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SPECIAL REPORT Q&A REPRINT August 2023

COMPETITION & ANTITRUST

FW discusses the antitrust implications of ESG initiatives with Kadambari Prasad, Nadine Watson and Frédéric Palomino at Compass Lexecon.

Q&A:
Antitrust implications of ESG initiatives

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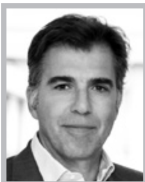

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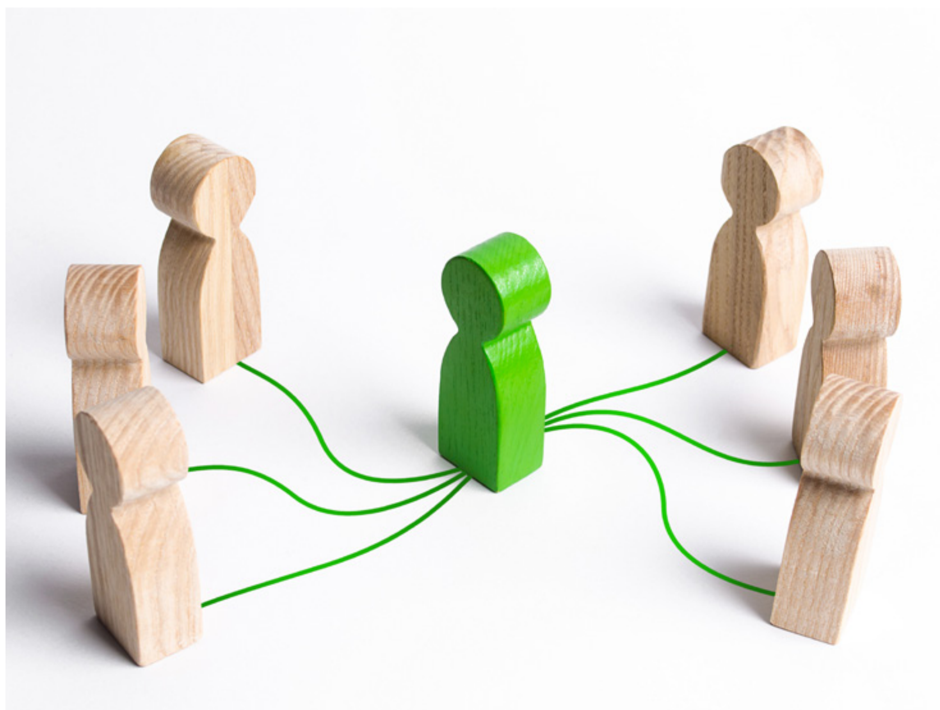
FW: Could you provide an overview of recent policy developments pertaining to antitrust law and its intersection with environmental, social and governance (ESG) initiatives?

Palomino: In February 2023, the UK Competition and Markets Authority (CMA) published guidelines. These focus on sustainable environmental agreements and consider "climate change agreements" to be a subset of environmental agreements that cover agreements that contribute to the UK's binding climate change objectives under national or international law. These guidelines, therefore, do not take into account sustainable development agreements covering, for example, improved working conditions or animal welfare.



Prasad: In June 2023, the European Commission (EC) published its final guidelines on horizontal agreements, including a chapter on sustainability agreements. Much like other authorities, it has committed to provide informal guidance on novel and unresolved issues, however it has kept the door open to levy fines and pass infringement decisions if needed. Unlike the CMA, it has not made a distinction for climate change agreements, indicating that benefits must accrue to the same consumers that suffer the harm. Relating to specific standards which may need to be agreed between competitors to meet sustainability objectives, it has stated that price increases may be acceptable if the cumulative market share of the parties is small enough – less than 20 percent – or if the price increases relate to inputs that do not command a large share of the cost, and so do not lead to a significant increase in the price to consumers.

Watson: In parallel to the initiatives taken by competition authorities providing more guidance on the assessment of sustainability agreements, there is an increasing interest in pursuing sustainability issues in abuse cases and in private litigation. In abuse cases, sustainability can be used both as a sword – prices can be considered abusive if they fail to account for the cost of pollution in pricing or encourage excessive use of scarce resources – or as a shield – charging a higher price to cover environmental costs or offering low prices for new sustainable products. In private litigation, there has been a recent and significant increase in the number of climate-related cases brought against corporations both in the US and the European Union. For example, in 2021 Shell was found to have violated a duty of care and human rights obligations by failing to take adequate action to curb contributions to climate change.

FW: Drilling down, what specific regulatory trends are you seeing with regard to sustainability agreements? What particular challenges do firms face in determining whether such agreements may be anticompetitive?

Prasad: There is a fair bit of guidance from the authorities but there have been very few cases, so many of the finer points of detail – which are crucial for businesses to be able to self-assess – are not settled. In such a world it is particularly important to use the tools available, such as sandboxes and open-door policies, to engage in discussions with the authorities and ask for informal guidance related to these novel issues. The main challenges relate to the quantification of the benefits of such agreements. While there are well-established tools that can be tailored to measure the benefits – for example, surveys and choice modelling – there are crucial unresolved questions. One is the appropriate time horizon, and discount rate, to consider given that the benefits accrue over a much longer period. Another is the appropriate counterfactual, given that some agreements may only provide incremental benefit, and in fact may increase the time needed to implement more structural changes which would provide greater sustainability benefits.

Palomino: In the absence of settled case law, it is difficult to say a priori whether a sustainability agreement will be considered as anticompetitive – the harm to competition will be greater than the benefits of the agreement. If there is uncertainty about the costs and benefits of an agreement, presenting the project to the relevant competition authority at an early stage may be useful in order to understand its position on the case, in particular what consumers and what time horizon it will

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> FRÉDÉRIC PALOMINO
> Compass Lexecon

take into account for the competitive assessment, and how it will compare short-term costs – a reduction in competition – and long term sustainability benefits.

Watson: One of the main challenges, common to all types of agreements and mergers, remains demonstrating that benefits are sufficiently verifiable and certain to be considered. In the case of sustainability agreements, the hurdle may be more demanding as they refer to new technologies whose success will depend in part on the speed and scope of implementation and the time horizon that is considered. In this respect, the EC's final guidelines on horizontal agreements still rely on the conditions of verifiability and indispensability in the article 101(3) guidelines that do not account for the special nature of sustainability agreements. For example, more guidance is needed on the degree of certainty required on efficiencies materialising.

FW: How should companies go about comparing ESG-related costs incurred in the short term, with the benefits obtained over a long period? What discount rates need to be considered?

Palomino: There is extensive economic literature on social discounting, as opposed to financial discounting. The social discount rate is set, or should be set, so as to answer the following question: at what rate should society be compensated in the future for giving up a unit of consumption today such that the overall wellbeing is preserved? In particular, this literature suggests that as future discount rates are uncertain and uncertainty grows with time, very long run projects should apply a declining discount rate. Using this rate mechanically increases the present value of future benefits. The use of a declining discount rate to evaluate public projects is now commonplace in countries such as the UK, France, Norway and Denmark.

Watson: It is important to think about the difference between social and individual discount rates. There is extensive literature showing that individual discount rates are typically 10 times higher than social discount rates and that these vary with income, products being purchased and level of uncertainty. Companies and competition authorities need to take into account in the comparison of short-term costs and long-term benefits that, due to high individual discount rates, the penetration of sustainable products may require reducing the initial cost of adoption either through low prices or increased access to financing, and allowing future price increases to recover costs. This is consistent with the use of declining discount rates and longer time horizons. In fact, as in the case of mergers, long-run considerations have recently been suggested to be superior for the analysis of merger efficiencies.

FW: What time horizon is appropriate to apply when undertaking a cost/benefit analysis of ESG issues?

Prasad: In the general assessment of mergers and horizontal agreements, time horizons are relatively short. The authorities assess whether the claimed efficiencies are realised in a timely manner – usually three to five years – with a longer time period indicating more doubt that these would be achieved at all. The benefits of environmental, social and governance (ESG) agreements will usually take much longer to realise, so a longer time horizon is needed to adequately assess their merits. Of course, the key question then relates to the choice of discount rate and there is very little practical guidance on that.

Palomino: In its guidelines, the CMA acknowledges that the benefits of ESG initiatives will need to be assessed over longer time horizons. However, the key challenge is that costs will likely be incurred in the short term, which makes the discount rate very important. If a high discount rate is used, then this is tantamount to giving little or no weight to benefits that are distant in time, while giving much weight to the costs. This issue is also related to which consumers are taken into account in the competitive assessment, such as only current effective consumers or a larger set of consumers.

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> NADINE WATSON
> Compass Lexecon

FW: What consumers do companies need to take into account as part the cost/benefit analysis of a sustainability agreement?

Palomino: A cost/benefit analysis is highly case dependent. For example, the Dutch Authority for Consumers and Markets (ACM) guidelines on sustainability distinguish between environmental-damage agreements, for which it will consider benefits for society as a whole as part of the cost-benefit analysis, and other types of agreements, for which it will only assess the impact of an agreement on consumers, as the ACM did in the 'Chicken of Tomorrow' case.

Watson: Prior to defining the set of consumers that need to be considered, it is important to set out how the agreement is likely to alter consumer choices in the future. An analysis based exclusively on current customers, particularly one based on historical purchases, will fail to incorporate changes in the preferences of current consumers and non-consumers as available choices widen, social attitudes change, and the effects of climate change become more apparent. The use of survey methods that inform consumers on the relevant trade-offs and allow consumers to attach value to the reduction of climate change effects, will provide a more accurate assessment of preferences of well-informed consumers.

Prasad: Deciding what consumers to take into account depends on the type of agreement and the authority. While for most agreements the authorities only consider the welfare of the consumers of the product in question, the ACM and CMA have outlined a set of agreements relating to environmental damage and climate change, for which they will consider the welfare of all consumers, not just the consumers of the product in question. This is to account for the large positive externalities these agreements might result in.

FW: What steps can firms take to understand and assess whether their ESG plans are compliant with current competition regulations? What advice would you offer to companies contemplating ESG-related agreements, in terms of understanding the antitrust landscape?

Palomino: The first issue to address is whether the agreement affects the main parameters of competition between firms: price, quantity, quality or innovation. If it does, it is necessary to assess whether competition parameters are significantly affected. For example, any agreement leading to a reduction in supply through the withdrawal from the market of products that are not environmentally friendly is likely to be considered anti-competitive. On the contrary, an agreement that leads to the introduction of new high-quality environmentally friendly products – without withdrawing any low-quality product – is much more likely to be accepted as it increases the variety of products available in the market. Second, was the agreement necessary and independently carried out on the basis of objective factors, for example because firms do not have the necessary technical capabilities, as would be the case for article 101(3) exemption?

Prasad: Given the lack of practical guidance, firms should reach out to regulators to discuss their ESG plans informally. They should self-assess these agreements, under a range of different assumptions, and test sensitivities which cover a range of scenarios. Agreements that have, as their main objective, a sustainability initiative, and are indispensable for the attainment of the benefits, are less likely to be problematic. The more evidence the firms can present regarding the materiality of the benefits and the probability that they will be achieved, the more convinced the authority is likely to be.

Watson: Possibly the most important step is to clearly set out the rationale of the agreement, preferably with references to internal documents or discussions that substantiate four key factors. First, consumers' lack of awareness of the harms of non-sustainable products or their limited willingness to pay for sustainable alternatives. Second, the need to invest in raising consumer awareness of the benefits of sustainable products. Third, the need to temporarily limit production of certain non-sustainable products to introduce a new sustainable substitute in the market, Finally, the importance of economies of scale and the impact on price. ■

> GIVEN THE LACK OF PRACTICAL GUIDANCE, FIRMS SHOULD REACH OUT TO REGULATORS TO DISCUSS THEIR ESG PLANS INFORMALLY.
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