1. Explain two key characteristics of the market structure that these coffee chains operate in and why allocative inefficient exists in this market structure. [10]
2. Market structure of Coffee chains 🡪 Oligopoly/ Duopoly in Singapore

**Not duoploy – mc market, low btr**

Introduction: The industry of coffee chains is being dominated by Starbucks Coffee Company and The Coffee Bean and Tea Leaf (CBTL) which makes the industry an oligopoly or to be more accurate, a duopoly. This is due to the presence of barriers to entry such as the need for strong brand recognition and high upfront capital outlay which allows the incumbent companies to maintain their market dominance. As such, there is allocative inefficiency as the firms practice price discrimination.

**MB1:** The two key characteristics are high market dominance and high barriers to entry

* High market dominance – 2 companies dominate the industry – high market share Starbucks and CBTL
* High BTE – the need to compete for brand recognition, in which Starbucks have an abundance of due to being ingrained in modern culture
* Huge BTE (ii) – High upfront capital outlay – rental costs, labour + training costs, logistics for coffee beans and advertisement expense

**MB2:** Pricing decisions for oligopolist market

* Firms will seek to maximise profits – usually will practice MC pricing ( wrong)
* Oligopoly however, is able to set prices through the practice of price discrimination
* Therefore, will no longer be at mc pricing, thus will have allocative inefficiency

**Draw diagram (structure of oligopoly)**

**Describe diagram:**

* Price will be at P1>P0, where MC=AR, firms will earn greater profit, at the expense of consumer surplus. Firms will be able to earn supernormal profits in the long run

**Conclusion:** Hence there will be allocative inefficiency due to the practice of price discrimination as a result of the firm’s market dominance.

1. Discuss the possible strategies that Starbucks Coffee company could undertake to respond the rising labour costs. [15]

Introduction: Rising labour costs would increase the cost of production for the company which will result in eroding profits. As such, to maintain profits, the Starbucks Coffee company could undertake strategies such as restructuring, increasing EOS, increasing market share through advertising or merger and acquisition.

**MB1:** Effects of rising labour costs

* Labour is a factor of production in the industry of coffee chains, baristas, logistics etc etc.
* The increase in cost of the factors of production will lead to an increase in cost of production and thus result in an increase in both MC and AC and erode profits
* Thus, the company could either find ways to lower costs through cost savings or increase revenue.

**MB2:** Lower costs through cost savings

* The company could engage in restructuring, removing unprofitable endeavours and departments 🡪 lower costs and lower the need for more labour. However, Starbucks is still deciding to expand 🡪 this strategy would thus not be viable.
* Leverage on more EOS 🡪 expand their production network 🡪 link their process of production 🡪 from owning the coffee plantations to the transportation network to the Starbucks outlets. This will increase cost savings through increased EOS but will requite a huge amount of capital

**MB3:** Increase Revenue

* Price measure 🡪 reduce prices 🡪 increase market share 🡪 increase in revenue
* However, competition will match price fall or even engage in price war which will be bad for both companies.
* Advertising 🡪 inculcate brand loyalty and influence taste and preferences 🡪 makes goods more price inelastic 🡪 increase in price from increase of COP will result in a less than proportionate fall in quantity demanded 🡪 profits maintained or even increased
* Merger and acquisition 🡪 acquire rival companies 🡪 gain their market share and revenue 🡪 increase profits
* However, the market is already dominated by 2 large companies, merger is out of the realm of possibility as governments will step in through anti-trust laws

**Conclusion:** Hence the best method that Starbucks could consider is either increase advertisements or through expanding their production network to increase EOS.