Rewarding Learning

ADVANCED
General Certificate of Education
January 2013

Economics

Assessment Unit A2 1

Business Economics

[AE211]

AE211

TUESDAY 22 JANUARY, MORNING

TIME

2 hours.

INSTRUCTIONS TO CANDIDATES

Write your Centre Number and Candidate Number on the Answer Booklet provided.
Answer **Question 1** and **one** question from **Questions 2, 3 or 4**.

INFORMATION FOR CANDIDATES

The total mark for this paper is 80.
Quality of written communication will be assessed in all questions **except 1(a)**.
Figures in brackets printed down the right-hand side of pages indicate the marks awarded to each question or part question.

ADVICE TO CANDIDATES

You are advised to take account of the marks for each part question in allocating the available examination time.

1 Study the information below and answer the questions which follow.

Case Study: The UK Energy market

Source 1: Are energy customers being ripped off?

Anyone who has recently tried to switch energy supplier knows how difficult it is to compare what is on offer, even though there are only six big players offering gas and electricity.

There's the rate you pay for the first chunk of power you use and then the rate for everything else. Some tariffs are quoted with VAT included, some without. There are the discounts offered for different payment methods. There are deals for managing bills online or for having certain kinds of meter. And then there's the option of fixing prices for a period.

It can be bewildering enough comparing what a single company is offering. Very few of us have the time or intellectual capacity to assess the 300 odd different packages on offer from the six largest companies in the industry. The so called "big six", which are listed below, supply more than 99% of British customers.

- British Gas
- EDF Energy
- E.ON
- Npower
- Scottish Power
- SSE

This complexity in pricing is reducing the intensity of competition in the market, according to industry regulator Ofgem. In a report published recently, Ofgem accused the big six of profiteering at the expense of consumers. The report claimed that the profit margins of the big firms had increased by 38% over the past year.

The report has been published just weeks after four of the big six announced double digit price increases for both gas and electricity. The energy companies claim that the price rises are beyond their control and are simply in response to increases in the wholesale price of energy. However Ofgem stated that it had found evidence of the big six raising retail gas prices much more in response to rising wholesale prices than cutting them when wholesale prices fell.

The chart below shows the changes in wholesale and retail gas prices between January 2004 and December 2010.

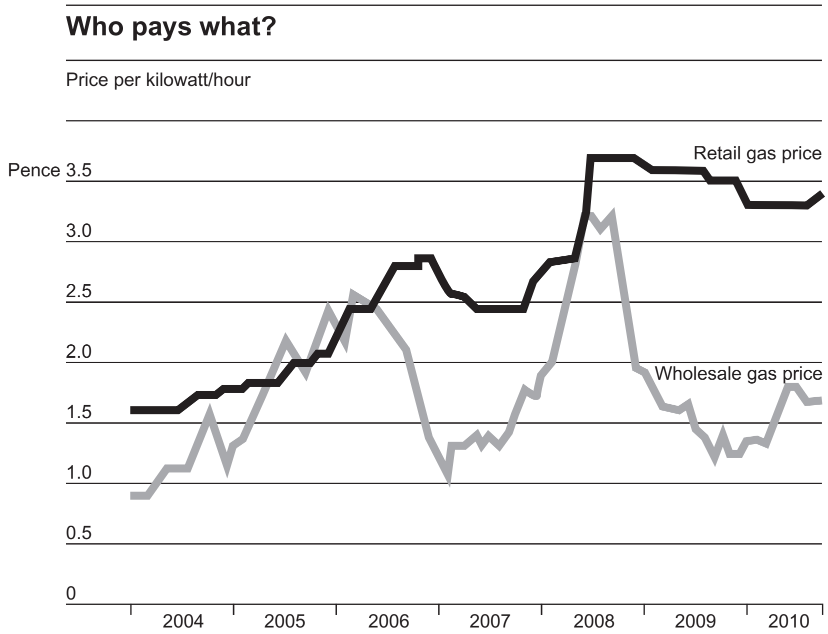

Fig. 1: Wholesale and retail gas prices January 2004–December 2010

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To improve the market for consumers, Ofgem has proposed that power companies should be forced to auction energy to smaller suppliers to increase competition. They have also suggested that there should be a radical standardisation and simplification of tariffs for standard energy deals to make it easier for consumers to compare prices.

Adapted from © BBC News at bbc.co.uk/news

Source 2:

UK energy: A natural oligopoly

The UK energy market has changed dramatically since the bad old days when consumers could only buy from state owned monopolies such as British Gas or from their local public sector electricity supplier. However, privatisation of the gas and electricity markets and their subsequent deregulation gave consumers the power to choose any company they wanted to supply their domestic energy.

Consumers are now free to shop around for the best deal, with many observers claiming that the increased competition has helped bring down prices and improve the range of services available for consumers.

Switching rates in Britain are the highest in the world, with approximately five million energy consumers switching supplier each year and energy prices are among the lowest in the EU. This, says a spokesman for the energy industry, is evidence that the markets are working well for consumers.

However, not everyone agrees that the UK energy market is competitive. Alan Asher, Chief Executive of Energywatch, claims that UK consumers are being ripped off by a "comfortable oligopoly of bloated electricity and gas supply companies". Mr Asher has accused the big six energy suppliers of engaging in tacit collusion and claimed that competition in the market is a myth. He pointed to data that showed that the price difference for energy paid by direct debit amounted to less than 10p per day. "Sadly, through a process of consolidation and merger we have seen the 20 suppliers of 10 years ago shrink to just six and it is the consumer who is the loser," he said.

Others, however, argue that consolidation has been good for the industry, Kevin Campbell of the Federation of Energy Traders claimed that "the nature of the UK energy market, and the economies of scale available, mean that it is a natural oligopoly, and therefore consumers will benefit more from fewer firms than from many".

Source 3:

Competition in the NI electricity market

In May 2010, Dublin-based energy company Airtricity, entered the Northern Ireland domestic electricity supply market, offering prices it claimed would undercut NIE Energy by as much as 14%.

Utility regulator Ian Osborne welcomed the Airtricity's decision to challenge Northern Ireland Electricity's (NIE) effective monopoly in Northern Ireland.

"We welcome Airtricity's entry into the domestic electricity market," he said. "Consumers have told us that they want a choice of electricity supplier and we have worked vigorously with potential suppliers to make this happen." The increased competition will drive down energy costs and should translate to an average saving of £95 per household.

A spokesperson for the existing generator NIE said that while it recognised a new entrant to the domestic market gave customers more choice, it was not unduly concerned about the increased competition. "We have been preparing for a more competitive environment for some time, last year we reduced our prices by 15% and we are confident that consumers are satisfied with our package of low prices and high quality customer service".

Source 4:

Government look to break up the “Big Six”

The government is drawing up radical plans to break up the big six energy companies an attempt to increase competition and make the market work better for consumers. Chr Huhne, the energy secretary, says the energy market has “been too cosy too long and it is madness that 99% of people get their energy from only six large firms. The current market simply can’t deliver, so we need more companies and more competition to keep price rises as low as possible”.

An energy spokesman poured scorn on the plan and claimed that the big six would fiercely resist any break up plan. “Only the big firms have pockets deep enough to make the £200 billion investment required to replace the UK’s ageing energy infrastructure and meet the government’s renewable targets”.

An industry observer claimed that if the market can’t be broken up then the government should regulate consumers’ electricity and gas bills. “Until these energy companies are forced to cap their bills or link them directly to wholesale prices, they will push even more people over the poverty line. British Gas posted profits of £1.3 billion and managed to pay its Managing Director £1.3 million. These fat cats are so busy counting their cash that they give no thought to the 12 million families and pensioners who will face fuel poverty this winter as a result of their greed”.

(a) Does the data in **Fig. 1** support the claim that energy companies are guilty of raising retail gas prices much more in response to rising wholesale prices than cutting them when wholesale prices fall? Explain your answer. [5]

(b) Explain why the UK energy market could be described as a natural oligopoly. [10]

(c) Source 3 states that NIE had an “effective monopoly in Northern Ireland”. Examine the likely impact of increased competition on NIE. [10]

(d) Evaluate some of the policies that the government could use to make the UK energy market work better for consumers. [15]

Essays:

Answer one from Questions 2, 3 or 4.

2 Non-price competition benefits consumers

(a) Explain why firms engage in non-price competition. [15]

(b) Critically examine the view that consumers benefit more from non-price competition than from price competition. [25]

3 Diseconomies of scale can be avoided

(a) Explain the relationship between a firm's short run and long run average cost curves. [15]

(b) Critically examine the view that firms can continue to grow without experiencing diseconomies of scale. [25]

4 "Green" policies may be counter-productive

(a) Explain some of the ways in which businesses may use and misuse the environment. [15]

(b) Critically examine the view that government "green" policies benefit neither businesses nor the environment. [25]

THIS IS THE END OF THE QUESTION PAPER
