THE EUROPEAN COMMISSION'S DRAFT REVISED GUIDELINES ON HORIZONTAL AGREEMENTS – SUSTAINABILITY AGREEMENTS

A submission by Frontier Economics

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THIS RESPONSE SETS OUT OUR VIEWS ON SECTION 9 OF THE EUROPEAN COMMISSION'S DRAFT REVISED GUIDELINES ON HORIZONTAL COOPERATION AGREEMENTS IN RELATION TO SUSTAINABILITY AGREEMENTS. FRONTIER ECONOMICS IS AN ECONOMIC CONSULTANCY THAT REGULARLY ADVISES CLIENTS BOTH ON ANTITRUST ISSUES RELATING TO EUROPEAN AND NATIONAL COMPETITION LAW AND ON ECONOMIC PROBLEMS RELATING TO SUSTAINABILITY.

KEY RECOMMENDATIONS

- The Commission has chosen not to include "out-of-market benefits" in its proposal for how sustainability agreements may be assessed under Article 101(3) TFEU. This is understandable if DG Competition is to avoid stepping outside the core responsibility of antitrust rules to protect competition on the market.

- Widening the type of compensatory consumer benefits that can be taken into account under a "fair share" test beyond consumer use value to include "collective benefits" is welcome, but is likely to have relatively little impact. Under this improved test, it will still remain hard to address the negative externalities which give rise to major sustainability challenges.

- This focus on *benefits* is not the only option. We propose an alternative which will allow sustainability challenges to be addressed without stepping outside the core objective to protect competition on the affected market: **the guidelines should be amended to clarify that there is no harm, and therefore no requirement to demonstrate compensatory consumer benefits, insofar as agreements result in consumers paying the *true cost* of their consumption**.

- We argue that sustainability challenges arise because of missing markets – the ability of consumers to engage in environmentally harmful consumption without facing the full costs of their consumption. This is economically inefficient and should not be protected as a feature of competition on the market. Indeed, effective competition requires that prices reflect costs. Measures that bring prices closer to true costs should not be seen as imposing harm that must be compensated. It is a false equivalence to believe that lower prices are always an indication of competition working better.

- Whilst this proposal might stop short of including the widest class of possible agreements that an out-of-market benefits test would enable, it could nonetheless provide a means of unlocking progress in addressing the most important sustainability challenges facing the European economy: from climate change to clean waterways – all areas where consumption imposes environmental costs that are not fully captured in the market price.

INTRODUCTION

1 The European Commission (the “Commission”) has recently published its Draft revised Guidelines on horizontal cooperation agreements (the “Draft revised Guidelines”) [1]. A much-anticipated addition to the existing Guidelines is a section clarifying how so-called “sustainability agreements” should be assessed under Article 101 of the Treaty on the Functioning of the European Union (“TFEU”), the clause prohibiting agreements between undertakings which may prevent, restrict or distort competition in the internal market. Frontier welcomes this clarification to the horizontal guidelines, which may ultimately reassure firms seeking to proactively improve the sustainability of their industries and where collaboration might be necessary in order to achieve this.

2 A “sustainability agreement” is an agreement between undertakings within the same market which has the stated objective of increasing sustainability. As with any agreement that affects one or more parameters of competition such as price, quantity, quality, choice or innovation, some sustainability agreements may raise competition concerns under Article 101 TFEU. Such agreements may be assessed to establish whether they qualify for exemption from competition rules under Article 101(3).[2] A key principle which the Commission proposes should underpin any assessment of such agreements is one of *compensatory benefits* to consumers in the affected market. That is, parties to an agreement which could have anticompetitive effects must demonstrate that the agreement brings real and quantifiable sustainability benefits to consumers which neutralise any associated anticompetitive harm in the affected market. The Commission terms this as the pass-on to consumers’ of a “fair share” of the benefits.[3]

3 Yet it is in the very nature of sustainability improvements that the main beneficiaries sit outside the affected market. Sustainability challenges exist principally because of negative externalities: the negative impact that consumption of a particular product has on non-consumers outside the market. As a result, many commentators had proposed that the Commission widen its guidelines to allow consideration of “out-of-market efficiencies” – so that the benefits of correcting negative externalities can be taken into account.

4 In rejecting this call for more radical change, the Draft revised Guidelines appear to have sought a ‘middle ground’ in which the concept of a fair share of benefits for consumers in the market is retained, but where the types of compensatory benefits that can be taken into account is explicitly widened to include non-use benefits and so-called “collective benefits”. This potentially allows the value which consumers (in their role as both as consumers and as citizens) place on wider sustainability concerns, as well as sustainability benefits accruing to consumers irrespective of their valuation of them, to be fully taken into account. We welcome this change. However, it is a modest step which is likely to have relatively little practical impact. As we explain below, this is for two main reasons:

5 First, there remains a “Catch 22” inherent in the “fair share” requirement. The *compensatory benefits* principle is likely to pose a challenge to parties seeking exemption of a sustainability agreement from competition rules. In some instances there may be a tricky path to navigate in

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[1] *Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal co-operation agreements*: https://ec.europa.eu/competition-policy/system/files/2022-03/draft_revised_horizontal_guidelines_2022.pdf

[2] EC, Draft revised Guidelines, para. 560

[3] Ibid., para. 588

proving that the "fair share" condition is satisfied without simultaneously providing evidence against another condition required to qualify for exemption - the principle of "indispensability".

6 Second, the main sustainability challenges facing Europe today exist precisely because there are large negative externalities – costs which consumers in one market impose on the wider economy and which they don't fully take into account. In simple terms, whilst consumers may indeed care about sustainability, they don't care enough; and that is why these challenges exist. This means that even though there will be agreements where there is no contradiction between proving that the "fair share" and "indispensability" conditions are both met, the restriction of the pool of relevant beneficiaries for the purposes of the assessment to consumers within the relevant market substantially limits the types of agreements that may qualify for exemption from competition rules.

7 There therefore appears to be a material risk that agreements which could make a genuine contribution towards sustainability goals may be blocked by EU competition rules.

8 In this consultation response, we argue that the pool of beneficiaries relevant for the assessment should not be limited to consumers of today in the relevant market. Rather, if competition policy is to genuinely support the implementation of the sustainability agenda, then it needs to consider how firms may best internalise *all* negative externalities imposed by the production and consumption of their products.

ASSESSMENTS BASED ON CONSUMER VALUATION OF THE BENEFITS MAY RESULT IN A CATCH-22

9 The Draft revised Guidelines present several ways in which the pass on of a "fair share" of the benefits to consumers may be evaluated. Firstly, benefits to consumers may include the so-called "use value" that consumers derive from consuming a product with improved sustainability characteristics. This might be, for instance, an improvement in the quality of a product or any other form of benefit which improves consumers' "experience" from consuming the product.[4] Secondly, the Commission also recognises that benefits may accrue from "non-use" sources. This essentially means the satisfaction that consumers derive from consuming a product with improved sustainability characteristics even where there is no change to their actual experience of consuming the product in question.[5] For instance, consumers may, for altruistic reasons, appreciate that emissions-efficient electrical appliances carry a lower carbon footprint than standard appliances.

10 Both consumer use and non-use values pertain to the valuation that a consumer places on the sustainability benefit in question. One way to quantify this, which is put forward by the Draft revised Guidelines, is by using a measure of consumers' *willingness-to-pay* ("WTP") for the benefit. The consumer WTP can either be derived from empirical purchasing data or from surveys which ask a pool of consumers to state their WTP for certain sustainable attributes of a product. Consumers are deemed to receive their "fair share" of the benefits when the amount they are willing to pay for the sustainability benefit compensates or exceeds any harm (in the form of

[4] Ibid., Section 9.4.3.1.

[5] Ibid., Section 9.4.3.2.

higher prices, lower quality, etc) arising from the agreement. Reciprocally, if consumers do not value the sustainability benefit sufficiently that they are willing to pay for it, then it is concluded that they would not receive their fair share of the benefits of the agreement.

11 There is a fundamental conceptual problem that arises from this kind of test. Sustainability problems arise when markets produce "negative externalities" – undesirable side effects from producing (and thus consuming) a good which are not costed into its price but which have a detrimental impact on society or the environment. The costs of the sustainability problem do not accrue only to consumers in that market but rather to all affected stakeholders. This is recognised by the Commission: "*…the sustainability impact from individual consumption accrues not necessarily to the consuming individual but to a larger group*".[6] Negative externalities thus exist because the costs of the problem may be shared between many but the benefits of consuming the product in question accrue to the individual consumer. An assessment based on the consumers WTP conditions the outcome of the assessment on individual consumer preferences, an individual cost-benefit trade-off which is already established as being biased against society or the environment by virtue of the fact that a negative externality exists.

12 This will make it difficult for parties to navigate exemption under Article 101(3) if using a consumer WTP approach. If we know that a negative externality exists in a particular market, then this very fact already tells us that consumers may be unwilling to pay for sustainability benefits in the form of measures seeking to remove the externality. If they were, then there would be demand for those benefits. Yet, if there is sufficient demand, then firms in that market should, in principle, implement those benefits unilaterally, obviating the need for an agreement to achieve the stated benefits. Hence, demonstrating that the "fair share" condition for exemption under Article 101(3) is satisfied on the basis of consumer WTP could simultaneously raise the prospect that the "indispensability" condition is not met. As the Draft revised Guidelines state: "*where there is demand for sustainable products, cooperation agreements are not indispensable*"[7]. It is a Catch-22.

13 In order for an agreement to prove *indispensable* to the attainment of its stated sustainability objectives under a consumer WTP approach to assessing the benefits, parties to the agreement must demonstrate that some other kind of market failure also exists which prevents the market from delivering the sustainability benefit even when consumers are willing to pay. Other types of market failure could include, but are not limited to:

- Information asymmetries: Consumers may value certain sustainability attributes in a product they purchase, but in a world of information overload, they may be unable to evaluate or verify which product truly delivers those attributes (e.g. food packaging).
- Coordination/economies-of-scale: Certain sustainable technologies require interdependent investments from both consumers and suppliers, for instance to establish a required infrastructure necessary for using the product (e.g. electric vehicles).
- Free rider problem: Consumers may in principle value certain sustainability benefits, but absent some external enforcement mechanism each individual has an incentive to deviate and purchase cheaper non-sustainable alternatives. If many consumers behave this way then the required critical mass of consumers paying for the benefit is absent.

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[6] Ibid., para. 601

[7] Ibid., para. 582.

- Consumer behavioural biases: Sometimes consumers are irrational and their actions can be inconsistent with their values. It may be, for instance, that consumers' ex-ante perceptions of their valuation of a sustainability benefit and its associated costs to them is pessimistic compared to their ex-post valuation once the measure has been implemented.

14 Demonstrating these types of market failure exist might help to circumvent the Catch-22 problem identified above, although they are likely difficult to demonstrate in practice. Moreover, Commission's requirement for *compensatory benefits* for consumers restricts the potential for exemption under Article 101(3) to the subset of agreements which seek to overcome these specific types of market failure, if the assessment is to be based on consumer WTP. Given the multitude of sustainability problems created by markets of today, a broader measure of benefit is required in order to allow assessments to be adapted for agreements which cannot be shoehorned into this narrow framework.

ASSESSMENTS BASED ON "COLLECTIVE BENEFITS" TO CONSUMERS CAN ONLY MAKE LIMITED PROGRESS TOWARDS IMPROVING SUSTAINABILITY

15 The Commission's answer to the problem articulated in the previous paragraph is to propose a third way of evaluating consumer benefit. That is, what the Guidelines term as *"collective benefits"* - sustainability improvements of interest to society more broadly, irrespective of the consumers' valuation of those benefits:. The Commission explains that where sustainability problems are not localised to consumers, *"…a collective action, such as a cooperation agreement, may be needed to internalise negative externalities and bring about sustainability benefits to a larger group of the society"*.[8] There could be many ways to quantify collective benefits, ranging from valuations of saved healthcare costs to non-market valuations of the improved quality of natural resources or avoided emissions. The field of environmental economics offers a range of tools for this.

16 But yet again, the Commission ringfences its assessment to the benefits accruing to consumers within the market, requiring *"substantial overlap"* between beneficiaries and the pool of consumers.[9] In doing so, it creates a clear inconsistency with the purpose of bringing about sustainability benefits to larger groups within society. As described above, negative externalities arise because there is a non-economic cost to production which is not factored into the market price that consumers pay and this cost accrues *externally* to the market - hence the problem is referred to by economists as an "externality". If the assessment of an agreement must be biased to partially or even fully exclude the beneficiaries experiencing the externality (where consumers in the market are unaffected), then any assessment under Article 101(3) is not guaranteed to arrive at an outcome that will allow the externality to be corrected. Furthermore, parties to sustainability agreements will be dependent upon adopting a technique for evaluating benefits which is far-removed from the concept of consumer WTP, if they are to avoid the Catch-22 situation articulated in the previous section applying to collective benefits too.

17 A demonstrative example alluded to in the Guidelines is a hypothetical agreement to phase out pollutive fuel types for motor vehicles. The agreement might have the anticompetitive effect of increasing fuel prices by reducing choice in fuel types, but it also benefits society by resulting in

[8] Ibid., para. 601

[9] Ibid., paras 602-604

cleaner air. According to the Commission's proposed approach, such an agreement could be exempt from competition rules if the benefits it brings to the consumers (e.g. improved health) compensate them for the increase in fuel prices. Notably, the detrimental health consequences of breathing air polluted by vehicle fuel emissions affects everyone in the relevant geography indiscriminately. Yet the health benefits accruing to other stakeholders who do not purchase the pollutive fuel (for instance, children living in the areas polluted by vehicle emissions) are apparently not pertinent to this assessment. If it was, in fact, found that the cost of the less pollutive fuel outweighed the health benefits accruing to consumers, this agreement would not be permitted under competition rules to the detriment of *all* stakeholders affected by the pollution.

18 The motor vehicle fuel example is an example where there *is* overlap between the pool of beneficiaries and consumers in that market. In these instances, non-consumer beneficiaries could in principle still benefit from sustainability agreements if the benefits accruing to consumers are sufficient enough to outweigh the costs. But there are also instances where there is *no* overlap between the consumer and beneficiary pools. An example of this, again provided in the Draft revised Guidelines, is clothing made from sustainable cotton which is cultivated using reduced chemical and water inputs.[10] The Commission is explicit that the benefits of the reduced chemical and water use in the cotton production process would not be relevant for assessment under Article 101(3) if they accrue only to local stakeholders, such as people living near the cotton fields. Hence any agreement seeking to implement these sustainability initiatives would not qualify for exemption from EU competition rules on the basis of the collective benefits it brings to society.

19 In both these examples, there is an unavoidable moral question around the implicit message that consumers should not be required to pay for improvements in the welfare of stakeholders outside of the market. As established, sustainability problems exist because consumers purchase products at prices which do not reflect the entirety of the costs of production to society. Preventing agreements which seek to internalise these costs could prove a hindrance to sustainable development and the promise of the European Green Deal that there should be "no person and no place left behind".[11]

THE SOLUTION IS TO REQUIRE NO COMPENSATION FOR CONSUMERS WHEN AGREEMENTS REQUIRE THEM TO PAY THE "TRUE COSTS" OF THEIR CONSUMPTION

20 Economic theory suggests that the most efficient way to correct a negative externality is to force the market to internalise the cost of the externality in question. If factories must pay a high enough price for effluent they emit into rivers or the air, then it will no longer be economically sensible for them to do so and they will either reduce production or invest in technology which helps reduce the emissions-intensity of their production processes. Genuine sustainability agreements propose to implement measures that are necessary to correct for the environmental or social harms caused by production. These measures may impose a cost (monetary or otherwise) on consumers. But this cost should not be viewed as a harm inflicted upon the consumer by a third party - rather, it is the "true cost" of consuming the product in question once non-economic costs are factored in. Put differently, it is the price required in order to avoid consumption of the product inflicting harm on others or the environment. If a consumer is willing to pay the true cost,

[10] Ibid., para. 604

[11] https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en

then the price they pay should help to offset that harm. If the consumer is not willing to pay, then they will be forced to reduce the amount they purchase, which in turn may lead to more sustainable levels of consumption.

21 It is understandable that that Commission has been unwilling to radically broaden the type of benefits that can be taken into account to include out-of-market benefits: since (as explained in the Commission's Policy Brief[12]) this risks stepping outside the core objective of antitrust to protect competition on the market – and instead, DG Competition becoming an agent of environmental policymaking. However, this focus on benefits is not the only option for clarifying the Guidelines for parties seeking to implement sustainability measures. There is also the question of what constitutes a harm to competition in the first place. We submit that insofar as any agreement simply results in consumers facing the *true cost* of their consumption (and no other competitive harm), this represents an improvement in competition on the market, not a harm. Indeed, a core objective of protecting effective competition is to ensure that prices reflect costs. There is a false equivalence in assuming that anything which results in lower prices must mean competition is working more effectively (and vice versa).

22 Seen in this way, agreements which simply ensure that the market (and its consumers) pay the true costs associated with its products would not require compensatory benefits to be shown, even if the superficial result were to be higher prices. Higher prices themselves would not be an indicator of competitive harm if they were to result in prices being brought closer into line with the total underlying costs of production. And, if there were no harm in such situations, it follows that there would be no requirement to demonstrate compensatory benefits.

23 We therefore propose that **the guidelines should be amended to clarify that there is no harm, and therefore no requirement to show compensatory benefits, insofar as agreements result in consumers facing the *true cost* of their consumption**. This would permit a departure from the cost-benefit approach which underpins the Commission's current thinking. Rather, assessments of sustainability agreements would need to establish that the agreement in question would indeed help to correct a negative externality and that any increase in costs to consumer genuinely reflect the costs required to implement that change.

24 Finally, it is also important to consider what the counterfactual to a sustainability agreement may be. There may be an implicit assumption that other policies will deal with the problems created by negative externalities. But this is premised on a strong view about the efficacy of policy as a counterfactual to an industry agreement. In many cases, industry agreements might be more efficient and cost-effective at tackling the problem in question than policy. Industry agents most likely know their production processes and customers better than regulators and may therefore be able to tailor the solution appropriately, applying a careful scalpel to the problem rather than a broadsword. Where this is the case, and under the premise that sustainability problems must be addressed somehow if the EU is to achieve its sustainability goals, some sustainability agreements by industry agents could end up saving consumers money. We therefore think that a sensible addition to the Guidelines would be to recognise that agreements which present a more efficient and effective alternative to current public policy solutions would be welcome.

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[12] European Commission, Directorate-General for Competition, Competition policy brief. 2021-01 ▯ September 2021, European Commission, 2021, https://data.europa.eu/doi/10.2763/962262

25 This is particularly pertinent given that the Draft revised Guidelines frame sustainability agreements as a last resort – any agreement seeking to achieve measures which are already required by policy are not seen as indispensable.[13] If these agreements are then found not to satisfy the *fair share* condition, the sustainability problems they seek to resolve seem likely to continue unaddressed. Facilitating the implementation of genuine industry sustainability agreements may be a vital instrument for supporting the European Green Deal and achieving sustainability objectives. The Commission should therefore reconsider the restrictive nature of its proposals for assessing these agreements under competition rules with a view to ensuring that any indispensable agreement which brings genuine and quantifiable sustainability benefits is not prevented from doing so by competition rules.

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[13] EC, Draft revised Guidelines, para. 583