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EU Issues Competition Safe Harbor Guidelines For Sustainability Agreements

June 13, 2023

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The European Commission **recently issued Guidelines** "on the competitive assessment of agreements between competitors that pursue sustainability objectives ('sustainability agreements')." Recognizing sustainability as a "core principle" of the European Union, the Commission promises "to implement the United Nations' sustainable development goals." Noting that the concept of "sustainability" includes climate change, such as the reduction of greenhouse gases, the Guidelines state they are also intended to embrace other economic, environmental and social sustainability objectives, citing labor and human rights as examples. The revised Guidelines are set to take effect in July 2023.

The new provisions explain that, as a threshold matter, not all sustainability agreements raise competition issues. Only those agreements that "negatively affect parameters of competition, such as price, quantity, quality, choice or innovation," are even subject to EU competition law. The language suggests that the first line defense of a challenge to a sustainability agreement among competitors is that the agreement is outside the scope of the statute because it does not affect a parameter of competition. The Guidelines provide examples (with no real analysis) of agreements that fall outside the scope of competition law:

- agreements that aim solely to ensure compliance with international treaties;
- agreements related to internal corporate conduct, for example on measures not to exceed a certain ambient temperature in their office building;
- agreements to set up an industry-wide database containing general information about suppliers that have (un)sustainable value chains (e.g., pay or do not pay a living wage; do or do not limit input supplies from sustainable manufacturers); and
- agreements related to industry-wide awareness campaigns.

The Guidelines next proceed to examine the application of competition principles to what it calls "sustainability standardisation agreements" (SSAs). SSAs are agreements between competitors to adopt and comply with certain sustainability standards, such as agreements to replace or phase out certain products (e.g., fossil fuels, such as oil and coal) or to harmonize product packaging to reduce waste or facilitate recycling. It distinguishes legitimate SSAs from sustainability standards that are used to disguise price fixing, output limitations and other anticompetitive practices, such as agreements to adopt sustainability measures but to pass on any higher costs in the form of increased sales prices to customers. By contrast the Guidelines provide safe harbors for SSAs that include the following six cumulative conditions:

First, the procedure for developing the standard must be transparent and open to all competitors in a market;

Second, the standard may not be imposed on competitors who do not wish to adopt it;

Third, competitors must remain free to adopt higher sustainability standards than those adopted by an industry;

Fourth, competitors may not exchange commercially sensitive information that is not objectively necessary to develop and implement the standard;

Fifth, non-discriminatory access to the outcome of the standard (e.g., an agreed-upon label) must be provided to each competitor; and

Sixth, the standard must satisfy at least one of the following two conditions: (a) it does not result in a "significant increase in price" or significant reduction in product quality; or (b) the combined market share of the competitors may not exceed 20% of any relevant affected market.

The Guidelines provide no guidance on what would constitute a "significant increase in price," except to say that the "significance of the price increase will depend on the characteristics of the product and the relevant market." For SSAs that do not qualify for safe harbor treatment, participants may nevertheless defend the agreement on the basis that it does not adversely affect competition or that it provides offsetting efficiency gains.

The Guidelines provide examples of SSAs that either would qualify for safe harbor treatment or else would create no appreciable effect on competition. As an example of the former, the Guidelines posit a situation where breakfast cereal manufacturers organize to limit excess packaging size, the result of which is the preservation of natural resources that go in to the packaging as well as a reduction in cost due to the decrease in packaging input purchases.

As an example of the latter, the Guidelines envision a clothing industry-wide effort to create a label to be used on garments made with fabric produced in developing countries where workers are paid a fair wage that is above the local prevailing wage rate. The hypothetical wage increase of 20% leads to an increase in the retail price of the goods of between 1.5-2%. The Guideline's analysis is that the positive labor effects (more nutrition and healthcare access for workers) offset the price increase to consumers so that the agreement is "unlikely to have appreciable negative effects for customer."

Taking the Temperature: The adoption of sustainable agreement safe harbors in the EU places the U.S. and EU antitrust enforcement of sustainability agreements in stark relief. In both the EU and, previously, the UK, antitrust enforcers are incorporating national and international sustainability goals into competition policy. In the U.S., however, federal antitrust enforcers remain largely silent about sustainability goals, while (mostly Republican) State AGs and federal and state legislators representing states with carbon production or processing industries continue to ramp up threats of antitrust lawsuits and investigations with attendant fines and damages against firms that participate in industry-wide climate sustainability agreements. The most recent industry reaction to the flurry of Republican warnings are reflected in reports of major insurers quitting the

Net-Zero Insurance Alliance (NZIA) over concerns about antitrust exposure. These reports follow earlier reports of other financial institutions abandoning their participation in certain financial sector climate coalitions. With no U.S. legislative or enforcement relief for sustainability standardization agreements in sight, it remains to be seen whether banks, insurers and other financial institutions subject to U.S. antitrust law will take sufficient comfort from the EU or UK policies to enter sustainability agreements despite the risks posed by U.S. antitrust law.

However, the new Commission Guidelines raise many unanswered questions, including how to determine what is a "significant increase in price" or a "significant reduction in quality" for purposes of applying the safe harbor. Similarly, the Guidelines suggest there may have to be an inherent balancing between the concern for consumer prices against the concern for higher labor wages, though it provides little or no guidance on how to analyze it. That same balancing act has caused an unresolved but continuing tension in current U.S. antitrust enforcement.

Italian citizens Sue Oil Supermajor To Compel Accelerated Emissions Reductions

June 13, 2023

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On May 9, 2023, Greenpeace, fellow climate change activist group ReCommon and 12 Italian citizens from regions affected by impacts of climate change announced their intention to file a **first-of-its-kind lawsuit** in Italy against the country's largest energy company. The plaintiffs claim that ENI has known about the detrimental effects of fossil fuel burning since 1970 but through "lobbying and greenwashing" continued to encourage extraction, thereby contributing to climate change. The allegations levied against ENI are, in part, concerned with a study the company carried out between 1969 and 1970, which found that rising fossil fuel use could lead to a climate crisis within decades. In its statement, Greenpeace Italy further claimed that ENI's current decarbonization strategy and policies are inconsistent with the Paris Agreement. The lawsuit also names two of the company's largest shareholders, Italy's Ministry of Economy and Finance (MEF) and Cassa Depositi e Prestiti S.p.A. (a public investment bank overseen by the MEF). The plaintiffs claim that the MEF strongly influences the company's policies and therefore bears a share of the responsibility.

The plaintiffs seek an injunction compelling (i) ENI to update its decarbonization strategy to commit to a 45% emissions reduction by 2030 (compared to 2020 levels), and (ii) the MEF, as an influential shareholder of ENI, to adopt a climate policy to guide its participation in ENI, each in line with the Paris Agreement.

The 12 Italian citizen plaintiffs have requested that the court rule on whether or not ENI has violated their rights, including their rights to life, health, and private and family life. Notably, the plaintiffs are not seeking to recover but rather are requesting an order regarding defendants' liability with respect to the events at issue.

Taking the Temperature: This novel litigation, brought against an oil major to compel it to change its emissions reduction strategy, is the latest in a slew of similarly motivated actions by shareholders and environmental pressure groups. We have covered shareholder initiatives that have sought to force emissions reductions onto board agendas. Recent examples include proposals from Follow This, and from ShareAction in January and again in April. The Italian lawsuit against ENI was tactically announced on the eve of the company's annual general meeting.

The claim against ENI is also part of a growing trend of individual citizens litigating against companies, national governments or state-owned entities based on claims linked to climate change. In March of this year, a group of Swiss citizens accused the Swiss government of infringing on the right to life and health of elderly women. In Montana, 16 residents—ranging from ages 2 to 18—commenced litigation claiming that they "have been and will continue to be harmed by the dangerous impacts of fossil fuels and the climate crisis," and that the defendants have violated the Montana Constitution by fostering and supporting fossil fuel-based energy policies in the state that led to these conditions. Similar constitution-based climate-related suits against state governments are pending in Hawaii, Utah, and Virginia. Relatedly, in August 2022, Brazil's Supreme Court declared that the Paris Agreement is a human rights treaty, meaning that the government was constitutionally bound to combat climate change.

Unlike other recent developments, such as the consumer class action filed against Delta Air Lines for allegedly falsely claiming to be the "First Carbon-Neutral Airline," or the report by Dutch environmental advocacy group Changing Markets Foundation's claiming that companies in the UK and German food sectors improperly are using claims such as 'carbon neutral' and 'climate positive,' the case against ENI concerns historic, not current, alleged greenwashing. Whether it leads to similar such actions remains to be seen. The trends also appear to be in line with a London School of Economics' study, which noted five areas to watch for climate-related litigation in 2023: cases involving personal responsibility; cases challenging commitments that excessively rely on greenhouse gas removals or 'negative emissions' technologies; cases focused on short-lived climate pollutants; cases explicitly concerned with the climate and biodiversity nexus; and strategies exploring legal recourse for the 'loss and damage' resulting from climate change.

Morningstar Sustainalytics Launches Low-Carbon Transition Assessment Tool for Investors

June 13, 2023

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In April 2023, as part of ongoing efforts to enhance transparency, Morningstar Sustainalytics launched a ratings system designed to provide investors with an assessment of a company's current net-zero alignment. The company's Low Carbon Transition Ratings provide a set of "forward looking" assessments of the degree to which a company's projected greenhouse gas (GHG) emissions diverge from its net-zero pathway between the time of the assessment and 2050. According to **Morningstar Sustainalytics**, the "two-dimensional framework" measures both a company's exposure from its expected GHG emissions and accounts for management actions, including its demonstrated short-term investment plans, policies and programs.

The new ratings framework builds on Morningstar's ESG risk ratings system and analyzes a company's low-carbon transition exposure and management preparedness across the company's value chain for each scope of emissions using the 1.5°C required policy scenario from the **Inevitable Policy Response (IPR)**. IPR is an initiative commissioned by the United Nations-backed global network of financial institutions **Principles for Responsible Investment (PRI)**, which seeks to prepare institutional investors for portfolio risks and opportunities related to climate change.

The company's overall degree of alignment is expressed as an "implied temperature rise"—the projected impact on the environment if all companies shared the assessed company's investment alignment and transition preparedness. Companies are placed in one of five categories: (i) aligned; (ii) moderately misaligned; (iii) significantly misaligned; (iv) highly misaligned; and (v) severely misaligned. The company-specific reporting also details the company's expected emissions across all three scopes from the present to 2050, its net-zero budget (i.e., the company's sector- and region-specific budget required to align to a net-zero emissions pathway by 2050), and the "expected emissions gap" (i.e., emissions that are not managed and the severity of misaligned emissions).

The value-chain analysis provides an individual assessment of the company's alignment to the net-zero budget for each scope of emissions (Scope 1, Scope 2, Scope 3 upstream and Scope 3 downstream), including how much each scope contributes to the company's overall rating. The analysis includes an assessment of GHG exposure, based on the expected emissions gap for each scope, and a score (out of 100) for management actions related to each emissions scope. Companies are also given an overall management score (out of 100) and individual scores across a set of indicators, including its GHG emissions reduction program, renewable energy program, scope of GHG reporting, GHG emissions targets, operating performance and solvency.

Taking the Temperature: As we have reported on extensively, the proliferation of ratings providers, using different criteria and ranking companies according to varied scoring systems, has prompted concern from regulators, investors and market participants. We thoroughly explored these issues in a longer article published in the Harvard Law School Forum on Corporate Governance, points echoed in a Review of Finance paper entitled Aggregate Confusion: The Divergence of ESG Ratings, which disclosed the findings of an investigation into the "divergence of sustainability ratings."

Regarding potential regulation, the UK government, for instance, recently launched a consultation set to close on June 30 on the scope of a future regulatory regime for ESG ratings providers. The Securities and Exchange Board of India launched a similar ESG ratings-focused consultation.

Moreover, ratings providers continue to adjust their approaches, with, for example, MSCI recently announcing significant changes to its ESG investment fund rating methodology that "aim to raise the requirements for a fund to be assessed as 'AA' or 'AAA' rated, improve stability in Fund ESG Ratings and add transparency through simpler attribution analysis." However, these changes will result in downgrades to 31,000 of the funds currently rated by MSCI. Likewise, Dow Jones recently announced changes to its Sustainability Index.

WBA Releases First Financial System Benchmark

June 13, 2023

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In May 2023, the World Benchmarking Alliance (WBA) **released a report** on the first edition of its **Financial System Benchmark**, which assesses financial institutions' progress toward climate change goals. The WBA is a non-profit organization which aims to develop a variety of benchmarks to assess and rank "the world's most influential companies" on their contribution to meeting the United Nations' Sustainable Development Goals (SDGs). The benchmark, which WBA launched at COP27 in November 2022, assesses and ranks the 400 "most influential" or "keystone" financial institutions worldwide — those "with disproportionate influence on the structure and function of the systems within which they operate" — on their contribution to global sustainability transition goals, such as the SDGs and the Paris Agreement. The financial institutions assessed include banks, asset owners such as pension funds, development finance institutions (DFIs), sovereign wealth funds, asset managers, including alternative investor entities such as private equity, venture capital and hedge funds, and insurance companies.

The institutions were **assessed across three areas**:

1. Governance and strategy (40% of the total score), using five indicators: impact management and strategy, senior leadership accountability and remuneration, gender equality and diversity, engagement policy, and public policy engagement;
2. Respecting planetary boundaries (30% of the total score), using nine environment- and climate-related indicators, five on alignment with the Paris Agreement (financed emissions, financed emissions targets, engagement aligned with a 1.5° C trajectory, climate solutions and approach to fossil fuel sectors) and four on nature and biodiversity (nature and biodiversity-related impacts, protection and restoration of nature and biodiversity through finance, protection and restoration of nature and biodiversity through engagement, and nature- and biodiversity-related solutions); and
3. Adhering to societal conventions (30% of the total score), using 18 indicators related to human rights.

The report highlighted seven key takeaways:

1. The entire financial system scores poorly on governance and climate. Although there are "no notable overall outliers," some financial institutions have made progress in certain areas and can stand as examples for others.

2. The entire system is lagging on the approach to fossil fuels, a "contentious issue" that requires "stronger multi-stakeholder collaboration" and more transparency.
3. Financial institutions that have "gender-balanced boards" outperform those that do not across all climate-related indicators.
4. Financial institutions that tie executive compensation to sustainability also outperform across all climate indicators.
5. Stronger regulations result in greater transparency, which in turn leads to better performance across climate indicators.
6. Asset owners that are regarded as "important influencers" lack transparency and score poorly on climate-related indicators.
7. Despite often being at the forefront of financing climate solutions, private equity and venture capital are typically outside the scope of "mainstream regulations," lack transparency and score poorly on climate indicators.

The WBA report offers specific recommendations for stakeholders, including regulators, standards organizations, activists and financial institutions themselves, as well as five overarching calls to action:

1. Board responsibility and top-down leadership for climate and sustainability actions are essential.
2. Gender-balanced boards and leadership go beyond equity considerations by positively impacting climate-related and sustainability decision-making.
3. Financial institutions must recognize their influence and commit to positively changing the financial system from within.
4. Wide-ranging transparency in climate disclosures is critical to financial system transformation, in particular around climate-change solutions.
5. Given WBA's assessment that no institutions had "an adequate approach to phasing out all fossil fuels," collaboration among all stakeholders is necessary to tackle this complex issue.

Taking the Temperature: The financial services industry remains at the center of numerous climate-related issues and challenges, including concerning emissions financing, financial system stability and regulatory capital requirements, as well as having to navigate "anti-ESG" forces in the U.S. While banks increasingly are voluntarily establishing emissions financing reduction targets and strategies, as are some insurers, at least some financial institutions have been subject to litigation and shareholder activity about their absolute climate commitments or the adequacy of plans to meet articulated targets.

Meanwhile, regulators remain concerned about whether financial institutions are adequately assessing and disclosing climate-related risk, and about overall financial system stability. Recent examples include studies on these issues conducted by the Bank of England and the European Central Bank; guidelines issued by Canada's Office of the Superintendent of Financial Institutions on climate risk management applicable to insurers and financial institutions; and guidance from the New York Department of Financial Services for New York domestic insurers on managing the financial risks from climate change.

MSCI Publishes Latest Annual Report on Public Company Climate Progress

June 13, 2023

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According to the recently published **MSCI May 2023 Net Zero Tracker report**, more listed companies are making climate commitments, setting decarbonization targets, and providing related disclosures, but these steps have not resulted in reductions of direct emissions by those companies. The report is the latest edition of the firm's periodic reporting on progress by public companies towards the Paris Agreement's goal of limiting global temperature increases to 1.5 degrees Celsius above pre-industrial levels.

MSCI's report is based on its All Country World Investable Market Index, which includes large-, mid- and small-capitalization listed companies across 23 developed market and 27 emerging market countries, covering approximately 99% of global equities.

The report shows a broad range of commitments made by the companies analyzed. While nearly half (44%) of public companies have set decarbonization targets, only 17% of those targets, if achieved, would align emissions with the Paris Agreement's 1.5oC goal. Just over half (51%) of listed companies align with a warming below 2 degrees Celsius. Even within those net zero targets, some companies rely on carbon offsets lacking third-party validation. MSCI reports that listed companies will emit 11.2 gigatons of direct Scope 1 emissions in 2023, showing no change since 2022. That accounts for 18.6% of global emissions, and demonstrates, according to MSCI, that "the trajectory of both global and corporate carbon emissions" was not permanently reduced either by the global financial crisis or coronavirus pandemic. MSCI reports that the proportion of listed companies providing "at least some of their Scope 3 emissions" has increased to more than a third, up from around 30% seven months ago. This comes as Scope 3 emission reporting is becoming more commonplace as the regulatory landscape moves closer towards mandatory climate disclosure requirements.

MSCI also examined by industry revenue exposure to alternative energy, energy efficiency, and green buildings. REITs, utilities and companies in the real estate management, automobiles and capital goods sectors had the largest exposures, with banks, insurance companies, consumer services firms, biotech and life sciences and pharmaceutical companies having the lowest exposure. Because some "of the largest shares of sustainable impact revenue show up in utilities and other carbon-intensive industries," MSCI contends that investors may need to

“tolerate more portfolio emissions in the near term – particularly in industries that are hard to decarbonize – to drive down emissions in the real economy by 2050.”

Taking the Temperature: We have previously reported on the challenges faced by companies in meeting their net-zero pledges – including the potential risk of regulatory enforcement action or civil litigation due to a company’s lack of progress toward or inability to meet a disclosed net-zero commitment in a timely fashion. With this in mind, the report highlights that even where a company discloses a climate target, often that would not result in meeting Paris-aligned goals. Shareholder and regulatory scrutiny of this issue has been increasing. We previously discussed climate activist shareholder group Follow This’s bid to push several oil majors to set more ambitious targets covering Scope 3 emissions. Likewise, Border to Coast Pension Partnership, a pension pool consisting of 11 UK local government pension schemes, announced that “[o]il majors and banks must make greater progress on climate pledges or risk losing the support of Border to Coast Pensions Partnership on key votes this” Annual General Meeting season. Similar pressure has recently been exerted by New York City pension funds.