

### Introduction

- Provide background information. Establish that the demand for electricity is a derived demand.
- State approach

### Body (1) – Explain PED and YED concepts, Apply to context

- Define PED and determine the likely PED for electricity.
- Define YED and apply the concept to explain the likely impact of an expected increase in future income on the demand for different types of goods.

### Body (2) – Explain how an increase in price of electricity and expected increase in future income can impact total consumer expenditure on electricity

- Analysing the market for household electricity, recognise that the increase in price of electricity due to government policy will decrease supply.
- [Illustrate with diagram] Explain how given a fall in supply, total consumer expenditure increases since demand for electricity is price inelastic.
- Explain how an expected increase in future income is likely to increase demand for electricity and hence total consumer expenditure.
- Analyse the combined effects.

### Body (3) – Explain how an increase in price of electricity and expected increase in future income can impact total revenue for different firms, which is also consumer expenditure on different markets

- Recognise that the increase in price of electricity will increase costs of production and decrease supply for goods and services in general.
- Recognise and explain that given a fall in supply, the impact on total revenue will depend on PED. (summarise since it is explained earlier)
- Explain how given an expected rise in future income, total revenue
  - decreases for an inferior good
  - increases by a small extent for a normal necessity
  - increases by a large extent for a normal luxury
- Analyse the combined effects. For combinations where the outcome is uncertain/ambiguous, suggest a likely outcome based on the extent of the shifts in demand and supply.

### Evaluative conclusion

- Is the impact on households or firms likely to be greater?
- Are there any factors that may affect the extent of the impact?

Knowledge, Comprehension, Analysis and Application		
Level		Marks
L3	For an answer that exhibits rigorous explanation of how PED and YED can affect the impact of a rise in price of electricity and expected increase in future income on total consumer expenditure and total revenue, and analyses the combined effects. Answer is well organised and uses appropriate economic diagrams.	15 - 21
L2	For a developed answer that applies PED and/or YED concept to explain the impact of a rise in price of electricity and expected increase in future income on total consumer expenditure and total revenue, but fails to deal with the combined effects.	10 - 14
L1	For a descriptive and superficial answer that briefly explains the impact of a rise in price of electricity and expected increase in future income on total consumer expenditure and total revenue, with no reference to elasticities.	1 - 9
Evaluation, Synthesis		
Level		Marks
E2	Insightful, evaluative comments supported by economic or contextual analysis.	3 - 4
E1	Statements not based on economic or contextual analysis.	1 - 2

(a)

### **Introduction**

- [Explain what rational decision is in the context of an airline merger] Assuming that the airline firms seek to maximise profits, the firms will weigh the marginal private costs of the merger against the marginal private benefits.
- [State approach] This essay seeks to explain the factors that influence airlines' decision to merge, which are essentially the marginal private costs and the marginal private benefits of an airline merger.

#### **Body 1: Marginal Private Benefit – Increase revenue from the increase in market share**

Explain how the merger can increase the airline's market share → increase the firm's demand and make the demand curve more price inelastic → greater market power → increase revenue

#### **Body 2: Marginal Private Benefit – Cost savings from reaping internal economies of scale**

Explain how the merger can allow the airline to expand its scale of production and reap greater internal economies of scale → lower LRAC. Define and give examples.

- e.g. marketing economies such as bulk purchase of aircrafts or lower unit costs of advertising.
- e.g. technical economies arising from greater efficiency of large planes - the initial outlay may be lower and operating costs may be saved as a double-decker plane can carry twice as many passengers but the initial cost is not twice as much nor is the running cost doubled because the number of pilots required is not doubled.

#### **Body 3: Marginal Private Benefit – Higher costs from internal diseconomies of scale**

Explain how firms may experience internal diseconomies of scale when they grow beyond a certain size → LRAC may increase. Give examples.

- managerial diseconomies of scale - organisation, administration, planning and control are all more complex in a large operation. slow decision making, one section of the firm may not know what the other sections are doing and duplications may occur resulting in wastage.

### **Conclusion**

The airline should decide to merge if and only if the marginal private benefits from taking the action are at least as great as the marginal private benefit.

Level	Knowledge, Comprehension, Analysis and Application	Marks
L3	For an answer that exhibits <u>rigorous</u> explanation of the marginal private benefits and costs of a merger, showing application to the airline industry.	7 - 10
L2	For an answer which explains the marginal private benefits and costs of a merger without applying to the context of the airline industry, or may be limited in scope or depth  or an one-sided answer that only explains clearly the marginal private benefits or costs of a merger between airlines.	4 - 6
L1	For a descriptive and superficial answer that mainly lists the marginal private benefits and costs of a merger.	1 - 3

(b)

### Introduction

- [Explain what the term “firms’ strategies” refers to] Firms’ strategies may include pricing and output decisions, type of competition, i.e. price competition or non-price competition, and whether the firms compete/collude.
- [State approach] This essay seeks to explain how a firm’s objectives, and business risks may influence its strategies, before discussing which is a more significant factor in determining firms’ strategies.

### Body (1) – Explain how a firm’s objectives may determine its strategies

- Explain how a profit maximising firm determines price and output.  
[can illustrate with a model, showing three levels of output - below/at/above output level where  $MC=MR$ ]
- Explain how a firm that seeks to maximise growth may engage in predatory pricing to drive rivals out and increase their market share. Refer to the preamble: Price war in the airlines industry
- Explain how sales managers and commission-based employees (e.g. financial advisers) whose income are dependent on the total revenue earned by the firm, might choose to maximise revenue rather than to maximise profits → produce at output level where  $MR=0$

### Body (2) – Explain how business risks may determine a firm’s strategies

- Refer to preamble, explain how rising fuel cost increases airlines’ costs of production, and recession may lower revenue, therefore affecting profitability → airlines may merge to lower costs and increase market share (as mentioned in part a) to prevent a bankruptcy and achieve greater stability.  
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### Evaluative conclusion

- Firms ultimately aim to maximise profits in the long run (elaborate), therefore the objective of profit maximisation is probably the main determinant of firms’ strategies in the long run.
- In the short run, a firm’s strategies may be determined by its alternative objectives, such as growth maximisation. (Link to the preamble)
- However, it appears that in the case of the airlines industry, during an economic downturn, business risks might influence the objectives of firm, causing the airlines to switch from maximising market share to maximising profits, thereby being a more significant determinant of a firm’s strategies in the short run.

Level Knowledge, Comprehension, Analysis and Application		Marks
L3	For an answer that exhibits rigorous explanation of how objectives or business risks may affect firms' strategies. Answer is well organised, uses appropriate economic diagrams and is supported with real world examples.	7 - 9
L2	For an answer that is lop-sided, e.g. an answer that explains with examples how objectives of firms OR business risks may determine firms' strategies  Or an answer that explains how objectives of firms and business risks may determine firms' strategies, but may be limited in scope or depth; contains accurate though undeveloped explanations, not consistently analytical	5 - 6
L1	For a descriptive and superficial answer that briefly explains how objectives or business risks may affect firms' strategies.	1 - 4
Level Evaluation, Synthesis		Marks
E2	Insightful, evaluative comments supported by economic or contextual analysis.	3 - 4
E1	Statements not based on economic or contextual analysis.	1 - 2