Please check the examination details below before entering your candidate information

Candidate surname: StemUp Model Solution

Other names:

Centre Number | Candidate Number

Pearson Edexcel International Advanced Level

Time 2 hours

Paper reference **WEC13/01**

Economics

International Advanced Level
UNIT 3: Business behaviour

You must have:
Source Booklet (enclosed)

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 in Section A and Section B.
- Answer **TWO** questions in Section C.
- Answer the questions in the spaces provided
  – *there may be more space than you need.*

Information

- The total mark for this paper is 80.
- 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.
- Check your answers if you have time at the end.

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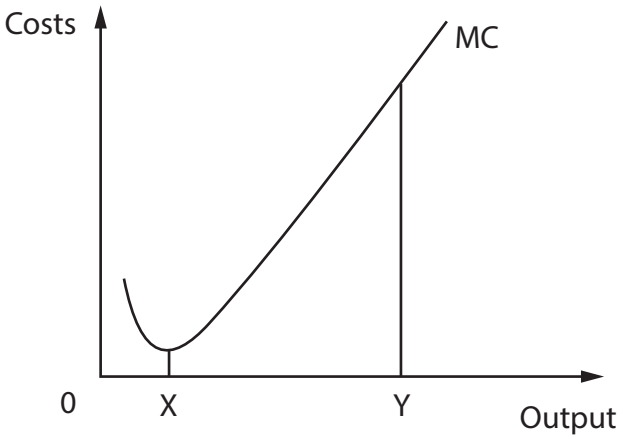
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SECTION A

Answer ALL questions in this section.

Questions must be answered with a cross in a box ☒. If you change your mind about an answer, put a line through the box ☒ and then mark your new answer with a cross ☒.

1 The diagram shows a short-run marginal cost curve for a small café in Thailand.



Which **one** of the following is the reason why the MC curve slopes upwards from point X to point Y?

- ☒ **A** Decreasing returns to scale
- ☒ **B** Increasing fixed costs
- ☒ **C** Diminishing returns
- ☒ **D** Diseconomies of scale

(Total for Question 1 = 1 mark)

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2 The output of a textile manufacturer based in Botswana is 30 000 units of clothing per month. The firm's total revenue is $78 000, its total costs are $57 800 and its total fixed costs are $30 800 per month.

Which **one** of the following is the firm's average variable cost at this level of output?

- ☒ **A** $0.90
- ☒ **B** $1.03
- ☒ **C** $1.93
- ☒ **D** $2.60

(Total for Question 2 = 1 mark)

3 A survey conducted in 2021 found that 76% of US companies with factories in China were in the process of moving operations to other countries in southeast Asia. This would cause thousands of manufacturing workers in China to lose their jobs.

Which **one** of the following government measures is most likely to increase the occupational mobility of labour?

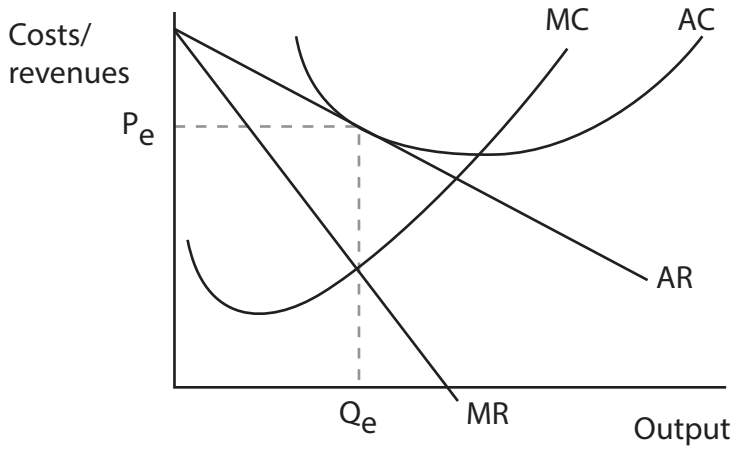
- ☒ **A** An increase in unemployment benefits
- ☒ **B** An increase in relocation grants for businesses
- ☒ **C** An increase in training schemes
- ☒ **D** An increase in the national minimum wage

(Total for Question 3 = 1 mark)

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4 The diagram shows the short-run cost and revenue curves for a profit maximising street food business in Sri Lanka.



Which **one** of the following can be deduced from this diagram?

- ☒ **A** The firm is dynamically efficient
- ☒ **B** The firm is making normal profit
- ☒ **C** The firm operates in a perfectly competitive market
- ☒ **D** The firm will shut-down in the short-run

(Total for Question 4 = 1 mark)

5 A monopolist changes its objective from profit maximisation to sales volume maximisation.

Which **one** of the following is the most likely impact of this decision?

- ☒ **A** A fall in the number of workers employed by the firm
- ☒ **B** An increase in the price of the good
- ☒ **C** A fall in the firm's total fixed costs
- ☒ **D** An increase in the firm's output

(Total for Question 5 = 1 mark)

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6 The elasticity of demand for agricultural workers in South Africa is estimated to be –0.3.

Which **one** of the following is the most likely reason for this value of the elasticity of demand for labour?

- ☒ **A** Labour cannot be easily replaced by capital
- ☒ **B** Wage rates are relatively high in the agricultural industry
- ☒ **C** Consumer demand for the final product is price elastic
- ☒ **D** Productivity is relatively low in the agricultural industry

(Total for Question 6 = 1 mark)

TOTAL FOR SECTION A = 6 MARKS

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SECTION B

Study Figures 1 and 2 and Extracts A and B in the Source Booklet before answering Question 7.

Write your answers in the space provided on the following pages.

7 (a) With reference to Figure 1, calculate the percentage change in the wholesale price of gas from 1 April 2021 to 1 April 2022. You are advised to show your working.

(2)

(b) With reference to Figure 2 and the second paragraph of Extract A, explain what is meant by the term 'concentration ratio'.

(4)

(c) With reference to Figure 2 and Extract A, analyse **two** barriers to entry that might prevent a new firm from entering the UK energy market.

(6)

(d) With reference to Figure 1 and Extract A, examine the impact of the increase in the wholesale price of natural gas on the cost of production for UK gas suppliers.

(8)

(e) With reference to Extract A and Extract B, discuss the likely effects of the increase in the energy price cap on both energy suppliers and consumers.

Illustrate your answer with an appropriate cost and revenue diagram.

(14)

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7 (a) With reference to Figure 1, calculate the percentage change in the wholesale price of gas from 1 April 2021 to 1 April 2022. You are advised to show your working.

(2)

Change in price = 280p − 47p = 233p per therm

Percentage change = (233 ÷ 47) × 100

= +495.74% (2 d.p.), an increase of about 496%

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(b) With reference to Figure 2 and the second paragraph of Extract A, explain what is meant by the term 'concentration ratio'.

(4)

A concentration ratio is the combined market share of the largest n firms in a market. For example, the six-firm concentration ratio is the total market share of the six biggest firms.

Using Figure 2, the six-firm concentration ratio in Q4 2020 was 26.9 + 12.5 + 12.5 + 8.2 + 8.0 + 6.3 = 74.4%. By Q4 2021 the six largest suppliers controlled 82.3% of the market (Extract A), so the concentration ratio rose by 7.9 percentage points. The four-firm concentration ratio in Q4 2021 was 27.6 + 14.7 + 11.4 + 11.1 = 64.8%, showing the gas market is a highly concentrated oligopoly.

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(c) With reference to Figure 2 and Extract A, analyse **two** barriers to entry that might prevent a new firm from entering the UK energy market.

(6)

Barriers to entry are obstacles that make it difficult or impossible for new firms to enter a market.

1. Economies of scale enjoyed by large incumbents. The six largest suppliers controlled 82.3% of the gas market by the end of 2021, and British Gas, which gained 729 000 new consumers, alone has a 27.6% share. Their high output lets them spread costs and buy gas in bulk, so they achieve greater economies of scale and lower average costs than a small new entrant could. The incumbents could therefore cut prices if a new firm entered (limit pricing), and the entrant, with higher average costs, would make a loss. This is reinforced by brand loyalty to well-known firms such as British Gas.

2. Stricter regulation by Ofgem. Extract A says Ofgem will seek to increase barriers to entry by strengthening regulations, after 31 smaller suppliers shut down in 2021. A new firm would have to meet tougher standards, for example holding more financial reserves or proving it can cope with price rises. This raises the start-up costs and sunk costs of entry, so fewer firms can afford to enter. The market share of small suppliers has already fallen from 7.2% to 3.2%, which suggests entry and survival are becoming harder.

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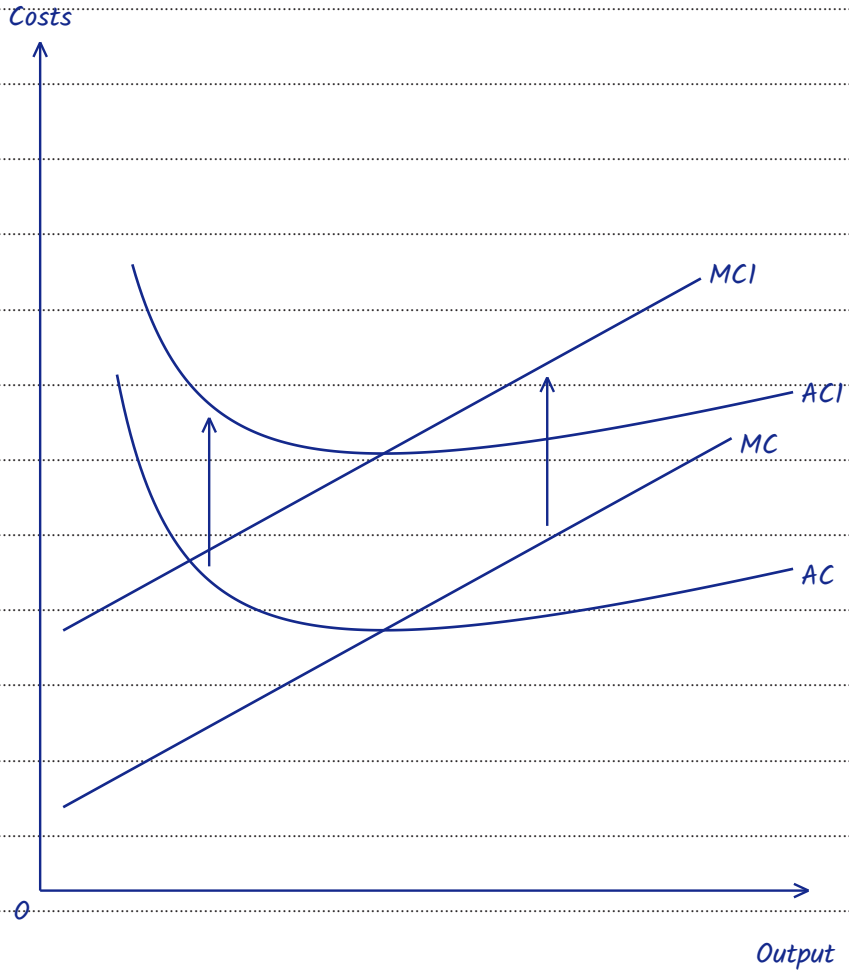
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(d) With reference to Figure 1 and Extract A, examine the impact of the increase in the wholesale price of natural gas on the cost of production for UK gas suppliers.

(8)

Natural gas bought on the wholesale market is a variable cost for gas suppliers: it varies directly with output, since the more gas they supply to consumers, the more they must buy. Total cost = fixed cost + variable cost, so a rise in variable cost raises total costs.

Figure 1 shows the wholesale price rose from 47p to 280p per therm between April 2021 and April 2022, an increase of about 496%. Because UK suppliers must purchase gas at world market prices, they cannot avoid this rise. As gas makes up about 35% of the total costs of large suppliers, a 496% rise in its price means costs increase very sharply. Each extra unit supplied now costs more, so marginal cost rises from MC to MC1 and average cost rises from AC to AC1, shown below.



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Higher costs reduce profit margins. Extract A shows the rise made it impossible for 31 smaller suppliers to cover their costs, so they shut down.

However, the impact is not equal for all suppliers. Gas is only 35% of large suppliers' costs, so the other 65% (such as staff and network costs) is unaffected, and large suppliers may offset some of the rise by cutting other costs or using economies of scale. Small suppliers were hit far harder. The impact also depends on timing: firms that bought gas in advance on fixed-price contracts would not face the higher price until those contracts end, and if the wholesale price falls again the rise in costs would only be short-run.

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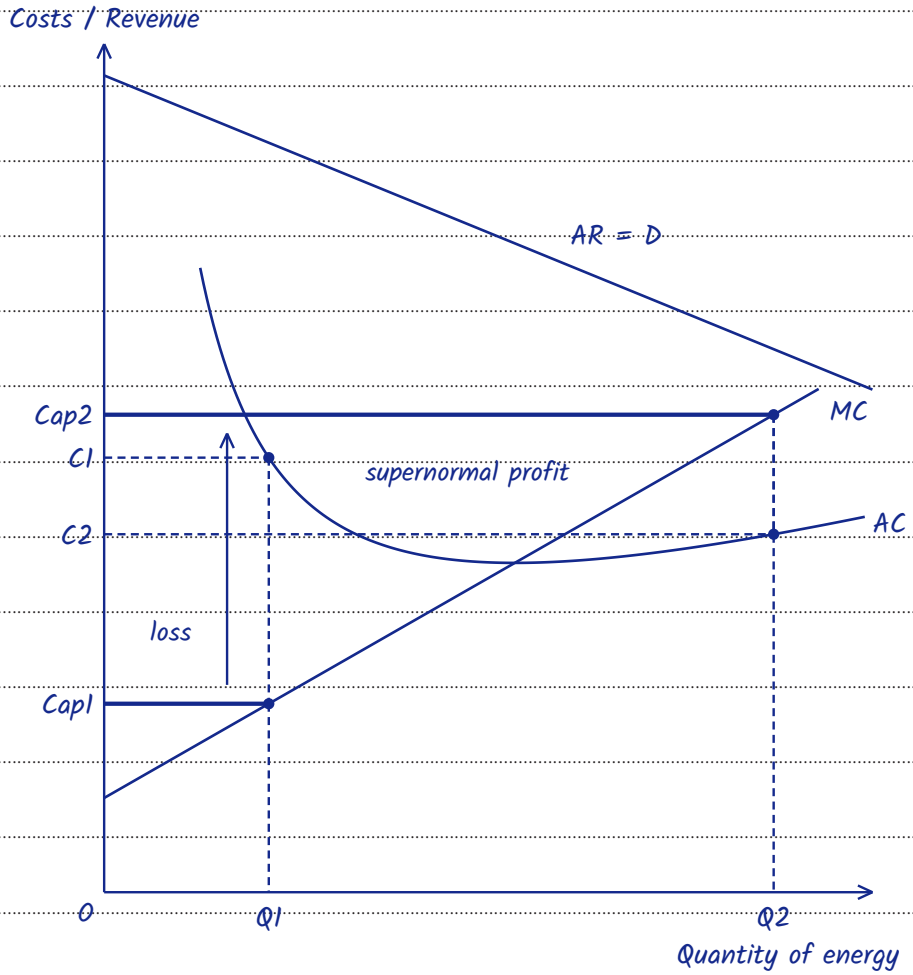
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(e) With reference to Extract A and Extract B, discuss the likely effects of the increase in the energy price cap on both energy suppliers and consumers.

Illustrate your answer with an appropriate cost and revenue diagram.

(14)

An energy price cap is a maximum price that a supplier can charge. Ofgem is increasing the cap from £1 277 to £1 971 per year in April 2022, a rise of about 54% ((694 ÷ 1 277) × 100).



The diagram shows a typical supplier after the rise in wholesale gas prices. Under the old cap (Cap1) the firm's AR is horizontal at the cap, so MR = Cap1 and it produces Q1 where MR = MC. Price is below average cost C1, so it makes a loss, which is why 31 suppliers left the market. When the cap rises to Cap2, output rises to Q2 and price is above average cost C2, so the firm makes a supernormal profit shown by the rectangle between Cap2 and C2.

Suppliers therefore benefit: higher revenue lets them cover the higher wholesale costs, so the

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surviving firms can stay in the industry and energy supply is secured. Producer surplus rises, and firms may be able to fund investment. Fewer firms may fail, and a profitable market could even attract new entrants, increasing competition in the long run.

Consumers lose: the maximum bill rises by £694 a year, so consumer surplus falls. Energy is a necessity with price inelastic demand, so households must cut spending on other goods, and the cost of living and standard of living fall. Quantity demanded falls only slightly, as some households reduce usage or invest in insulation or solar panels.

However, the effects on consumers depend on income. Low-income households spend a larger proportion of income on energy, so they are hit hardest. Extract B shows the Government will give 28 million households a £200 discount, plus a £150 cash payment for some, which offsets about half of the £694 rise. But the £200 must be repaid over 5 years, so it only delays the cost, while the £150 is a genuine gain.

For suppliers, the benefit depends on the wholesale price. Figure 1 shows gas rose to 280p per therm, so if wholesale prices rise again the new cap may still not cover costs and more firms could fail. If consumers keep cutting usage, revenue gains will also be smaller.

Overall, the rise in the cap mainly helps suppliers survive in the short run, while consumers bear the cost, especially poorer households, though government support reduces the impact for now.

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(Total for Question 7 = 34 marks)

TOTAL FOR SECTION B = 34 MARKS

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SECTION C

Answer TWO questions from this section.

8 The Government of Norway fully subsidises university education. Universities in Norway have social objectives rather than a profit maximising objective. By contrast, in the USA, students pay fees to study at profit maximising universities.

Evaluate the view that the objectives of state-owned enterprises and private sector organisations always differ.

Illustrate your answer with an appropriate diagram(s).

(Total for Question 8 = 20 marks)

9 The global supermarket chain, Walmart, operates 10 500 stores in 24 countries. It has monopsony power when buying agricultural products and employing labour in these countries. A 2021 study suggested that Walmart buys these agricultural products at a lower price than when they are sold to other businesses.

Evaluate the likely impacts of monopsony power on employees and suppliers.

Refer to a firm with monopsony power in your answer.

(Total for Question 9 = 20 marks)

10 In 2022, the Canadian airline WestJet completed a takeover of Sunwing Travel Group, an airline and luxury holiday provider. WestJet's objective was to sell luxury flights and holidays to more destinations.

Evaluate the benefits of growth by takeover for a business in an industry of your choice.

Illustrate your answer with an appropriate diagram(s).

(Total for Question 10 = 20 marks)

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Write the answer to your FIRST chosen question here.

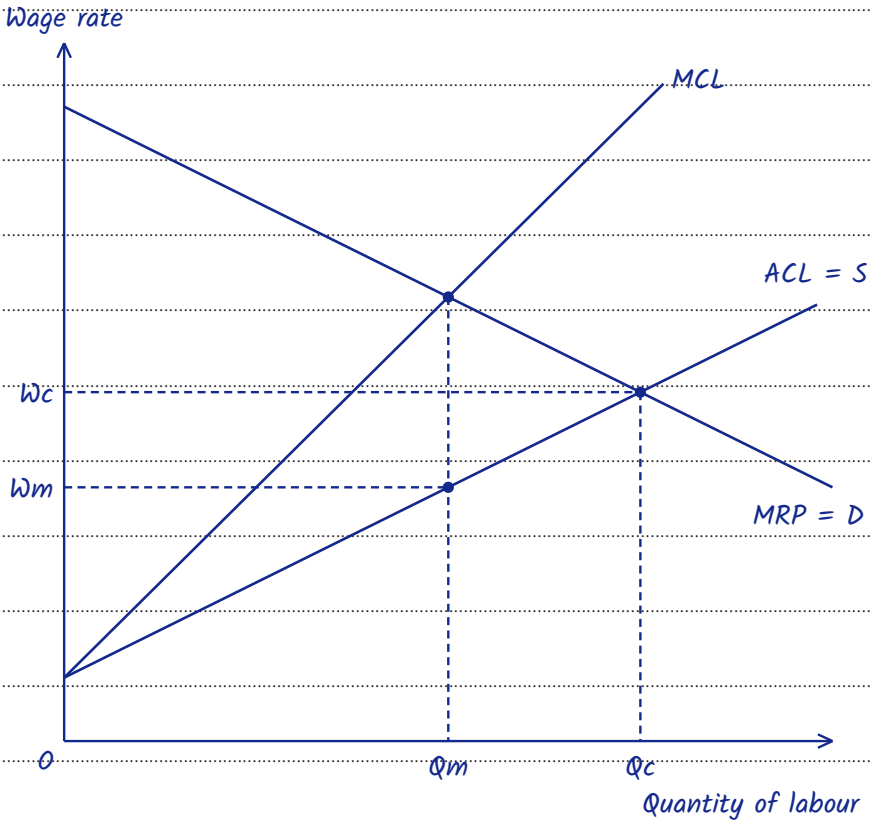
Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.

Write the answer to your SECOND chosen question on page 22.

Chosen question number: **Question 8** ☐ **Question 9** ☒ **Question 10** ☐

A monopsony is a market with a single buyer, for example a single employer of labour or a single buyer of a product. Monopsony power exists when a firm is such a large buyer that it can influence the price it pays. Walmart operates 10 500 stores in 24 countries, so it is one of the largest buyers of agricultural products and one of the largest employers in many local labour markets.

Employees. A monopsony employer is a wage setter. To hire more workers it must raise the wage for all of them, so the marginal cost of labour (MCL) lies above the average cost of labour (ACL), which is the labour supply curve.



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A profit maximising monopsonist employs where MCL = MRP, at Qm, and pays only the wage needed to attract Qm workers, Wm, read off the ACL curve. In a competitive labour market employment would be Qc at wage Wc, where supply equals demand. So Walmart's employees receive a lower wage (Wm < Wc), fewer people are employed (Qm < Qc) and workers are paid less than their marginal revenue product. Because workers have few other employers in a town dominated by one large store, they also have little bargaining power over hours and working conditions, which may be poorer than in a competitive market.

Suppliers. As a monopsony buyer, Walmart can force farmers to accept lower prices, because they have few other large buyers to sell to. The 2021 study suggests Walmart buys agricultural products at a lower price than they are sold to other businesses. This reduces suppliers' revenue and profit margins and their producer surplus. With lower profits, farmers have less to invest in new machinery or better methods, so dynamic efficiency falls. Walmart may also pass costs onto suppliers, for example demanding longer payment periods or that they pay for packaging and promotions. Many suppliers become dependent on one main customer, so they are vulnerable if Walmart switches supplier, and some small farms may be forced out of business if prices fall below average cost.

However, the impacts may be less harmful than the theory suggests. For employees, Walmart is rarely a pure monopsony: in most cities workers can also work for other retailers, warehouses and restaurants, so if Walmart pays too little it will lose staff and face high recruitment and training costs. When labour markets are tight, large employers often have to raise pay to compete. Where trade unions exist, a bilateral monopoly forms, and the wage depends on relative bargaining power, so it may be pushed up towards Wc. A national minimum wage set between Wm and Wc can actually raise both the wage and employment in a monopsony market, because the firm no longer has to raise the wage of all workers to hire one more. In addition, working

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for a large firm may offer greater job security, training and promotion opportunities than a small business.

For suppliers, being a Walmart supplier can bring large, stable contracts that guarantee demand for big volumes. This reduces risk, gives suppliers the confidence to invest, and lets them gain economies of scale that lower their own average costs, which may partly offset the lower price. The impact also depends on how dependent each supplier is: a farm that sells only a small share of its output to Walmart can sell to other supermarkets, wholesalers, farmers' markets or abroad. Farmers can form cooperatives to increase their bargaining power, and competition authorities or codes of practice can stop a large buyer from abusing its dominance. If Walmart wants to protect its reputation and corporate social responsibility, it may choose to pay suppliers fairer prices, for example through Fairtrade products.

There is also a wider trade-off. Lower costs from monopsony buying allow Walmart to charge consumers lower prices, so some of the welfare lost by suppliers and workers is passed on to consumers, although Walmart may simply keep it as supernormal profit for shareholders.

In conclusion, monopsony power is likely to harm both employees and suppliers by lowering wages, employment and supplier prices. The impact on suppliers is probably greater, since the 2021 study shows Walmart already pays lower prices and many small farmers have no real alternative buyer, whereas employees in large cities usually have other employers. The size of the impact depends on the degree of monopsony power in each local market, on whether workers and farmers are organised in unions or cooperatives, and on how strongly governments regulate the firm.

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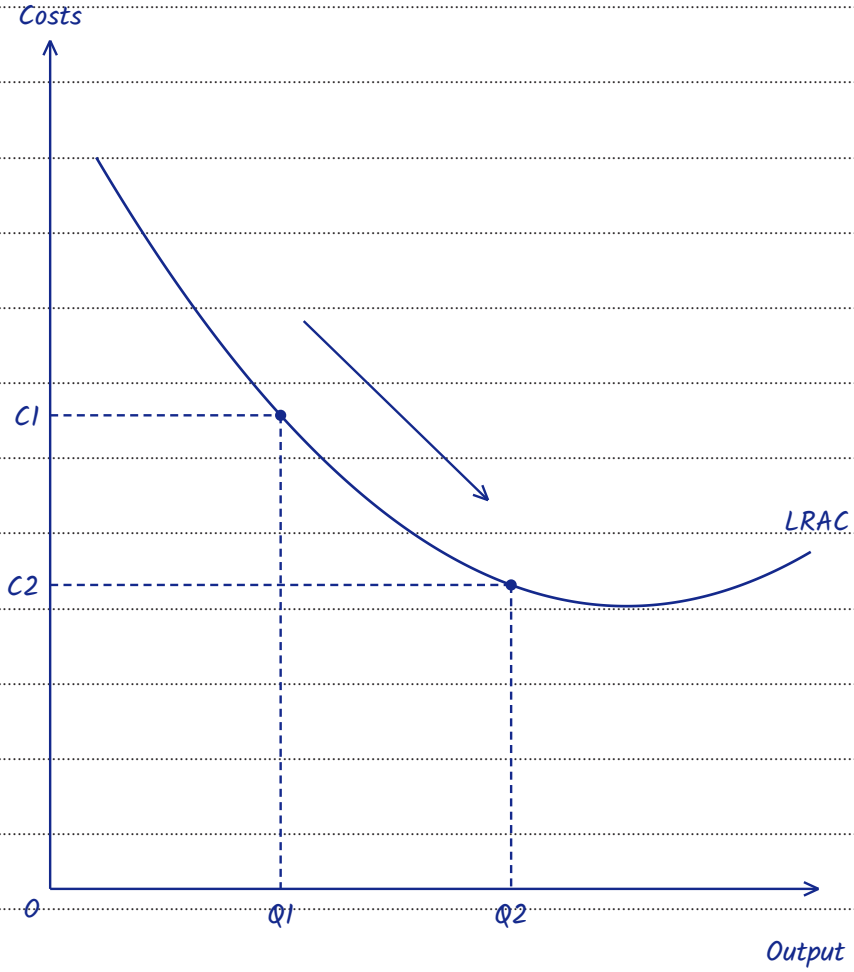
Write the answer to your SECOND chosen question here

Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.

Chosen question number: **Question 8** ☐ **Question 9** ☐ **Question 10** ☒

A takeover is when one firm buys a controlling share (over 50%) of another firm, so that it gains control of it. This is external, or inorganic, growth. In the airline industry, WestJet completed a takeover of Sunwing Travel Group in 2022, an airline and luxury holiday provider.

The first benefit is economies of scale. A takeover increases the size of the firm, so long-run average costs fall as output rises, as shown below.



After the takeover, WestJet's output rises from Q1 to Q2 and average costs fall from C1 to C2. It can gain purchasing economies by buying fuel, aircraft and spare parts in bulk at a discount; technical economies by using larger aircraft and filling more seats, so the fixed cost of each

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flight is spread over more passengers; managerial economies from employing specialist managers; and financial economies, because a larger airline can borrow more cheaply. Lower average costs raise profit margins, or allow WestJet to cut fares and win more customers.

Secondly, a takeover enables a firm to grow quickly and enter new markets. Building new routes, brands and holiday packages through organic growth would take years, but by buying Sunwing, WestJet immediately gains its destinations, customers and luxury holiday brand. This achieves WestJet's objective of selling luxury flights and holidays to more destinations, raising revenue and market share. Because Sunwing also sells holidays, the takeover is partly a forward vertical integration, so WestJet can sell directly to consumers and keep the profit margin that tour operators would earn.

Thirdly, the takeover reduces duplication. The combined firm needs only one head office, one marketing department and one booking system, which cuts costs further. It can also share expertise, for example Sunwing's knowledge of the luxury holiday market, and spread risk by diversifying into holidays as well as flights, so a fall in demand for one product is offset by the other.

Fourthly, a horizontal takeover removes a competitor and increases market power. With a larger market share, WestJet becomes more of a price maker, so it can raise fares and earn higher supernormal profit. These profits can be reinvested in new aircraft and services, improving dynamic efficiency.

However, the benefits may be smaller than expected. If the firm grows too large it may suffer diseconomies of scale: poor communication, coordination problems and lower staff motivation raise average costs, so beyond the minimum point of the LRAC curve costs rise rather than fall.

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Combining two airlines with different cultures, IT systems and staff contracts is difficult, and many takeovers fail to deliver the cost savings promised. Takeovers are also expensive: the buyer often pays a premium above the market value of the target, which may be financed by debt, so interest costs can wipe out the gains.

The benefits also depend on the type of market. Demand for luxury holidays is highly income elastic, so in a recession demand may fall sharply and WestJet's extra capacity may be left unused. The competition authorities may block the takeover or impose conditions, such as giving up some routes, if it is likely to reduce competition, which would limit the gain in market power. Moreover, higher market power benefits the firm but not consumers, who may face higher fares and less choice, and without competition the firm may become X-inefficient. Finally, the benefits are often long-run: cost savings from integrating fleets and systems take years to appear.

In conclusion, growth by takeover offers significant benefits to WestJet, especially rapid entry into the luxury holiday market and economies of scale, which are large in the airline industry because fixed costs such as aircraft are so high. Overall the takeover is likely to benefit the firm, provided it manages integration well, avoids diseconomies of scale and has not overpaid for Sunwing.

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Time 2 hours

Paper reference **WEC13/01**

Economics

International Advanced Level
UNIT 3: Business behaviour

Source Booklet

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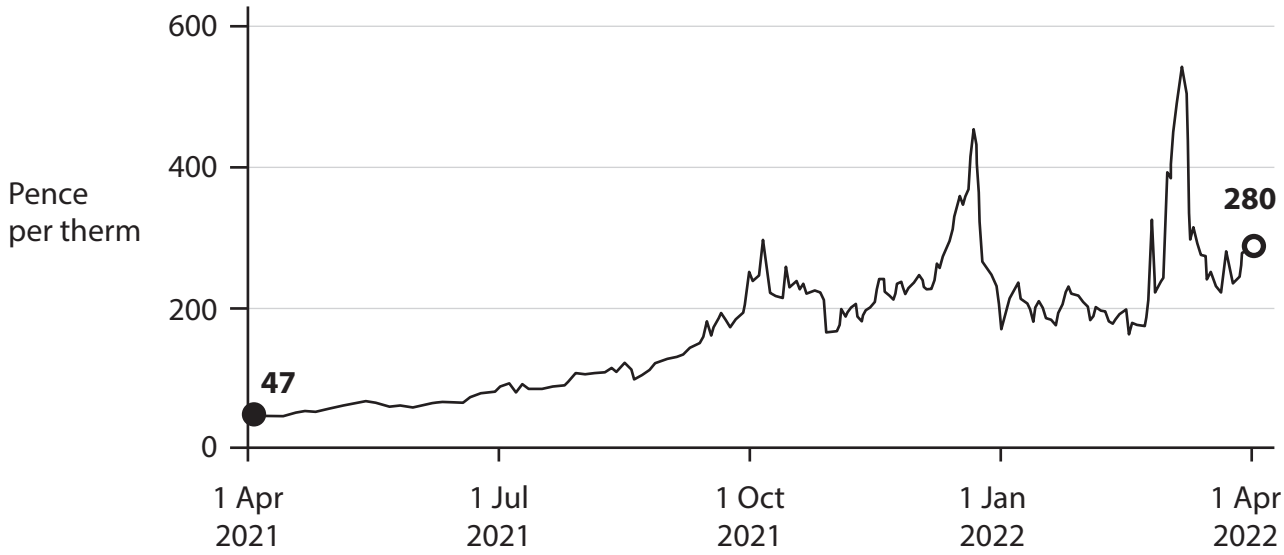
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Sources for use with Section B

The UK energy market

Figure 1 The UK wholesale price of natural gas, pence per therm*, 1 April 2021 to 1 April 2022



*A therm is a unit of heat

Figure 2 Market share of companies supplying natural gas, Q4 2020 and Q4 2021 (%)

	Q4 2020	Q4 2021
British Gas	26.9	27.6
E.ON Energy UK	12.5	14.7
Ovo	12.5	11.4
EDF UK	8.2	9.6
Scottish Power	8.0	7.9
Octopus	6.3	11.1
Other medium-sized gas suppliers	18.4	14.5
Small-sized gas suppliers	7.2	3.2

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Extract A The UK energy market

In 2021 the global wholesale price of natural gas increased significantly. This caused a large increase in the costs for UK companies supplying gas because they have to purchase gas at world market prices. Purchasing natural gas accounts for approximately 35% of the total costs for large gas suppliers. This increase in the wholesale price made it impossible for 31 smaller suppliers to cover their costs and resulted in them shutting down.

With the closure of many small suppliers, there was an increase in the concentration ratio in the market. The six largest suppliers controlled 82.3% of the market for gas by the end of 2021. These larger suppliers increased their market shares by acquiring new consumers from those firms that had left the market. For example, British Gas acquired 729 000 new consumers, EDF UK 580 000 new consumers and E.ON Energy UK 239 000 new consumers. This change in the market enabled these large suppliers to increase their output and achieve greater economies of scale.

It is expected that the energy regulator, Ofgem, will seek to increase barriers to entry in this market by strengthening regulations, to prevent similar disruptions happening again. In addition, Ofgem, announced plans to increase the energy price cap (the maximum price that a supplier can charge for energy to a consumer) from £1 277 per year to £1 971 in April 2022. This should help the surviving suppliers to remain in the industry and secure energy supply for consumers.

Extract B UK Government support for consumers

The cost of living for consumers is set to rise significantly after the increase in the price cap. In response, the UK Government announced help for approximately 28 million households by providing a discount on energy bills worth £200 in 2022. Consumers would be required to pay this back to the Government over 5 years. There would also be a £150 cash payment to some households that will not need to be repaid.

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Acknowledgements

Figure 1: https://www.thetimes.co.uk/article/b9862172-b1aa-11ec-8b8c-0207c0fd6104?shareToken=331dddc29573a7930c76be2a67bd692c

Figure 2: https://www.ofgem.gov.uk/energy-data-and-research/data-portal/all-available-charts?sort=created&page=2

Extract A: https://www.independent.co.uk/news/uk/home-news/what-energy-price-cap-bills-gas-b2038789.html

https://www.forbes.com/uk/advisor/energy/failed-uk-energy-suppliers-update/

https://www.fitchratings.com/research/corporate-finance/uk-energy-price-cap-increase-helps-suppliers-pass-on-costs-04-02-2022

Extract B: https://www.gov.uk/government/speeches/chancellors-statement-to-the-house-energy-price-cap

https://www.independent.co.uk/news/uk/home-news/what-energy-price-cap-bills-gas-b2038789.html