



Economics Questions By Topic:

Contestability (3.4.7)

Mark Scheme

A-Level Edexcel Theme 3

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SECTION B

Question Number	Answer	Mark
1	<p>KAA (6) award up to 3 points (2 marks each) or 3 + 3</p> <p>Reasons why the industry is contestable (this might count as KAA or Evaluation)</p> <ul style="list-style-type: none"> • Established firms are large and able to cross subsidise e.g. Samsung • existing firms are bringing out new versions of phones and other products e.g. Apple Watch, with other phone companies diversifying into this market in the future if the trends continue • evidence sales if iPhones are stagnating (Figure 2) (sign that firms are entering?). 'The only way is down' Extract 2. • Use of data to evidence the new firms that have started up/or that the existing phone firms have easily been able to diversify • Technological change can make entry easier e.g. flexible machinery <p>Do not award answers based on competitiveness rather than contestability</p> <p><i>KAA marks can be awarded for saying that the market is not contestable and then evaluating that it is.</i></p> <p>Evaluation 8 marks e.g. 4 + 4 marks, 3 + 3 + 2, 2 + 2 + 2 + 2 This may take the form that the market is not contestable.</p> <ul style="list-style-type: none"> • Established firms might have economies of scale • Profitability is high Ext. 1 lines 1-2 (sign that firms cannot enter and erode profits) • Patents keep new firms out (e.g. brand name) • The design element acts as a barrier to entry e.g. Ext. 2 rubberbanding • Start-up costs as a barrier to entry (especially due to the design costs) • Sunk costs e.g. marketing costs as a barrier to entry e.g. brand name 'Apple' • Potential for larger firms to use anti-competitive practices to keep newer firms out – collusion in the future • It depends if things change, e.g. vertical and horizontal mergers might lead to market concentration • Internet technology (selling online) evaluation e.g. knowledge still difficult to get, marketing still 	

	<p>expensive</p> <ul style="list-style-type: none"> • Technological change can make entry more difficult or exit more expensive e.g. sunk costs of machinery, or higher minimum efficient diagram • Some actions illegal, and might lead to fines • Problem of recession – may be necessary to cut price/see slower growth • Staying the same size in a shrinking global market would mean higher market share • Not enough evidence in extracts to form fair picture • Extract 1 implies that conditions are likely to change soon, e.g China issue • Perhaps Apple can do nothing as its popularity is already falling in China <p>Price cutting can lead to retaliation, e.g. price war. Game theory could be used to develop strategies</p>	(12)
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Question Number	Mark scheme	Mark
2	<p>KAA 8 marks</p> <p>Award up to 4 points e.g. 4 + 4 marks, 3 + 3 + 2, 2 + 2 + 2 + 2</p> <p>Reasons why the industry is contestable (this might count as KAA or Evaluation)</p> <ul style="list-style-type: none"> • new firms are entering 'most traditional brands are coming out with e-bike lines as well' Ext. 3 line 9 • existing firms are bringing out electric versions of their traditional bicycles • all firms have to pay the same costs for motors/batteries, so small firms can exist/not squeezed out Ext. 3 line 12 • evidence profits are low (sign that firms are entering) • could see bigger firms such as car manufacturers diversifying into this market in the future if the trend continue • Use of data to evidence the new specialist firms that have started up/or that the existing bike firms have easily been able to diversify • Bike can be sold online e.g. internet technologies make most markets more contestable now – knowledge is better, fixed costs can be reduced • Technological change can make entry easier e.g. flexible machinery <p>Do not award answers based on competitiveness rather than contestability</p>	16

KAA marks can be awarded for saying that the market is not contestable and then evaluating that it is.

Evaluation 8 marks e.g. 4 + 4 marks, 3 + 3 + 2, 2 + 2 + 2 + 2

This may take the form that the market is **not contestable**.

- Established firms are large and able to cross subsidise e.g. only two firms in Ext 3 line 9 do not already make traditional bikes
- Established firms might have economies of scale
- Retail outlets might be unwilling to stock e-bikes
- Profitability is high Ext. 3 lines 2-3 (sign that firms cannot enter and erode profits)
- Patents keep new firms out (allow legal barriers)
- The design element acts as a barrier to entry e.g. Ext 2 line 4 'sophisticated electronic controls'
- As the established firms grow there might be economies of scale or abuse of oligopoly power, making the industry less contestable
- Start-up costs as a barrier to entry (especially due to the batteries)
- Sunk costs e.g. marketing costs as a barrier to entry e.g. brand name 'Cannondale'
- Potential for larger firms to use anti-competitive practices to keep newer firms out – collusion in the future
- It depends if things change, e.g. vertical and horizontal mergers might lead to market concentration
- Internet technology (selling online) evaluation e.g. knowledge still difficult to get, marketing still expensive
- Technological change can make entry more difficult or exit more expensive e.g. sunk costs of machinery, or higher minimum efficient diagram
- Depends on which 'market' e.g. EU 1.5m, China (largest market) or world (40m)

Question Number	Answer	Mark
<p>3</p>	<p>6 KAA + 6 evaluation</p> <p>KAA up to 6 marks for arguing either for or against the argument that the market is contestable.</p> <p>Definition of contestability (low or no sunk costs, or low or no barriers to entry/exit) (1)</p> <p>KAA the market is contestable (may be argued that it is not contestable):</p> <p>Award up to three arguments as 2 + 2 + 2 or 3 + 3 with and evidence. Factors might include:</p> <ul style="list-style-type: none"> • Volkswagen’s new saloon made the biggest impact on the opening day at Detroit, ‘causing some concern for local manufacturers’ • Evidence of fragmenting market (eg Magnificent Seven) as ease of possible entry into the market • Focus on low energy/battery powered cars could create a new niche for entrants, eg Chinese BYD • New firms have been able to set up easily, with examples from South Korea and China, • Other firms have left the market implying low barriers to exit • The names of the some new entrants are already well established, so it easier for these firms to enter a market. <p>Evaluation 6 marks (either for or against high contestability) Award up to three arguments as 2 + 2 + 2 or 3 + 3</p> <p>Factors that the market is not contestable might include:</p> <ul style="list-style-type: none"> • The 2008 crash allowed Chrysler, GM and Ford to cut costs and increase efficiency – meaning that it will be harder for new entrants to compete with the now leaner incumbents • there are high sunk costs, such as gaining a place on the Detroit platform, R&D • firms find it difficult to enter, and the ones that have entered have economies of scale in other markets, funds e.g. \$3bn to spend on marketing, Audi and Volkswagen have new dealerships, can cross subsidise • Toyota ‘still has the most efficient system for product development and manufacturing’ implying that large 	

	<p>scale investment would be required of any new entrant to compete on average costs.</p> <ul style="list-style-type: none">• Limited evidence that the new entrants will survive.• Incumbents may have access to better production techniques or other asymmetric information problems• Supernormal profits are evidence of low contestability• National identity is important in the car industry, especially as a large proportion of income is spent (low PED)	(12)
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Question Number	Answer	Mark
4	<p>KAA (8 marks). Award up to 4 factors e.g. (2 + 2 + 2 + 2) or (4 + 2 + 1 + 1) or (3 + 3 + 2)</p> <p>Definition of increased contestability (1)</p> <p>Positive effects on firm's behaviour</p> <ul style="list-style-type: none"> • Lower prices e.g. price war • better service • firms could enter so the firm must behave as if there were competition by cutting costs • Non profit-maximising pricing • Predatory pricing • Limit pricing • Lower profits force firms to become efficient • Use of pricing policies • Use of non-pricing policies • Use of game theory to explain collusion or other outcomes • Allow use of kinked demand theory to explain why there might be no change to firm's price • M&As • Off-shoring or outsourcing • Increased innovation or efficiency <p>Award use of diagram (see below) showing falling profits.</p> <p>Award max 6/8 KAA if no reference to specific industrial case studies</p> <p>Evaluation (8 marks). Award up to 4 factors e.g. (2 + 2 + 2 + 2) or (4 + 2 + 1 + 1)</p> <p>Factors might include:</p> <ul style="list-style-type: none"> • More competition might mean underinvestment in R&D • It depends on the size of firms/market structure. If the competition is relatively small relative to the size of incumbents there will be little change in behaviour. • Firms might wait-and-see if the competition has any impact • Patents and other statutory monopoly power reduces impact • The firms might already be acting as if there were competition, if competition authorities act as a surrogate for competition • The importance of quality in the industry as opposed to pricing, so firms are constrained as to their reaction • Prioritisation with justification - e.g. limit pricing might be safer than predatory pricing when judged to be legal • Other differences in the long run • Also allow critique of points made in KAA 	(16)

Question Number	Answer	Mark
5	<p>KAA 6 marks, award up to 3 factors (2 x 3 marks or 3 x 2 marks or 3 + 2 + 1)</p> <p>Can be argued for increased or decreased contestability.</p> <p>Definition of contestability (may be implicit) e.g. low or no sunk costs, low or no barriers to entry/exit (1 mark) with application that this causes barriers to entry or exit for new firms (limit pricing might occur); use of data to support argument that markets will be less contestable.</p> <p>Factors suggesting lower contestability might include:</p> <ul style="list-style-type: none"> • Increased barriers to entry and exit • Firm can cross-subsidise routes and effectively use a limit price strategy in contestable markets • Economies of scale (can be developed as separate points) • Concentration ratio might increase • Increased market power • Price fixing or collusion might be more likely • After the merger there will be more profits which is a sign of decreased contestability <p>Evaluation: Award up to 6 marks (2x3 or 3x2 marks)</p> <ul style="list-style-type: none"> • Counterargument: Can be argued for increased or decreased contestability • Barriers to entry might be the only way that companies can survive, so in the long run are beneficial to consumers and stops the market becoming even more concentrated • Suppliers have monopoly power, so bilateral powers are levelled out • Depends on the degree of monopsony - might strangle suppliers • Many agreements against the law if they are anti-competitive • Will make little difference as airline industry was highly incontestable before the merger? • EU powerless in global market (Ext 1 lines 34 - 35) • Lack of profitability suggests that the industry is contestable • Low cost and emerging economies' airlines are entering, which is a sign of high contestability • With the strikes (Extract 2) brand loyalty might diminish, and consumers might be more willing to shift • Diseconomies of scale/lack of synergies might mean new entrants find it easier to compete • Ext 1 Line 30 More landing slots might become available, increasing contestability • Other things are not equal. Contestability might change for other reason, e.g. internet bookings, more planes available to lease 	(12)

Question Number	Answer	Mark
6	<p>KAA: 6 marks (2x3 marks or 3x2 marks) or (3 + 2 + 1) KAA might be argued for or against a difference in contestability</p> <p>Definition of contestability (may be implicit) e.g. low or no sunk costs, low or no barriers to entry/exit (1 mark)</p> <p>Points might include:</p> <ul style="list-style-type: none"> • Online news is a highly competitive market with a high level of contestability. Brand loyalty is low. Use of data in Fig 1 to support argument. • Online news has low sunk costs, easy to set up. • Print set up costs are high, needing high levels of equipment • Print edition news is less contestable. Use of Figure 2 for evidence of concentration. • Comment on related demand for advertising: advertisers have more choice about where to place the online adverts (higher price elasticity of demand) and they view customers of the newspapers as being more disloyal online so the expected returns are lower. • Lack of profitability suggests that the industry is contestable • There may be more hit-and-run in the online market <p>If the answer is referring to only one kind of market for news or for newspapers in general, then cap KAA at 4/6 marks</p> <p>Evaluation: 6 marks (2 x 3 marks or 3 x 2 marks or 3+2+1).</p> <p>Points might include:</p> <ul style="list-style-type: none"> • Counterarguments to above points, e.g. that there is not a significant difference in contestability. • Online set up costs are in fact very high • Printing set up costs might be low e.g. because the technology already exists • Contestability of both markets increasing as internet is used more widely for reading news (also 24 hour TV news) • Some newspapers are starting to charge for or 	(12)

	<p>limit online news (Google and Times) but we do not yet know impact on demand (Fig 2 and own knowledge)</p> <ul style="list-style-type: none">• Increased contestability may worsen the quality of news reporting - negative impact will be wider than just on the firms• Newspapers have become more contestable particularly local newspapers, as a result of new technology.• Fig 1 shows BBC dominance, therefore online news is not contestable• Websites might seem contestable but they are not, because of network effects of readers and path-dependency of search engines	
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Question Number	Answer	Mark
7	<p>KAA 4 marks (2 x 2 marks or 1 x 4 marks)</p> <p>Meaning of contestability e.g. in terms of low sunk costs, low barriers to entry or exit (1 mark)</p> <p>Consideration of reasons why market may be contestable: Award as 4 or 1+3 or 2+2 or or 2+1 or 1+1.</p> <ul style="list-style-type: none"> • Evidence of new entry e.g. Starbucks Via brand; McCafé espresso-based • Entry by supermarkets own label brands which have a relatively high market share (Figure 1) • Market for coffee growing so possibility of entry for niche suppliers • ‘A growing willingness among consumers to trade up to premium and speciality variants’ provides opportunities for new entrants. • ‘Growing awareness of health, wellbeing and ethical trading’ might provide opportunities for new entrants • Barriers to entry might fall as the internet has increased influence <p>Evaluation 4 marks</p> <p>Consideration of reasons why market is not contestable Award as 4 or 1+3 or 2+2 or or 2+1 or 1+1</p> <ul style="list-style-type: none"> • Highly concentrated market: Nescafe supplies over half the market which implies high barriers • Strong brand names - examples from Figure 1 - supported by heavy advertising (high sunk costs) • Cost of machinery required • Entry only by well-established firms • Patent on Via is a legal barrier • 20 years of research into Via • Extract 1 £17m promotional campaign by Nescafe <p>Candidate may take either approach (4 + 4e) or offer overall judgement, with justification.</p>	(8)

END OF SECTION B