A-level
ECONOMICS
7136/1

Paper 1 Markets and market failure

Specimen 2014 Morning Time allowed: 2 hours

Materials
For this paper you must have:
- an answer book
- a calculator.

Instructions
- Use black ink or black ball-point pen. Pencil should only be used for drawing.
- Write the information required on the front of your answer book. The **Examining Body** for this paper is AQA. The **Paper Reference** is 7136/1.
- In **Section A**, answer **EITHER** Context 1 **OR** Context 2.
- In **Section B**, answer **one** essay.

Information
- There are 80 marks available on this paper.
- The marks for questions are shown in brackets.

Section A

Answer **EITHER Context 1 OR Context 2.**

EITHER

Context 1 **Total for this context: 40 marks.**

The UK energy market

Study **Extracts A, B and C** and then answer **all** parts of Context 1 which follow.

Extract A: Average household dual fuel bills August 2009–2013 (£)

	2009	2010	2011	2012	2013
Household bills	1145	1105	1250	1310	1420
Wholesale energy costs per bill	615	485	585	625	635
Profit per bill	10	55	45	50	95

Source: Contains public sector information licensed under the Open Government Licence v. 1.0

Extract B: Are energy firms exploiting their market power?

The UK energy market was privatised in the early 1990s and is dominated by six firms, British Gas, EDF Energy, E.ON, Npower, Scottish Power and SSE. These firms supply, produce and own energy reserves. Gas is the main source of fuel used by electricity generators.

The increase in household fuel bills has been a cause of rising inflation in recent years. In autumn 2013, prices were increasing at three times the rate of inflation. Energy prices have risen faster than average earnings and 6.5 million households were spending over 10% of their incomes on energy and so experiencing ‘fuel poverty’.

Are the oligopolistic energy utilities exploiting their monopoly power? Firms raise prices quickly when their wholesale costs increase, but are slow to reduce them when market conditions change. The energy regulator, OFGEM, doesn’t regulate prices or profits, but aims to promote greater competition in the market. OFGEM has found no evidence of collusion between energy suppliers to date.

Wholesale energy costs are responsible for around half the final domestic bill. Suppliers buy energy on the wholesale market from energy producers. Contracts are complex and firms buy energy to cover their future needs. A generator may sell energy to a supplier within the same company before it is sold on to the consumer. The determination of wholesale prices and their link to retail prices aren’t clear.

UK households faced over 1756 different price plans in early 2013. This makes it difficult for consumers to compare rates and few consumers switch supplier. In 2013 OFGEM intervened to fix the maximum number of price plans to four per firm; this should bring greater price transparency.

Source: News reports, October 2013

Extract C: Are price rises inevitable?

Do UK consumers pay too much for energy? Department of Energy & Climate Change research shows domestic electricity prices were fourth lowest and gas prices second lowest in a survey of 15 EU countries. Firms claim profits, averaging a return of 5% in 2012, are not excessive and are used to fund much-needed investment in both infrastructure and future energy supplies.

Will Morris, Group Managing Director of SSE, claims many factors are responsible for driving up prices: “Buying wholesale energy in global markets, delivering it to customers, and government-imposed levies collected through bills all cost more than last year.”

Ed Miliband, Leader of the Opposition in the UK, promised that a future Labour government would impose “a price freeze for twenty months because the market is not working”, and that the regulator would make the market more competitive.

In the longer term, the UK needs to become less dependent on imported energy and use ‘greener’ sources such as wind, solar and nuclear. One in five UK power stations will be obsolete by 2023 and there is a risk of power shortages in coming years. The Government guarantees high prices to firms producing energy from renewable and nuclear sources but these costs are then passed on to consumers.

The Government claims that high guaranteed prices for power generators makes good long-term sense. Gas prices are expected to rise over the longer term, despite the discovery of shale gas in the UK. Could more be done to encourage households to reduce their demand for energy? Energy conservation could result in lower bills but few households are making use of the ‘Green Deal’ scheme to make homes more energy efficient.

Source: News reports, October 2013

0 1 Using the data in **Extract A**, calculate, to **two** decimal places, the overall percentage change in household bills from 2009 to 2013.

[2 marks]

0 2 Explain how the data in **Extract A** show that energy companies have exploited their market power.

[4 marks]

0 3 **Extract B** (lines 11–12) states that there is ‘no evidence of collusion between energy suppliers to date.’

With the help of a diagram, explain how collusion between energy suppliers could affect the retail prices paid by consumers.

[9 marks]

0 4 In **Extract C**, (lines 9–10) Ed Miliband is quoted as saying that a future Labour government would impose “a price freeze for twenty months because the market is not working”.

Using the data in the extracts and your economic knowledge, assess whether you agree that fixing a maximum price for energy that is sold to households is the best way of dealing with market failure in the UK energy industry?

[25 marks]

Do **not** answer Context 2 if you have answered Context 1.

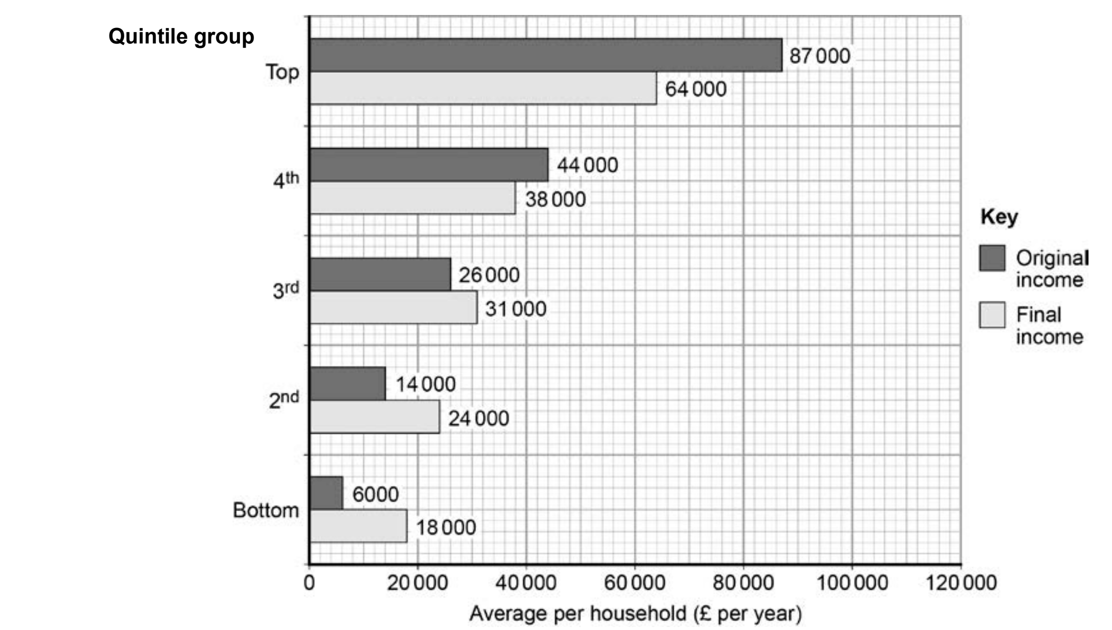
OR

CONTEXT 2 **Total for this Context: 40 marks**

Inequality

Study **Extracts D**, **E and F** and then answer **all** parts of Context 2 which follow.

Extract D: The effects of taxes and benefits in the UK on household income by quintile groups, 2011–2012



Source: Office for National Statistics licensed under the Open Government Licence v. 1.0.

Extract E: In favour of inequality

The way in which society's resources are distributed has long been of major concern to economists, directly affecting as it does the level of social welfare. Changes in the size and distribution of national output raise important questions of efficiency and also involve basic issues of equality. However, what is equitable is a matter of considerable debate amongst economists of different political persuasions.

It has been argued by the supporters of free-market capitalism that growing inequality would create incentives, kick-start enterprise, boost growth and is good for us all. Free market economists would argue that justice automatically arises from the interaction of demand and supply and the existence of competitive markets. In such a scenario, each factor receives what it is worth in terms of the value of its marginal revenue product. Disparities in income and wealth are justified by such factors as greater levels of innate or acquired skills which enable some factors to be more productive than others and earn a greater amount. Differences in the distribution of income and wealth are therefore viewed as inevitable and also desirable in that they provide the necessary incentives for individuals to study, train, supply their factor services and set up new businesses. These differences help the smooth operation of the price system and lead to an efficient resource allocation.

Moreover, an unequal distribution of income is seen as necessary to ensure economic efficiency and a faster growth rate – by making the rich richer, the size of the national cake, that is real GDP, will grow, and the benefits will trickle down to the less well off.

Source: News reports, November 2013

Extract F: Against inequality

The main outcome of the post-1980 experiment in neo-liberal (market) economics has been an economy that is much more divided and unhealthy, both of which are closely related. There are three powerful reasons why the global financial crisis of 2008 and 2009 had its roots in excessive concentrations of income and wealth.

First, above a certain limit of inequality, economies develop a natural tendency to deflation. In the UK and US, by cutting the purchasing power to buy the extra output being produced, the long wage squeeze has created consumer societies without enough consumers. The solution has been to allow an unsustainable increase in private debt to fill the gap.

Second, concentrating income in fewer and fewer hands eventually leads to bubble economies in which the prices of assets, such as houses and shares, rise continuously until the 'bubbles' eventually burst. From the early 1990s, the growing inequality created a global mix of increasing company profits, excessive bank lending and rapidly growing personal wealth, all of which contributed to the bubbles in property and share prices. This eventually brought the global economy to its knees.

Finally, excessive concentrations of wealth create dangerous concentrations of economic power. Corporate lobby groups, which promote the interests of the financial sector, are able to promote measures such as weak financial regulation by the state and lower taxes on the wealthy.

Source: Copyright Guardian News & Media Ltd 2011

0 5 Using the data in **Extract D**, calculate the difference between the mean original income and the mean final income of the five quintile groups.

[2 marks]

0 6 Explain how the data in **Extract D** show that taxes and benefits have been successful in reducing inequalities in household income in the UK.

[4 marks]

0 7 **Extract F** (lines 9–10) states that 'concentrating income in fewer and fewer hands eventually leads to bubble economies in which the prices of assets, such as houses and shares, rise continuously'.

With the help of a diagram, explain how growing inequality might lead to a persistent rise in the price of houses.

[9 marks]

0 8 **Extract E** (lines 6–7) states that 'growing inequality would create incentives, kick-start enterprise, boost growth and is good for us all'.

Using the data in the extracts and your economic knowledge, assess the view that inequality is 'good for us all.'

[25 marks]

Section B

Answer **one** essay from this section.

Each essay carries 40 marks.

EITHER

Essay 1

Apple sells iPhones and iPads at considerably lower prices in the USA than in the UK market, but sources the products from the same factories in the Far East.

0 9 Explain why firms, such as Apple, might be able to charge different prices for the same product in different markets.

[15 marks]

1 0 Discuss the view that price discrimination only benefits suppliers, such as Apple.

[25 marks]

OR

Essay 2

Traditional economic theory assumes that consumers make rational decisions that maximise their economic welfare, but behavioural economists disagree.

1 1 Using examples to illustrate your answer, explain how anchoring **and** loss aversion can affect an individual's choices when deciding how to spend or save their income.

[15 marks]

1 2 The Government would like to improve the well-being of the population by encouraging people to adopt a healthy diet. Using your knowledge of **both** traditional economic theory **and** behavioural economics, assess alternative policies that the Government might adopt to try to achieve its objective

[25 marks]

OR

Essay 3

It is generally accepted that we need to adopt new ways of charging for the use of our roads. This is partly because of worsening congestion, but is also due to the reduction in revenue generated from taxes on fuels as a result of more fuel-efficient vehicles.

1 3 Explain why, in the absence of government intervention, too many journeys are likely to be made by road and too few by rail.

[15 marks]

1 4 Assess the view that a system of road-pricing is the best way to tackle the problem of worsening traffic congestion in the UK.

[25 marks]

END OF QUESTIONS

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