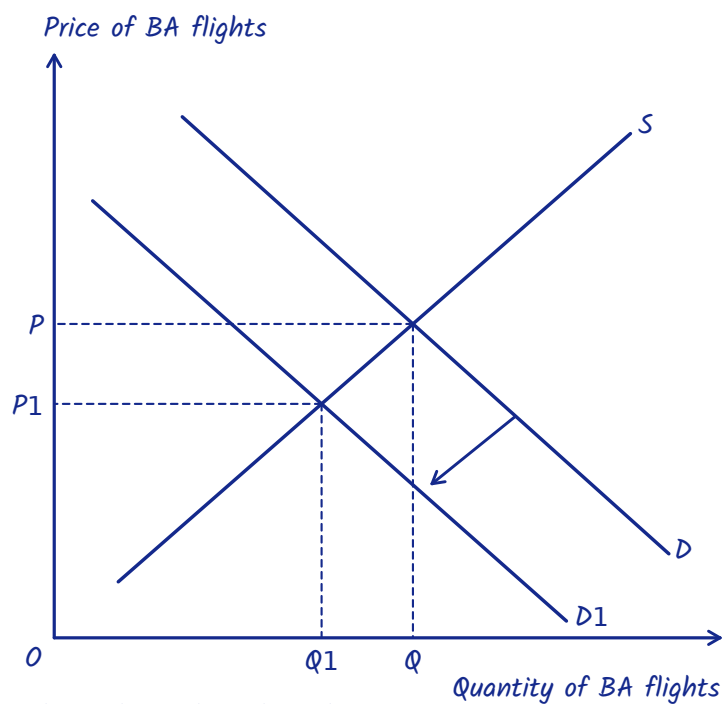
Change in quantity = 7 - 6 = 1 refit

MR = £286 000 $\div$ 1 = £286 000



- (c) Using a supply and demand diagram, illustrate the likely impact on BA of further bad publicity for the business.

(4)



Bad publicity reduces demand: D shifts left to $D1$, so price falls from P to $P1$ and quantity from Q to $Q1$.



- (d) Analyse **two** ways secondary market research may be used by airlines, such as BA, to help increase sales.

(6)

Secondary market research is the use of data that has already been collected by someone else, such as government statistics, industry reports and competitors' websites.

Firstly, airlines can use it to identify changes in trends in the market. Published data, for example from airports or the Civil Aviation Authority, shows the number of passengers flying to different destinations. If BA sees that demand for routes to America is growing, it can respond quickly by adding flights to existing destinations or launching new ones, such as its no-frills long-haul fares, before rivals do, resulting in higher sales.

Secondly, airlines can use it to monitor the prices of competitors. The fares of low-cost rivals such as Ryanair, EasyJet and Norwegian can be easily accessed online at almost no cost. BA can then set its fares at or below those of its rivals on key routes, making it more price competitive, so that price-sensitive customers switch to BA, resulting in higher sales and market share.



(e) Discuss the importance to BA of survival as a business objective.

(8)

Survival as a business objective means a firm aims to remain viable and operational, covering its costs so that it can continue trading, rather than aiming for maximum profit.

Survival may be important to BA because it faces a growing threat from budget airlines such as EasyJet and Ryanair on short-haul flights and Norwegian on long-haul routes. BA has responded by cutting costs: it has scrapped free meals on short-haul flights and reconfigured aircraft to add more seats, reducing legroom. It is also planning no-frills fares on long-haul flights. This suggests BA feels threatened and is concerned about its future, so it is changing its strategy to keep customers. It may even accept lower profits, lowering prices to compete for customers, or engage in predatory pricing to drive out rivals, putting survival ahead of profit maximisation.

However, the extract shows BA is performing well financially. In 2017 sales revenue rose by 7.3% to £12.30bn and profit for the year increased from £1.28bn to £1.4bn, a profit margin of about 11% ($\text{£1.4bn} \div \text{£12.30bn}$). With high and rising profits, BA is clearly not struggling to survive, which suggests profit maximisation, or growing market share, is still its main priority.

Overall, survival is of limited importance to BA at present. Its cost cutting indicates it is being competitive rather than fighting for survival. Survival would only become a priority if profits fell sharply, for example if fuel prices rose or demand fell in a recession.



- (f) Assess the government's decision to reduce air passenger duty (APD) as part of its vision for UK aviation.

(10)

Air passenger duty (APD) is an indirect tax, a tax levied on goods and services rather than on income or profits, charged on each passenger on flights departing from the UK. It was introduced in 1994 to pay for the environmental costs of air travel. The government has now removed APD for children under the age of 16.

This is a saving for families flying on holiday, reducing the cost of a family trip. Lower prices may encourage families to fly more frequently, increasing demand for flights. Higher passenger numbers would create spending in the economy, both on airlines and on goods and services in airports, such as shops and restaurants. This supports the vision for an industry that already directly supports 240,000 jobs and contributes around £22bn to the UK economy each year. More demand may lead to the creation of more jobs and an increase in aggregate demand, and it fits with projects such as the £1bn expansion of Manchester Airport's Terminal 2, which aims to grow passenger numbers from 27 million to 45 million a year.

However, the limiting factor is that the cut only applies to under 16s, so the impact on total demand may be minimal: business travellers and adults without children still pay the tax. APD may also be a small percentage of the total cost of a family flight, so the saving may not be enough of an incentive to make many more families fly, especially if demand for holidays is price inelastic. In addition, a key aim of the aviation vision is to connect UK firms to trading opportunities overseas, and this will not be affected by a reduction in APD for children.

The decision may also be regarded as unethical, or inconsistent, because the purpose of the tax is to cover the environmental damage of flying. Encouraging more flights increases negative externalities such as carbon emissions and noise, and the government loses tax revenue that could have been used to offset this damage.



Overall, the decision is likely to have only a small positive effect on the UK aviation industry. It benefits families and airports in the short run, but the overall increase in demand and jobs is likely to be minor and must be weighed against lost tax revenue and higher environmental costs. Its success depends on how price elastic family demand for flights is and how much of the saving is passed on to customers.



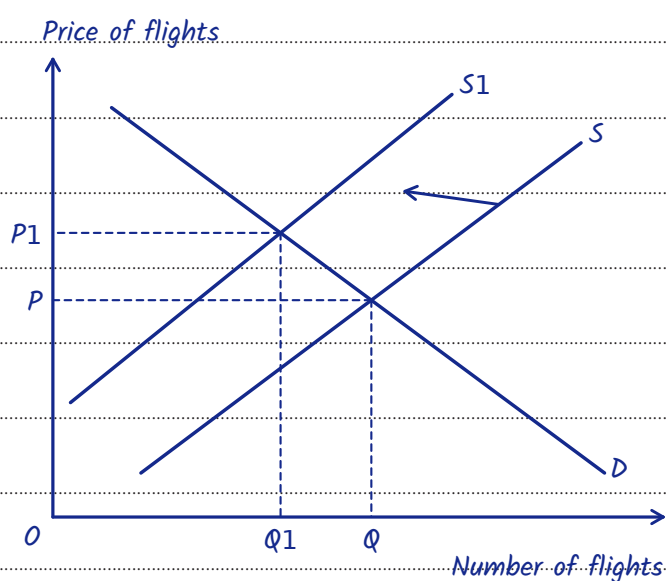
(g) Assess the possible impact of rising fuel prices on an airline business.

(12)

Jet fuel is one of the largest input costs for airlines, along with staff and airport costs.

Extract C shows the price fluctuated greatly, from a peak of about \$4 per gallon in 2008 (\$3.89 in July 2008) to a low of under \$1 in early 2016. Since 2016 there has been a steady rise, to \$1.95 in January 2018 and over \$2 by mid-2018.

Rising fuel prices increase the costs of production, so the supply of flights shifts left from S to S_1 , as shown in my diagram. Airlines are likely to be forced to increase prices for flights from P to P_1 , which leads to lower demand, a fall in quantity from Q to Q_1 and lower capacity utilisation, with fewer seats filled on each flight. This could lead to fewer routes and unemployment in the industry.



If airlines do not pass the cost on, their profitability will fall. This hits budget airlines such as Ryanair and EasyJet hardest, because they operate on low profit margins, and some may be forced out of the industry or decrease supply. The industry may also be forced to cut costs elsewhere, which may reduce the quality of the service provided to consumers, for example removing free meals as BA has done. The fluctuating prices also create uncertainty, which makes it harder to plan fares and may discourage new entrants. However, the impact may be limited. Although prices rose steadily from 2016 to 2018, at



around \$2 they are still significantly lower than the \$3 to \$4 seen from 2011 to 2014, so airlines may still be enjoying reasonable profit margins, as BA did with profits of £1.4bn in 2017. Rising fuel prices affect all airlines, so no single airline loses its competitive position; they may instead compete on non-price factors, such as service and routes, to increase market share.

The industry is also growing, with passenger numbers expected to rise, for example from 27 million to 45 million at Manchester Airport. If demand for flights is price inelastic, especially for business travellers, demand may not be impacted significantly if airlines raise prices. Furthermore, airlines can minimise fluctuations by hedging, buying fuel in advance through forward markets at a fixed price, which delays the impact of rising prices.

In conclusion, rising fuel prices are likely to reduce profits, especially for low-margin budget airlines, but the size of the impact depends on how much prices rise, how price elastic demand is and how far the airline has hedged its fuel. A large, profitable airline such as BA is far more able to absorb the increase than a smaller budget airline.



The European Commission has fined BA for its involvement in a cartel.

(h) Assess the extent to which this may negatively impact BA.

(12)

A cartel is a group of firms that collude to increase their collective profits by means of price fixing, limiting supply or other restrictive practices. BA, along with ten other airlines, was fined by the European Commission for fixing fuel and security charges on flights within the European Economic Area. The airlines were fined €776m in total, of which BA paid €104m (£90m).

The fine is a direct cost that will reduce BA's profit for the year. This could reduce dividends to investors, which may lower the share price, and/or reduce retained profit available for future investment plans, such as new aircraft or routes, weakening BA's ability to compete with budget airlines in the long run.

The scandal also creates further bad publicity. BA has already faced criticism from loyal customers over scrapping free meals and reducing legroom, so the cartel news may damage its brand image as a trustworthy, long-established airline. This may discourage customers from booking flights with BA, reducing demand and sales revenue. If BA raises fares to recover the fine, this conflicts with its current strategy of cutting fares to compete with budget airlines such as EasyJet, making it less price competitive.

However, the negative impact is likely to be small. The £90m fine is only about 6.4% of BA's 2017 profit of £1.4bn ($\text{£90m} \div \text{£1.4bn} \times 100$) and less than 1% of its £12.30bn sales revenue, so it can easily be absorbed and should have little effect on BA's operations. It may even be that the extra revenue BA gained from fixing fuel and security charges outweighs the fine. Despite the bad publicity, revenue still grew by 7.3% and profit rose, suggesting customers did not switch away.

Many members of the public may be unaware of the scandal, and because the fine was shared among eleven airlines, BA's reputation is not damaged relative to its rivals, so



customer loyalty and sales may be unaffected. The greater long-term risk is that BA is closely watched by regulators in future, limiting its ability to collude again and so reducing future profits.

Overall, the fine is unlikely to have a significant negative impact on BA in the short run, as it is small relative to its profits. The extent of the impact depends mainly on whether the reputational damage, added to the earlier bad publicity, causes a lasting fall in demand, and whether further fines or tighter regulation follow.

(Total for Question 1 = 60 marks)

TOTAL FOR SECTION A = 60 MARKS



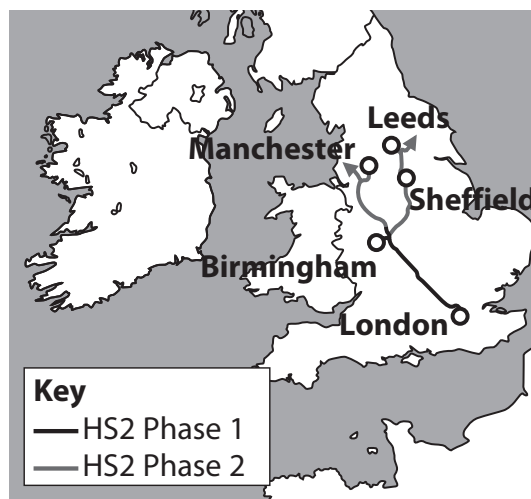
SECTION B

Read the following extracts (D and E) before answering Question 2.

Write your answer in the space provided.

Extract D

A new high-speed rail network connecting the north and south.



The High Speed Two (HS2) is a new railway aimed to improve Britain's transport network. It involves 345 miles of new high speed track and will connect the city centres of London, Birmingham, Manchester and Leeds. HS2 is expected to carry around 100 million passengers a year when fully operational. Construction has started on phase 1 which will link London and Birmingham by 2026. Land has been cleared and houses demolished to make way for the new railway tracks and stations. Phase 2 will run from the Midlands to Manchester and Leeds and is planned to be completed by 2033. The government's budget for HS2 is £56bn and it estimates that for every £1 invested in HS2 the UK will receive £2.30 in benefits.

5

10

The project aims to help join up the major urban areas around the country. This connectivity will enable businesses in the North and the Midlands to gain better access to new markets in the UK and Europe. Since HS2 was announced, new records have been set in Birmingham, Manchester and Leeds for building new offices, homes and hotel rooms. The new railway aims to reduce congestion and improve reliability for millions of commuters and tourists using Britain's railways.

15

Those opposing the plans argue that returns for the level of expenditure are debateable and may result in more economic activity created in London at the expense of the rest of the country.

(Sources: adapted from <https://www.hs2.org.uk/why/investing-in-our-economy/>,
<http://www.hs2actionalliance.org/what-is-hs2/timeline/>)

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Extract E

Estimated time-savings from HS2

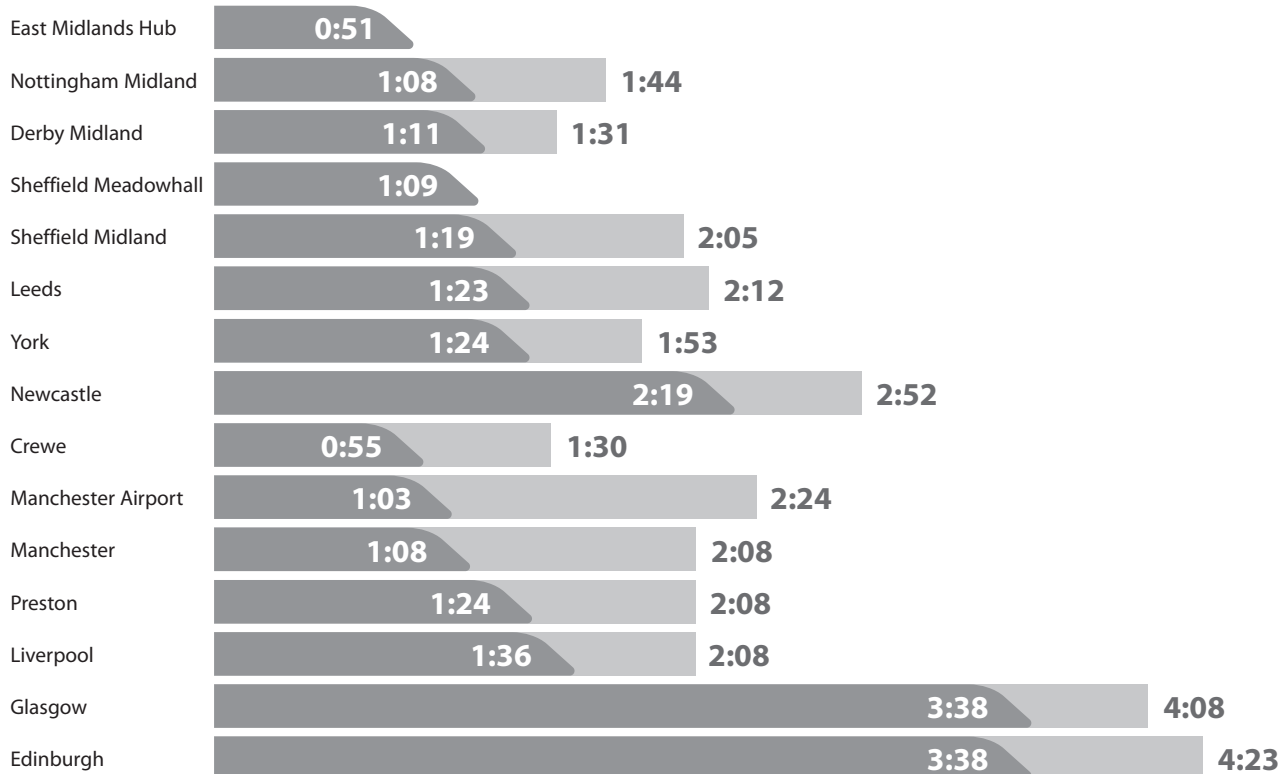
Journey times

HOURS:MINUTES

HS₂ JOURNEY TIMES

CURRENT TIMES

London to



(Source: adapted from http://assets.hs2.org.uk/sites/default/files/consulation_library/pdf/P2C37_Journey%20times%20and%20frequencies%20LOW.pdf)



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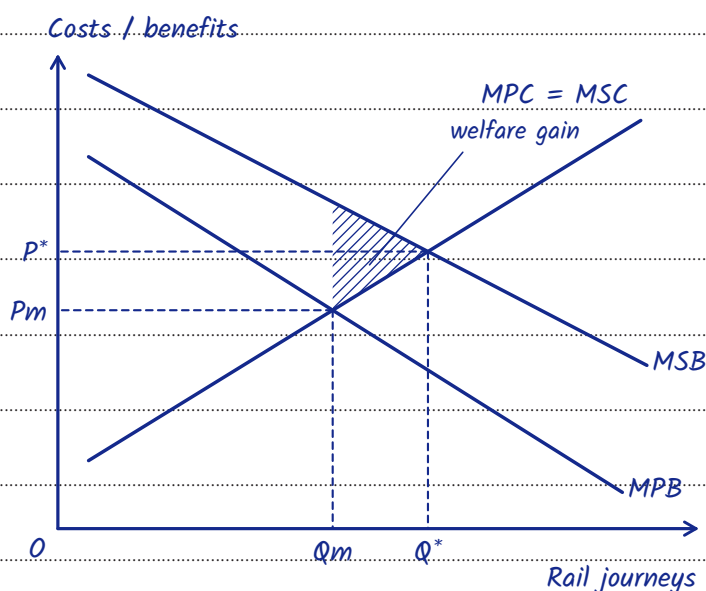
HS2 is likely to create positive externalities.

2 Evaluate the extent to which these externalities are likely to benefit the UK economy.

(20)

Externalities are third-party effects arising from the production or consumption of goods and services. A positive externality is a benefit enjoyed by a third party, not involved in the transaction, while a negative externality is a cost suffered by a third party. With a positive externality the marginal social benefit (MSB) exceeds the marginal private benefit (MPB), so the free market under-provides at Q_m rather than the social optimum Q^* .

Investment in HS2 moves output towards Q^* , giving the welfare gain shaded below.



Firstly, HS2 is expected to carry around 100 million passengers a year, almost 300,000 a day. Many will be tourists and business visitors to cities such as Manchester, Leeds and Birmingham, which benefits third parties such as hotels, restaurants and attractions. This creates jobs and spending in the tertiary sector, and through the multiplier effect, further increases in income and spending in these regional economies.

Secondly, better connectivity will enable businesses in the North and the Midlands to gain better access to new markets in the UK and Europe. Extract E shows large time savings: London to Manchester falls from 2:08 to 1:08, a saving of one hour, and London to Leeds from 2:12 to 1:23. Firms in these cities can reach clients and recruit workers from a

wider area, helping them grow and become more attractive to global investors. Higher demand for these firms adds to aggregate demand and increases GDP.

Thirdly, HS2 aims to reduce congestion and improve reliability for millions of commuters. If people switch from cars and existing crowded lines to HS2, there will be fewer vehicles on the roads, so other road users and firms benefit from shorter, cheaper journeys. Lower transport time and costs improve productivity, reduce firms' costs and improve the UK's global competitiveness. Fewer cars may also reduce pollution, benefiting local residents.

Finally, since HS2 was announced, record numbers of new offices, homes and hotel rooms have been built in Birmingham, Manchester and Leeds. This creates jobs in construction and related industries and reduces unemployment, with a positive effect on government finances through higher tax revenue and lower benefit spending. The government estimates that for every £1 invested the UK will receive £2.30 in benefits, a strong return on the £56bn budget.

However, the extent of these benefits is uncertain. Critics argue that returns for the expenditure are debatable and that the new line may create more economic activity in London at the expense of the rest of the country, as firms in London can now serve the North without locating there. If so, the north-south divide will not be bridged and the regional benefits will be smaller than expected.

The time savings for some journeys may also be too small to have a major effect. London to Nottingham falls from 1:44 to 1:08, about 36 minutes, Derby saves only 20 minutes and Glasgow just 30 minutes on a journey of over four hours, so some towns in the Midlands, the North and Scotland may gain little. The benefits will not arrive quickly either: phase 1 is not due until 2026 and phase 2 until 2033, and large projects often overrun, so the £56bn budget may rise and the £2.30 return may not be achieved.

HS2 also creates negative externalities that must be offset against the benefits. The 345 miles of new high-speed track cause environmental damage to the countryside and wildlife,



and land has been cleared and houses demolished, imposing costs on local residents.

Construction will also cause noise and disruption for years. There is an opportunity cost too: the £56bn could have been spent on improving existing regional rail links, roads or broadband, which might bring larger benefits.

In conclusion, HS2 is likely to create a wide range of positive externalities, such as jobs, spending, reduced congestion and better access to markets, which should benefit the UK economy in the long run. However, the extent of the benefit depends on the efficiency and reliability of the service, whether the project is delivered on time and on budget, and, most importantly, whether the northern cities benefit to the same extent as London. On balance the benefits are likely to be significant for the major cities directly connected, but much smaller for the rest of the UK.

(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

Amazon is not a traditional monopoly, but it does monopolise the attention of consumers

Amazon is already a huge part of many people's lives and is the world's largest online retailer. The company was originally a bookseller but has expanded to sell over 200 million different products in the USA and 120 million products in the UK, which include grocery products, clothing, sports equipment, electronics and books. Amazon's size gives it tremendous buying power. Just like *Walmart* and other big companies, Amazon can use that power to negotiate low prices from suppliers for the products and services that it sells. 5

Amazon is just one of several major tech companies, such as *Google* and *Facebook*, facing new scrutiny over their market power, which do not fit neatly in to the usual understanding of monopoly. In a traditional sense, Amazon still faces lots of competition. In the US market, *Walmart* remains the leading retailer overall, with more than three times Amazon's retail revenue. Although Amazon is the clear leader in e-commerce, much of worldwide retail spending is still in bricks-and-mortar stores. 10 15

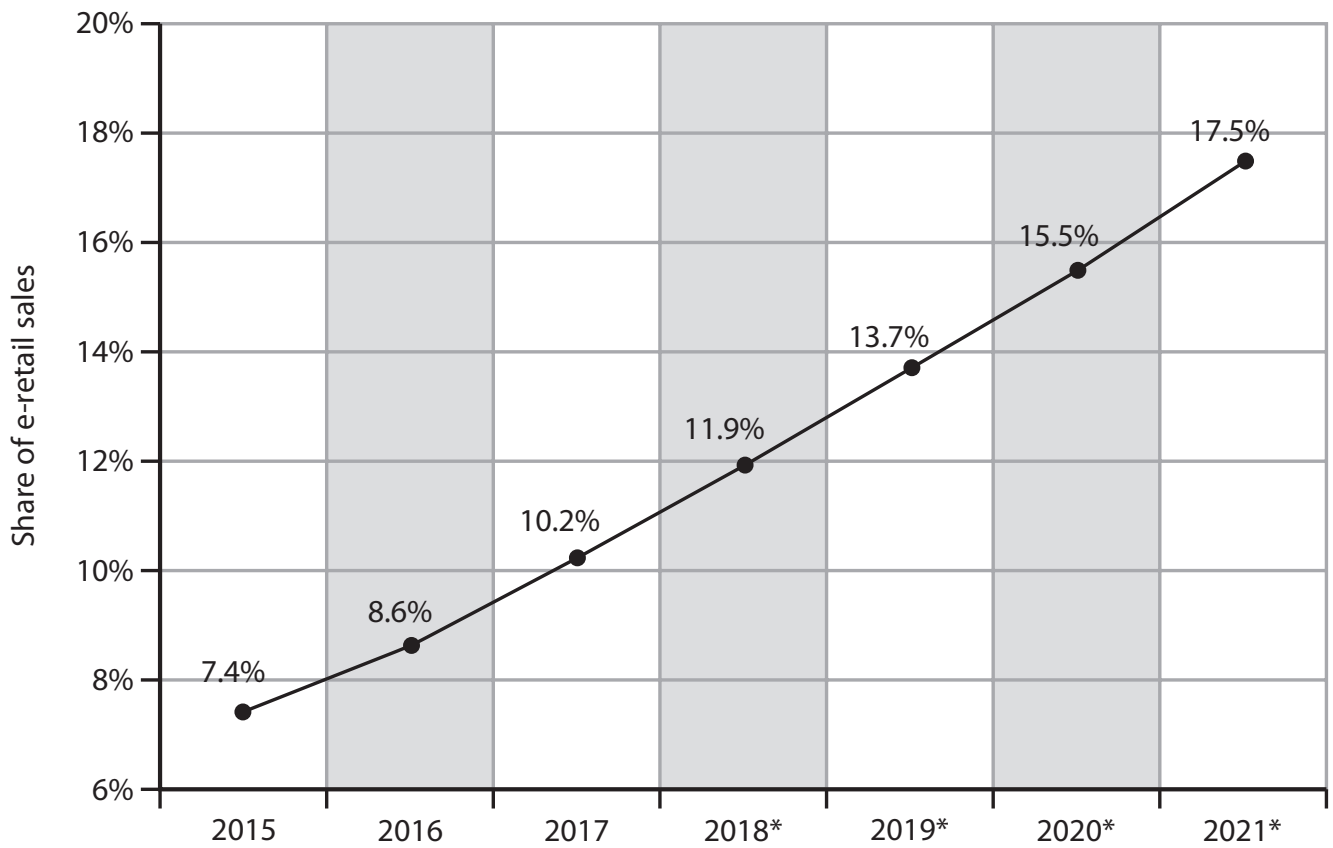
Since 2017 Amazon has purchased companies at an unprecedented rate in its quest to expand. These include *PillPack* a pharmaceutical company for \$1bn, *Ring*, a start-up that specialises in smart-camera doorbells for \$900m and \$13.7bn for *Whole Foods*. Billion-dollar transactions are not foreign to Amazon; it acquired *Zappos*, an online shoe and clothing retailer, for \$1.2bn in 2009 and \$1bn for *Twitch*, an online gaming company in 2014. But until recently, that kind of big spending was sporadic with Amazon CEO Jeff Bezos preferring to develop projects in-house. 20

(Sources: adapted from <https://www.inc.com/associated-press/amazon-whole-foods-commerce-antitrust.html>,
<https://www.cnn.com/2018/06/28/amazon-is-buying-companies-at-an-unprecedented-rate-and-why-matters.html>)



Extract G

E-commerce share of total global retail sales from 2015 to 2021. (* denotes forecasted E-commerce share)



(Source: adapted from <https://www.statista.com/statistics/534123/e-commerce-share-of-retail-sales-worldwide/>)

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3 Evaluate the potential impact of Amazon's market power on its stakeholders.

(20)

Market power is the ability of a firm to influence or control the terms and conditions on which goods are bought and sold, such as price. Stakeholders are individuals or groups who are affected by, or have an interest in, a firm, including consumers, suppliers, competitors, employees and the owners of acquired firms. Amazon is the world's largest online retailer and the clear leader in e-commerce, selling over 200 million products in the USA and 120 million in the UK.

Consumers may be negatively affected. As the leading online retailer, Amazon may have the power to dictate prices for products such as books, which may lead to higher prices for consumers if it faces little competition online. If competitors are forced to exit the market, consumer choice will be reduced and Amazon may have less incentive to innovate or offer good service.

Suppliers may be exploited due to Amazon's buying power. Extract F states that Amazon's size gives it tremendous buying power to negotiate low prices from suppliers, like Walmart. This reduces suppliers' profit margins, reducing their retained profit and their opportunities to invest and expand. Small suppliers that depend on Amazon for most of their sales have little choice but to accept its terms.

Competitors may struggle to compete and grow in the online market, where Amazon is dominant and sells a huge range of products, from groceries to electronics. Smaller online and high street retailers cannot match its economies of scale, low prices or fast delivery, so they may lose market share or be forced out.

Firms taken over by Amazon, such as Whole Foods (\$13.7bn), Zappos (\$1.2bn) and PillPack (\$1bn), and their employees may suffer from job losses and redundancies as Amazon rationalises the business to cut costs and remove duplication.

However, Amazon's market power also brings benefits. Its size gives it economies of scale,



and the low prices it negotiates from suppliers can be passed on to consumers as lower prices, along with greater choice and convenience. Suppliers that sell through Amazon may enjoy high levels of revenue and profitability due to the vast volume of goods it sells and its access to a global market that they could not reach alone.

The firms acquired by Amazon may benefit from extra funding and expertise to help them grow, for example Ring or Whole Foods using Amazon's technology and delivery network, which may secure jobs in those companies. Amazon's own employees may benefit from its dominance through job security, pay rises and promotion opportunities as the company expands, and shareholders gain from rising profits and share prices.

Furthermore, Amazon's market power may be smaller than it appears. Extract F says that Amazon is not a traditional monopoly: in the US, Walmart has more than three times Amazon's retail revenue, and much of retail spending is still in bricks-and-mortar stores.

Extract G shows e-commerce was only 11.9% of global retail sales in 2018, so other non-e-commerce retailers may not be significantly affected by Amazon. Its power is mainly within online retail.

However, Extract G also shows the e-commerce share rising quickly, from 7.4% in 2015 to a forecast 17.5% in 2021, more than doubling. Combined with Amazon's unprecedented rate of acquisitions since 2017, this suggests its market power is likely to grow, increasing the risk that suppliers and competitors are squeezed in the future and that regulators will need to intervene.

In conclusion, although Amazon is not a monopoly in the strictest sense, its dominance in online retail means it can to some extent influence the market. In the short run consumers are likely to benefit from lower prices and convenience, while suppliers and competitors are the stakeholders most likely to lose out. The overall impact depends on whether Amazon uses its power to pass on cost savings or to exploit stakeholders, and on how effectively competition authorities monitor its acquisitions. If it continues to grow at



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its current rate, its market power, and the risk to stakeholders, is likely to increase.

(Total for Question 3 = 20 marks)

TOTAL FOR SECTION C = 20 MARKS
TOTAL FOR PAPER = 100 MARKS



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