Rewarding Learning

ADVANCED
General Certificate of Education
2017

Economics

Assessment Unit A2 1
Business Economics

AE211

[AE211]
TUESDAY 13 JUNE, AFTERNOON

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.

Price changes by Big 6 Energy Firms September 2012–July 2015

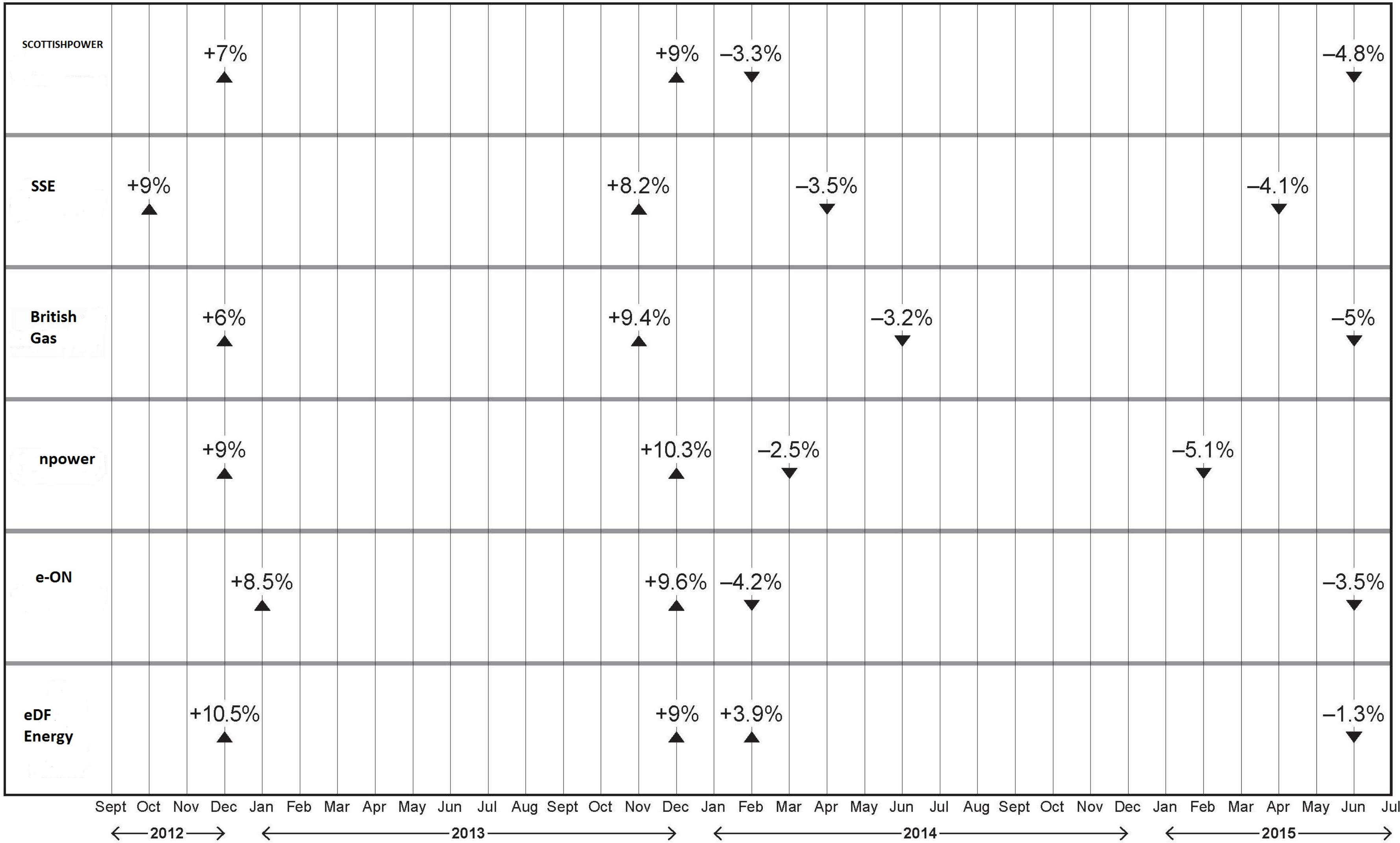

Fig. 1

Question 1

These articles were compiled in September 2015. Please read them carefully and answer the questions which follow.

Case study: UK energy: A malfunctioning market!

Source 1: Tacit collusion in the UK energy market?

Rising energy prices have long been an issue of concern and discussion at the UK's dinner tables. In the last 5 years average annual dual-fuel bills (gas and electricity combined) have increased by 24%, which is more than twice the rate of inflation over the same period.

These rising prices call into question the level of competition in the UK energy market. Major energy suppliers have been accused of colluding to fix prices and profiteer at the expense of vulnerable consumers.

The chart opposite **(Fig. 1)** shows the major price change announcements by the big six since 2012. Many analysts suggest that both the timing and the magnitude of the various price changes provide compelling evidence of at least tacit collusion if not outright price fixing.

The UK retail energy market is dominated by six large companies, Scottish Power; SSE; British Gas; npower; E.ON and EDF energy. These companies, collectively known as "The Big Six", supply energy to around 98% of UK homes and businesses.

A key feature of the UK energy industry is the degree of vertical integration that exists within the industry, with those same six companies also accounting for around 70% of all the energy produced in the UK. While some argue that this vertical integration allows each firm to supply energy in an efficient manner, it does lead to a lack of transparency with regard to how changes in wholesale prices are passed along to the consumer in terms of retail price changes.

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Source 2: Lots of competitors but little competition

Two separate reports published recently have concluded that the retail energy market in the UK is not functioning as well as was hoped when the industry was privatised in the 1980s. As a result, millions of consumers are paying hundreds of pounds too much for their gas and electricity.

The reports by energy market regulator Ofgem and the Competition and Markets Authority (CMA), have both concluded that there are a number of features in this market which act as a barrier to effective competition.

One such feature highlighted in the Ofgem report is the fact that a significant amount of capital is required to trade energy in the wholesale market which makes it almost impossible for smaller companies to purchase the energy required to compete with the big six.

Another feature which acts to limit potential competition is the fact that all of the current big six are vertically integrated, which enables them to avail of significant cost savings compared to non-vertically integrated firms.

The Competition and Markets Authority report also points out that the vast array of different tariffs available from the big six increases the complexity of calculating potential bills and therefore makes it extremely difficult for consumers to compare the deals offered by different firms.

In response to the reports, market analyst Jill Roberts stated, “to function effectively markets require competition between rivals, transparency on pricing and genuine choice of product. None of these features exist in the UK energy market. Electricity and gas are homogenous products. Demand for them is both price inelastic and income inelastic and as such you would expect price to be the most important factor in determining which supplier to use. However the retail energy market in the UK is characterised by low customer engagement, with millions of UK households stuck on inefficient and uncompetitive deals”.

Source 3: Big six earning excessive profits from their retail divisions

Analysis published by the Competition and Markets Authority indicates that the profits of the big six energy retailers have increased ten-fold since 2007 and by a third in the last year. In 2007 the combined UK profits of the big six were £110 million and by 2014 this had increased to £1.1 billion.

The CMA report also calculates an average Return On Capital Employed for the big six to be around 28%, which is well above the 10% which would be the benchmark figure in a competitive market.

This huge increase in profits has prompted allegations that the energy companies are ripping off their customers with one Labour MP stating, “this is yet more evidence that energy companies are earning supernormal profits on the back of spiralling bills for households and businesses”.

Not surprisingly however, the energy companies dispute this assertion. Laurence Sandler, a spokesman for the energy industry, said that independent studies proved that Ofgem’s estimates are unrealistic and inaccurate. “The figures used by Ofgem are outdated, statistically biased and downright inaccurate. They take no account of what energy companies pay out in financing costs, interest payments or tax and make mistaken assumptions about levels of energy consumption”. The average net profit ratio for the industry is 3.9% which is significantly lower than the 5%–6% that is typically earned in other similar sized industries such as the UK grocery market.

Energy analyst John Barnett stated that “the notion of excessive or supernormal profit is an academic concept which is of little value in the real world. Companies exist to make profits for their owners, while academics sit in their ivory towers and make normative judgements on what constitutes excessive profits. The retail energy market in the UK is actually extremely competitive with UK consumers paying some of the lowest prices in Europe. Critics need to understand two things: firstly, energy companies make most of their profits through energy generation, not supply; secondly, five of the big six make profits from selling in other countries, but report these profits in the UK”.

Source 4: Labour leader calls for nationalisation of UK energy market

Labour leader Jeremy Corbyn has pledged to reverse the changes of the 1980s and renationalise the UK energy market if Labour wins the next election. The left-wing leader said a government under his leadership would start buying shares in each of the big six until it owned a controlling stake in each firm.

Energy analyst and supporter of nationalisation Anna Gribben stated that “a nationalised energy company could generate electricity 20% more cheaply than a private firm since it could borrow money at around 3% – half of the rate typically paid by private firms. In addition, the nationalised firm would not have to pay dividends to shareholders so all the profits could be reinvested to improve efficiency and quality of service and reduce price. Finally, a nationalised firm could plan strategically for the whole country. Surely this would be much better than the current system where each firm is focused on maximising short term profits.”

However, not everyone is in favour of renationalising the energy sector. Right-wing commentator Bill Jones thinks nationalisation is a terrible idea. “The government is unlikely to be any better at running energy than private firms. Renationalisation, by removing the profit motive, would stifle innovation and remove any incentive to improve efficiency or service to the consumer. It would simply result in a bureaucratic system clogged with red tape.”

1 **(a)** Using the data in **Fig. 1**, compare the timing and magnitude of the price changes announced by the “big six” over the period shown. [5]

(b) Explain why it is difficult for new firms to enter the UK energy retail market and compete with the big six. [10]

(c) Examine why it might be difficult for economists to determine if the big six energy firms are earning supernormal profits from their retail divisions in the UK. [10]

(d) Critically examine the case for nationalisation of the UK energy market. [15]

Essays:

Answer **one** question from **Questions 2**, **3** or **4**.

2 UK government criticised for ignoring social costs

(a) Explain why it is difficult for an economist to accurately measure the social cost of production. [15]

(b) Evaluate the range of policies the UK government could use to reduce the negative impact of production on society. [25]

3 Concentration is the key to efficiency

(a) Explain why, in theory, perfectly competitive markets lead to an efficient allocation of resources. [15]

(b) Critically examine the view that economic efficiency is more likely to be achieved in highly concentrated markets than in highly competitive markets. [25]

4 Foreign takeovers are bad for all UK stakeholders

(a) Explain the difference between organic growth and growth by acquisition or merger. [15]

(b) Critically examine the view that the UK government should prohibit the foreign takeover of UK firms. [25]

THIS IS THE END OF THE QUESTION PAPER

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