

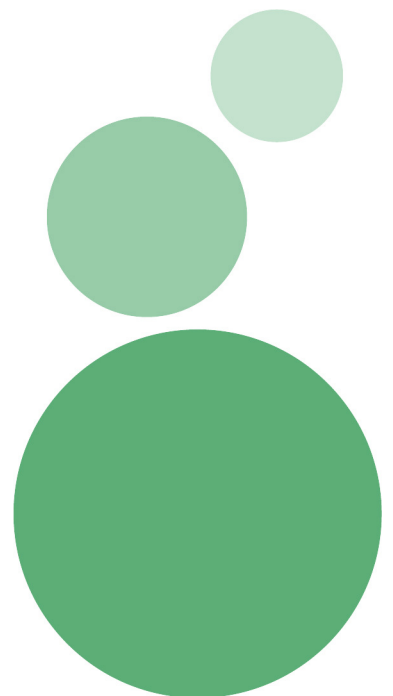


European Commission
Internal Market and Services DG

Contract with regard to access to services
in the Internal Market (MARKT/2008/10/E):
Study on business practices applying
different condition of access based on the
nationality or the place of residence of
service recipients - Implementation of
Directive 2006/123/EC on Services in the
Internal Market

Final Report

November 2009



Disclaimer

In keeping with our values of integrity and excellence, Matrix has taken reasonable professional care in the preparation of this report. Although Matrix has made reasonable efforts to obtain information from a broad spectrum of sources, we cannot guarantee absolute accuracy or completeness of information/data submitted, nor do we accept responsibility for recommendations that may have been omitted due to particular or exceptional conditions and circumstances.

Contents

| | |
|---|----|
| 1.0 Key findings | 4 |
| 2.0 Introduction and policy background | 7 |
| 2.1 Policy background | 7 |
| 2.2 Objectives and overall approach | 7 |
| 3.0 Sector background | 10 |
| 3.1 Car rental | 11 |
| 3.2 Digital downloads | 15 |
| 3.3 Online sale of electronic goods | 21 |
| 3.4 Tourism: travel accommodation | 23 |
| 3.5 Conclusions | 28 |
| 4.0 Drivers of price and access differentiation | 31 |
| 4.1 Drivers of Price and Service Differentiation | 33 |
| 4.2 Legal and regulatory considerations | 37 |
| 4.3 Supply-related drivers | 50 |
| 4.4 Demand-related drivers and source market pricing techniques | 62 |
| 4.5 Conclusions | 68 |
| 5.0 Implementation of differentiation | 70 |
| 5.1 Implementation offline | 70 |
| 5.2 Implementation online | 70 |
| 5.3 Implementation practices and consumer outcomes | 74 |
| 5.4 Implementing differentiation based on factors other than country of residence | 76 |
| 6.0 Conclusions and implications | 78 |
| 6.1 Overview of Main Findings and Key Questions | 78 |
| 6.2 Implications | 80 |
| 6.3 Recommendations | 82 |

1.0 Key findings

Incidence of differentiation

1. The report has revealed prima facie evidence for different treatment based on the place of residence of the customer across all four sectors covered in this study (car rental, digital download, online sale of electronic goods, tourism) and at different stages of the business value chain (from input supplier to end consumer). Differentiation was identified in particular with regards to services provided online, while very little indication of such practices could be found offline.
2. There was no prima facie evidence of systematic differentiation based on the nationality of the customer.
3. The incidence of different types of differentiation practices varies across sectors, but also across firms within one sector and it does not always put cross-border customers at a disadvantage compared with domestic business. All of these factors point to a combination of different drivers of differentiation at firm, sector and national levels
4. The report discusses a number of different practices for implementing price and service differentiation in online business transactions, including automatic Internet Protocol (IP) address-based redirection, the existence of parallel national websites or the existence of nationally targeted services available through a central website as part of the booking process.

Drivers of differentiation

5. Legal and regulatory drivers of differentiation identified as part of the interview programme included direct financial costs, other compliance costs, differences in national legislation, including as a result of the national implementation of EC instruments (e.g. fragmentation of consumer protection and environmental legislation) and information and regulatory uncertainty.
6. Supply-side drivers of differentiation identified as part of the interview programme included costs and difficulties linked to obtaining inputs from suppliers, order and payment processing, transport and delivery costs, marketing costs, customer support costs and corporate structure, including franchising.
7. Demand-side drivers of differentiation identified as part of the interview programme included differences in competition conditions and customers' willingness to pay.

8. These drivers of differentiation can and do interact to offset or reinforce one another. The same consumer outcomes in terms of pricing and service provision can be due to different economic drivers, while the same drivers for differentiation may lead to different consumer outcomes. Thus, a multivariate empirical analysis is required to disentangle the impact of individual drivers on outcomes.

Business responses to economic and regulatory drivers and implementation of differentiation

9. In response to these drivers of differentiation, businesses adopt one of four strategies, each leading to different consumer outcomes in terms of prices or services offered:
 - a) Compute an average price across all source markets;
 - b) Differentiate between domestic and cross-border source markets;
 - c) Differentiate between all source markets; or
 - d) Refrain from entering some source markets either completely or with a like-for-like service.
10. Due to the range of different business responses to the same drivers, consumer outcomes, such as observed price differences, cannot always be traced back to individual economic and regulatory drivers of differentiation.
11. Business strategies aiming at implementing differentiation vary in the extent to which they allow customers to override segmentation into different geographically or linguistically defined markets. Looking in particular at services provided online, several practices can be highlighted:
 - a) national segmentation of markets and information with no possibility for customers to override this segmentation
 - b) national segmentation of markets with the possibility for customers to override the segmentation of information about these markets
 - c) Possibility for customers to override both the national segmentation of the market and information about these markets (i.e. full access to services irrespective of the place of residence of the customer)

Assessment and recommendations

12. The question of interest in terms of the non-discrimination clause in Article 20 (2) of the Services Directive is not whether price and service differentiation occurs but whether this differentiation consists in discrimination based on the place of residence of the consumer. It is therefore crucial to investigate whether:
 - a) the differentiation mirrors underlying economic and regulatory drivers (possible objectivity); and
 - b) the extent of differentiation is proportional to the underlying economic and regulatory drivers (possible proportionality).

13. An assessment of the objectivity of economic drivers for price and service differentiation based on the place of residence of the customer needs to take into account sectoral characteristics such as the number and importance of intermediaries within the distribution model or the importance of online relative to offline business. In addition, sectors that rely on individualised, tailored services may face different economic drivers for differentiation than sectors where services are more standardised.
14. While the report has identified a large number of potential drivers of price and service differentiation, an assessment of the proportionality of these potential justifications is also needed, in particular to take into account the extent to which observed differences in consumer outcomes mirror these drivers in a proportionate way.
15. With regards to the drivers of differentiation, the report has shown that fragmentation and inconsistencies of EU and national legislation as well as compliance costs may result in differentiation in treatment based on the place of residence of the customers. There therefore seems to be a clear economic rationale for intervention aiming at attenuating the impact of regulatory drivers of differentiation. The intervention logic concerning market-related drivers (demand and supply) is less clear and more attention needs to be paid to the way in which differentiation is implemented in order to determine whether observed differentiation is based on objective reasons and proportionate to underlying drivers
16. The report proposes a list of questions for national authorities to consider as a starting point in their assessment of the objectivity and proportionality of economic and regulatory drivers of residence-based price and service differentiation for the purpose of the application of Article 20(2) of the Services Directive.

2.0 Introduction and policy background

This document contains the **final report for the assignment MARKT/2008/10/E on "Access to services in the Internal Market. Study on business practices applying different conditions of access based on the nationality or the place of residence of service recipients"**. The objective of this document is to describe the study methodology, set out the findings and develop conclusions, implications and recommendations.

2.1 Policy background

The objective of **Directive 2006/123/EC** on Services in the Internal Market (the Services Directive) is to achieve progress towards a genuine Internal Market in services so that both businesses and consumers can take full advantages of the opportunities it offers. Building on Internal Market freedoms laid down in Articles 43 and 49 of the EC Treaty, the provisions of the Directive aim in particular at removing barriers which create obstacles to the freedom of establishment and to the freedom to provide and receive services within the EU.

Article 20 of the Services Directive, in the section of the Directive devoted to the "rights of recipients of services" is the most relevant existing provision in EC Law when it comes to dealing with cases of service providers who refuse consumers access to their services or apply different conditions of access because of the consumer's nationality or residence. The focus throughout this study is on the **principle of non-discrimination laid down in paragraph 2 of Article 20 of the Services Directive**, which requires Member States to ensure that "the general conditions of access to a service, which are made available to the public at large by the provider do not contain discriminatory provisions relating to the nationality or place of residence of the recipient". Article 20 (2) specifies at the same time that differences in the conditions of access can be applied "where those differences are directly justified by objective criteria".

This study aims in particular to provide a starting point for establishing the range of objective criteria that might justify price and service differentiation based on residence or nationality under Article 20, paragraph 2 of the Services Directive. While the study does not intend to come to a conclusive assessment of the **objectivity** of the drivers it aims to provide an evidence base for implementing and enforcing Article 20 of the Services Directive.

2.2 Objectives and overall approach

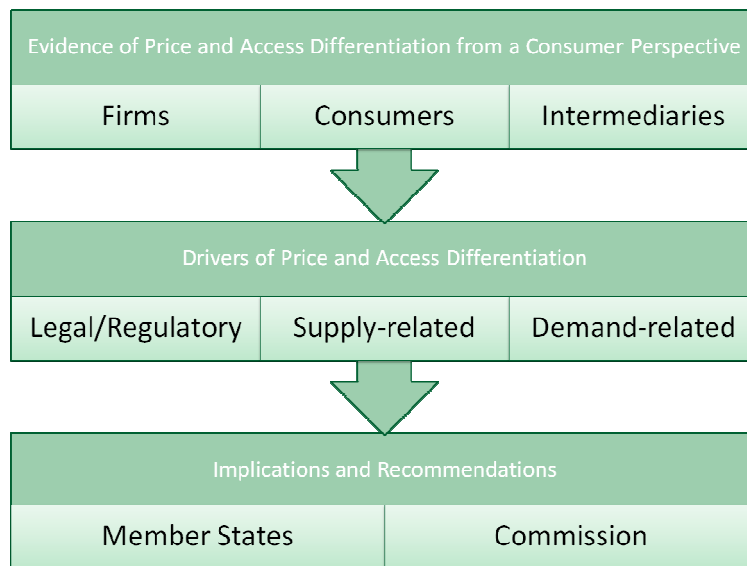
The value of the study for the Commission lies primarily in identifying existing typologies of practices of differentiations based on the nationality or place of residence of service recipients as well as the drivers behind such practices. In doing this, the study **also highlights gaps in the existing evidence base** and opportunities for further investigation. The results **provide input into the Commission assistance** to Member States in the implementation and enforcement of Article 20 (2) of the Services Directive.

To summarise, the main objectives of the study are fourfold:

- 1) **Identify cases of different treatment** with respect to nationality or residence of the customer.
- 2) **Identify drivers of differentiation** in consultation with relevant stakeholders.
- 3) **Describe and analyse ways in which companies implement differentiation, in particular** in online business transactions.
- 4) **Develop input into the assessment** of existing practices and possible justifications for differences of treatment in relation to Article 20, paragraph 2 of the Services Directive.

The figure below provides an overview of our overall approach to this study.

Figure 1: Overall study approach



The study commences (**Section 3**) by identifying *prima facie* evidence of differentiation in treatment depending on residence or nationality of the customer in four sectors (car rental, online sale of electronic goods, digital downloads and tourism) based on analysis of documentary evidence, contacts with European Consumer Centres (ECCs) and a targeted ‘mystery shopping’ exercise. The report highlights the link between specific examples of differentiation, the structure and distribution models of the sectors in which they take place and the tools and methods that companies use to implement differentiation based on the place of residence of the customer.

In a second step (**Section 4**), the study then examines the drivers behind this evidence based on an extensive interview programme with companies, industry representatives at European and national levels and consumer associations. This section shows that drivers fall within one of three categories: legal/regulatory drivers, supply-related drivers and demand-related drivers. For each of these broad categories, the report illustrates the economic rationale for a segmentation of the European markets along national borders based on documentary evidence and interview feedback.

The third step of the study (**Section 5**) contains a discussion of different methods used to implement differentiation, focusing on the online component of the sectors covered by the study, and links them to consumer outcomes. This step of the study emphasises the fact that it is not only the differentiation, but also the way in which it is implemented that needs to be considered when assessing the objectivity and proportionality of economic and regulatory drivers.

The final step of the study (**Section 6**) summarises the findings, analyses their implications, and provides recommendations for the implementation and enforcement of Article 20 of the Services Directive. This includes an approach for collecting information necessary for undertaking an assessment, as well as a list of questions that can help determine the objectivity of the drivers and proportionality of the business practices.

3.0 Sector background

Please note that the examples provided in this section are based on mystery shopping exercises conducted at specific points in time during 2009. Across all of the sectors described here, price and service offers change frequently and the examples and prices mentioned in this section may therefore not always reflect the present situation.

The study focuses on four sectors: **car rental**, **digital downloads**, **online sales of electronic goods** and **tourism**. The methodological rationale for the choice of these sectors is described in Appendix 1. The remainder of this section presents, for each of the four sectors:

- an overview of the sector;
- a simplified distribution model;
- prima facie evidence of price and service differentiation based on the consumer's place of residence or nationality; and
- a brief description of the way in which price and service differentiation are implemented in a selection of online transactions.

The objective of this section is to focus on the **incidence** of cross-border service differentiation from a consumer perspective. In other words, where might consumers experience differential treatment and why might they question the appropriateness of business practices to differentiate prices and services based on their residence or nationality?

Key Findings

Sectoral characteristics

- The number and importance of intermediaries and the importance of online business in the distribution model vary significantly across sectors
- The nature and market structure of the sectors differ from bespoke tour packages to standardised car hire services.

Evidence of differentiation

- Evidence of price differentiation at different levels of the value chain in all sectors
- Some evidence of service differentiation in all sectors, including refusal to deal in digital downloads, differences in payment options in car rental and promotional offers targeted at different source markets
- No evidence of differentiation based on nationality

Implementation of differentiation

- In online transactions, differentiation is enforced through automatic IP address-based redirection, through parallel national websites or through direction to nationally targeted services as part of the booking process. In some cases this can lead to an outright refusal to sell.

Conclusions

- Any assessment of potential justifications for price and service differentiation will need to take into account the relative size of observed differences.

- Cross-border customers are not always at a disadvantage compared to domestic customers
- Differentiation in prices and services varies across sectors but also across firms within one sector
- Evidence of differentiation points to a combination of different drivers at firm, sector and national levels

3.1 Car rental

3.1.1 Overview

The European car rental sector features a small number of major international companies, few national companies, and smaller companies operating on a local scale. Euromonitor, a research organisation, estimated that the total car rental revenue in 10 key European markets (France, Germany, Italy, Spain, UK, Austria, Belgium, Netherlands, Portugal, and Switzerland) in 2007 was EUR 8.81 billion. In that period 44 million rentals were made and the industry operated a total fleet of 1.2 million vehicles. Euromonitor also estimated that in 2007 around 53.3 percent of the market consisted of leisure customers, 40.2 percent of corporate customers, and 6.3 percent of insurance/replacement customers, with approximately 41.6 percent of all rentals being airport rentals. Market growth was estimated to be 2.6 percent per annum in the period between 2002-2007, and is projected to be 4.7 percent per annum in the period 2008-2012¹.

The main players in the market, taking into account franchises and fully owned outlets, are Europcar (with a market share of 25.3 percent in 2008), Avis Europe (17.7 percent), Hertz (15.3 percent) and Sixt (8.7 percent)². That means that four businesses dominate two thirds of the European market. Avis, the second largest European car rental company, found that in 2007, 23 percent of its revenues were generated in France, 18 percent in Germany, 16 percent in Italy, 15 percent in the UK, and 14 percent in Spain³.

Of importance to the car rental market is the presence of intermediaries (e.g. brokers or booking websites, such as Holiday Autos, Auto Europe, Travelsupermarket, Hirecars, Opodo or Expedia) to which companies rent cars wholesale for further distribution to retail customers. The distinction between business-to-business (B2B) wholesale transactions and business-to-consumer (B2C) retail rentals is important to keep in mind when investigating this (and other) sectors as pricing and access practices at retail level may originate in wholesale distribution agreements. Within the B2C market, a further distinction has to be made between rentals to individual customer and corporate accounts where rental rates and terms and conditions are negotiated on a case by case basis.

The development of online business has had a significant impact on the car rental market, both in terms of the ability of customers to compare prices between different providers and in terms

1 Euromonitor IMIS Travel Database 2007 in <http://www.avis-europe.com/content-49>.

2 Ibid.

3 <http://www.avis-europe.com/content-49>.

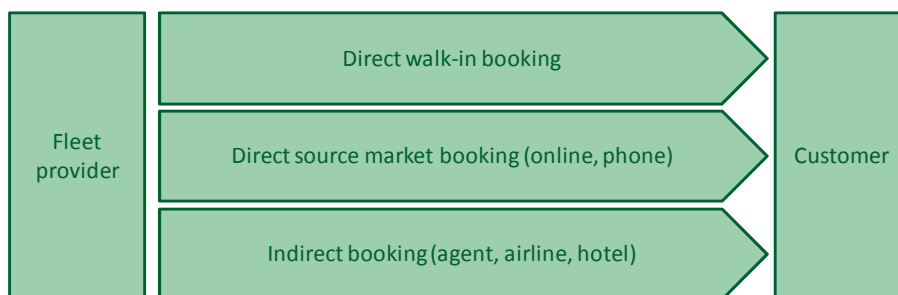
of the ability of companies to target their offers to particular source markets.⁴ Generally, the take-off in online business has increased the pace of price dynamics both within domestic and cross-border car rentals.

With around 40 percent of rentals being airport rentals, there is a significant number of customers renting cars in countries where they are not resident, which, in turn, means that there is significant potential for price and service differentiation across territorially defined customer groups (source markets).

3.1.2 Distribution model

The car rental sector is characterised by a relatively standardised product where one can expect a substantial amount of price competition. The main actors and transactions involved in the car rental sector are shown in the simplified distribution model below.

Figure 2: Outline of transactions and actors involved in sales in the car rental sector



As the figure shows, the fleet provider, both at the place of rental and the final destination, is the actor that ultimately offers the service (rents and receives the returned vehicle) to the customer. The customer can however book this service in a number of ways, either directly with the fleet provider at the place of rental (for instance at an airport), directly from a remote location online or by phone, or indirectly through a travel agent, airline, or a hotel.

The variety of booking channels in the car rental sector thus introduces additional actors beyond the fleet provider and the customer, with a commensurate increase in the potential for business practices that could lead to price or service differentiation.

3.1.3 Evidence of Differentiation

The table below presents some evidence of price differentiation based on place of residence from the websites of four major car rental companies. For a 24-hour rental of an economy car (class B) from Frankfurt airport, starting on August 21, 2009 at 10am, the following prices were quoted on 13 August 2009.

Table 1: Price comparison between different car rental providers by country of residence

⁴ See also the sections on digital downloads and online sale of electronic goods below for a more detailed discussion of cross-country variation in online purchasing.

| Country of Residence | Avis | Europcar* | Hertz | Sixt | easyCar |
|--|------------------------|------------------------|---|---|------------------|
| UK | GBP 52.62 | GBP 99.96 | Pre-pay online: GBP 83.83 On return: EUR 75.80 | Pre-pay online: EUR 101.99 On return: EUR 106.79 | EUR 78.78 |
| France | EUR 56.21 | EUR 87.60 | Pre-pay online: EUR 75.75 On return: EUR 79.53 | Pre-pay online: EUR 101.99 On return: EUR 106.79 | EUR 78.78 |
| Germany | EUR 66.63 | EUR 77.99 | Pre-pay online: EUR 85.50 On return: EUR 97.01 | Pre-pay online: EUR 101.99 On return: EUR 106.79 | EUR 78.78 |
| Poland | EUR 49.34 | EUR 87.60 | On return EUR 75.74** | Pre-pay online: EUR 101.99 On return: EUR 106.79 | n/a |
| Italy | EUR 54.97 | EUR 91.20 | Pre-pay online: EUR 72.08 On return: EUR 75.74 | Pre-pay online: EUR 101.99 On return: EUR 106.79 | EUR 78.78 |
| Cheapest (online) | Poland | Germany | Italy | n/a | n/a |
| Most expensive (online) | Germany | UK | Germany | n/a | n/a |
| Maximum difference (% of highest price) | EUR 17.29 (26%) | EUR 21.97 (22%) | EUR 13.42 (16%) | n/a (n/a) | n/a (n/a) |

Notes: exchange rate used 1.161 EUR/GBP (correct as of 13/08/2009); * French and Italian Europcar customers can pre-pay online (paying EUR 85.19 and EUR 80.40 respectively), all prices are for booking and paying on arrival; ** Polish residents could only book a rental with Hertz by paying online.

This random spot check of prices and services offered by the same four companies to customers from different Member States constitutes clear evidence of differentiation based on place of residence. At the time of this spot check, German residents were quoted the highest price for this rental in Frankfurt by Avis and Hertz, but the lowest by Europcar. All companies offered different prices to residents of different countries with the two exceptions being Sixt and easyCar, where, the prices in Euros seemed to stay the same. While the table clearly illustrates differentiation, it also shows that cross-border customers are not always offered higher prices than domestic (in this case German) customers. In other words, price differentiation in the car rental sector cannot be explained purely by additional costs associated with cross-border transactions. The fact that not all of the car rental firms appear to engage in differentiation also

suggests that the differentiation might not be a response to a set of drivers with equal effect on the whole sector.

There is also evidence of service differentiation, with Polish Hertz customers having to pay for their rental on return, while residents of other countries can pay online in advance, which usually comes with a discount. In the case of Europcar, French and Italian customers were offered the option to pay for their rental online, which also came with a discount. This option was not available to other customers at the time. While there is clear evidence of geographically targeted services, this is not always to the detriment of cross-border customers, as the example of payment options available only to cross-border customers from France and Italy shows.

Another type of differentiation which is not necessarily captured in the above price comparison relates to promotions. For instance, one interviewee pointed out that Scandinavian customers often rent cars in the holiday period for leisure trips across Europe (e.g. to Spain or Italy). In response to such customer preferences, car rental companies in this market are planning to introduce special mileage-inclusive promotions targeting holiday customers in Northern Europe (i.e. available through local car rental websites). Beyond pricing, promotions can also lead to differences in the services available to customers from different Member States, with UK car rental customers for example having access to “fun cars” (e.g. sports and luxury cars), especially in traditional UK holiday destinations such as Spain through promotions which are not available on other national websites⁵.

3.1.4 Implementation of Differentiation

In order to implement the types of online price and service differentiation described above, car rental companies must be able to direct customer from different place of residence to targeted offers for their national markets. The following table shows how major car rental companies restrict access to services destined to customers from other Member States.

Table 2: Implementation of differentiation in the car rental sector

| Service | Implementation |
|---------|---|
| Avis | <ul style="list-style-type: none"> • No automatic redirection based on IP-address • Customers to central site (avis.com) asked for a “country site preference” which re-directs customers to national websites (i.e. avis.de) • Customers are also asked for country of residence in the booking window on the central websites. • National websites are accessible and do not ask for country of residence |
| easyCar | <ul style="list-style-type: none"> • No automatic redirection based on IP-address • Site asks for choice of currency and language • National sites exist and are accessible, but appear to be mirrors of the central website (easycar.com) |

⁵The drivers for this are outlined in Section 4. Section 5 of this report has a discussion of the ways in which customers can circumvent nationally targeted prices and services.

| | |
|----------|--|
| Europcar | <ul style="list-style-type: none"> • Accessing the central website (europcar.com) suggests (based on IP address) one country-specific website or the central website, although other country-websites are accessible from a side menu • National and central websites automatically select country of residence (based on IP address), which can be changed. Changing the country does not cause re-direction. |
| Hertz | <ul style="list-style-type: none"> • Accessing the central website (hertz.com) automatically selects country of residence (IP-address based), which can be changed. • Selecting a country of residence does not cause redirection. • National websites (i.e. hertz.de) are accessible and have same country of residence selection options, although the default country is now the one linked to the national website. |
| Sixt | <ul style="list-style-type: none"> • Accessing the central website (sixt.com) automatically selects country of residence (IP-address based), which can be changed. • Selecting a country of residence does not cause redirection. • National websites (i.e. sixt.de) are accessible and have same country of residence selection options with the default country being selected based on IP-address. |

Although, in most cases, there is no automatic IP (Internet Protocol) address-based redirection, customers are directed to the service tailored to their country based on information about their country of residence, prompted as part of the booking process. Whereas the customer's country of residence can be changed, a default country is often automatically assigned based on IP-address. In most cases, the only way of circumventing targeted pricing in instances where customers are prompted about their country of residence is for them to provide false information, which could expose them to risks in terms of breaching contractual provisions. Section 5 of this report provides a more detailed discussion of the implementation of differentiation across all of the study sectors.

3.2 Digital downloads

3.2.1 Overview

Digital downloads have grown rapidly with improved internet access and availability of higher bandwidth connections. Eurostat reports that the proportion of individuals regularly using the internet in EU27 countries has grown from 36 percent in 2004 to 56 percent in 2008, with 48 percent of EU27 households having access to a broadband Internet connection in 2008, compared to only 14 percent in 2004⁶.

As the International Federation of the Phonographic Industry (IFPI) notes in its 2009 Digital Music Report, the sector is dominated by games and music downloads, with digital revenues in 2008 constituting 35 percent of total global revenues from games and 20 percent from music,

⁶ Eurostat Structural Indicators 2002-2008, available at http://epp.eurostat.ec.europa.eu/portal/page/portal/structural_indicators/indicators

compared to only 4 percent for films and newspapers and 1 percent for magazines. The digital music sector also has grown rapidly, with digital music revenues constituting only 2 percent of the total industry in 2004 and 20 percent in 2008, which the IFPI notes has slowed down the rate of decline in the overall recorded music market⁷. The market leader in the music download sector is Apple's iTunes service, although it faces increasing competition, such as from AmazonMP3⁸.

The digital downloads sector can be divided into so-called 'a-la-carte' services, such as iTunes, allowing downloads of individual files, and subscription services which usually allow unlimited downloads for a set fee. Another notable distinction is that between online digital sales and mobile sales, with the former focusing on purchasing music using a personal computer and playing it on the computer or other audio devices and the latter focusing on sales aimed at multimedia-ready mobile phones.

In Europe, the largest digital music market is the UK, followed by Germany, France, and Italy. Globally the US is the leader with about 50 percent of the market and 1.1 billion single track downloads in 2008, compared with 110 million in the UK⁹. Online music revenue is currently estimated at EUR 103 million in the UK, EUR 53 million in Germany, and EUR 35 million in Italy, with the total European market being valued at almost EUR 300 million¹⁰. Music downloads have recently come under close legal scrutiny from consumer and competition authorities, both at national and EU level¹¹.

Besides music, the digital downloads sector also encompasses other forms of digital media, such as video, games, or e-books. As mentioned earlier, these sectors are much less developed than the music download sector, partly due to the bandwidth requirements needed for high quality video or game downloads. This is also the reason why the market is more diffuse, market leaders more difficult to identify and a lot of the services available in the United States have yet to be introduced in Europe.

Apple's iTunes, in addition to being the market leader in music downloads, now provides a substantial amount of video content. In addition, there is a large number of Video-On-Demand (VOD) services provided on multiple platforms, such as cable networks and the internet. Examples of such services are those offered by Internet Service Providers (ISPs), such as Arcor or T-Online in Germany, as well as websites using a similar business model to the US Netflix service (postal and download DVD rentals), such as Glowria in France and Lovefilm in the UK. The market is nevertheless still very small compared to music downloads: Sweden, the single

7 IFPI (2009). IFPI Digital Music Report 2009.

8 Ibid.

9 Ibid.

10 European Commission (2008). Preparing Europe's Digital Future – i2010 Mid-Term.

11 One example being the Norwegian consumer ombudsman declaring Apple's iTunes service illegal in 2007 due, in part, to a license deemed unsuitable for Norway and, in part, to the incompatibility of some downloaded content with non-Apple devices (see Ibsen, D., Terazono, E., and Waters, W. (2007, January 24). Norway declares Apple's iTunes illegal. Financial Times). In 2007 iTunes services were also under the scrutiny of the EU Commission from the perspective of EU competition law rules (see press release IP/08/22 of 09/01/2008 : European Commission welcomes Apple's announcement to equalise prices for music downloads from iTunes in Europe)

largest VOD market in Europe in the third quarter of 2007, saw only 449,000 individual streams or downloads¹².

Game downloads are offered by individual manufacturers in online shops (for example by leading game publishers Electronic Arts and Ubisoft), but also through services like Steam or Direct2Drive, which distribute games in a similar fashion as online music vendors.

3.2.2 Distribution Model

The digital download sector is characterised by a large number of different business models, including aforementioned 'a la carte' and subscription models, ad-supported models or models that bundle digital content with a service or a physical device (in the music industry known as 'music access' models), such as "Nokia Comes With Music", where customers who purchase certain Nokia phones can obtain time-limited free music downloads. The following diagram presents a simplified version of the transactions and actors involved in providing digital content.

Figure 3: Outline of transactions and actors involved in sales in the digital downloads sector



In the digital content sector there are four key actors, the copyright owners (e.g. authors or performers), the rights managers (e.g. the publishers of the musical works, or collecting societies managing authors' rights), the digital distributor of the content (i.e. online shops), and the consumer. The model for providing the content differs: a web-based shop is a common model, some businesses provide download services through webstores requiring the use of specific software (i.e. iTunes, Napster), as well as mobile platforms, or video game consoles with internet connection. In this sector there are no issues around physical storage or delivery of product (except for server space), so costs relate to obtaining licenses for sale of content, maintaining the distribution channel (i.e. software, webpage, and servers), processing of orders, and other marketing and media costs.

3.2.3 Evidence of Differentiation

The tables below provide some examples of differentiation in the digital content sector in Europe. The focus here is on music, the biggest digital content market with the most businesses operating across multiple Member States. It is also important to note that a number of large digital download services operate only on the US market

The table shows a price comparison for the album 'Only by the Night' by the Kings of Leon, as well the single from the album, "Use Somebody" for European 'a la carte' download services.

12 European Commission (2008) Preparing Europe's Digital Future – i2010 Mid-Term.

Table 3: Comparison of individual song and album prices for 'a la carte' download services

| Country | 7digital | Amazon MP3 | iTunes | Napster (single downloads) |
|------------------|---|----------------------|--------------------------------------|----------------------------|
| UK | EUR 1.15/5.80 (discounted from 9.28) | EUR 0.69/7.53 | EUR 0.92/9.27 | EUR 0.92 |
| France | EUR 0.99/9.49 | EUR 0.99/9.99 | EUR 1.29/6.99 (promotional price) | N/A |
| Germany | EUR 0.99/9.49 | EUR 0.98/6.62 | EUR 1.29/9.99 | EUR 0.99 |
| Cheapest | France and Germany/UK | UK/Germany | UK/France | UK |
| Most expensive | UK/France and Germany | France/France | France and Germany/Germany | Germany |
| Variation | EUR 0.13/3.82 | EUR 0.31/2.47 | EUR 0.39/3.00 | EUR 0.09 |

Notes: The prices are as of 13th August 2009. Exchange rate used 1.161 EUR/GBP (correct as of 15/08/2009). The original prices in GBP were 0.99/5.00 (discounted from 7.99) for 7digital, 0.59/6.49 for Amazon, 0.79/7.99 for iTunes, and 0.79 for Napster. Where there is an 'N/A' entry, the services in questions do not have a dedicated service for that country.

The table shows that there are differences in pricing, mostly between the UK and other European countries, but also within the eurozone. Although services like 7digital and iTunes generally tend to have a single price in Europe, there are also Member State-specific promotions.

The next table looks at subscription services, showing the monthly price of different subscription options for each country-specific service. These include both download services, like eMusic and Napster, as well as streaming services, such as Spotify.

Table 4: Price comparison for subscription services

| Country | eMusic | Napster | Spotify (premium) |
|------------------|-------------------------------------|----------------------|--------------------|
| UK | EUR 12.46/13.60/17.00 ¹³ | EUR 11.28/16.95 | EUR 11.33 |
| France | EUR 13.99/16.99/20.99 | N/A | EUR 9.99 |
| Germany | EUR 13.99/16.99/20.99 | EUR 9.95/14.95 | EUR 9.99 |
| Cheapest | UK | France and Germany | France and Germany |
| Most expensive | France and Germany | UK | UK |
| Variation | 1.53/3.39/3.99 EUR | 1.33/2.00 EUR | 1.34 EUR |

Notes: The prices are as of 18th May 2009. Exchange rate used 1.134 EUR/GBP (correct as of 15/05/2009). The original prices in GBP were 10.99/11.99/14.99 for eMusic, 9.95/14.95 for Napster, and 9.99 for Spotify's premium service. Where there is an 'N/A' entry, the services in questions do not have a dedicated service for that country. The three eMusic plans are called Basic, Plus, and Premium and offer 30, 50, and 75 song downloads respectively. The two Napster subscription plans allow unlimited downloads on up to three computers, and on up to three computers and three portable media players respectively.

As with 'a la carte' downloads, there are differences in prices of subscription downloads depending on the consumer's place of residence, although differentiation is mainly between the United Kingdom and the Euro zone.

In terms of service differentiation, there is clear evidence that some services are not available to residents from some Member States, such as Napster in France, or the ad-supported free Spotify streaming service which, at the time of writing, was only offered in Sweden, Norway, Finland, UK, and Spain¹⁴.

3.2.4 Implementation of Differentiation

Most music download and streaming services implement differences in prices or service by introducing access restrictions corresponding to the country of residence. These restrictions are in some cases based on IP addresses and in other cases they are specified terms and conditions, where, for example, customers have to be resident in a given country in order to sign up for the service. These restrictions can usually only be circumvented by providing false information when registering for the service in question, since national websites do not allow to select a different country of residence. The exceptions here are streaming services like Deezer or We7, which appear to have a single website for all customers. The following table summarises how nationally targeted price and service differences are implemented by the main digital download service providers.

¹³ <http://www.emusic.com/help/subscription.html>

¹⁴ <http://www.spotify.com/en/help/faq/#country-availability/>

Table 5: Implementation of differentiation for download services

| Service | Description | Implementation |
|---------------------|---|---|
| 7digital | 'A la carte' music service with national websites for Belgium, Germany, Spain, France, Ireland, Italy, Netherlands, Austria, Portugal, Switzerland, and the United Kingdom. | <ul style="list-style-type: none"> • Automatic redirection to national website. • Other websites are accessible, but Terms and Conditions specify that customers have to reside in the country in question. • Registration restricts choice of country of residence. |
| Amazon MP3 | 'A la carte' music service with national websites for Germany United Kingdom and France. | <ul style="list-style-type: none"> • No automatic redirection, but Terms and Conditions specify that service is limited to the Member State in question |
| Bleep | Record label-specific online store. | <ul style="list-style-type: none"> • Automatic currency selection. • Other selections are not accessible. • Single website for all customers. |
| Deezer | Advertisement-based free music streaming service. | <ul style="list-style-type: none"> • Automatic language selection, although other languages are accessible. • Single service website for all customers. |
| Dell Download Store | Computer manufacturer's online store offering mainly software, but also music downloads with national websites for UK, France, and Germany. | <ul style="list-style-type: none"> • Automatic redirection. Other services not accessible. |
| eMusic | Subscription service offering music from smaller labels with a dedicated UK, European, Canadian and US service. | <ul style="list-style-type: none"> • Automatic redirection to country-specific service. |
| iTunes | 'A la carte' music service available in 15 EU Member States through a software-based shop. | <ul style="list-style-type: none"> • Automatic redirection. • Other services are accessible, but Terms and Conditions specify that service is limited to the Member State in question. |
| Musicload | 'A la carte' music store with national websites for Austria, Germany, and Switzerland. | <ul style="list-style-type: none"> • Other services are accessible, but Terms and Conditions specify that service is limited to the Member State in question |

| | | |
|---------|---|---|
| Napster | Subscription service offering music from smaller labels with a dedicated UK, European, Canadian and US service. | <ul style="list-style-type: none"> • Automatic redirection. • Websites for other services are accessible, but Terms and Conditions specify that service is limited to the Member State in question. |
| Spotify | Advertisement-based free music streaming service with a paid subscription option. | <ul style="list-style-type: none"> • Automatic redirection (currency choice). • Specifies that credit card has to be from the country of residence. |
| We7 | Advertisement-based free music streaming service. | <ul style="list-style-type: none"> • Single service website for all customers. • Limited service outside of the UK¹⁵. |

The above table shows that most services limit cross-border access either by automatic redirection, or by allowing access, but prohibiting customers from making the purchase in the terms and conditions specified on the website, which can be later reinforced at the point of registration or purchase.¹⁶

3.3 Online sale of electronic goods

3.3.1 Overview

Online selling of goods has developed together with the rapidly increasing use of the Internet in recent years. Eurostat reports that the percentage of enterprises' total turnover via Internet has grown in the EU27 from 2.1 percent in 2004 to 4.2 percent in 2007. It estimates that in 2008, 16 percent of enterprises in the EU27 received orders on-line, with the highest proportion in the UK (32 percent), followed by the Netherlands (27 percent), Ireland (25 percent), and Lithuania (22 percent)¹⁷.

The global leader in online retail is Amazon.com, which currently receives 1 million orders a day in the UK alone and has moved on from selling books to offering a wide range of products, including electronics¹⁸. Amazon currently operates through three European websites, namely one for Germany, one for France, and one for the UK (which are accessible to customers from all Member States). Actors in the field of electronic goods also include other retailers, as well as the online shops of manufacturers, such as Apple or Dell.

¹⁵ <http://blogs.we7.com/weblog/2008/10/index.html>

¹⁶ As in the case of car rental, it should be noted that there are exceptions such as the two streaming services Deezer and We7.

¹⁷ Eurostat Structural Indicators 2002-2008, available at http://epp.eurostat.ec.europa.eu/portal/page/portal/structural_indicators/indicators

¹⁸ Papworth, J., and Collinson, P. (2008, November 15). Up the Amazon this Christmas. The Guardian.

3.3.2 Distribution model

The transactions and actors involved in the online retail sector are outlined in the figure below.

Figure 4: Outline of transactions and actors involved in sales in the online retail sector



This simple diagram highlights some key differences between online retail and the digital downloads sector. Since the products sold in this case are physical units, there are issues related to stocking and distribution costs. Whereas in the digital downloads sector the key actors that businesses deal with are license holders, here these include companies responsible for shipping of goods (these can be national postal services or courier companies), or in some cases what is known as fulfilment houses, businesses responsible for storage, packing, and shipping of items to consumers.

3.3.3 Evidence of Differentiation

The table below provides some evidence for price differences among companies selling electronic goods online. The product in question is the 2nd generation Apple iPod Touch portable media player with 16GB disk space and the comparison looks at two online shops, Amazon and Pixmania and their local websites in three EU Member States, France, Germany, and the United Kingdom.

Table 6: Price comparison between country-specific online shops (VAT included)

| Country | Apple Store | Amazon | Pixmania |
|--|------------------------|------------------------|------------------------|
| UK | EUR 239.68 | EUR 229.65 | EUR 220.31 |
| France | EUR 289.00 | EUR 262.99 | EUR 261.09 |
| Germany | EUR 279.00 | EUR 258.95 | EUR 250.10 |
| Cheapest (online) | UK | UK | UK |
| Most expensive (online) | France | France | France |
| Maximum difference (% of highest price) | EUR 49.32 (17%) | EUR 33.34 (13%) | EUR 40.78 (16%) |

Notes: The prices are as of 12th May 2009, except for Apple Store (20th May 2009). Exchange rate used: 1.120 EUR/GBP (correct as of 12/05/2009). The original prices in GBP were 214.00 for Apple Store, 205.00 for Amazon, and 196.80 for Pixmania.

The comparison above shows quite clearly that prices for the same products (not including delivery costs and independently from the drivers which may be behind this differences which

will be discussed further in Section 4) differ across websites, with a clear pattern of lower UK and higher French prices.

3.3.4 Implementation of Differentiation

The table below focuses on implementation of the above examples of differentiation by examining whether customers have the option to shop for goods using online outlets directed at Member States which they do not reside in.

Table 7: Implementation differentiation for online shops selling electronic goods

| Service | Implementation |
|-------------|--|
| Apple Store | <ul style="list-style-type: none"> No automatic redirection, other websites accessible. Requires that the credit card billing address be located in the given country. Items can only be shipped to the credit card's billing address. |
| Amazon | <ul style="list-style-type: none"> No automatic redirection, all national websites (i.e. UK, Germany and France) are accessible to customers from other Member States |
| Pixmania | <ul style="list-style-type: none"> No automatic redirection, other websites accessible. Specifies that the product can only be delivered within the given country and to deliver to another country, the website of that country must be used. |

Combined with the evidence of price differentiation, this table shows that customers willing to purchase electronic goods from these online sellers are in fact charged different prices depending on their country of residence and they do not always have the option of buying the goods from an online shop operated by the same company in a different Member State.

3.4 Tourism: travel accommodation

3.4.1 Overview

According to 2008 Eurostat figures, in 2006 there were approximately 200,950 hotels in the EU27 offering 11.5 million beds and having an annual occupancy of approximately 36 percent. Spain, Italy, Germany, and France were the European leaders in terms of nights spent in hotels, and the average annual growth rate of nights spent in the EU27 amounted to 1.1 percent in the period 2000-2006¹⁹.

Key players in the European hotel sector are groups such as Accor (home to Sofitel, Novotel, Mercure, Ibis, Etap, and Formule 1 brands), and InterContinental Hotels Group (home to InterContinental, Crowne Plaza, and Holiday Inn brands), as well as chains such as Best Western and Hilton. Accor, the European leader, currently operates 1,393 hotels in France and

¹⁹ Eurostat (2008). Panorama on Tourism 2008 Edition.

869 in the rest of Europe, which constitutes 73 percent of its global sales (in 2007 these amounted to EUR 5.8 billion²⁰). Best Western, claiming to be the world's largest hotel chain, in comparison currently has approximately 1,312 properties in Europe²¹. Similarly to the car rental sector, hotel chains also combine different modes of ownership, with approximately 20 percent of Accor hotels being operated as a franchise²².

In addition to hotels, according to the 2008 Eurostat Tourism Statistics Pocketbook estimates, there were approximately 75,000 tour operators and travel agencies registered in the EU27 in 2005 (latest available figures). Italy, Germany, Spain and the UK have the highest number of companies (11,100; 9,200; 8,400 and 6,700 respectively) and together they represent almost one half of the EU27 total.

Nevertheless, the tour operator market is dominated by a few major players. In Germany, TUI and Thomas Cook in 2003 secured a combined share of 51 percent of industry revenue from all-inclusive tours to the Mediterranean, while in the UK, the top five tour operators together accounted for 52.4 percent of revenue²³. Other major European players include Neckermann Reisen, Marco Polo, and the REWE Group, which includes Dertour, Meier's Weltreisen, and ADAC Reisen, as well as package providers ITS, Jahn Reisen, Tjaereborg, and other agencies such as Der and Atlasreisen. Other companies only operate in a few countries such as Best Tours and Alltours.

Seasonality is an important aspect that affects the hospitality business, with hotel occupancy increasing significantly in the summer. The difference in gross utilisation of hotel beds between the busiest month (usually August) and the least busy month of 2006 exceeded 60 percentage points in some countries²⁴.

Package holidays are the dominating product of the summer holiday market from the northern parts of Europe to the Mediterranean. An analysis undertaken in 2003 showed that 52 percent of vacations booked for the Mediterranean are all inclusive tours²⁵. According to the European Travel Monitor²⁶, 55 percent of Britons who travelled abroad in the year 2000 selected standard packages supplied by a tour operator compared with 43 percent of travellers in Germany.

Developments in IT technology have had significant impact on the tourism sector in terms of booking single elements such as hotels or flights. Many hotel chains and individual hotels allow online bookings and there are now a number of online hotel booking or comparison sites such as laterooms.com, Expedia or Opodo that offer not only hotel rooms but also air travel and package holidays.

20 http://www.accor.com/gb/groupe/activites/hotellerie/chiffres/chiffres_hotellerie.asp#.

21 http://www.bestwestern.com/newsroom/factsheet_detail.asp?FactID=4.

22 http://www.accor.com/gb/groupe/activites/hotellerie/chiffres/chiffres_hotellerie.asp#.

23 Gruner and Jahr (2004). Veranstalterreisen: Branchenbild cited in Koutoulas, D. (2006), The Market Influence of Tour Operators on the Hospitality Industry. In Papatheodorou, A. Corporate Rivalry and Market Power. Competition Issues in the Tourism Industry

24 Eurostat. (2008). Panorama on Tourism 2008 Edition.

25 Ibid.

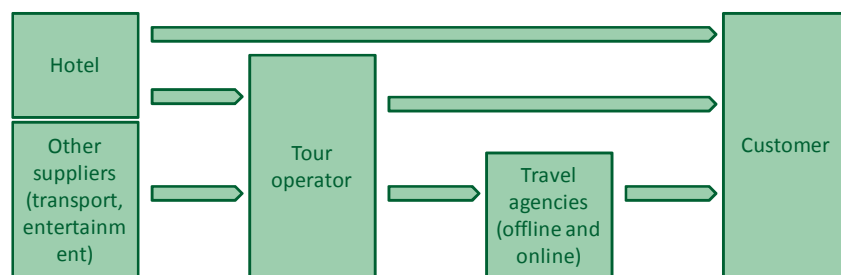
26 IPK International (2001).

The impact of online booking is significantly smaller in the tour operator sector. It was estimated by two interview partners that between 80 and 90 percent of package bookings are still generated through brick-and-mortar travel agencies and tour operators, partly because holiday-makers rely on the expertise and advice offered by experienced travel agents and tour operators.

3.4.2 Distribution Model

The figure below has a simplified model of actors involved in the tourism sector.

Figure 5: Transactions and actors involved in the tourism sector



The services offered in this sector (for example accommodation in hotels, travel, or entertainment) are provided by actors based either in the destination country (like hotels), or elsewhere (like airlines) and the customer can book either directly, through a tour operator, or through a travel agency, which sells packages put together by the operators. A tour operator differs from a travel agency in that it directly negotiates with hotels and other actors to put together a package, which it sells to customers, either through a brick-and-mortar branch or online, or indirectly, through an agency. Travel agencies act as intermediaries between operators and customers, either online or through brick-and-mortar branches.

3.4.3 Evidence of Differentiation

Little evidence was found for differentiation in prices and service in **direct hotel bookings**. An example of price differentiation with respect to a room booking in the Hilton hotel in London is shown in the table below. Prices on both the German and the UK websites were provided in pound sterling with clear differences depending on the national site through which the booking was made

Table 8: Price differentiation example for Hilton Hotel, Euston, London

| Hotel booking site | Double Guest Room | King Deluxe | Twin Guest Room | Single Guest Room |
|-----------------------------|-------------------|------------------|------------------|-------------------|
| UK | GBP 86.09 | GBP 116.09 | GBP 86.09 | GBP 76.09 |
| Germany | GBP 99.00 | GBP 133.50 | GBP 99.00 | GBP 87.50 |
| Difference | GBP 12.91 | GBP 17.41 | GBP 12.91 | GBP 11.41 |
| (% of highest price) | 13% | 13% | 13% | 13% |

Note: prices on both German and UK websites were provided in GBP; Prices as of 22/05/2009 for one night (arrival: 31/05/2009).

For all room categories, prices listed on the German website appeared to be 13 percent higher than through the UK site. Similar mystery shopping on the sites of other hotel chains revealed no price differences. There were also no clear cases of refusing access or differentiated service.

In the case of **booking websites**, the following table outlines the lowest displayed prices for a room for two people at Hilton Hotel in London Euston on August 1st by three online booking services: Expedia, Opodo, and Laterooms.com

Table 9: Booking website prices

| Country | Expedia | Opodo | Laterooms.com |
|--|------------|------------|---------------|
| France | EUR 211.91 | n/a | EUR 211.41 |
| Germany | EUR 211.91 | EUR 221.38 | EUR 211.41 |
| Italy | EUR 211.91 | EUR 221.38 | EUR 211.41 |
| UK | EUR 212.47 | EUR 222.47 | EUR 212.47 |
| Maximum difference (% of highest price) | n/a | n/a | n/a |

Note: Exchange rate used was 1.159 EUR/GBP (correct as of 23/07/09). Prices as of 23/07/2009 for one night (arrival: 01/08/2009).

It is easy to see that, small exchange rate considerations aside, there is no differentiation in prices when booking through the three online booking services above. What is however worth noting is that the particular hotel used for the comparisons (Hilton Euston) was not available on the French Opodo website, suggesting that some differentiation in service provision might be taking place.

For **tour operators**, mystery shopping revealed significant price differences across different national websites. The table below provides a price comparison for a 7-day hotel stay starting from the 5th of September 2009, at the Fiesta Hotel Palmyra in San Antonio, Ibiza offered online by the UK, Belgian, and German subsidiaries of TUI and Thomas Cook. The prices below are the lowest total prices quoted for two adults in a double room with half board.

Table 10: Implementation of differentiation in online hotel bookings

| Country | TUI | Thomas Cook |
|--|-------------------------|-----------------------|
| UK | EUR 727.16 | EUR 836.80 |
| Belgium | EUR 880.54 | N/A |
| Germany | EUR 938.00 | EUR 910.00 |
| Maximum difference (% of highest price) | EUR 210.84 (22%) | EUR 73.20 (8%) |

Notes: The prices are as of 28th May 2009. Exchange rate used: 1.145 EUR/GBP (correct as of 28/05/2009). The original price in GBP was 635.00 for the UK TUI booking site (Thomson.so.uk) and 731.91 for Thomas Cook.

With a 22% difference in prices between the UK and German TUI websites, there is significant evidence that tour operators differentiate their prices based on geographically defined source markets. In addition, the significant but lower difference in prices offered through the national Thomas Cook sites, indicates that at least part of the drivers for observed price differentiation may be found at firm rather than at sectoral or national levels.

In terms of service differentiation, the table shows that the hotel chosen for this comparison was not available for booking through the Belgian Thomas Cook website even though the service was available to customers booking through the UK and German sites of Thomas Cook.

3.4.4 Implementation of Differentiation

The following table outlines the observed implementation of differentiation for three large European hotel chains:

Table 11: Implementation of differentiation in online hotel bookings

| Hotel | Implementation |
|-------------|--|
| Ibis | <ul style="list-style-type: none"> • Other national websites accessible. • For customers based in the UK, both the UK and the German Ibis booking websites display their offers in GBP. |
| Novotel | <ul style="list-style-type: none"> • Other national websites accessible. • For customers based in the UK, both the UK and the German Novotel booking websites display their offers in GBP. |
| Holiday Inn | <ul style="list-style-type: none"> • No obvious redirection or restrictions in use of other booking sites. |

The above table shows that, in general, there seem to be few obvious examples of restricting access to national specific websites, although the fact that prices are sometimes displayed in the customer's home currency even if using a website for residents of another country suggests that the websites do track customer IP addresses. This, in turn, suggests that it may be possible to target certain services to customers in specific countries and differentiation may take place in a less explicit way (i.e. offers, promotions). However, it should be noted that no evidence was found of such differentiation with regards to direct booking with hotel chains.

Implementation of differentiation in the case of online booking services is outlined in the following table:

Table 12: Implementation of differentiation in online booking services

| Hotel | Implementation |
|---------------|--|
| Expedia | <ul style="list-style-type: none"> • Other national websites accessible. • Currency changes according to choice of website. |
| Opodo | <ul style="list-style-type: none"> • Other national websites accessible, central website provides links to all country-specific websites. • Currency changes according to choice of website. |
| Laterooms.com | <ul style="list-style-type: none"> • Central website with individual language versions. |

Finally, looking at European-wide tour operators, both TUI and Thomas Cook did not practice any explicit redirection on their national websites. It is worth noting, however, that the national websites of these two tour operators differ significantly both in terms of design and content. For example, the following table outlines the range of destinations on different national TUI websites:

Table 13: Range of destinations offered on national TUI websites

| UK | Belgium | Germany |
|---|---|--|
| Algarve, Aruba, Balearic Islands, Barbados, Bulgaria, Canary Islands, Cape Verde, Corsica, Croatia, Cuba, Cyprus, Dominican Republic, Egypt, Florida, France, Goa, Greece, Israel, Italy, Jamaica, Kenya, Madeira, Maldives, Malta and Gozo, Mexico, Montenegro, Morocco, Spain, Sri Lanka, Tunisia, Turkey | Aruba, Bulgaria, Cape Verde, Croatia, Cuba, Cyprus, Dominican Republic, Egypt, France, Greece, Italy, Jamaica, Jordan, Malta, Mexico, Morocco, Portugal, Spain, Tunisia, Turkey | Africa, Asia, Australia, Austria, Benelux, Caribbean, Central America, Croatia, Cyprus, Czech Republic/Slovakia, Dubai, Eastern Europe, Egypt, France, Germany, Great Britain, Greece, Hungary, Iceland, Indian Ocean, Italy, Liechtenstein, Malta, Mediterranean, Middle East, New Zealand, Poland, Portugal, Scandinavia, Slovenia, South Africa, South America, Spain, Switzerland, Turkey, USA |

Together with different brand names in different countries (Thomson in the UK, Jetair in Belgium, and TUI in Germany), the diversity of destinations suggests that the tour operators operate as separate entities in individual Member States. While these national entities provide different services in different source markets, as reflected in the different content of their respective websites, it also needs to be stressed that no evidence of restriction of access based on country of residence was found, since national websites allow customers from other Member States to access these services.

3.5 Conclusions

This section has described the market structure and distribution models of the four sectors covered by this study, it has shown anecdotal evidence of price and service differentiation based on the place of residence of customers in each sector and it has provided an overview of ways in which companies enforce differentiation across Member States.

The table below summarises the main characteristics of each sector in terms of the main market players in Europe, the importance of cross-border transactions and general characteristics of the service itself.

Table 14: Sector overview

| Sector | Main market players | Cross-border dimension | Service characteristics |
|------------------------------------|---|--|--|
| Car rental | 4 businesses covering 2/3 of the market. | Market leaders operate across Europe. | Comparable services; significant online component |
| Digital Downloads | Apple's iTunes; many smaller players emerging. | Key vendors offer services in a number of European countries, but not all countries face a large choice ²⁷ . | Comparable 'a la carte' services; more differentiated provision for subscription services. |
| Online selling of electronic goods | Amazon with many smaller players. | Few companies operating across the continent; smaller players cater mostly to local customers. | Comparable services, service involves physical distribution of products |
| Tourism | Few key chains and groups; large number of independent hotels; significant share of the market controlled by tour operators | Largest hotel chains operate across the continent; vertically integrated tour operators active across Europe through national subsidiaries | Bespoke service for tour operators; limited online component for tour operators. Strong online component and more standardised service for hotel bookings. |

An important distinction between the four sectors is their online component, as well as the type of service provided. Digital downloads and online selling of electronic goods are by definition online sectors, while the car rental sector has a significant online component and so does the hotel booking sector. The sector for tour operators, on the other hand, has a more limited online component with bespoke services (e.g. tours) for individual customers.

Generally, offline transactions such as those of brick and mortar tour operators are less easily comparable on a like-for-like basis because they are more bespoke and they cater to local customer preferences. At the same time, online transactions allow companies to implement price or service differentiation based on different territorial source markets through a combination of automatic IP-based redirection, the establishment of parallel national websites or through direction to nationally targeted services as part of the purchasing process.

Prima facie evidence of differentiation in this section has shown examples of price and service differentiation based on residence in all four sectors covered by the study. However, it should be noted that evidence collected in this section demonstrates that differentiation does not

²⁷ IFPI Digital Music Report 2008 shows that a Portuguese consumer has access to 4 music download services, while a UK customer can choose from 14 different ones.

necessarily put cross-border customers at a disadvantage compared with domestic ones. As a result, objective drivers behind observed differentiation cannot lie purely in incremental costs associated with cross-border business.

At the same time, the evidence in this section shows differentiation not only across sectors, but also across firms within one sector. An example of this is the car rental sector, where some car rental companies do not differentiate prices or services whereas others engage in both types of differentiation. This finding suggests that any economic drivers for differentiation cannot be located only at national level (e.g. in different national regulations). Variation in differentiation at firm level within one sector can only be accounted for by economic drivers that also vary across individual firms.

Also, it is important to investigate the way in which price and service differentiation are implemented. For example, in the case of tour operators, different national websites may offer their services under different conditions (or offer different services) without preventing customers from having access to websites in other countries. In many other cases, though, circumvention of differentiation can be technically quite difficult or even impossible without a breach of terms and conditions (see in particular section 5 below).

Overall, the evidence presented in this section points to a combination of different economic drivers at firm, sector and national levels that may help account for pricing and service provision based on the residence and/or nationality of customers. The next section examines these drivers in greater detail.

4.0 Drivers of price and access differentiation

This section **identifies and presents drivers** of (or incentives for) price and service differentiation based on the place of residence or nationality of the customer described in Section 3. The section is written in non-technical language in order to appeal to a wide range of readers. Appendix 3 has a detailed overview of the concepts of price and access differentiation in economic theory.

The section does not assess whether certain business practices are incompatible with Article 20 (2) of the Services Directive. For instance, we identify that conditions of intense competition in the supply of a service in one Member State might provide a potential justification for the service provider setting a lower price to customers resident in that Member State than to its customers in other Member States: to do otherwise may result in lower profit and possibly elimination from a market. However, it does not follow that these criteria are sufficient to answer any legal questions about whether such a pricing strategy would be compatible with Article 20(2) of the Services Directive.

Instead, the objective is to **outline incentives for differentiating services or pricing** to help explain observed differentiation on the basis of customer's place of residence.

Key Findings

Input-Output Model of the Firm

- Firms maximise profits by maximising revenue or minimising costs within a given legal-regulatory environment
- Their emphasis on cost or revenue depends on the extent to which they are price takers or price makers in the market in which they operate.
- Drivers of price and service differentiation can therefore be ascribed to either the supply side, including the input environment and firm-specific processes, or to the demand-side, which focuses on the market for firm's outputs.
- Inputs, outputs, and the firm's processes themselves are shaped by the regulatory environment in which they take place.

Legal-Regulatory Drivers

- Interviewees identified a number of significant regulatory drivers for price and service differentiation based on residence of the customer, including
 - Direct financial costs such as
 - VAT across all sectors
 - Tour operator margin scheme in tourism
 - Copyright levies in the sale of certain electronic goods
 - Other compliance costs such as
 - Cross border car registration for car rental
 - Differences in implementation of the Package Directive for tourism companies
 - Financial guarantees to be provided by tour operators

- National implementation of the WEEE Directive in online retail
- Information and regulatory uncertainty
 - Copyright levies
 - National implementation of the Package Directive in tourism
 - Application of and inconsistencies in EU instruments applicable to online retail
 - Licensing in digital downloads
 - National implementation of WEEE Directive in online retail

Supply-Side Drivers

- Inputs from suppliers (right holders) in digital content
- Order and payment processing (address verification, payment methods, exchange rates) in online retail, digital downloads and car rental
- Transport and delivery costs in online retail
- Marketing costs (advertising, distribution channels) in online retail and car rental
- Customer support (language) in car rental and online retail
- Corporate structure
 - Franchising
 - National subsidiaries with different source markets and pricing freedom in the tourism sector

Demand-side Drivers

- Competition in all sectors
- Willingness to pay in all sectors

Main Conclusions

- Four strategies adopted by traders to deal with drivers leading to different consumer outcomes:
 - Compute an average price across all source markets
 - Differentiate between domestic and cross-border source markets
 - Differentiate between all source markets
 - Refrain from entering some source markets with a like-for-like service
- These drivers interact to
 - Offset one another (e.g. demand and supply factors might offset one another);
 - Reinforce one another (e.g. regulatory uncertainty leading firms to adopt national corporate structure)
- As a result, the analysis shows that:
 - the same consumer outcomes in terms of pricing and service provision can be due to different economic drivers and
 - the same drivers for differentiation may lead to different consumer outcomes

4.1 Drivers of Price and Service Differentiation

This section develops a typology of price and service differentiation based on a simple input output model of the firm. The model provides the conceptual underpinning for the description of individual drivers at firm, sector and national levels in the remainder of the report.

4.1.1 Input-Output Model of the Firm

At a very general level, firms can be described as a set of processes for turning inputs into outputs. In a competitive environment, firms maximise profit by either reducing costs or maximising revenue. The emphasis that they place on costs and revenue depends on their position within the market in which they operate:²⁸

- *Price-taking* firms are faced with a fixed demand curve in an often very competitive environment, where service differentiation is marginal and cost pressure intense. For example, if a firm in such environment were to raise its prices, its customers would simply switch to another firm, which would now offer a very similar or the same product or service for less. So such a firm has in practice its prices imposed on it by the market - hence it is 'price-taking'. The principal operations of this type of firm relate to maintaining/improving the quality of their product or service while keeping costs under control.
- *Price-making* firms operate in an environment where demand curves are not fixed, where service differentiation is very high and where (temporary) monopolies can arise as a result of innovation. A firm which provides a product or a service that is sufficiently different from most of its competitors is likely to retain many of its customers when it raises its prices - hence it is 'price-making'. As a result, for price-making firms, maximising revenues and exploring new markets, processes and services is of greater importance than for price-takers.

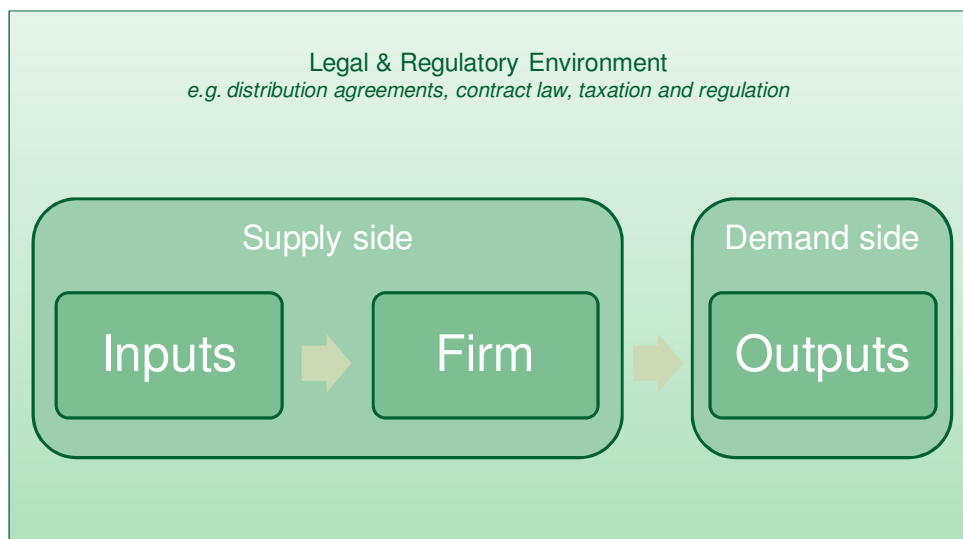
In practice, every firm in the four sectors covered by this study falls somewhere along a spectrum that reaches from a pure price-taker (e.g. a producer of a standardised commodity in a competitive environment) to a pure price-maker (e.g. a monopoly with no possibility of market entry for competitors, such as some utilities). A firm's position along the spectrum depends on characteristics of the sector, the structure of the market in which it operates (e.g. competition, demand, regulation) and the firm's own corporate structure.

With respect to this study, a firm's position along the price taker-price maker spectrum will influence its strategy for price and service differentiation. The closer the firm is to being a pure price-taker, the greater its emphasis on cost reduction as a way of maximising profits. Conversely, the closer a firm is to being a price-maker, the greater its emphasis on process and service innovation and on maximising revenue.

²⁸ See also Hausemer, P, and Coyne, M. (2008). The impact of regulatory uncertainty on productivity.

Against this background, drivers that might explain the evidence of price and service differentiation presented in the previous section can be ascribed directly to either the supply side, including the input environment and firm-specific processes, or to the demand-side, which focuses on the market for the firm's outputs. Inputs, outputs, and the firm's processes themselves are shaped by the political, legal and regulatory environment in which they take place.

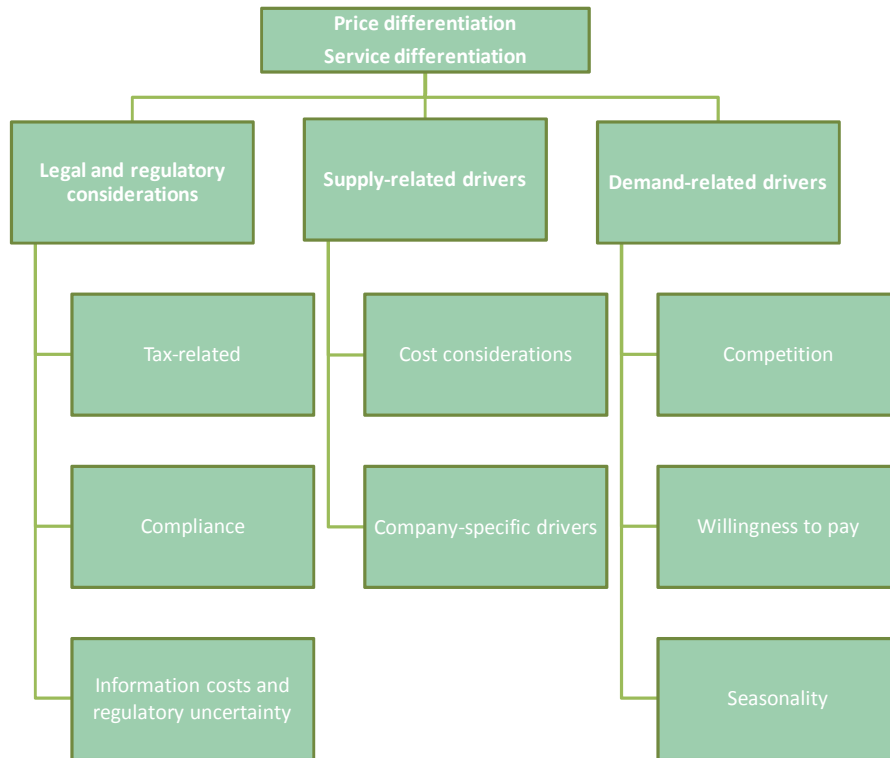
Figure 6: Input-Output Model of the Firm



4.1.2 Typology of Drivers for Price and Service Differentiation

The following figure provides an overview of drivers for differentiation of cross-border services by source market. Following the discussion in the previous section, the groupings are largely conceptual and there may be some overlap in practice between these drivers. Nevertheless, the framework was a useful fieldwork tool to guide discussions with businesses. On the whole, interviewees generally validated the approach and the relevance groupings in the typology.

Figure 7: Typology of drivers for price and access differentiation



As the figure indicates, there are three broad types of reasons for companies to engage in price or service differentiation across borders:

- **Factors related to legal and regulatory matters** refer to the politico-legal environment in which the firm operates, including taxation and compliance cost, information costs, and legal uncertainty.
- **Factors related to supply** including cost of sales, and firm-related characteristics, such as corporate structure.
- **Factors related to service demand in the downstream source market** including the nature of competition, the willingness to pay of different customer groups, and seasonality.

While we have chosen different labels for each of three broad categories, they are similar to those highlighted in a recent European Parliament briefing note on the internal market in e-commerce transactions.²⁹

For each of the broad categories in the typology, the fieldwork interview programme with individual companies in the four sectors covered by the study identified a set of specific

29 Helberger, N. (2007). Refusal to Serve Consumers because of their Nationality or Residence - Distortions in the Internal Market for E-commerce Transactions, European Parliament Briefing Note [IP/A/IMCO/IC/2006-207]

economic drivers that may lead to price and service differentiation. The table below outlines the drivers singled out and described by stakeholders in the four sectors.

Table 15: Overview of drivers identified in the fieldwork interviews

| Sector | Examples of identified drivers of differentiation based on the country of residence of the customer |
|----------------------|---|
| Car rental | Legal and regulatory <ul style="list-style-type: none"> • Costs of re-registering cars Supply-related <ul style="list-style-type: none"> • Exchange-rate fluctuations • Costs of marketing • Costs of 'no show rates', complaints • Corporate structure (franchising and fully-owned subsidiaries) Demand-related <ul style="list-style-type: none"> • Seasonality • Competition • Willingness to pay |
| Digital downloads | Legal and regulatory <ul style="list-style-type: none"> • VAT differences • Licensing uncertainty Supply-related <ul style="list-style-type: none"> • Costs of licensing • Costs of payment methods Demand-related <ul style="list-style-type: none"> • Competition |
| Online sale of goods | Legal and regulatory <ul style="list-style-type: none"> • VAT differences • Uncertainty regarding applicable law • Copyright levies • Environmental legislation Supply-related <ul style="list-style-type: none"> • Costs of address verification • Costs of payment methods • Shipping costs • Costs related to postal services • Advertising costs • Costs of customer support Demand-related <ul style="list-style-type: none"> • Competition |
| Tourism | Legal and regulatory <ul style="list-style-type: none"> • VAT differences • Transposition of the Package Directive • National licensing of tour operators • Acceptance of guarantee funds Supply-related |

| Sector | Examples of identified drivers of differentiation based on the country of residence of the customer |
|--------|--|
| | <ul style="list-style-type: none"> • Negotiating power of tour operators with regards to hotels • Corporate structure of tour operator companies Demand-related <ul style="list-style-type: none"> • Willingness to pay |

The following sections discuss each one of these drivers in more detail.

4.2 Legal and regulatory considerations

As discussed above, one of the main factors that drive differences in access and pricing of cross-border services based on the geographical market of the service recipient relates to the legal and regulatory considerations that govern the provision of the service. Regulatory provisions can raise the costs of cross-border service provision through a number of different channels. For example:

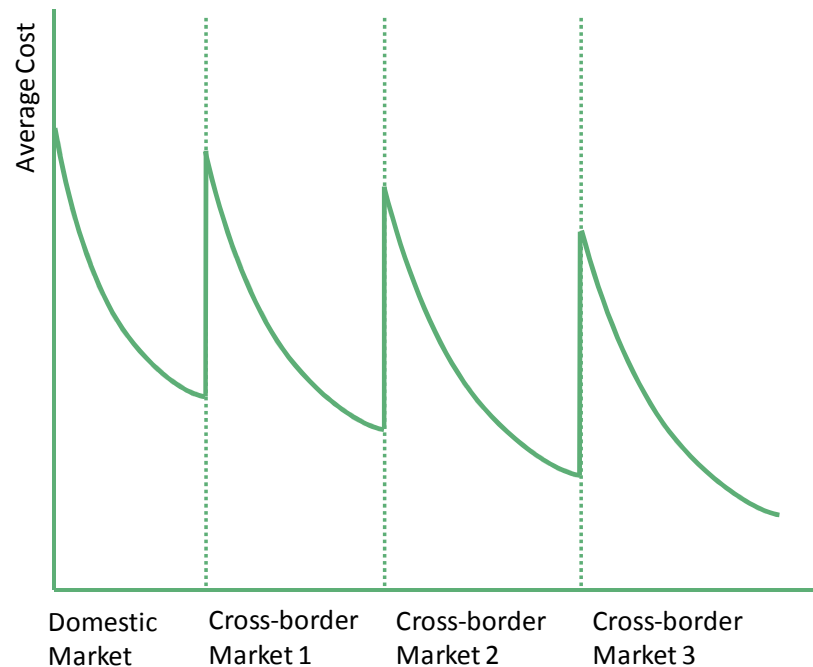
- national taxation may impose direct financial charges on the service provider which are passed on to customers residing in the country where the charges apply;
- intellectual property rights may impede or increase the costs of providing services to customers residing in particular countries;
- regulatory differences across countries may impose information and compliance costs which the service provider may recoup through a targeted pricing policy; and
- regulatory change and uncertainty surrounding legal obligations and liabilities may lead to risks around providing a service to customers in particular countries.

In some cases, these factors may lead to a differentiation in pricing and service provision between domestic customers (i.e. customers residing in the country where the service provider is established) and all cross-border customers. In other cases, these drivers could also explain differentiation between cross-border customers from different countries (source markets).

The figure below illustrates how the average cost of providing services may differ depending on the number of markets that the firm operates in.³⁰ The figure assumes that each market has a fixed set of regulatory requirements that companies need to comply with, irrespective of the number of units that they sell in that market. In such a scenario, a firm operating only in the domestic market would see its average costs decreasing with increasing market share. The greater the difference in regulatory requirements between two markets the greater the regulatory cost to firms operating in both markets. If a firm expands into another (cross-border) market, with a different set of regulatory and legal requirements, its average costs increase due to the need to invest in familiarising itself with different regulatory requirements and engaging in compliance activities. However, just like in the domestic market, average costs decrease with increasing market share in the cross-border market.

³⁰ It should be noted that this is a schematic illustration and a full empirical investigation is required to determine the precise shape of these cost curves.

Figure 8: Schematic Illustration of Regulatory Impact on the Cost of Cross-Border Service Provision



Clearly, if the picture above is an accurate representation of regulatory costs and risk factors associated with extending service provision into cross-border markets then this may be reflected in retail prices and service provision. From an economic perspective, there are four ways in which companies could address a cost structure such as that depicted above:

1. charge a single price to all their customers regardless of the market in which they reside based on the average cost of all of the firm's (domestic and cross-border) operations;
2. charge one price for domestic customers and a different price for all cross-border customers;
3. charge different prices for customers in different markets based on the cost of operating in each market; or
4. refrain from entering one or all cross-border markets.

With respect to this study, the four strategies above mean that the same regulatory provisions could lead to different outcomes in terms of pricing and access to services for cross-border customers. Which strategy a firm chooses will depend on a large number of factors, including market considerations such as the potential size of each cross-border market, the nature of the competition in each market and of course the regulatory costs associated with market entry.

The remainder of this section examines in greater detail the regulatory drivers for cross-border price and service differentiation in the sectors covered by this study.

4.2.1 Sales Tax / VAT

The interview programme pointed to national taxation, in particular VAT, as one of the most recurrent elements that may lead to differences in pricing for cross-border services. Where comparisons are made between prices that are inclusive of VAT, differences in VAT rates between Member States can explain price differences. Differences in VAT rates across the EU are presented in the table below.

Table 16: VAT rates across the EU

| Member State | Super Reduced Rate | Reduced Rate | Standard Rate | Parking Rate |
|----------------|--------------------|--------------|---------------|--------------|
| Belgium | - | 6/12 | 21 | 12 |
| Bulgaria | - | 7 | 20 | - |
| Czech Republic | - | 9 | 19 | - |
| Denmark | - | - | 25 | - |
| Germany | - | 7 | 19 | - |
| Estonia | - | 5 | 18 | - |
| Greece | 4.5 | 9 | 19 | - |
| Spain | 4 | 7 | 16 | - |
| France | 2.1 | 5.5 | 19.6 | - |
| Ireland | 4.8 | 13.5 | 21.5 | 13.5 |
| Italy | 4 | 10 | 20 | - |
| Cyprus | - | 5/8 | 15 | - |
| Latvia | - | 10 | 21 | - |
| Lithuania | - | 5/9 | 19 | - |
| Luxembourg | 3 | 6/12 | 15 | 12 |
| Hungary | - | 5 | 20 | - |
| Malta | - | 5 | 18 | - |
| Netherlands | - | 6 | 19 | - |
| Austria | - | 10 | 20 | 12 |
| Poland | 3 | 7 | 22 | - |
| Portugal | - | 5/12 | 20 | 12 |
| Romania | - | 9 | 19 | - |
| Slovenia | - | 8.5 | 20 | - |
| Slovakia | - | 10 | 19 | - |
| Finland | - | 8/17 | 22 | - |
| Sweden | - | 6/12 | 25 | - |
| United Kingdom | - | 5 | 15 | - |

Source: European Commission. (2009). *VAT Rates Applied in the Member States of the European Community*

At the moment, the applicable VAT rate for the supply of a service is determined by the place and time of supply of that service³¹. How the place of supply for a particular transaction is determined is a matter of VAT law, outside the scope of this study. Nevertheless, it is worth examining some of the possible repercussions of VAT rules for cross-border services on price differentiation based on residence and nationality of the customer.

At present, for B2C and B2B services, the general rule is that the place of supply is the place where the supplier is established³². Differences in the location of a service recipient should therefore not, by themselves, lead to differences in VAT rates.

Nevertheless, distance selling, which includes online sale of goods, is a case where VAT might be determined based on the place of residence of the customer. Here, VAT is charged according to the place of supply until sales to a certain Member State have exceeded a specific threshold (or 100,000 EUR, or 35,000 EUR in certain specific cases), at which point the seller must identify for VAT in the destination country. Distance sellers can also opt to do so even if this threshold is not reached³³. This implies that, in the case of some online retailers, especially those that sell large volumes of goods, the final VAT-inclusive retail price will include different VAT rates depending on the place of residence of the customer. Given higher VAT rates in France than in the UK, this might for instance partly explain consistently higher online prices for Apple iPods for French customers (see Section 3).

In addition, these VAT rules will be partly modified by Council Directive 2008/8/EC³⁴. For instance, from 1 January 2015, the place of supply of intra-EU B2C supplies of telecoms, electronically supplied services and broadcasting will be where the customer is established or usually resides,³⁵. Similarly, for B2B transactions, from 1 January 2010, the 'general rule' for the place of supply of services will be the place where the customer is established and no longer the place where the supplier is established as is currently the case³⁶.

However, for short-term hire of a means of transport (e.g. car rental), from 2010, the place of supply will be the place where the vehicle is "put at the disposal of the customer". In other words in the car rental sector, applicable VAT rates for cross-border hire will be based not on the place of residence of the customer but on the country where the service is provided³⁷. Based on information from car rental providers, cost differences as a result of VAT and taxation are generally fed through directly to consumers.

Overall, it seems clear that a system of taxation based on the location of the customer rather than on the location of the service supplier may be a factor leading to greater price differentiation based on the place of residence of the customer. Where there is an obligation on

31 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L 2006/347

32 Article 43 of Council Directive 2006/112/EC.

33 Articles 33 and 34 of the Council Directive 2006/112/EC.

34 Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC as regards the place of supply of services, OJ L 44/2008

35 See Article 5 of Council Directive 2008/8/EC.

36 Ibid.

37 Article 56 of Directive 2006/112/EC as modified by Article 2 of Directive 2008/8/EC.

service providers to indicate VAT separately in invoices, customers will be made aware that VAT is one of the drivers of price differences.

In the tourism sector, interviews pointed to the Tour Operator Margin Scheme (TOMS), Council Directive 77/388/EEC³⁸, as a specific VAT-related driver for differences in prices across Member States. Under this scheme, tour operators pay VAT-inclusive prices on the 'tour components' that they buy from their supplier. These transactions are treated for tax purposes as one single transaction, and the operators do not reclaim any VAT on these services. The operators' taxable amount becomes the margin between the total cost of the component (tax inclusive) and the price charged to the consumers. The operators have to pay tax on this margin. However, according to interviewees, the scheme is not applied uniformly in all Member States: some Member States would apply the scheme to packages sold by one operator to another (B2B), while others would exempt their operators from paying on the margin on certain EU holidays. For instance, in the UK, wholesale tour operators seem to have the choice to "opt out" of TOMS, since they do not sell directly to consumers³⁹.

According to businesses in the tourism sector, these differences in the way in which TOMS is applied across Europe lead to a disparity in taxes for tour operators which can be reflected in different prices for consumers booking identical services through the national subsidiaries of the same pan-European tour operator⁴⁰. It is interesting to note in this context that there was no evidence (see Section 3) for tour operators preventing online customers from accessing services offered through the national websites of countries other than the one where they reside.

4.2.2 Compliance Costs and Liability

Another key set of drivers relating to regulatory and legal environment are compliance costs and liability. Regulations in a Member State might require a service provider to obtain certain authorisations, registrations or accreditation before it can supply to customers resident in that Member State. While these regulatory costs should be attenuated by the application of the provisions on free movement of services laid down in the E-Commerce Directive⁴¹ and, upon completion of its implementation, of the Services Directive⁴², interview fieldwork conducted as part of this study suggests that differences in regulatory frameworks across Member States can still be an important obstacle to the provision of cross-border services.

38 Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment, OJ L388/1977. See in particular Article 26.

39 European Tour Operators Association. (2004). Discussion Paper on Proposal for a Council Directive Amending the Taxation of Travel Products. In addition, according to this paper, specific derogations appear to have been granted to certain Member States (in particular to Denmark, Ireland and the Netherlands).

40 See in particular in the website of ETOA, the European Tour Operator Association : <http://www.etoa.org/VAT.aspx#whatis>

41 Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market, OJ L 178/2000. See in particular Article 3.

42 See in particular Article 16 on freedom to provide services

Where regulatory frameworks differ across countries, differences in compliance costs for business might give rise to differences in prices and conditions of services supplied across borders. Similarly, national legislation can lead to refusal to sell on the part of service providers if it prohibits companies from offering a particular service in a Member States or if it requires the provider to alter terms and conditions under which the services are provided. By providing a service to a customer in a particular Member State, a service provider may thus bear risks of infringing legislation in that State. For instance, national consumer protection laws may give customers particular rights in the event that they are dissatisfied with a service they have received. Where consumer protection laws remain fragmented along national lines or where there is uncertainty regarding the applicable legal framework (discussed in further detail below) this could lead to difficulties for firms in estimating their obligations and risks which, in turn, could lead to access restrictions or price differences in cross-border business.

Differences in the rules that a service provider must comply with when supplying customers in different Member States may in turn have an impact on the expected costs of supplying customers in different Member States, including risks of infringement and potential penalties⁴³.

For example, in the case of **car rental**, the cost of re-registering cars in different Member States as imposed by national legislation was described by the interviewees as one of the factors that may increase the costs linked to the provision of cross-border services, since it dissuades pan-European companies from moving their fleet across internal EU borders to adjust shortages or oversupply in some markets⁴⁴. By preventing calibration of demand and supply for hire cars through physically moving the fleet from areas of oversupply to areas that experience temporary shortages, re-registration obligations on fleet providers can make price signals (including source market pricing) become increasingly important.

In the **tourism** sector, differences in national regulatory frameworks can result in different costs of compliance for tour operators and travel agencies. For instance, according to interviewees in the sector, operating costs for tour operators in Belgium are perceived to be higher than in the Netherlands as a result of stricter regulatory provisions in Belgium. In this sector, for operators providing services across several Member States, prices are generally set on the basis of average costs across the countries in which they are active, meaning that differences in costs of compliance mainly have a bearing on the profit margin of the companies.

Although there is limited evidence that these costs are passed on to consumers by way of higher prices, they can result in different services being provided to customers from different Member States, or potentially, to a refusal to deal. For instance, according to interviewees, partly in response to higher operating costs, tour operators in Belgium target customers likely to

43 There are several models which could help indicate to what extent firms factor regulatory compliance, liability and uncertainty into their strategic decision-making including pricing. See for instance Mike Coyne and Pierre Hausemer "The impact of regulatory uncertainty on productivity", BERR Occasional paper No 3, September 2008; Aminzadeh and Chikte, "Effects of regulatory delays and uncertainty on pricing decisions" *Mathematical Methods of Operations Research* Vol 30(4), 1986.

44 A Commission proposal on June 5 2005 for a Directive to restructure national passenger car taxation systems (COM/2005/261/FINAL) was rejected by the Member States. The accompanying document "Vehicle Taxation in the European Union 1997" identified the issue of cross-border car hire and stipulated that "in cases where cars are moved but not as part of a change of residence, double payment of registration taxes is a frequent occurrence."

be willing to pay for accommodations in 5 star hotels where margins are higher. In comparison, the Dutch branches of the same tour operator will be more likely to also focus on lower-budget options such as camping. Put differently, specialisation of national branches of the same tour operator in different market segments is partly due to differences in operating costs as a result of the regulatory environment⁴⁵.

In addition, interviewees in the tourism sector identified a large number of other regulatory differences across Member States that could result in compliance costs for cross-border service providers. However, it should be pointed out that there was a considerable degree of uncertainty about the circumstances in which these national regulations applied in cross-border transactions. As the next section shows, such uncertainty can, in and of itself, lead companies to refrain from offering their services to customers residing abroad or it can lead companies to adopt a corporate structure aimed at minimising regulatory uncertainty (e.g. by setting up separate legal entities in each market).

A first example of regulatory uncertainty given by interviewees in the tourism sector was the minimum harmonisation contained in the Council Directive 90/314/EEC, also known as **Package Travel Directive**⁴⁶, which regulates the package holiday market in the EU.

An assessment of the transposition of the Directive, conducted by Hans Schulte-Nölke and Leonie Meyer-Schwickerath as part of the “EU Consumer Law Compendium” project for the European Commission⁴⁷, shows that many of the key differences in requirements across the Member States relate to the information that a tour operator has to provide as part of the brochure, its pre-contractual information duties, the time period and requirements with regards to the information provided before the start of the journey, and elements of the contract. By way of example, the table below provides an overview of the national legislation transposing the information requirements with regards to the travel brochure.

Table 17: Transposition of the Directive’s information requirements with regards to brochures

| Nature of national transposition | Country |
|--|--|
| Substantially equivalent to the Directive | AT, DK, DE, EE, EL, LU |
| National information requirements going beyond the Directive | BE, BG, CY, ES, FI, HU, IE, IT, LT, MT, NL, PL, PT, RO, SK, UK |
| Deviations from the Directive’s requirements | FR, SE |
| Transposition not entirely clear | CZ, LV, SL |

Source: Schulte-Nölke, H. and Meyer-Schwickerath, L. (2008). Package Travel Directive (90/314); the wording in the table follows that of the original document.

45 According to interviewees in the tourism sector, an example of compliance costs imposed on tour operators seeking to provide cross border services (in this case in the Netherlands) is the Dutch guarantee fund organisation Stichting Garantiefond Reisgelden (SGR). Currently SGR – whose aim is to cover the costs of travel and accommodation in the case of tour operators' financial inability to provide their services - does not recognise the guarantees that most German tour operators use for domestic business as equivalent to Dutch requirements and it seeks additional guarantees from German tour operators wishing to sell to Dutch customers. This can imply higher costs for German tour operators which choose to provide services in the Netherlands and it could translate either into higher prices for Dutch customers, lower profit margins for German operators in the Netherlands, or it might deter some operators from providing a cross-border service. See SGR Statutes and Annual Reports at <http://www.sgr.nl>

46 Council Directive 90/314/EEC of 13 June 1990 on package travel, package holidays and package tours. OJ L 158/1990

47 Schulte-Nölke, H. and Meyer-Schwickerath, L. (2008). Package Travel Directive (90/314).

This table shows that a number of Member States require tour operators to provide customers with more information than the minimum level set out in the Directive. As a consequence, for example, a German firm complying with German legal requirements, which in the case above are substantially equivalent to those of the Package Directive, could thus be faced with additional costs to comply with stricter Belgian requirements..

Interviewees also identified differences in licensing systems across Member States as an obstacle to cross border service provision and a potential driver for differentiation. Licensing systems include requirements regarding, for example, the competence of the staff and financial guarantees, and therefore can constitute a financial burden for tour operators and travel agencies seeking to operate in a given country. The table below provides an overview of licensing systems in the EU.

Table 18: Licensing systems applicable to tour operators in the Member States

| Licence required | No licence required |
|--|---|
| Austria | Denmark |
| Belgium | Estonia |
| Bulgaria | Finland |
| Cyprus | Germany |
| France | Latvia |
| Greece | Lithuania |
| Hungary | Luxembourg |
| Ireland for tour operators selling package travel to destinations outside of Ireland | Netherlands |
| Italy | Norway |
| Malta | Sweden |
| Poland | Switzerland |
| Portugal | UK for travel agents and tour operators who do not sell package travel including air transportation |
| Romania | |
| Slovakia | |
| Spain | |
| UK for tour operators selling packages including air transportation. | |

Source: ECTAA

If a tour operator providing a service in a certain country is required to comply with the national regulation, its compliance costs can differ depending on whether the Member State in question has a licensing system in place. In turn, this may lead in certain cases to differentiation in treatment based on the place of residence of cross-border customers.

4.2.3 Information Costs and Regulatory Uncertainty

In addition to the specific examples of regulatory drivers for price and service differentiation above, an equally (and perhaps even more) important driver behind cross-border price and service differentiation are the information costs and uncertainty associated with regulatory variation across EU Member States. Where service providers are more familiar with the requirements and liabilities they face when supplying domestic customers, they might attach a greater risk premium to supplying cross-border customers and this can be reflected in pricing and conditional access to services.

For instance, in **online retail**, uncertainty perceived by traders refers mainly to determining which national consumer protection rules apply in the case of cross-border commerce. For small businesses in particular, information costs surrounding these multiple source of regulatory requirements can constitute a significant impediment to cross-border trade, thus leading to access restrictions for customers from abroad or differences in pricing depending on the place of residence of the customer. For instance, 'cooling-off periods', the periods of time during which a sale can be cancelled and the product can be returned by the customer without charge vary across Member States⁴⁸. As a consequence, the length of this period for a particular transaction can be difficult to determine in the case where the retailer and the consumer are located in Member States with different cooling-off periods⁴⁹.

Cross border services in online retail are also subject to a number of European instruments, including the Distance Selling Directive (97/7/EC)⁵⁰, the E-Commerce Directive (2000/31/EC)⁵¹, the "Brussels" Regulation on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (44/2001)⁵², and the "Rome I" Regulation on the law applicable to contractual obligations (593/2008)⁵³.

Private International Law Rules were highlighted by interviewees as an important source of uncertainty which may lead to higher transaction costs and, in turn, to different treatment based on the residence of the customer. Regulation on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (the so-called "Brussels" Regulation 44/2001)⁵⁴ stipulates that consumers can take legal actions before the court of the place where they are domiciled if the trader "directs such activities to that Member State". In the case of

48 A list compiled by the Norwegian ECC shows that these periods range from 7 working days in a number of countries (i.e. Austria, Belgium, France, United Kingdom) to 15 days in Malta and 14 in Cyprus, Czech Republic, Denmark, Estonia, Finland, Latvia, Portugal, and Sweden). See http://forbrukereuropa.no/engelsk/articles/cooling_off_complaint_periods

49 The Commission is currently proposing to harmonise the length of the cooling off period throughout the EU with the recent proposal of Directive on consumer rights, whose adoption is currently being negotiated in the EU Parliament and the Council. COM (2008) 614 final of 8.10.2008.

50 Directive 97/7/EC of the European Parliament and of the Council of 20 May 1997 on the protection of consumers in respect of distance contracts OJ L 144/1997. ,

51 Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market ('Directive on electronic commerce') OJ L 178/2000

52 Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters; OJ L 12/2001

53 Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I), OJ L 177/2008.

54 Council Regulation (EC) No 44/2001 of 22 December 2000 mentioned above, see in particular Articles 15 and 16.

online retail, if the Member States to which the activity is directed is understood as all Member States from which the trader's website can be accessed, this would expose e-commerce traders to potential litigation before jurisdictions in all EU Member States, a risk that businesses might factor into the provision of services across borders.

The concept of "directed activity" is also present in the above mentioned "Rome I" Regulation on the law applicable to contractual obligations⁵⁵, Article 6 of which specifies that a contract "shall be governed by the law of the country where the consumer has his habitual residence, provided that the professional [...] by any means, directs such activities to that country or to several countries including that country". In addition, the same provision states that in any case the consumer cannot be deprived of the protection afforded to him "by provisions that cannot be derogated" by virtue of the law of the Member State where he resides.

Another area where regulatory uncertainty can lead online retailers to differentiate their prices is the system of **copyright levies** in individual Member States. Copyright levies are charges aimed at compensating the holders of intellectual property for the negative economic impact of private copying of media. According to the European Commission's background document entitled 'Fair compensation for acts of private copying', which accompanied the 2008 stakeholder consultation on copyright levies⁵⁶, levies differ across Member States in at least three ways:

- they apply to different equipment or media that can be used to produce copies;
- they differ in levels for the same media or equipment; and
- they differ in whether they are imposed on the manufacturers, importers or distributors of media or equipment, or consumers.

In 2008, the only countries without a levy system were Ireland, UK, Malta, Cyprus, and Luxembourg⁵⁷. The basics of the copyright levy system in other Member States, excluding Bulgaria and Romania, are presented in the table below:

Table 19: Levies in 20 Member States

| Member State | Levies applied to media | Levies applied to equipment |
|----------------|-------------------------|-----------------------------|
| Austria | Yes | |
| Belgium | Yes | Yes |
| Czech Republic | Yes | Yes |
| Denmark | Yes | |
| Estonia | Yes | Yes |
| Finland | Yes | Yes |
| France | Yes | |
| Germany | Yes | Yes |
| Greece | Yes | Yes |
| Hungary | Yes | Yes |
| Italy | Yes | Yes |

⁵⁵ Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 mentioned above, Article 6.

⁵⁶ European Commission. (2008). Background Document: 'Fair compensation for acts of private copying', http://ec.europa.eu/internal_market/copyright/docs/levy_reform/background_en.pdf

⁵⁷ Ibid.

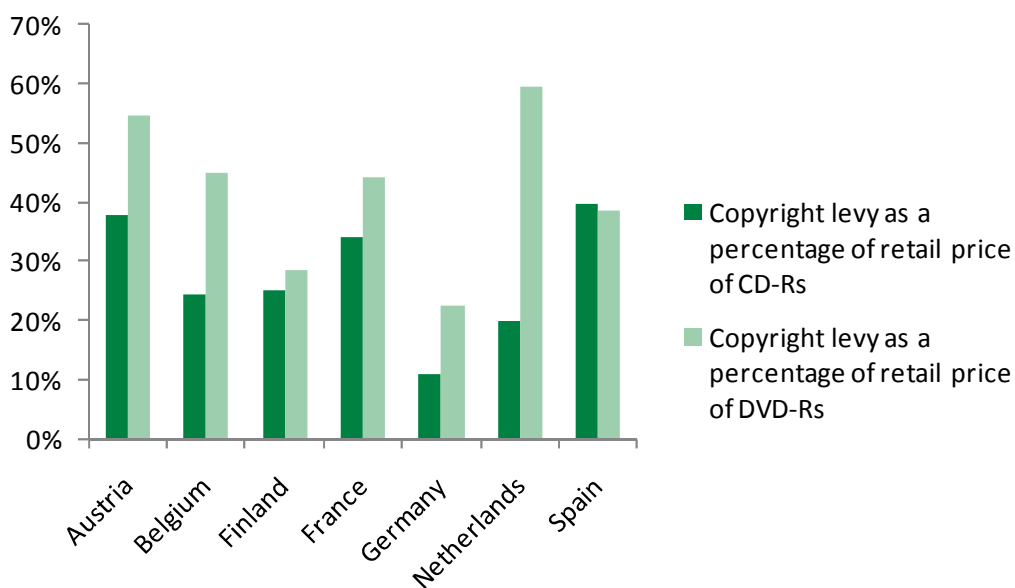
| Member State | Levies applied to media | Levies applied to equipment |
|-----------------|-------------------------|-----------------------------|
| Latvia | Yes | Yes |
| Lithuania | Yes | |
| The Netherlands | Yes | |
| Poland | Yes | Yes |
| Portugal | Yes | |
| Slovakia | Yes | Yes |
| Slovenia | Yes | Yes |
| Spain | Yes | Yes |
| Sweden | Yes | |

Source: European Commission. (2008). *Background Document: 'Fair compensation for acts of private copying'*

The above table shows quite clearly the differences between individual Member States, but behind this high-level picture are even finer discrepancies. Within the broad category of equipment' some countries, like Germany, impose levies on computer hard drives or mobile phones, whereas others do not⁵⁸.

The following figure shows some of the differences with regards to the size of the levies relative to the retail price of media to which they apply.

Figure 9: Relative size of copyright levies on media in selected countries in 2006



Source: EconLaw Strategic Consulting. (2007). *Economic analysis of private copy remuneration.*

The figure shows quite clearly the different levy rates across Member States, as well as the differences in size of levies depending on the media in question. Levies in the Netherlands applied to DVD-Rs accounted for 60 percent of the retail price, whereas the levies applied to

⁵⁸ Ibid.

CD-Rs were only around 20 percent of the retail price. In Germany, on the other hand, these levies were around 20 and 10 percent respectively.

The 2008 European Commission background document on copyright levies notes that an internet retailer selling blank media or devices across borders can pay the levy twice if it has paid it in its home Member State, is liable to pay it in the Member State of the customer and is not eligible for a refund in the home Member State (not all Member States offer refunds)⁵⁹. Even if the actual costs of paying a higher or a double levy are disregarded, the complexity of the system can result in administrative costs associated with identifying the products on which levies should be paid, the rates, and whom these should be paid to. For instance, as a result of these complexities, one online retailer interviewed as part of the fieldwork had decided not to sell blank media from the UK to Germany.

A further regulatory issue raised in the interviews was the impact of environmental regulation on cross-border distance selling via the internet. Directive 2002/96/EC, or the **Waste Electrical and Electronic Equipment Directive (WEEE)**⁶⁰ and implementing legislation at national level, have been identified by interviewees as an important driver for differentiation. The Directive, in place since 2004 but likely to be revised following a recent Commission proposal⁶¹, places responsibility on producers to collect waste equipment and ensure its appropriate disposal: The Directive specifies that the “Member States shall ensure that [...] producers provide at least for the financing of the collection, treatment, recovery and environmentally sound disposal of WEEE from private households deposited at collection facilities”⁶².

Fieldwork interviewees indicated that differences in the transposition of the Directive across Member States may create potential country-specific costs for online retailers who are also producers or distributors of the articles covered by the Directive. For instance, differences relating to the way responsibility for collection of WEEE from private households is assigned depending on national legislation can have a significant impact on costs for online retailers. The magnitude of costs is not easy to establish, although it has been estimated that “end-of-life treatment” of a product could amount to 1.5 to 3 per cent of the sale price of the product⁶³.

The table below shows that a producer or a distributor selling products covered by the Directive online to a number of Member States may be faced with different responsibilities depending on the applicable Member State's legislation:

59 Ibid.

60 Directive 2002/96/EC of the European Parliament and of the Council of 27 January 2003 on waste electrical and electronic equipment (WEEE), JO L 96/2003

61 See the press release IP/08/1878 of 3.12.2008. Environment: Commission proposes revised laws on recycling and use of hazardous substances in electrical and electronic equipment, <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1878&format=HTML&aged=0&language=EN&guiLanguage=en>

62 See Article 8 of Directive 2002/96/EC.

63 See for example in the website of Cobham Technical Services, a technology consultancy and design company : http://www.era.co.uk/news/rfa_feature_07a.asp. They also note that the UK government's estimate of the cost to British equipment producers and importers ranges from GBP 217 million to GBP 455 million per year

Table 20: Allocation of Responsibility for Collection of WEEE from private households in National Legal Text:

| Member State | Physical Responsibility | Financial Responsibility |
|---------------------|-----------------------------------|---------------------------------|
| Austria | Distributor/Municipality/Producer | Distributor/Producer |
| Belgium (Brussels) | Distributor/Municipality | Distributor |
| Bulgaria | Producer | Producer |
| Cyprus | Producer | Producer |
| Czech Republic | Distributor/Producer | Distributor/Producer |
| Denmark | Municipality | Municipality |
| Estonia | Distributor/Producer | Distributor/Producer |
| Finland | Distributor/Producer Producer | Producer |
| France | Distributor/Municipality/Producer | Distributor/Producer |
| Germany | Municipality | Municipality |
| Greece | Producer | Producer |
| Hungary | Producer | Producer |
| Ireland | Distributor/Municipality | Distributor/Producer |
| Italy | Distributor/Municipality | Distributor/Municipality |
| Latvia | Producer | Producer |
| Lithuania | Distributor/Municipality/Producer | Producer |
| Luxembourg | Distributor/Municipality | Distributor/Municipality |
| Malta | Distributor/Producer | Distributor/Producer |
| Netherlands | Distributor/Municipality | Distributor/Municipality |
| Poland | Distributor | Distributor |
| Portugal | Distributor/Municipality/Producer | Distributor/Producer |
| Romania | Municipality | Municipality |
| Slovakia | Distributor/Producer | Distributor/Producer |
| Slovenia | Distributor/Municipality | Distributor/Municipality |
| Spain | Distributor/Municipality | Producer |
| Sweden | Producer | Producer |
| UK | Distributor/Producer | Distributor/Producer |

Source: Ökopol, iiiiee, and RPA. (2007). *The Producer Responsibility Principle of the WEEE Directive Executive Summary*

In addition to responsibilities for collecting WEEE, Member States also differ in the registration requirements they impose on the distance sellers specified in Article 12 of the Directive. For example, according to a study on the producer responsibility principle contracted by the European Commission in 2007, there are two main approaches applied to distance sellers. The first approach requires distance sellers to register in the Member State where they are located and report the number of products placed on the market where products are sold, and the second requires sellers to register in the end-user's Member State and report the number of products on the market where end users are located. The authors of the study show that 10 Member States used the first approach, 7 the second, two combined the approaches, and two Member States did not require cross-border distance sellers to register.

As a result, online retailers, regardless of whether they are producers or distributors, are faced with a diverse set of obligations, which in turn may result in different costs of providing services in certain Member States and, ultimately, lead to differentiation based on the place of residence.

In the **digital downloads** sector, an important source of legal uncertainty relates to licensing issues. Licensing content from collecting societies and right holders can constitute a significant cost, which can vary considerably across Member States. It can also introduce complexity which can lead to either higher administrative costs, or refusal to deal. One interviewee noted that obtaining licenses for content across Europe meant that businesses needed to deal with a complex matrix of licensing rights, with Member States on one axis, repertoire on the other axis, and where rights to the same content across Europe can be held by different parties.

In other words, costs associated with licensing not only involve purchasing the actual licenses, but also determining who licensing contracts should be signed with. This process may at times constitute a significant barrier to providing a uniform digital distribution service across all Member States. The fact that many digital download services restrict access for customers from outside the home market could support the notion that licensing bodies operating within national borders may to some extent be the reason for service differentiation. At the same time, some streaming services, which also require licenses, do not seem to introduce this differentiation.

Finally, in determining the extent to which legal uncertainty feeds through to retail pricing or conditions of access to cross-border services, the distinction between larger and smaller businesses is particularly significant. Based on our interviews, major online retailers are less affected by legal uncertainty and complexity due to the low share of cross-border sales that give rise to legal concerns. For smaller companies, uncertainty can nevertheless be a very significant issue because the prospect of legal action, even if remote, is more daunting. Put differently, larger companies may see the legal repercussions of cross-border trade as a low-probability and medium- or low-impact event. In contrast, for a smaller business the impact of a legal case can be devastating even if it is a low probability. As a result, smaller businesses are more likely to differentiate prices or services based on the place of residence of the customer to factor in risks around legal uncertainty, or they may, in some cases, refuse to engage in cross-border trade altogether.

4.3 Supply-related drivers

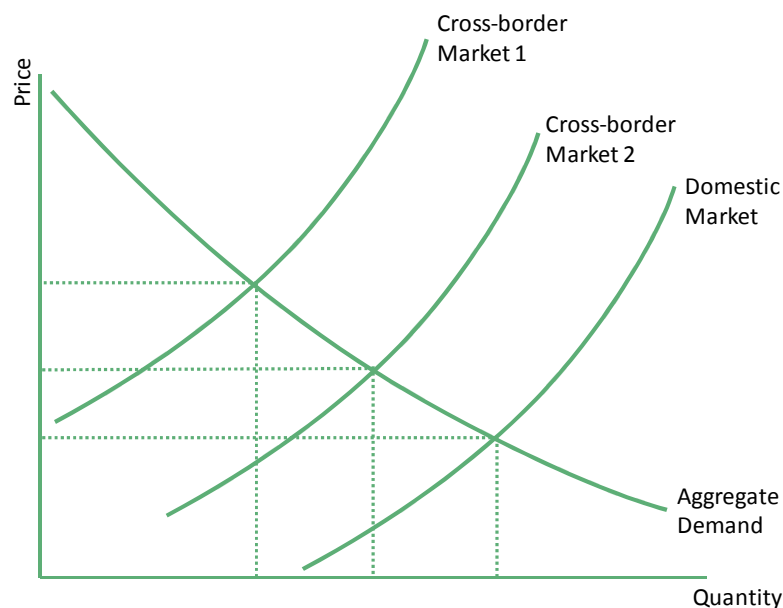
A second set of drivers for price and access differentiation based on the residence of the service recipient relates to the actual supply of the service. If costs associated with producing or delivering the service are country-specific then profit-maximising firms may pass these costs on to customers in these markets. Supply side drivers could affect pricing or access decisions via a number of different channels:

- Costs such as input costs from suppliers, order and payment processing, transport and delivery, or marketing may differ depending on the country where the customer resides, irrespective of the location of the service provider
- Company specific factors, such as corporate structure, licensing and franchising agreements may also lead to territorial price and access differentiation

As in the case of legal and regulatory drivers, in some cases, these factors may lead to differentiation in pricing and services for domestic customers (i.e. residing in the same country as the service provider) and all cross-border customers. In other cases, these drivers could also explain differentiation between cross-border customers from different countries.

The figure below illustrates how supply-side factors may affect prices for customers based in different source markets. Again, the figure is a schematic illustration of a hypothetical situation. A full empirical analysis would be required to determine supply and demand curves in different markets and the quantitative effect on prices or access to services of any supply-side shifts.

Figure 10: Schematic Illustration of the impact of supply side shifts on cross-border price and access to services



As for regulatory drivers, there are different ways in which companies can address supply side differences:

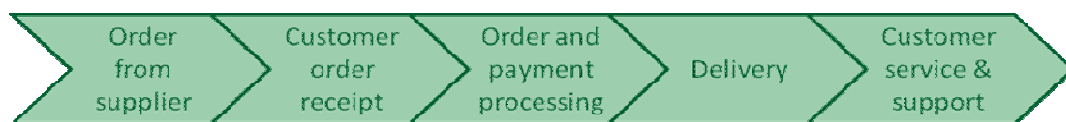
1. compute an aggregate supply curve and establish a single price for all source markets;
2. differentiate between pricing and/or services for domestic customers and customers in other countries;
3. differentiate between different source markets; or
4. decide not to supply to certain or any cross-border source markets.

It should be noted that businesses providing services across a number of Member-States that face the same supply side drivers may make different decisions about which strategy to pursue. As for the regulatory drivers discussed above, corporate strategy will be affected by market considerations such as the potential size of each cross-border market, the nature of the competition in each market, and any regulatory costs associated with the market.

The remainder of this section examines in greater detail the supply side drivers for cross-border price and service differentiation in the sectors covered by this study.

The figure below shows a basic graphic representation of a B2C online retailer's value chain, used here to present the various stages where cost differences may lead to differentiation across some markets. Due to the variety of business models, this very simple visualisation does not apply to all online businesses or to other sectors covered by this study, but it provides the basis for understanding which cost drivers result in a differentiation of prices and services.

Figure 11: Example of a simple online retail value chain



4.3.1 Inputs from suppliers

Starting at the beginning of the value chain, the terms on which a service provider makes services available to the public will be affected by wholesale prices and the terms on which it deals with suppliers of the inputs it needs. Suppliers might face different prices for inputs depending on the place of residence of the end user they are supplying. For instance, an online retailer of music downloads may rely on agreements with record companies and collecting societies to sell music downloads to customers. These agreements might mean that the service provider pays different fees to suppliers when supplying customers in different Member States.

Similarly, these terms might require the service provider not to supply a particular service, or service specification, to some customers. For instance, a service provider might not have the intellectual property rights necessary to supply customers resident in some Member States. In other words, to fully understand drivers of price and service differentiation based on the end user's place of residence, it is necessary to examine source market-based costs imposed by the upstream supplier⁶⁴.

On the whole, most interviewees did not consider input costs as a major driver with the exception of the digital downloads sector. For instance, interviewees in the **online retail** sector generally did not point out any input cost drivers. The cost of ordering goods, which in the case of electronic goods are very often manufactured outside of Europe and often come from the

⁶⁴ In this context it should be noted that the ability of upstream suppliers to impose discriminatory terms on their customers is constrained by EC (e.g. Article 82 on abuse of a dominant position) and national competition law. In addition, vertical distribution agreements between upstream suppliers and retailers are subject to European competition law and in certain cases may be contrary to Article 81 of the Treaty

same suppliers regardless of the end customer's nationality or place of residence, generally has no impact on price or service differentiation. Similarly, interviewees in the **car rental** sector did not point out any particular input costs that would lead to price or service differentiation based on the place of residence of the customer.

However, input costs can be a significant driver of differentiation in the **digital downloads** sector where the cost of licensing through collecting societies is seen as a major input cost.

Licences for digital downloads will often involve more than one right holder (in the case of music, for instance, it would involve normally the rights of authors, performers and producers). Licences may therefore be required from more than one party. There may be a need to obtain a licence from authors or publishers (normally via their collecting societies), from record companies (or the collecting society representing them if they have been mandated to license such rights) and from performers (via the record companies or their collecting societies depending on who holds the rights). Thus, a business offering copyrighted digital content in Europe, regardless of the actual distribution model (streaming or downloads, subscription-, pay-per-use, or advertisement-based) is likely to need to purchase a license from several sources.

Such licensing costs can differ significantly between Member States. For instance, the latest online music license from PRS for Music in the UK stipulates a fee of 8% with a minimum set at £0.04 (approx. €0.045) per work⁶⁵, while the German GEMA license for music work with playing time up to 5 minutes sold online through a Music-on-demand model is set at 15% of the final selling price, with a minimum of €0.1287 per work⁶⁶. This amounts to €150 for 1,000 tracks priced at €1 compared to €80 in the UK, a major cost difference.

Second, the licence will have to take into account the territories where the exploitation is going to take place. In the online case, multi-territorial (in the EU often referred to as pan-European) licences will be needed.

For instance, one interviewee noted that contracting with record labels in Europe to obtain licenses for digital distribution often involves signing a pan-European framework contract, followed by negotiations in individual Member States. These negotiations can result in different costs for the same content from a single label in different countries. This is often a result of record labels constituting different business entities in different Member States, as well as other factors, including expectations formed by previous similar contracts, or other national characteristics.

The consequence of differing input costs can be different prices, different profit margins, or a refusal to deal. Due to the dominance of iTunes in the digital content sector, companies often face a hard price constraint if they want to compete. This, in turn, implies that where obtaining all required licences is too costly, businesses might choose not provide the relevant content to customers. One digital download service interviewed as part of this study pointed out that it

65 [http://www.prsformusic.com/SiteCollectionDocuments/Online and Mobile/Download licence - Scheme Summary-bj30.pdf](http://www.prsformusic.com/SiteCollectionDocuments/Online%20and%20Mobile/Download%20licence%20-%20Scheme%20Summary-bj30.pdf)

66 http://www.gema.de/fileadmin/inhaltsdateien/musiknutzer/tarife/tarife_ind/tarif_vr_od5_e.pdf

does not provide content from Universal Music Group in France because it would not be commercially viable to do so.

Looking at the price comparison tables in the earlier section, it is difficult to draw clear conclusions. Generally higher prices of 'a la carte' downloads in Germany than in the UK suggest that costs of obtaining licenses from German or UK collecting societies may partly explain these differences. Nevertheless, price differences are not fully consistent for full albums, while some subscription services present a reverse pattern, with German subscribers paying less than their UK equivalents.

Whereas the above examples refer to digital music files, similar issues arise in the case of other digital content, such as video, audio books, or e-books, where there are also licenses that have to be obtained to distribute content digitally. While a full investigation of all digital content services was beyond the scope of this particular study, the findings for the music download sector suggest that there would be considerable merit in broader and more in-depth investigation across a wider range of digital content services.

4.3.2 Order and payment processing

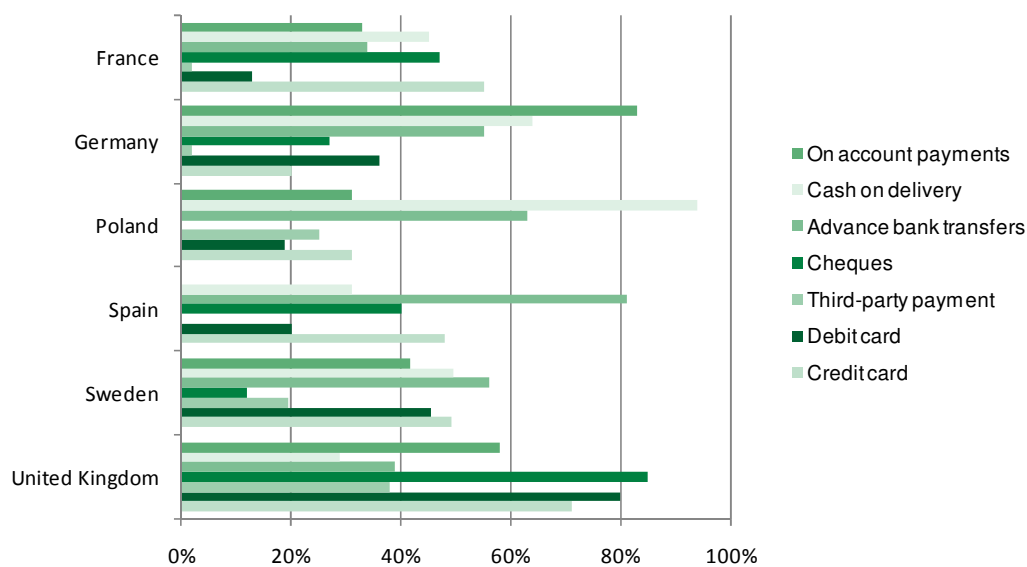
Moving along the value chain presented at the beginning of this section, businesses can incur different costs depending on the place of residence of the customer at the order processing and payment stage. In most cases, this involves higher costs of servicing customers from outside the country where the business is located. Interviewees consulted as part of the fieldwork for this study identified issues such as address verification methods, costs of different forms of payment, and exchange rate fluctuations as key drivers. These are discussed in greater detail in the remainder of this section.

First, **address quality verification** is a very significant issue for online retailers. When receiving orders, it is important for retailers to know whether the shipping address provided by the customer is genuine and entered correctly. The ability to detect and correct errors in addresses (for instance those caused by mistakes when typing) allows to reduce the number of returns, which can be costly for retailers, while the ability to detect addresses that do not exist allows to identify potential instances of fraud. Services that verify address quality, for instance software solutions offered by Experian QAS or Uniserv, generally cover only one or a few countries. For example Uniserv offers "Postal Address Check" service for only 17 Member States⁶⁷. Opening up a retail offering to a new market outside the coverage area of its address quality verification system, implies that the company has to acquire the relevant capability (by purchasing a software solution or investing additional human resources in a manual verification process), which has cost implications, or take additional risk of fraud or increasing number of returns, which can also translate into additional costs.

67 <http://www.uniserv.com/en/products/data-quality-functions-features/address-validation-data-capture.php>

Second, **payment methods** can act as another cost-side driver with a possible effect on differentiation based on the place of residence of the online retailer's end customer. Some stakeholders identified the diversity in preferred payment systems across Europe as an obstacle with significant cost implications. The figure below illustrates the diversity by presenting information from DG Enterprise & Industry's 2007 Sectoral e-Business Watch Survey with regards to payment methods used in different Member States⁶⁸:

Figure 12: Percentage of retailers accepting various payment methods for online orders



Source: European Commission (2007). Sectoral e-Business Watch Survey 2007

The figure above could be a manifestation of a number of different phenomena. It can represent how online retailers operating nationally adapt to consumer preferences regarding payment methods, but it can also be a reflection of retailers' preferences, as well as the national regulation. This picture may change due to ongoing initiatives such as the Payment Services Directive 2007/64/EC⁶⁹ which, following adoption by the Council, will need to be implemented by November 2009 and will constitute the basis for the Single European Payment Area (SEPA) to create a single market for retail payments⁷⁰.

The above figure does nevertheless suggest that an online retailer from France, or the United Kingdom might need to consider offering a 'cash on delivery' payment option in order to compete in the Polish market. Making this choice can in turn result in a number of costs with regards to necessary research into different payment methods, or integrating these methods into existing systems. Even if a retailer offers a sufficiently wide range of payment methods,

68 http://www.ebusiness-watch.org/statistics/table_chart_reports.htm

69 <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:319:0001:01:EN:HTML>

70 Deutsche Bank Research. (2007). E-commerce settles for established payment systems.

these have different costs and risks associated with them. This implies that entering a market where the most popular payment methods are either more costly or riskier could result in potentially higher end-user prices for services in this market.

In the fieldwork interviews for this study, valuable insights regarding payment methods came from a company offering **digital downloads** across a number of European Member States. According to the interviewee, the cost of debit card transactions can amount to up to 15 percent of the final price in the case of single music tracks, considerably more than in the case of credit cards, where transaction costs amount to approximately two percent of the final price.

The structure of card payment costs is complex and warrants a more detailed discussion. The European Commission Interim Report on Payment Cards, part of the Sector Inquiry under Article 17 Regulation 1/2003 on retail banking outlines actors and fees involved in card transactions⁷¹. The three types of fees involved include:

- Account fees (paid by cardholders to the bank/card issuer);
- Interchange fees (charged to retailer's bank by card issuers); and
- Merchant fees (charged to retailers by retailer's banks)

The fees that are directly paid by retailers are the merchant fees, with a large proportion of these fees being the interchange fee passed on to the retailers by their banks, which in turn are set to a large extent by payment card companies⁷². In the case of the above digital download business, the cost stems from high debit card interchange fees, which, unlike credit card fees are more likely to be minimum or lump sum fees, rather than percentage fees, which is why they are seen as high in the case of small transactions, such for single media files⁷³. The consequence of this is that the cost of offering a product in a country where customers are more likely to use their debit cards will be higher than in a country where more transactions are via credit cards. Furthermore, interchange fees can vary by type of debit or credit card, even between different Visa cards issued by the same bank, which can result in further cost differences depending on country of origin⁷⁴.

Faced with high costs of certain types of card payments, businesses can offer a wider range of payments systems across all countries or offer differentiated payment systems depending on the market, where customers from different countries could have a different choice of payment methods. Although this could provide the customer with more choice and potentially reduce the cost of transactions, such solutions are costly and difficult to implement.

Finally, exchange rate fluctuations are another payment related driver. For online businesses, fluctuations in exchange rates can result in perceived price differentiation across currency zones. For example, if a business based in the eurozone offers a service to British customers at price in pounds similar to its euro price, after a major change in exchange rate, it will find itself charging very different prices. It can then change the GBP price, which would be a case of

71 See http://ec.europa.eu/competition/sectors/financial_services/inquiries/interim_report_1.pdf

72 Ibid.

73 Ibid.

74 Ibid.

differentiation (as British customers would see the price fall, while eurozone customers would not), or leave prices unchanged, which in turn would mean that British customers would pay considerably more or less than their eurozone counterparts. Thus, regardless of the business decision, exchange rate fluctuations will most likely result in perceived price differentiation.

4.3.3 Transport and delivery costs

Third, for some services, such as selling electronic goods through a website, supply to service recipients may involve freight costs, such as charges for postal delivery. Even where the service does not directly involve delivery to the customer's place of residence (e.g. car hire), there might be delivery costs for contractual documents and other information distributed to a customer as part of the transaction.

Delivery costs in the **online retail** sector will depend on the delivery method and the distance, so they are likely to vary according to customers' place of residence. This variation is not necessarily large, many carriers (both national postal services and private couriers) price their services according to zones, with the EU generally being in one zone, but some differences do exist. DHL, one of the leading courier services, places a number of EU territories in a separate zone where shipping is more expensive. Examples include Faroe Islands in Denmark, the Campione d'Italia and Livigno regions in Italy, or the British Channel Islands⁷⁵. FedEx, another major carrier, on the other hand, places all the EU12 newer Member States in a different, more expensive, zone than the rest of the EU⁷⁶.

Depending on the business model of the online retailer, however, these differences in shipping costs do not necessarily have an impact on the profit margin. It is also important to note that online retailers often enter into various agreements with one or more providers of shipping services which also has an effect on the shipping costs. It is thus very difficult to draw any definite conclusions regarding actual shipping costs to customers with different places of residence as drivers of service or price differentiation.

Many businesses apply delivery costs on top of the product price and if these fully reflect the shipping costs faced by the retailers, these differences are accounted for. If, however, the retailer was to charge a single shipping fee while being faced with different actual shipping costs, these differences could have an impact on the retailers' profit margin. In certain cases high shipping costs to certain countries could also lead to a refusal to sell to customers in those countries.

There are however other, more indirect, mechanisms, through which shipping goods to different EU Member States can have cost implications. One issue raised by one of the interviewees related to the period of time a package is allowed to remain in a post office in case it is not picked up by the customer. This can vary by more than a week: whereas in Germany a package

75 http://www.dhl.de/dhl?xmlFile=3001057&lang=de_EN

76 http://images.fedex.com/downloads/rates/pdf/2009/GB_EN/FedEx%20International%20Priority%20Export%20service%20GB.pdf

will be returned to sender after 7 working days⁷⁷, in France this period is 15 days⁷⁸. The implication of these differences is that the return period can vary by country, which has business implications for the retailer, mainly in terms of re-stocking and re-shipping of items.

4.3.4 Labour costs

Labour costs are generally not a driver for differentiation, as long as a business with a specific workforce in a specific location or set of locations uses the same staff to provide the service regardless of the customer's place of residence or nationality. For example in the case of car rental, the labour costs of renting a car in a certain location should not change depending on whether the customer has booked the rental from, for example, France or Sweden – the costs of pickup, delivery, maintenance, and staff at the counter remains the same.

Labour costs can however be a driver of differentiation, if providing a service to certain customers involves specific workers with specific skills. For instance, interviewees pointed to the fact that where call centres play a prominent role, staff and labour costs related to providing services in specific languages factor into costs of sales and, eventually, retail prices. This is similar for outbound sales teams, which play different roles in some European markets than in others. For instance, if a company has a weaker presence in particular markets relatively high-cost sales teams can be deployed to attract customers whereas this is not necessary in markets where the company is an established player.

4.3.5 Marketing costs

Some interviewees in the car rental sector also indicated that service providers selling the same service across the EU may tailor their marketing campaigns to customers in different Member States. The cost of attracting and retaining customers may then vary between Member States, and these costs might be reflected in different prices according to the place of residence of customers. For example, there may be large differences between Member States in the costs of TV advertising airtime. An interviewee in the **online retail** sector identified differences in the costs of television and internet advertising as important drivers.

In the **car rental** sector, interviewees highlighted that the mix of distribution channels varies with customer preferences across different source markets and that this can have significant cost implications. For instance, in the UK, use of e-tailers and e-commerce is more widespread than in other countries. One way to approximate this is through the spread of broadband penetration which reaches 60 percent in the UK but remains much below that limit in Spain for example.

4.3.6 Customer support

There may be costs associated with customer support to a service recipient based on the place of residence of the customer. These may originate in activities required before sales (e.g.

77 http://www.dhl.de/dhl?tab=1&skin=hi&check=yes&lang=de_DE&xmlFile=3001524#13321question13348

78 <http://www.coliposte.net/gp/services/main.jsp?m=10006005#question5>

handling queries) or after sales (dealing with complaints, end of life disposal and recycling). These differences might relate to place of residence if elements of support are provided at the location of the customer, rather than remotely, and in the customer's language.

For instance, interviewees in online retail mentioned providing customer support by telephone or email in the language of the customer as a major cost driver. Similarly, an interviewee in the tourism sector noted that businesses operating in Belgium need to translate all brochures and website content into French, Flemish and German. In the online retail sector, this could for example include enclosing instruction manuals in a language relevant to a given market. More generally, one interviewee stated that language is in fact the major cost driver at all points in the value chain.

Other than language issues, interviewees did not point out any other customer support related drivers (e.g. costs of after-sales guarantees) as significant drivers of price or service differentiation.

4.3.7 Company-specific drivers

Besides costs, an important driver on the supply side relates to the **corporate structure** of the firm.

For instance, in the **car rental** sector some companies use a franchising model in some source markets and wholly owned subsidiaries in others. As specified on the Avis website⁷⁹, the company's operations are divided into twelve countries where the company fully owns its operations directly, and licensee regions where it operates through franchising agreements which allow local operators to use the Avis brand without granting the parent company direct control over local operations beyond the franchising agreement.⁸⁰ Often franchisees have significant freedom regarding pricing of services that they provide under the parent company's brand name.⁸¹ The table below illustrates Avis' corporate structure:

Table 21: Avis Europe Structure

| Zone 1 Corporate Countries | Zone 2 Corporate Countries | Licensee regions |
|----------------------------|----------------------------|-------------------------------------|
| France | Austria | Asia |
| Germany | Belgium | Africa and Indian Ocean |
| Italy | Czech Republic | Middle East and Mediterranean |
| Spain | Luxembourg | Scandinavia, Central/Eastern Europe |
| UK | Netherlands | |

⁷⁹ <http://www.avis-europe.com/content-48>

⁸⁰ Franchises are a type of license granted by the parent company. Generally, franchising agreements stipulate which services the licensee can provide but also how these services will be provided. Nevertheless, important elements, such as pricing, may be left to the franchisee to decide. From a legal/regulatory perspective, there are almost no differences between franchising and licensing agreements.

⁸¹ While this discussion focuses on a car rental company (Avis), a similar corporate structure exists in other car rental companies, among some tour operators and in a number of other sectors that are not directly covered by this study.

| Zone 1 Corporate Countries | Zone 2 Corporate Countries | Licensee regions |
|----------------------------|----------------------------|------------------|
| | Portugal | |
| | Switzerland | |
| | Singapore | |

Source: <http://www.avis-europe.com/content-48>

A segmented franchising/licensee structure means that the parent company has more influence on the practices of some of its national subsidiaries than on others. Where a company wholly owns its subsidiaries it can set prices and services centrally. Relations with franchisees on the other hand can rely more on indirect influence. For instance, there could be differences in payment options offered to customers from different markets as a result of technical limitations of the local company website.

While corporate structure may lead to differences in services provided by the same brand across countries, the same also holds at sub-national level in cases where there are different licensee arrangements within one country. For instance 50 percent of the French operations of one of the major operators in Europe are dealt with by sub-licensees outside the direct control of the brand holder which can lead to service and price differentiation within France.

The Avis example shows that many international businesses operating across borders in the Single Market are still organised along national lines and, perhaps as a result, continue to think of their business in terms of national markets. This can partly be attributed to the corporate histories of some of these firms as separate national businesses, and partly to the fact that many economic and regulatory drivers still vary along national borders. Finally, compared to other customer characteristics, the country of residence can be a relatively straightforward way of segmenting markets.⁸² The result of national corporate structure, corporate history and national market segmentation is that companies in some markets continue to differentiate their prices and services based on the place of residence of the end customer.

Outside of car rental, in the **tourism** sector, company specific characteristics are also a possible driver of differentiation. Large tour operators significantly influence the European tourism market because *“their decisions determine which tourist destinations, accommodation and transport companies receive a high percentage of the international tourist demand”*⁸³. This is partly due to the fact that accommodation companies in particular in southern Europe are small and medium-sized enterprises without the resources and capabilities to market their facilities and products directly in international markets.

Generally, bigger operators are in a better negotiating position than smaller ones when dealing with hotels and therefore are able to offer different prices. The table below provides evidence from a 2005 survey of Greek hotels:

⁸² For instance Section 5 of this report discusses different ways of using online tools to engage in national market segmentation in online business models.

⁸³ Medina-Munoz, R. D., Medina-Munoz, D. R. and Garcia-Falcon, J. M. (2003). Understanding European tour operators' control on accommodation companies: an empirical evidence.

Table 22: Impact of tour operators on hotels in 2004

| Tour operator the hotels are working with | Average room occupancy (2004) | Average room rate charged to tour operators (2004) | Average room rate charged to individual guests and travel agencies (2004) | Average room rate discount applied by hotels to tour operators |
|---|-------------------------------|--|---|--|
| TUI | 71.5% | EUR 70.00 | EUR 92.70 | 25.3% |
| Thomas Cook | 74.0% | EUR 54.92 | EUR 74.33 | 25.7% |
| REWE | 76.3% | EUR 50.73 | EUR 71.18 | 29.0% |
| MyTravel ⁸⁴ | 76.7% | EUR 66.89 | EUR 89.75 | 18.9% |

Source: Koutoulas, D. (2006), The Market Influence of Tour Operators on the Hospitality Industry. In: Papatheodorou, A. *Corporate Rivalry and Market Power. Competition Issues in the Tourism Industry*

The above table shows prices and discounts that tour operators obtained from individual hotels, with REWE group operators obtaining on average the highest discount, and MyTravel the lowest. If the national subsidiaries of the different tour operators above negotiate separate rate deals with hotels and/or if they focus on different types of holidays or destinations, then these differences will be passed on to customers in the different markets where the customer is based. There is evidence that tour operators focus on specific source markets when designing holiday packages, as shown in the table below:

Table 23: Tour operators' source markets

| Tour operator | Source Market |
|------------------------|--|
| TUI | Germany, UK, France, Austria, Netherlands, Belgium, Nordic countries, Poland |
| Thomas Cook | Germany, Netherlands, UK, Belgium, Austria, Hungary, France |
| Rewe | Germany, Austria |
| MyTravel ⁸⁵ | UK, Nordic countries, |
| Alltours | Germany |

Source: Koutoulas, D. (2006), The Market Influence of Tour Operators on the Hospitality Industry. In: Papatheodorou, A. *Corporate Rivalry and Market Power. Competition Issues in the Tourism Industry*

In addition, tour operators act as separate entities in different countries (e.g. TUI UK, which operates under the name Thomson, TUI Germany, or TUI Belgium, which uses the name Jetair) and they negotiate individual contracts with hotels at typical holiday destinations for the specific group of customers in their source market. Customers in the source markets of large national tour operators should therefore be more likely to benefit from good deals than customers in other countries, even if they use their local branch of the same company (of course in all cases where access to national website is not restricted - see section 3 above – customers in small countries would be able to shop abroad and receive services from national branches in other countries).

⁸⁴ Thomas Cook AG and MyTravel merged in early 2007. http://business.timesonline.co.uk/tol/business/industry_sectors/leisure/article1370591.ece

⁸⁵ Thomas Cook AG and MyTravel merged in early 2007. http://business.timesonline.co.uk/tol/business/industry_sectors/leisure/article1370591.ece

Examining the structure of some tour operators in more detail, the segmentation into different markets becomes clear. For instance, in its annual report, TUI segments its operations into three regions: Northern (UK, Ireland, Scandinavia, and Canada), Central Europe (Germany, Switzerland, Austria, and Eastern Europe), and Western Europe (France, Belgium, and the Netherlands)⁸⁶. The company then reports underlying profit margins for these three regions, which differ significantly, as shown in the table below:

Table 24: TUI operating margins by region

| Region | Underlying operating margin % 2008 | Underlying operating margin % 2007 | Change % |
|-----------------|------------------------------------|------------------------------------|-------------------------|
| Northern Region | 4.1% | 2.2% | 190 basis points |
| Central Europe | 1.3% | 1.0% | 30 basis points |
| Western Europe | 1.4% | 0.3% | 110 basis points |
| Total | 2.3% | 1.3% | 100 basis points |

Source: TUI Travel PLC. (2008). *Annual Report & Accounts 2008*.

Geographical reporting in Annual Reports suggests that business decisions are based on performance in the three regions, which in turn could result in price and service differentiation depending on the region where the customer resides.⁸⁷

A final firm-related driver of differentiation identified during the fieldwork interviews relates to the tour operator’s choice of contract when booking hotel rooms. A ‘guarantee contract’ obliges the operator to pay for all booked rooms, while under an ‘allotment contract’ a certain quantity of rooms is pre-booked, but the booking can be cancelled and the hotel can sell the rooms to other customers. The former type of contract is usually associated with a higher discount than the latter, but also has a higher risk attached to it. The decision to sign a certain kind of contract, based for instance on how risk averse the operator is, could result in different costs. If this decision is also associated with the source market of the operator and cost differences are passed on to consumers, the choice of contract can result in price or service differentiation.

4.4 Demand-related drivers and source market pricing techniques

The third set of drivers for geographically defined price and access differentiation based on the residence of the service recipient relates to demand for the service. If demand conditions for a service vary according to geographical criteria then companies may want to differentiate their services or prices to respond to customer preferences or competition in these markets. Demand side drivers could affect pricing or services in different geographical source markets via two main channels:

⁸⁶ TUI Travel PLC. (2008). *Annual Report & Accounts 2008*.

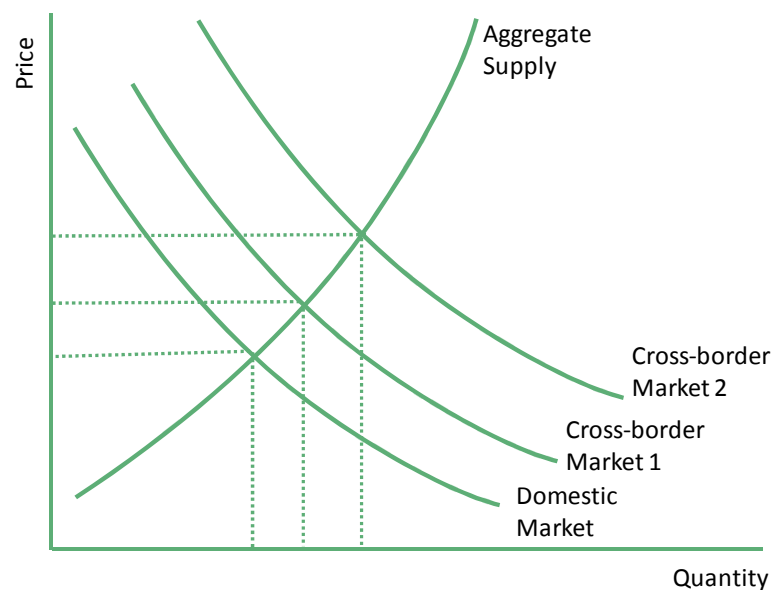
⁸⁷ It is worth noting here, that unlike Avis, TUI uses a more regional approach to structuring its business, with more focus on country groups. Nevertheless, the fact that the company uses different brands within a single region (i.e. TUI in France and Jetair in Belgium), suggests that the focus on national markets is nevertheless very strong.

- competition; and
- customers' willingness to pay.

As for legal and regulatory drivers, in some cases, these factors may lead to differentiation in pricing or services between customers (i.e. residing in the same country as the service provider) and all cross-border customers. In other cases, these drivers could also explain differentiation between cross-border customers from different countries.

The figure below has an illustration of how demand-side factors may affect prices for customers based in different source markets. Again, the figure is a schematic illustration of a hypothetical situation. It depicts a trader operating across three Member States and being faced by three different demand curves, which, from an economic perspective, would imply that there are three different equilibrium price levels, one for each of the markets. This is however only a schematic picture. A full empirical analysis would be required to determine supply and demand curves in different markets and the effect on prices or services of any demand-side shifts.

Figure 13: Schematic Illustration of the impact of demand side shifts on cross-border price and access to services



As for other types of drivers, there are different ways in which companies can address demand side differences such as those depicted above:

1. Compute an aggregate demand curve and establish a single price/service for all source markets
2. Differentiate between pricing and/or services for domestic customers and customers in other countries.
3. Differentiate between different source markets
4. Decide not to supply to certain or any cross-border source markets

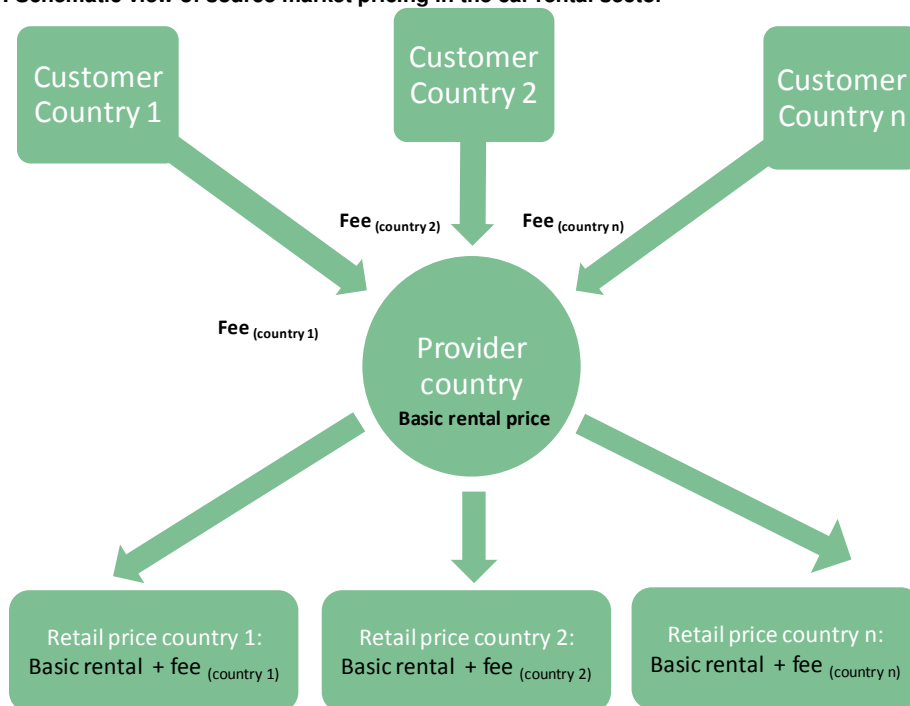
It should be noted that two firms facing the same demand side drivers may make different decisions about which strategy to pursue. Corporate strategy will be affected at the same time by supply and regulatory considerations such as delivery and payment processing costs, intellectual property rights or any regulatory costs associated with the source market.

4.4.1 Source Market Pricing

The car rental sector provides a good example of how in practice demand-side considerations are factored into the pricing and services provision decisions. **Source market pricing (SMP)** refers to the practice of charging customers a country-specific fee (or applying a country specific discount) for the service provided, on top of the basic rental fee which does not vary across countries. The fee structure differs depending on the country of residence of the customer rather than the country of service provision⁸⁸.

In other words, source market pricing leads to observable price differences for equivalent services across customer groups from different countries of origin. From an economic perspective, source market pricing is a tool for companies to balance demand and supply for services in cross-border transactions. It does not imply that price differences across source markets are permanent (e.g. prices can change daily in the car rental sector and hotel bookings; price changes are less frequent for online sales of goods). In the car rental sector customers from some countries might pay more at certain times and less at others depending on the market conditions at the time of booking. The figure below illustrates the concept of source market pricing in car rental:

Figure 14: Schematic view of source market pricing in the car rental sector



⁸⁸ In addition to car rental, the concept of SMP could inform pricing in various sectors that are highly price sensitive and where the origin of customers affects demand for a service to be provided in a different country. There was however no evidence of a similar system operating in any of the other sectors covered by this study.

As the discussion above makes clear, the precondition for source market pricing to occur is the existence of separate markets within a company's sphere of operations. As competition economics shows, defining market boundaries can be very difficult. For instance, separate markets in car rental could be defined by differences in the degree or conditions of competition between companies or different revealed preferences across clearly identifiable customer groups (e.g. average length of rental, average rental price, preferred car type, etc.).

In the case of the car rental sector, in most cases, source markets have been defined along national borders thus leading to different prices for customers from different Member States. As mentioned earlier, national structures could be linked to corporate history, as well as to regulatory drivers, which are still largely national, for example car registration requirements. Furthermore, it can be argued that where there are business reasons to differentiate between customers, doing this on grounds of place of residence is easier to implement. Online implementation of differentiation will be discussed in more detail in the following chapter.

It should be noted that for the car rental sector, the discussion of source market pricing refers exclusively to direct retail deals – not deals through brokers (e.g. Expedia, Opodo) or partnerships (e.g. airlines such as Ryanair or Easyjet). For instance, low-cost airlines do not usually engage in source market pricing and car rental deals in association with airlines usually also do not differentiate between source markets even when the car rental company does engage in source market pricing in its direct online operations through its own website.

The reason for car rental companies to forego source market pricing in such wholesale partnership agreements might be that the companies face less competitive pressure in these situations and they have a more captive audience in airline passengers through their exclusive deals with individual carriers. Pricing through brokers is based either on a commission-type deal where the broker pays the car rental company a fee for every rental but pricing power remains with the car rental company or it is based on a "net rate" type of arrangement where the car rental company agrees a flat rate with the broker who then sells the service on at their own price.

The remainder of this section examines in detail the key demand-side drivers which are taken into account in source market pricing:

4.4.2 Competition

Competition in different source markets was identified by most interviewees as an important driver of price or service differentiation depending on customers' place of residence. In the online retail sector, competition is the key demand-side factor, which determines what product and at what prices a business will offer its services in the given market. Similarly, in the car rental sector, competition is primarily in terms of price and as a result of such pressure, prices change rapidly in response to the behaviour of the competition and other market considerations. The need to be competitive in multiple European markets is the key reason why most

interviewees across all sectors dismiss the idea of uniform pricing across the EU as not viable for business.

If a service provider operates in a competitive environment, the price it can charge will be constrained by the threat of losing market share to rivals. There might be differences in the competitive constraints faced by a service provider when supplying different customer groups, including groups defined by their place of residence. When there are no active competitors in the market, the service provider might still be constrained by a threat of new entry, namely the risk that higher prices would create an opportunity for a new supplier to enter the market and reduce the provider's market share.

The importance of the nature of competition is clearly illustrated by differences in practices of car rental companies in online and offline transactions. Online, car rental companies compete against one another in different source markets. In other words, their pricing and the services that they offer are geared to attract customers based in different places of residence with a common destination. As described above, the industry has responded to this with a sophisticated form of source market pricing. At the car rental desk, however, the country of origin of the customer is irrelevant for competition purposes. Customers at the desk will rent a car from one of the service providers on site and competition takes place between companies at adjacent desks based purely on supply and demand factors at the time of rental.

However, differences in the nature of competition would not, by themselves, explain why a service provider decides to differentiate pricing or services based on geographically defined source markets. As mentioned at the beginning of this section, other aspects such as the nature of the firm as a price-maker or price-taker need to be considered. For instance, companies with significant pricing power in their source markets (i.e. price makers) can raise their prices locally without facing a significant drop in demand for their services. As a result these firms are in a position to engage in price differentiation in cross-border transactions. Conversely, firms without pricing power in their source markets (i.e. price takers) would see significant drops in demand even for marginal price rises. Finally, firms can be price takers in some source markets and price makers in other source markets. In this situation, the company can compensate for low prices in certain markets by charging higher prices in markets where it has more pricing power.

Similar considerations apply to the digital downloads sector, with the need to be competitive manifesting itself especially in music downloads. Due to the dominance of the Apple iTunes service, other businesses have to adjust their prices in accordance with iTunes. Firms thus find themselves in a 'price-taking' environment, where raising prices would lead customers to switch to a cheaper competitor. With the option of charging higher prices not available, companies respond to differing costs described by refusing to sell in certain markets. For instance, if licensing costs make it impossible for firms to maintain a sufficient profit margin without losing business to iTunes or to another service, they may decide to withdraw from countries with the highest licensing costs.

One of the key differences between the digital downloads sector and, for instance, car rental is that car rental companies can respond to different regulatory, supply and demand-side drivers

by adjusting their prices whereas digital download businesses face a harder price constraint. As a result, digital download companies tend to be more selective than companies in other sectors in the number of markets that they enter.

4.4.3 Market Share

In the case of car rental, **market shares** in different source markets differ substantially among the large European car rental companies. Whereas Sixt is the leading provider in Germany, Avis has a much greater market share in France and, as one interviewee pointed out this places pressure on both companies to price their products so as to attract customers in the markets where they have a lower share. Similarly, in the UK, a large share of car rental business is carried by online brokers such as travelsupermarket.com which operate only nationally. Where national intermediaries such as online agents and brokers control a larger share of the market, they can strike better deals on rental rates with individual providers in that source market. Differences in market shares and in the presence of intermediaries therefore can result in differentiation in pricing and services across source markets.

Looking back at the prima facie evidence of price differentiation at the beginning of this report, differences in car rental prices do mirror market shares to some extent. Avis Europe, for example, obtains a larger share of revenue from France, Germany, or Italy, than it does from the UK⁸⁹ and lower prices for customers from the UK could reflect this fact. German customers are however faced with a higher price than French customers despite the fact that Avis has a stronger position in France, so clearly other factors also influence pricing.

4.4.4 Willingness to pay

Willingness to pay is another key driver for differentiation. The economic literature on price discrimination (see Appendix 3) shows that, if a supplier can segment customers into different customer groups, it may be more profitable to charge different prices to each group, rather than a uniform price, even if the costs of supplying them are the same. This applies where there are differences between customer groups in terms of how much demand the group has for a service at a given price and the way in which the group's demand changes in response to price changes. A textbook example is prices for rail tickets, which may provide discounts for customer groups deemed more price sensitive, such as senior citizens.

If there are differences in customers' willingness to pay for a service that are correlated with place of residence or nationality, a service provider may make a greater profit if it charges prices that differ according to the place of residence or nationality. Correlations between willingness to pay and place of residence or nationality might be due, for example, to **seasonality**. In the car rental sector, for instance, differences in holiday patterns across the EU could lead to demand outstripping supply in certain markets at certain times. This could be addressed by temporarily charging higher prices to customers in the higher-demand markets through source market

89 <http://www.avis-europe.com/content-49>

pricing. Some tour operators also confirmed that they take into account the public holidays and holiday seasons of a given Member State in their pricing decisions.

Differences in willingness to pay might also lead to situations where there is a refusal to sell to particular customer groups based on their place of residence or nationality because supply would be unprofitable at any price. This might occur in circumstances where a supplier would incur specific costs related to supplying that customer group (e.g. the need for hands-on customer support at the location of the customer) or where expected revenues from supplying that customer group are not sufficient to cover costs. For instance, there might not be a market at any price for a particular type of folk music from one Member State in another Member State. Similarly, there might not be a viable market for supplying customer support to remote locations without online access. In most cases, however, as discussed above additional costs to supply customers resident in one Member State will lead to higher prices to be offered to those customers, without justifying a policy of not supplying them at all.

4.5 Conclusions

This section has identified three broad categories of economic drivers for price and service differentiation based on the place of residence of customers:

- Legal/regulatory drivers
- Supply-related drivers
- Demand-related drivers

For each category, the report has provided specific examples based on company interviews that show how these drivers can lead to different costs and opportunities for service providers and how they can influence corporate strategies for pricing and service provision.

The report has identified four responses to the economic and regulatory drivers described in this section, each leading to different consumer outcomes. In each case, companies can either:

1. Compute an average price across all source markets
2. Differentiate between domestic and cross-border source markets
3. Differentiate between all source markets
4. Refrain from entering some source markets with a like-for-like service

A very important point to come out of the analysis in this section is that the different categories of drivers interact to offset or reinforce one another in terms of the consumer outcomes that they produce. In other words, the same consumer outcomes in terms of pricing and service provision can be due to different economic drivers and the same drivers for differentiation may lead to different consumer outcomes.

An analysis of the extent to which individual drivers at firm, sector or national level influence actual observed consumer outcomes therefore might require an empirical analysis, using a number of variables to capture firm, sector, and national-level drivers. The potential impact of

each relevant driver on consumer outcomes would need to be valued and considered in combination with the other drivers. Such an analysis is beyond the scope of this study.

From the perspective of Article 20 (2) of the Services Directive it is important to assess whether different conditions applied by businesses in different Member States constitute discrimination based on the place of residence (or the nationality) of the customer. In order to do so it is important to determine whether and to what extent companies seek to implement the differentiations by restricting or preventing the customer access to services provided in other Member States or from other national websites. This is done in the next section of the report.

5.0 Implementation of differentiation

Previous sections of this report have identified a number of drivers of price and service differentiation, while the sectoral overview earlier in the report presented the evidence of differentiation in the four sectors covered by this study: car rental, digital downloads, online sale of electronic goods, and tourism. In terms of Article 20 (2) of the Service Directive, however, it is important to supplement information pertaining to evidence of differentiation and underlying drivers with an understanding of how differentiation is implemented in different sectors and by individual firms.

This section provides a more detailed discussion of implementation methods and presents a typology of implementation methods from the perspective of the consumer. The final part of this chapter will briefly touch upon the issue of implementing forms of differentiation other than those based on the country of residence.

5.1 Implementation offline

Only two of the sectors covered by the study have an offline component: car rental and tourism with the offline component being particularly significant in the case of tour operators.

Limited amount of information could be collected about whether and how differentiation is implemented offline. However, interviews indicated that in the case of car rental, prices at the counter were the same for all customers and there was no evidence of different prices when residents of different countries performed bookings at a hotel or in a brick-and-mortar travel agency or tour operator office.

Partly, this is due to the fact that, in order to engage in differentiation offline, the trader would need to be able to determine the place of residence or nationality of the potential customer. Offline, this can only be done by asking the customer directly about their place of residence prior to quoting prices.

Generally, there appears to be very little or no offline price or service differentiation and, effectively, customers at a car rental counter, at a hotel, or in a brick –and-mortar travel agency/tour operator, are treated the same irrespective of their place of residence.

5.2 Implementation online

As opposed to offline differentiation, much more evidence of online differentiation was identified across all four sectors, with a number of different methods available to identify the country of residence (there is no evidence of that being the case for nationality) of the customers. This section will discuss the different techniques and provide a framework for classifying differentiation according to how it is implemented. It is important to note that some of these

techniques are also used to identify customers even though no obvious differentiation in price or service takes place.

The sections below outline the key methods traders can use to differentiate between customers based on their country of residence. These include:

- automatic geolocation techniques;
- country-specific websites;
- self-identification; and
- terms and conditions,

It is important to note that these techniques are nearly never used in isolation and in practice traders will most likely use a combination of them.

5.2.1 Automatic geolocation techniques

The sectoral overview at the beginning of this report outlined a number of instances where the customer’s place of residence was automatically detected by the trader’s website. This can be done through a process known as geolocation, an umbrella term covering a number of techniques used to, with varying degree of accuracy, automatically identify the geographic location of customer’s machine on the internet. Muir and van Oorschot (2006) present an overview of the main geolocation methods⁹⁰:

Table 25: Overview of internet geolocation approaches

| Category | Approach |
|---|---|
| Information intentionally registered in databases | <i>whois</i> look-up by IP address |
| | <i>whois</i> look-up by Autonomous System |
| | <i>whois</i> look-up by domain name |
| | DNS LOC records |
| Information leaked | geographic codes in domain name |
| | user- or application-submitted information |
| Network routing and/or timing information ⁹¹ | approximation through round-trip times using <i>ping</i> |
| | inference based on routing data; e.g., BGP or <i>traceroute</i> |
| | reconnaissance of ISP networks |

Source: Muir, J. A. and van Oorschot, P. C. (2006) Internet Geolocation and Evasion

The detailed technical explanation of each of these approaches is beyond the scope of this study, it is however worthwhile to quickly describe the simplest and most common approach,

⁹⁰ See www.ccsf.carleton.ca/~jamuir/papers/TR-06-05.pdf

⁹¹ This refers to methods allowing to deduce location by tracing packets of data or tracing the geography of a network. Ping command allows to send echo message to a host, while traceroute command allows to trace a packet of data and deduce location from hosts near the target. Reconnaissance of ISP networks refers to deducing location using network topology data obtained from the Internet Service Provider (ISP).

namely IP look-up using the *whois* database. The Internet Protocol (or IP) address is a string of numbers which identifies a particular device on a network, while a *whois* database is a mapping of identifiers, such as IP addresses, and “real-world entities”⁹². Automatically looking up the IP address in the database allows to match the IP address to the contact details of the organisation or individual to whom it is registered, for instance an Internet Service Provider (ISP). Knowing a user’s ISP allows to determine in which country it is located, which in turn allows to infer the location of the user.

Geolocation was originally used to target advertising to specific customers, but the technology now also serves a number other purposes. Svantesson (2004) argues that geolocation allows the owner of the website to comply with local or national regulations by restricting access from territories governed by regulation with which the website content does not comply (or from territories where the trader do not intend to sell). Another example is that of allowing streaming video of sporting events to comply with television rights in a given country⁹³. In the area of electronic retail, geolocation data can also be used to combat fraud, for example through singling out instances where there is a large distance between the location of a network connection and the shipping address for the order.

In the context of this discussion, geolocation can be used in a number of ways to implement differentiation according to place of residence of the customer. One, “hard” approach is to automatically redirect customers to a website destined for their country of residence while restricting access to resources destined to customers of a specific country (i.e. French customers would be redirected to a .fr domain when accessing a .com domain and could not access either the .com or, for example, .it domain manually). Examples of such an approach include the Dell Download Store, where national websites are not accessible from outside the country in question. A “softer” approach might still involve redirection, but would allow the other national services to be accessed (i.e. this is the case with iTunes).

Geolocation can also be used in other ways, by for instance automatically selecting the country of residence in a drop-down menu on a website based on IP address (i.e. in the case of Sixt). Another approach is the use of geolocation to suggest that the customer accesses the website targeted to the country where they are located (i.e. Amazon, 7digital), to display prices in the local currency (i.e. Ibis hotel), or to display messages explaining whether certain services are available in the country from which the website is being accessed (i.e. Amazon MP3), which can be then ‘enforced’ at the point of registration or purchase by asking for the customer’s address.

Technically, the IP address-based techniques are not impossible to circumvent.⁹⁴ However, using such approaches is both slow and costly (dial-up), relatively complex for an average user (proxy), or it requires a remote device. Moreover, in certain cases, circumventing restrictions to access may expose customers to breach of contract terms.

92 Ibid.

93 See: http://epublications.bond.edu.au/law_pubs/63/

94 Muir and van Oorschot present some of the methods for doing so: - Using a long distance dial-up, where user can call an access number in another territory; - using a proxy, an intermediary program between the user and the server, which accesses the website on the user’s behalf, but the website server will only record the IP address of the proxy; and - using a remote device, where the browser is accessed remotely and the IP address recorded is that of the remote device. See: www.ccsf.carleton.ca/~jamuir/papers/TR-06-05.pdf.

5.2.2 Country-specific websites

Another common method of implementing differentiation is the use of country-specific websites. These often accompany a central website (often with a .com domain), which, for US-based businesses usually is the US-market website (i.e. Amazon, Avis). Country-specific websites are commonly used among electronic retailers, and there are studies highlighting the importance of websites adapting to and mirroring the culture (over and above only language) of the consumers they are trying to target, although from the businesses standpoint there are also arguments for standardisation, which reduces costs and can potentially strengthen the company's brand image⁹⁵.

Country-specific websites surveyed as part of this study use both adaptation, as well as standardisation approaches. Most car rental websites, for example, tend to be simply different language and currency versions of the central website. Similarly, parallel national websites of a number of online retailers and digital content distributors have same or similar design, but different language and offers (i.e. Amazon, Pixmania, 7digital). On the other hand, tour operators' country-specific websites tend to conform more to the adaptation approach, with different designs and branding, which can be attributed to the fact that the national subsidiaries of large pan-European tour operators often operate as separate businesses, sometimes under a different name.

If national websites are used to engage in differentiation, the way they are accessed is very important, since that determines to what extent customers from certain countries can be informed of prices and offers targeted at other countries or benefit from them. As mentioned above, in some cases there is an IP-based redirection, which can be considered the 'hard approach'. In other cases, national websites can be accessed from links on the central website, with some traders using a central website only as a gateway to country-specific sites (i.e. Opodo). Country-specific websites can also often be accessed directly, by typing in the URL containing the correct country domain name (i.e. ".it" or ".co.uk") or using a search engine.

Accessing a country-specific websites does not automatically imply that users are considered residents of that country and that it is possible for them to gain access to the prices and products and services offered on the website. National websites may still require self-identification, discussed below, by asking for the country of residence (e.g. Hertz), by specifying terms and conditions with variations based on the place of residence of the customer, or by asking for the customer's country of residence as part of the registration or purchasing process. For instance in the case of 7digital, an online mp3 download service, registration at a country-specific website (required to purchase files) does not allow to select a different country of residence than the one for which the website is intended. Thus, even when national websites are accessible, it is often not possible to purchase goods or services without providing false information.

⁹⁵ For a discussion of country-specific websites and cultural adaptation see Sinkovics, R. R., Yamin, M. and Hossinger M. (2007). Cultural Adaptation in Cross Border E-commerce: A study of German Companies. Journal of Electronic Commerce Research. Retrieved from <http://www.csulb.edu/journals/jecr/issues/20074/paper2.pdf>

5.2.3 Self-identification

Self-identification is another way of implementing differentiation according to place of residence. It includes asking customers about their place of residence through menus on the homepage, (e.g. used by car rental companies) but it also includes questions asked when registering for an account (necessary to make most online transactions) or completing the purchase, which in most cases involves asking the customer to specify their place of residence. In the former case, self-identification can be used to provide customers with targeted offers and prices or direct them to a country-specific website, while in the latter it is a method of restricting customers from using a service not targeted to their country. One example is to not allow customers to enter any other country than the one a given website is destined for, which is used on some country-specific digital downloads websites (i.e. 7digital),

Customers can circumvent self-identification by providing false information about their country of residence but this could put the customer in breach of the terms and conditions and/or it might make it impossible for the customer to complete transactions where a match between billing and shipping addresses is required.

5.2.4 Terms and conditions

Terms and conditions are another method of implementing differentiation often used in conjunction with country-specific websites. By specifying which customers can use the service (i.e. Pixmania), and asking them to access country-specific websites, traders can make sure that the customers are provided with prices and offers targeted at their country. Terms and conditions can be easily disregarded, but in order to complete a transaction, a customer would often also need to provide false information at the self-identification stage, which in turn could cause problems when compared to the debit or credit card billing address.

As can be seen in the above section, the tools for implementation are often used in conjunction with each other. Car rental companies, for example, tend to combine central websites with country-specific websites, self-identification, and geolocation methods, while some digital download shops use IP address-based messages together with national websites and terms and conditions to implement differentiation. The way in which these methods are used and the extent to which they are “hard” or “soft” affords different outcomes (conditions of access, pricing, information) to consumers.

5.3 Implementation practices and consumer outcomes

The implementation practices outlined above can result in consumers having different amount of information about services on offer and different levels of freedom to choose between services offered to customers in other Member States. As described in the previous sections, differentiation is usually implemented by combining a number of different practices. The table below provides an overview of some consumer outcomes and the associated practices for implementing either price or service differentiation:

Table 26: Practices used to implement price/service differentiation and consumer outcome

| Consumer outcome | Practices | Examples |
|--|---|---|
| <ul style="list-style-type: none"> • No information about prices/service offered to other MS • No ability to access cross-border services (i.e. refusal to sell) | <ul style="list-style-type: none"> • National websites • IP address-based redirection • IP address-based restricted access to national websites | <ul style="list-style-type: none"> • Dell Download Store |
| <ul style="list-style-type: none"> • Access to information about prices/service offered to other MS • No ability to access cross-border services (i.e. refusal to sell) • Price differentiation | <ul style="list-style-type: none"> • Accessible national websites • IP address-based redirection • Self-identification • Terms and conditions | <ul style="list-style-type: none"> • Avis, Hertz, Europcar • 7digital, iTunes • Pixmania |
| <ul style="list-style-type: none"> • Access to information about prices/service offered to other MS • Full access to cross-border services • Limited price differentiation | <ul style="list-style-type: none"> • Single central website • Accessible national websites | <ul style="list-style-type: none"> • Amazon, most tour operators and hotels • Deezer, We7 |

The table shows that the various implementation practices can result in three broad categories of outcomes for the consumer.

The first outcome is one where the consumer not only cannot access the prices and services targeted to a specific country (i.e. obtain lower rental price, download files, purchase goods), but also cannot even see what is on offer and at what price. This usually involves a form of “hard” redirection and access restriction to national websites or services. In the case of digital download services that use a software rather than web interface, or a web interface other than an online shop (i.e. Spotify, eMusic) one can argue that this can also be the case, since one usually needs to register to download the software or access the web interface, which in turn requires self-identification. Nevertheless, whereas the range of downloads offered might be unknown, services such as Spotify or eMusic do usually display their prices.

The second type of possible consumer outcome is the situation where prices and offers can be viewed, but not accessed. This often involves accessible country-specific websites, but with terms and conditions and self-identification restricting potential customers from obtaining products or prices not destined for their country of residence. This is the case for online retail firms, most car rental firms (although to view differences in prices customers need to falsely self-identify), and a number of digital download shops.

The final consumer outcome is one where consumers can not only see what prices and products or services are offered in other countries, but can also access them. This is the case for tourism, as well as some online retailers, such as Amazon (excluding the MP3 service). In this situation, practices such as using national websites, self-identification, and IP address are also often in place, but they place no explicit restriction on customers. For example, the French Amazon website suggests, through geolocation, that British shoppers use the British website, but doesn't restrict them from purchasing goods from the French site.

The category not discussed above is one where there is no explicit differentiation in the prices and conditions at which a service is offered throughout the EU, such as in the case of a few car rental companies which do not engage in source market pricing. This however does not mean that the various practices described above are not used. Although easyCar only appears to have a central website with a language selection, Sixt uses both country-specific websites, self identification (customers are asked for place of residence), as well as geolocation (place of residence is selected automatically). This in turn implies that even if there is no prima facie evidence of price differentiation at the moment, firms might still in some cases possess the necessary tools to easily implement it. Indeed, prima facie evidence in Section 3 has shown that Sixt does practice a limited amount of service differentiation with customers from the Polish source market being offered different payment options than customers from France, Germany, Italy or the UK (see Section 3).

Finally, it is important to keep in mind that the above discussion has focused on explicit online practices and their outcomes. Geolocation allows firms to engage in less explicit differentiation in prices or services, for example by displaying different prices and products on a country-specific website if it is accessed from abroad without any clear indication that this is being done. Although such practices would be possible to identify, it is unlikely that an average consumer would be able to do so. The implications of this and other different implementation practices for the Article 20 (2) of the Services Directive will be discussed in the next section of this report.

5.4 Implementing differentiation based on factors other than country of residence

A common thread throughout the section focusing on drivers of differentiation is the fact that many businesses operating across Europe and internationally remain organised on a national basis. This can be traced to the historical legacies of these companies, as well as to the fact that the regulatory and legal framework in which they operate still maintains some national characteristics. Nevertheless, not all of the drivers for differentiation presented in the section above operate on a fully national level. Competition and willingness to pay may differ between urban and rural areas, or between regions of countries, while seasonality is also not fully national, with school holidays in a number of countries starting at different times on a regional basis. In order to contribute to the above debate, one should thus ask if differentiation on a basis other than country of residence could be implemented by the businesses to address these drivers.

Looking through the different implementation tools, it appears that differentiating at lower levels of aggregation than the customer's country of residence can present difficulties for companies. As Muir and van Oorschot point out, IP-based geolocation solutions are not accurate enough at a sub-country level. For instance, current technology might geolocate a device within a radius of several hundred kilometres, which would correspond to a user in Ottawa (Canada) being linked to a physical address in Toronto, 450 kilometres away⁹⁶.

While separate websites for regions or cities could be an option to improve accuracy of targeting customers at sub-national levels but development of city-specific websites can be costly, especially for businesses which operate across several countries. In addition, users might find it difficult to determine which website they should access. For instance, users in an area around a large city may think of themselves as living in the city, although the business may prefer to classify them as non-urban customers.

One of the few examples of using city-specific websites in e-commerce are classifieds websites, such as Gumtree or Craigslist, which have city-specific sites for their main market and abroad (in the case of Gumtree this is mainly the UK, with some coverage of cities in Poland, Australia, South Africa, New Zealand, Hong Kong, and Singapore). These websites rely on the geographical proximity of their users because they tend to target landlords and tenants, buyers and sellers, or employers and jobseekers, which is different from companies in the sectors covered by this study where the motivation behind geolocation lies primarily in segmenting the customer base. However, where businesses use advertising to generate revenue, sub-national (e.g. city-specific) websites might allow better targeting of ads.

The above discussion suggests that differentiation based on factors other than country of residence can be difficult to implement. This in turn implies that when examining different forms of differentiation one must consider whether segmenting the consumer base by country is a response to drivers that operate on national level, or whether it is used as a 'second-best' option to address drivers that might operate on a sub-national or regional level.

96 www.ccsf.carleton.ca/~jamuir/papers/TR-06-05.pdf

6.0 Conclusions and implications

The key objective of the study was to provide a high-level overview of drivers behind price and service differentiation. This report does not aim to establish whether the drivers identified are “objective” in the sense of Article 20 (2) of the Services Directive and to what extent they might or might not “justify” observed price and access differentiation by place of residence of the customer. A detailed legal analysis would be required to make such an assessment on a case-by-case basis.

The focus throughout the study has been on business-to-consumer (B2C) transactions, where prices and tariffs are publicly available. As a result, it is important to keep in mind that the findings and recommendations below are targeted specifically to such B2C transactions even though business-to-business transactions (B2B) are also covered by Article 20 (2) of the Services Directive.

The sections below summarise the main findings of the research and indicate the types of issues that would need to be investigated to assess whether the drivers identified above can provide objective justifications for price and service differentiation. Finally, they also sketch out an approach to be employed to make these assessments.

6.1 Overview of Main Findings and Key Questions

This section summarises the main findings of the interview programme with companies, industry representatives, consumer associations and desk research presented in this report.

Incidence of differentiation

- The report has revealed **prima facie evidence of price and service differentiation based on the place of residence of the customer across all four sectors** covered in this study (car rental, digital download, online sale of electronic goods, tourism) and at different stages of the business value chain (from input supplier to end consumer). Differentiation was identified in particular with regards to services provided online and very little indication of such practices could be found offline.
- There was **no prima facie evidence of systematic differentiation based on the nationality** of the customer.
- The **incidence of different types of differentiation practices** varies across sectors, but also across firms within one sector and it does not always put cross-border customers at a disadvantage compared with domestic business. All of these factors point to a combination of different drivers of differentiation at firm, sector and national levels

- The report discusses a number of **different practices for implementing price and service differentiation** in online business transactions, including automatic Internet Protocol (IP) address-based redirection, the existence of parallel national websites or the existence of nationally targeted services available through a central website as part of the booking process.

Drivers of differentiation

- **Legal and regulatory drivers** of differentiation identified as part of the interview programmes included direct financial costs, other compliance costs, differences in national legislation, including transposing EC instruments, fragmentation of consumer protection and environmental legislation and information and regulatory uncertainty.
- **Supply-side drivers** identified as part of the interview programmes included costs and difficulties linked to inputs from suppliers, order and payment processing, transport and delivery costs, marketing costs, customer support costs and corporate structure including franchising.
- **Demand-side drivers** identified as part of the interview programmes included different competition conditions and customers' willingness to pay.
- These **drivers of differentiation can and do interact to offset or reinforce one another**. The same consumer outcomes in terms of pricing and service provision can be due to different economic drivers and the same drivers for differentiation may lead to different consumer outcomes. Thus, a multivariate empirical analysis is required to disentangle the impact of individual drivers on outcomes.

Business responses to economic and regulatory drivers and implementation of differentiation

- In response to these drivers, companies adopt **one of four strategies**, each leading to different consumer outcomes (i.e. prices or service offers):
 - a) Compute an average price across all source markets
 - b) Differentiate between domestic and cross-border source markets
 - c) Differentiate between all source markets
 - d) Refrain from entering some source markets with a like-for-like service
- Business strategies aiming at implementing differentiation vary in the extent to which they allow customers to override segmentation into different nationally or linguistically defined markets. Looking in particular at services provided online, it can be noted that some practices segment markets and information on national basis, others segment markets nationally but allow customers to override national segmentation of information about these markets, and yet others allow customers to override both the national

segmentation of markets and information about these markets, thus allowing full access to services irrespective of the place of residence of the customer.

6.2 Implications

This section presents some of the implications of the findings above for the implementation and enforcement of Article 20 (2) of the Services Directive.

First and most importantly, the report has shown that there are a number of drivers that might lead to price and service differentiation based on the customer's place of residence. These drivers are related either to the regulatory environment or the market structure (demand and supply) in which companies operate. The question of interest in terms of the implementation and enforcement of Article 20 (2) of the Service Directive is not whether price and service differentiation based on place of residence of the customer occurs at all but rather:

- Which drivers underlying differentiation can be considered "objective reasons" under Article 20(2) of the Services Directive. It is important to note that from a legal perspective, not all drivers of differentiation necessarily constitute "objective reasons"; and
- to what extent differentiation is proportional to underlying economic and regulatory drivers constituting "objective reasons".

Second, due to the range of different business responses to the same drivers, consumer outcomes, such as observed price differences, cannot always on their own be traced back to individual economic and regulatory drivers of differentiation. As the report has shown, differentiation depends not only on a single set of drivers but also on sectoral characteristics, such as the nature of the services to be provided and distribution models and on the preferences of the main market actors, including the firms themselves, intermediaries, and consumers. Similarly, companies in the same sector may react differently to the same drivers of differentiation. For instance, some companies (e.g. price takers) might prefer to lower their profit margin while other businesses (e.g. price makers) might prefer to differentiate their services or prices based on the country of residence of some of their customers. Understanding the drivers behind price and service differentiation thus requires a thorough understanding of these intervening characteristics.

Due to these interactions between and within different sets of drivers (especially demand and supply) and between consumer outcomes and other intervening factors, in depth analysis is required to disentangle the impact of individual drivers on outcomes for consumers. Such analysis will be needed in particular when determining whether business response to a set of "objective drivers" is proportional. However, where a driver or a set of drivers are not deemed "objective" outright, a proportionality assessment will not be required.

Third, looking at the different sets of drivers identified as part of the interview programme, some of the regulatory and legal drivers present clear incentives for companies to segment their operations along national lines and, as a result, differentiate on the basis of the place of residence of the customers. Direct costs such as differences in taxation can clearly be linked directly to price differences from customers in different source markets. Similarly, indirect regulatory costs, such as information and uncertainty can provide an incentive for companies to set up different legal entities in the Member States where they operate. The study has shown that there is a clear rationale for intervention to attenuate the impact of regulatory drivers of differentiation (e.g. removing contradictions in regulatory texts at European level and between European and national legislation, simplifying the regulatory environment and enforcing existing EU legislation).

The intervention logic concerning market-related drivers (demand and supply) is less clear. All of the sectors analysed as part of this report are characterised by competitive markets. Supply and demand in the sectors are intrinsically linked and the effects of shifts in demand and supply are unlikely to be passed on fully to consumers in the form of different price or service outcomes. As a result it would be very difficult to establish a link between changes in consumer outcomes and demand and/or supply shifts of the kind described in the Section 4. Furthermore, interventions focusing on supply- or demand-side drivers could infringe on commercial freedoms and thus market-related drivers have to be handled with particular care.

Fourth, with regards to services provided over the internet, the study has shown that companies employ a wide range of strategies to implement price and service differentiation on the basis of the country of residence or nationality of consumers. Implementation techniques include situations where

- consumers cannot obtain information about prices and availability of services outside of their country of residence and cannot access these services;
- consumers can obtain this information, but cannot access these services; and
- consumers can obtain the information, as well as access the services.

In some cases, the report has shown evidence that these techniques are used to segment the market into different nationally based customer groups. In other cases, no evidence for price or service differentiation could be found. In all cases online segmentation techniques on the basis of country of residence need to be assessed in terms of whether they mirror objective economic or regulatory drivers and to what extent their impact on consumers is proportional to the underlying driver.

6.3 Recommendations

As this report has shown, an assessment of price and service differentiation based on the country of residence or nationality of the consumer needs to be informed by two criteria:

- **Objectivity**, namely whether the differential treatment of consumers based on their nationality or country of residence mirror objective economic or legal drivers; and
- **Proportionality**, namely whether the responses to the drivers of differentiation are proportional.

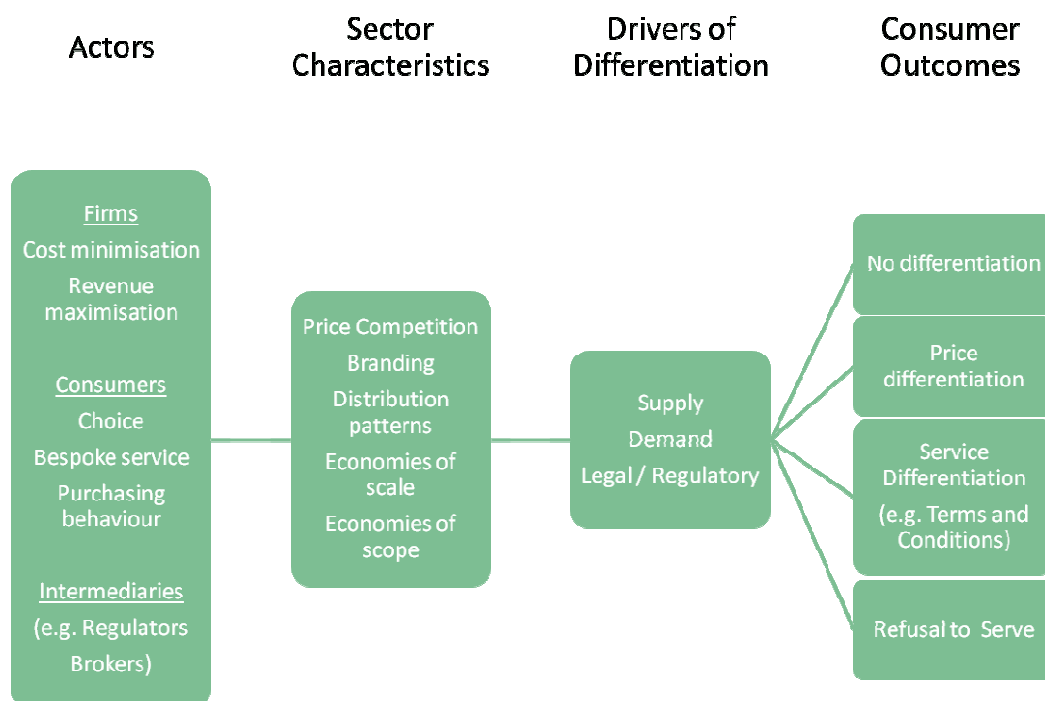
This section presents some specific recommendations to feed into the assessment of the objectivity of economic and regulatory drivers and the proportionality of company practices in response to these drivers.

As discussed above, there are four types of consumer outcomes of interest to this study:

- price differentiation;
- service differentiation (including terms and conditions);
- refusal to provide the service; and
- no differentiation.

The decision tree below links these consumer outcomes to drivers of differentiation, sectoral characteristics and actor preferences.

Figure 15: Modelling consumer outcomes



Populating the decision tree above makes explicit the **links between main actors, sectoral characteristics, drivers of differentiation and eventual consumer outcomes** and allows a better assessment regarding the objectivity and proportionality of the drivers. The steps required to populate the decision tree are summarised in the box below:

Box 1: Main steps in populating the decision tree

1. Identify main actors and their preferences
 - Identify main corporate players, their reach and corporate structure
 - Describe consumers' revealed and/or stated preferences
 - Identify intermediaries (regulators, distribution channels, etc.)
2. Identify main markets and sectoral characteristics, including
 - Service
 - Market size
 - Main source markets
 - Main provider markets
 - Study time frame
3. Identify main drivers of differentiation
 - Legal-regulatory
 - Supply side
 - Demand side
4. Scan consumer outcomes:
 - Over time
 - For different source and provider markets
 - Using different distribution channels

The two boxes below propose a set of questions in order to assess the objectivity and proportionality (in view of Article 20, paragraph 2 of the Services Directive) of company practices that differentiate prices or services on the basis of the country of residence or the nationality of the customer,

First, with regards to objectivity, the following questions can inform an assessment of the extent to which underlying drivers may be considered objective reasons for differentiation.

Box 2: Questions to assess objectivity of drivers of differentiation based on the country of residence or nationality of the customer

To what extent do compliance with regulatory provisions or uncertainty about applicable rules result in higher costs for the provision of the service to customers resident in certain countries?

If there are additional costs associated with providing a service to customers resident in certain countries, companies may seek to differentiate pricing or access to their services along national borders. Where regulations are the same across several territories, this should be reflected in differentiation practices. Since business practices also depend on the practices of their suppliers, the impact of regulatory provisions on suppliers needs to be examined as well.

Do regulatory provisions match the response capacity of individual firms (e.g. their size, their position in the value chain)?

Where firms do not have the capacity to respond to regulatory provisions, they may choose not to supply their services to customers in particular markets. This is particularly likely for smaller companies and for smaller markets where companies may not be willing or able to invest resources into regulatory compliance activities.

To what extent do (non-regulatory) costs of providing the service vary across geographical borders?

In addition to the regulatory costs mentioned above, the cost of physically providing a service to customers in different Member States (e.g. delivery, transport, cost of inputs at wholesale level, order and payment processing) may differ along national borders. Where this is the case companies may choose to differentiate pricing and access to their services based on the country of residence of the customer. Where these differences are not reflected consistently in business practices (i.e. where some input costs are passed onto consumers and others are not) there may be grounds for a more in depth examination.

Is differentiation applied only to some cross-border customer or to all cross-border customers?

Some costs are associated with all types of cross-border business but they do not on their own explain differentiation between different national markets.

Does competition in the markets where the service is supplied vary along country borders (e.g. market share, use of different distribution channels)?

Differences in competition across countries and differences in market share for particular companies can explain price and access differences. Where a company has a large share of the national market, it may generate brand loyalty and reduce customer price sensitivity, which can be reflected in higher prices in this market. On the other hand, in countries where price competition is stronger (e.g. where customers make greater use of online distribution channels) prices might be lower and some companies may even be priced out of these markets.

Do customer preferences in terms of willingness to pay, branding preferences and service characteristics vary across countries?

Where there are geographically defined differences in the demand for a service based on the customer's place of residence this may be reflected in prices and services available to customers. Examples include special marketing campaigns and promotions or differences in seasonality. However, seasonality considerations should equally apply to domestic business.

Second, with regards to proportionality, the following questions can inform an assessment of the extent to which company responses are proportional to underlying economic and regulatory drivers.

Box 3: Questions to assess proportionality of drivers of differentiation based on the country of residence or nationality of the customer

Are differentiation practices proportional to regulatory costs/risks?

If differentiation is due to national regulatory provisions, incremental costs or access restrictions should not exceed incremental cost of engaging in cross-border business.

Are differentiation practices proportional to costs of service provision?

If documented variations in costs across territories exist, the corresponding differences in prices or services provided can be compared to the cost variations to determine to what extent they are proportional.

Does the level on which drivers operate match the level of differentiation?

If objective drivers for differentiation suggest that business practices should vary at a sub-national level or across several countries, price and service differentiation based on the customer's country of residence might be deemed disproportional. For instance, the seasonality of demand for a service might vary within a country (e.g. where school holidays are timed differently across sub-national regions) or across multi-country regions (e.g. where services are provided in a language spoken across several countries – e.g. German).