CLEARY GOTTLIEB

Sustainability and competition in the financial sector

Assessment of Withdrawal and Carbon Pricing Agreements

FCA Competition Law and Sustainability Roundtable

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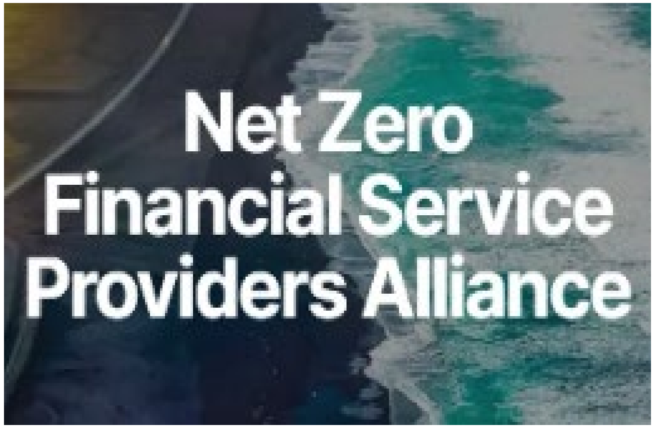
Net-Zero Alliances

NZAOA

GFANZ

NZIA

NZBA



NZFSPA

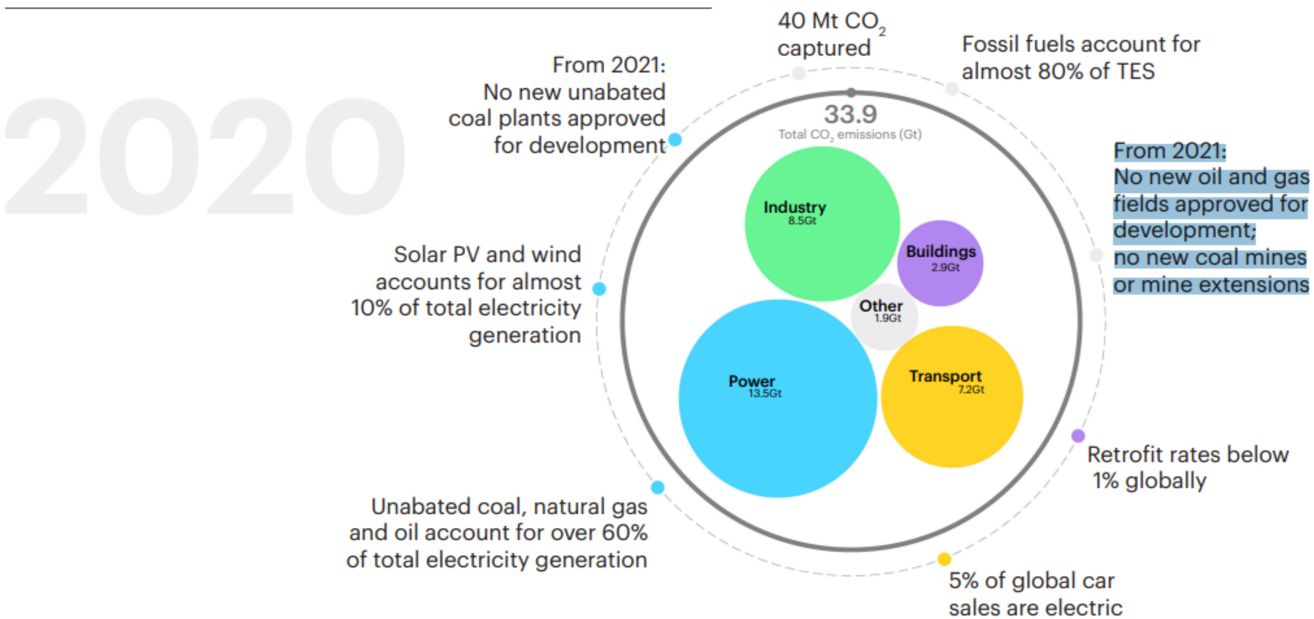
NZAMI

Alliances' commitments

- Reduce GHG emissions (Scope 1, 2 and 3) reaching net-zero by 2050, consistent with a maximum temperature rise of 1.5° C above pre-industrial levels;
- Report on progress, establish intermediate science-based targets and review them every five years (Article 4.9 of the Paris Agreement);
- Publish TCFD disclosures;
- Engage on corporate and industry actions for a low-carbon transition of economic sectors in line with science and considering associated social impacts;
- Engage in governmental policies for a science-based and socially just transition to net zero;
- Work together with economic peers, financial regulators and supervisors, governments, trade bodies, policymakers, the UN and other intergovernmental organizations to promote the goals of the alliances;
- Engage with leading scientific, methodological and data-related organisations, academia, non-governmental organizations and other key stakeholders.
- Comply with the UN Sustainable Development Goals and the UN Race to Zero criteria;
- Can they add "withdrawal from coal"?

IEA "Net Zero by 2050 – A Roadmap for Global Energy
(May 2021)

"Beyond projects already committed as of 2021, there are no new oil and gas fields … and no new coal mines or mine extensions"



International Institute for Sustainable Development: existing hydrocarbon fields and mines around the world would together release some 936 gigatons of CO2 "if fully depleted and burned" – 60% over carbon budget for the Paris Agreement target of 1.5°C and "exhausting the remaining budget for staying well below 2°C".

Decision tree for Sec 9 CA98, 101(3) TFEU, or proportionality analysis

1

Agreement to reduce emissions or pollution

2

Climate change abatement = objective justification

3

No market failure?
Are consumers willing to pay for sustainability?;
adequate regulation?

Parties should compete on meeting demand for sustainable products

Agreement is "*not indispensable*", and is therefore not allowed unless a Block Exemption Regulation applies, or agreement needed to create economy of scale or scope, to create synergies, or to share prohibitive risk (see Guidelines)

Market failure, if consumers are not sufficiently willing to pay for sustainability; and no adequate regulation:

4

Parties pursue short-term profit?

Secrecy / internal evidence / lack of stakeholder involvement are indicators

Risk of collusion as in ***AdBlue***

Agreement does not "*contribute*" to sustainability; no "fair share" to consumers, and is therefore prohibited

Parties pursue long-term "spill-over benefits

"*improves production or distribution, or promot[e] technical or economic progress.*"

Public, open / internal evidence / stakeholder involvement are indicators

5

Apply ancillary restraint or exemption criteria

(a) no less restrictive equally effective alternative; (b) "*fair share*" (should reflect "polluter pays" principle); and (c) "residual competition" possible

Step 1: does the agreement restrict competition?
Step 2: If the agreement restricts competition, follow this decision tree

Criteria for Exemption (proportionality; Sec 9 CA98)

1. quantitative and/or qualitative sustainability **benefits** ("*improving production or distribution, or promoting technical or economic progress*")

2. Consumers must receive a **fair share**, deriving from three different kinds of benefits:
   – "individual use value benefits" -- such as better quality of product;
   – "individual non-use value benefits" -- consumers' appreciation of the impact of their sustainable consumption on others;
   – "collective benefits" -- positive externalities that benefit society as a whole.

   Consumers can be deemed to receive a "fair share" of the benefit so long as the incremental cost they bear is below the sum of
   (i) the benefit they get plus
   (ii) the benefit to society – reduced social costs of carbon.

3. Agreement must prove **necessary** to attain the sustainability objective:
   – cure first mover disadvantage/market failure where regulations are inadequate;
   – achieve economies of scale;
   – nudge consumers' preferences.

4. Residual competition

Carbon Pricing Agreement -- an alternative to withdrawal?

— Insurers or investors agree to pay an internal carbon price equal to the "scope 3" emission cost of a project, to create a joint climate change abatement fund.

- Only for projects carbon tax or emissions trading right are below social cost of carbon.
- Proceeds to be used to lower finance or insurance costs for renewable energy projects, or impact projects.
- This agreement gives incentives to lower scope 3 carbon costs – and reward positive externality.
- Consistent with the "polluter pays" principle.

— No restriction of competition

— Possible FCA role:

  - Ensure there is no agreement to impose a carbon price surcharge to customers – pass-on should remain an individual decision;
  - Allocation of Climate Change Abatement Funds could be decided by a joint entity without conflict of interests, based on objective criteria.

Conclusion: What could the FCA do?

Foster blockexemption for withdrawal agreements and sustainability standards

- to eliminate fear of fines and damage claims

— Guidelines (coordinated with CMA): follow the principles of the EC Draft Revised Horizontal Guidelines, but

- with more leeway for sustainability standards,
- with a rebuttable presumption that sustainability agreements seeking spillover benefits are legitimate.
- At the very least, the "fair share" analysis should follow the polluter pays principle and take full account of collective benefits.

— Precedent decision (which could be a "test case")

— Open door policy for agreement-specific feedback

— International cooperation

Backup

Standards Setters

VRF

TCFD

IOSCO

GRI

ISSB

TNFD

Firms have incentives to *improve* sustainability where there are "sustainability spill-over benefits"

Firms increasingly realize that (a) they benefit in the long term, if (b) their *rivals* eliminate greenhouse gas emissions ("spillover benefits"), and (c) these private benefits align with public benefits. If so, firms have a genuine incentive to pursue efficient sustainability goals, and competition authorities don't need to assume that they are just out to raise short-term profits at the expense of consumers.

> *"where positive spill-overs exist between firms, efforts by one firm also benefit other firms. In this case, the level of sustainability efforts by other firms would actually have a positive effect on a firm achieving its own objectives. Allowing firms to coordinate their sustainability efforts will then lead to higher overall effort levels."*

Examples: reduced existential threat from climate change; genuine social objectives; common cost savings; improved industry reputation; avoiding costly and inefficient regulation

Source: "*When to give the green light to green agreements*" (Jenkins et al, Oxera)

Draft Revised EU Horizontal Guidelines – Assessment under Article 101(1) TFEU

- Guidelines confirms that sustainability is a policy priority;

- Guidelines confirm sustainability agreements may **fall outside the scope of the prohibition** of Article 101 TFEU, if they do not affect any parameters of competition:
  - agreements that do not concern competition, but firms' internal corporate conduct;
  - agreements to create database containing information about sustainable suppliers;
  - agreements for organizing industry-wide or consumers' awareness campaigns.

- Guidelines describe "soft safe harbor" for widely defined **sustainability standards agreements – even if mandatory** – if 7 cumulative conditions are met:
  - unlimited participation and transparent process for selecting the standard;
  - no obligation for third parties to comply with the standard; [571 - "no pressure"?]
  - participating companies can adopt a higher sustainability standard;
  - no exchange of commercially sensitive information beyond what is necessary;
  - non-discriminatory access to the outcome of the standardization process;
  - no appreciable increase in price; ["appreciable"?; could narrow the safe harbor?]
  - monitoring system ensuring compliance.

- EC offers **individual guidance**

Draft Revised EU Horizontal Guidelines – Assessment under Article 101(3) TFEU

1. If an agreement restricts competition, it can still be allowed if it leads to **efficiency gains**: quantitative and/or qualitative sustainability benefits;

2. Agreement must prove **necessary** to attain the sustainability objective:
   - overcome first mover disadvantage;
   - cure market failures where public policies and regulations fail to do so;
   - achieve economies of scale;
   - nudge consumers' preferences.

3. Consumers must receive a **fair share**, deriving from three different kinds of benefits:
   - "individual use value benefits" -- such as better quality of product;
   - "individual non-use value benefits" -- benefits resulting from the consumers' appreciation of the impact of their sustainable consumption on others;
   - "collective benefits" -- positive externalities that benefit society as a whole.

      - HG 603: "*where consumers in the relevant market* ***substantially overlap*** *with, or are* ***part of*** *the beneficiaries outside the relevant market, the collective benefits to the consumers in the relevant market occurring outside that market, can be taken into account if they are significant enough to compensate consumers in the relevant market for the harm suffered.*"

4. Residual competition

When (and how much) do collective benefits count? (1)

- Until 2001, EC applied ***CECED*** (1999) precedent
  - *"Individual economic benefits ... savings on electricity bills allow recouping of increased costs of upgraded, more expensive machines within nine to 40 months"*
  - *"Collective environmental benefits ... the benefits to society ... appear to be more than seven times greater than the increased purchase costs of more energy-efficient washing machines. Such environmental results for society would adequately allow consumers a fair share of the benefits even if no benefits accrued to individual purchasers"*

- After that, collective benefits did not count. Until ***Mastercard*** (2014), para 234:
  - "*appreciable objective advantages of such a character as to compensate for the disadvantages which that agreement entails for competition [Consten & Grundig]*".
  - As the Dutch ACM explains

    "*this statement by the Court therefore does not determine whether full compensation of negatively affected consumers is necessary or whether these advantages should be in or out of market. …MasterCard clarifies the case law ... as follows:*

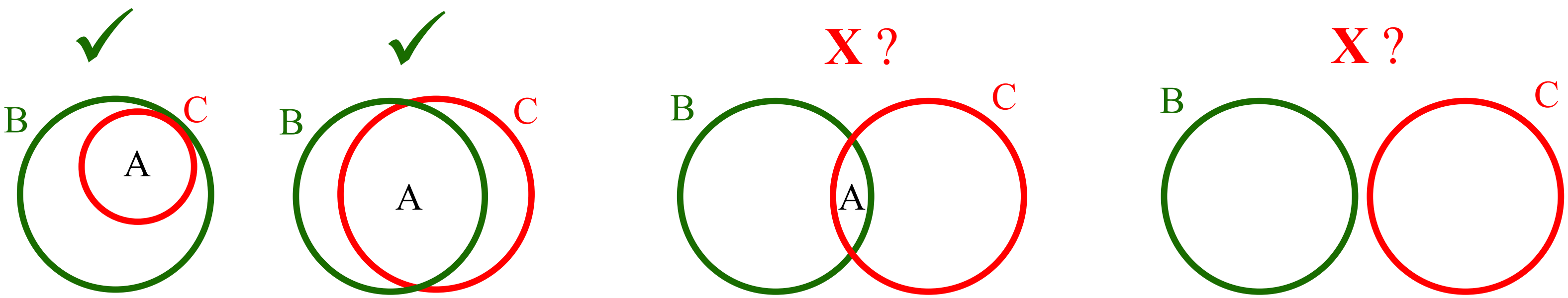
    (i) out of market benefits are counted towards compensation of the consumers negatively affected, in particular if they affect substantially the same group;

    (ii) out of market efficiencies benefiting other consumers can also be counted toward a fair share for consumers overall; and

    (iii) full compensation of the negatively affected consumers is not required, just conferral of appreciable objective advantages. "

When (and how much) do collective benefits count? (2)

<u>Question 1</u>: Can collective benefits justify restriction only where *"consumers in the relevant market substantially overlap with, or are part of the beneficiaries"* (as EC proposes in HG para 602-605)?



Consumers (C) paying for clean fuel are also Beneficiaries (B) from clean air (or substantially overlap)

Consumers (C) buying sustainable wood mostly grown abroad: bio-diversity benefits (B) don't count at all?

Consumers (C) buying sustainable cotton made abroad: collective benefits (B) don't count at all?

<u>Question 2</u>: What share of the benefits are counted to balance against competitive harm – All benefits (B)? Or only those experienced by consumers who pay (A), as the EC proposes. This leads to bad results – Example of 1st class fliers asked to pay for sustainable fuel – Agreement not allowed because A is less than the extra price they pay, even it could avoid high social costs (B)?

<u>Proposed answer: "Fair share" analysis should be in two steps</u>

- <u>Step 1</u>: *before* assessment of the benefit to consumers, social cost ("externalities") should be internalized to calculate "true price" (as required in "polluter pays" principle Art 191(2) TFEU).
- <u>Step 2</u>: *After* step 1, if agreement price > "true price", check if agreement confers *"appreciable objective advantages of such a character as to compensate for the disadvantages which that agreement entails for competition"* (*Mastercard*)
    - Compensation need not be full, but must be "fair"