

<b>Title:</b> <b>Bidding in auctions of emissions allowances</b>	<b>Impact Assessment (IA)</b>
<b>IA No:</b> <b>Lead department or agency:</b> HM Treasury <b>Other departments or agencies:</b> n/a	<b>Date:</b> 31/05/2012 <b>Stage:</b> Final <b>Source of intervention:</b> EU <b>Type of measure:</b> Secondary legislation <b>Contact for enquiries:</b> Annie.gascoyne@hmtreasury.gsi.gov.uk
<b>Summary: Intervention and Options</b>	<b>RPC Opinion: RPC Opinion Status</b>

Cost of Preferred (or more likely) Option			
Total Net Present Value	Business Net Present Value	Net cost to business per year (EANCB on 2009 prices)	In scope of One-In, Measure qualifies as One-Out?
£0.906m	£0.906m	£0.12m	No   NA

**What is the problem under consideration? Why is government intervention necessary?**

EU law requires the financial regulation of specific bidders in Government auctions of EU emissions allowances. These rules mainly apply to the banks and investment firms that would bid for those emissions allowances on behalf of UK industry. The rules mean that in order for such UK based persons to bid in Government auctions across the EU, they must first be authorised by the Financial Services Authority. Without an authorisation framework, this authorisation cannot occur and they cannot lawfully bid.

**What are the policy objectives and the intended effects?**

The policy objective is to ensure that relevant UK based persons are able to bid in auctions of emission allowances across Europe, and relevant EU persons are able to bid in UK auctions, under the EU regulatory framework. We are therefore implementing the relevant provisions of the EU Auctioning Regulation, as required. Relevant UK based persons that wish to bid in auctions of emissions allowances will then have the option to apply for the necessary Financial Services Authority authorisation.

**What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)**

These changes are required by the EU in order for certain UK based persons to bid in auctions of emissions allowances, and relevant EU persons are able to bid in UK auctions. A failure to implement could prevent certain UK based persons from bidding in auctions of emissions allowances across Europe and certain EU persons from bidding in UK auctions. Preventing these persons from bidding would mean they could not offer a service to UK industry to purchase emissions allowances; thus having a significant impact on the Government's approach to hitting its emissions targets. Furthermore, preventing them from bidding in auctions of emissions allowances would damage London's position at the heart of the carbon market, of which London currently enjoys an 80% global share.

The assumptions in this IA have been tested in consultation - no substantive responses were received.

<b>Will the policy be reviewed?</b> It will be reviewed. <b>If applicable, set review date:</b> 06/2017					
Does implementation go beyond minimum EU requirements?			Yes		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.		Micro Yes	< 20 Yes	Small Yes	Medium Yes
What is the CO <sub>2</sub> equivalent change in greenhouse gas emissions? (Million tonnes CO <sub>2</sub> equivalent)				<b>Traded:</b>	
				<b>Non-traded:</b>	

*I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.*

Signed by the responsible Minister:

M Hsu

Date:

11/6/12



# Summary: Analysis & Evidence

# Policy Option 1

**Description:** Cost estimates are based on current auctioning information and Financial Services Authority estimates of their regulatory costs.

## FULL ECONOMIC ASSESSMENT

Price Base Year 2012	PV Base Year 2012	Time Period Years 9	Net Benefit (Present Value (PV)) (£m)		
			Low: n/a	High: n/a	Best Estimate: -£0.906m

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	n/a	n/a	n/a
High	n/a	n/a	n/a
Best Estimate	0.08125	0.12	0.906

### Description and scale of key monetised costs by 'main affected groups'

There will be one-off costs to relevant persons of completing an application for Financial Services Authority authorisation and annual costs of refreshing the bidders authorised status. The total one off cost is estimated to be £81,250. The total annual costs are estimated to be £120,000 per annum. These figures are based on current auctioning data and FSA regulatory experience.

### Other key non-monetised costs by 'main affected groups'

n/a

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	n/a	n/a	n/a
High	n/a	n/a	n/a
Best Estimate	n/a	n/a	n/a

### Description and scale of key monetised benefits by 'main affected groups'

The benefits stemming from this increased regulation of bidders in carbon auctions are difficult to quantify. They will essentially be the ability for certain firms to provide services to their clients in relation to auctions of emissions allowances and increased confidence in the primary carbon market.

### Other key non-monetised benefits by 'main affected groups'

The carbon market is still in its infancy. Recent challenges faced by the market have included fraudulent attacks on the secondary market and phishing scams attacking the registry system (the accounts that hold the allowances). These have threatened to undermine confidence in this emerging market. There are several work streams at EU level to bolster security in the carbon market. These regulatory changes implement a more robust regulatory framework for the primary carbon market.

### Key assumptions/sensitivities/risks

Discount rate (%)

3.5

The key assumption is around the number of firms that will seek FSA authorisation and that these firms will already be regulated by the FSA. Assumptions have also been made on the time it will take to complete an application. This assumption was tested during the consultation process, where no substantive responses were received.

## BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 0.12	Benefits: n/a	Net: -0.12	No	NA



## Evidence Base (for summary sheets)

The policy objective is to ensure that relevant UK based persons are able to bid in auctions of emission allowances across Europe, and relevant EU persons are able to bid in UK auctions, under the regulatory framework set out in the European Auctioning Regulation (AR). This will help ensure auction participation and preserve and strengthen London's position at the heart of the carbon market, of which London currently enjoys an 80% global share. The changes will be welcomed by market participants and implement the EU requirements necessary to allow certain persons to bid to auctions of emissions allowances.

### The policy context

#### The EU Emissions Trading System

The EU Emissions Trading System (EU ETS) is at the heart of UK Government policy to tackle climate change. The system covers sectors responsible for around half of the UK's carbon dioxide emissions. The EU ETS is expected to deliver annual carbon savings of 51MtCO<sub>2</sub> in 2020, a reduction in the emissions of the power sector and heavy industry of 22 percent based on 2008 levels.

The EU ETS works on a 'cap and trade' basis. A cap is set on EU Member States' emissions, which declines over time. Emissions allowances equal to each year's cap are then issued and allocated to sectors covered by the system. Allowances can be allocated for free or auctioned by national governments.

Levels of auctioning in the EU ETS are set to rise dramatically in phase III (from 2013). This is reflected in the forecast quadrupling of UK revenues from auctioning. The EU regulatory framework for auctions has been strengthened to reflect this large increase in auctioning. This includes requiring certain bidders in the auctions to be authorised to bid by the Financial Services Authority (FSA).

It is worth noting that aviation will be joining the EU ETS from 2012. These changes also apply to certain bidders in auctions of aviation emissions allowances.

#### Phase III of the EU Emissions Trading System

The AR sets out the regulatory framework for auctioning emissions allowances during phase III and aviation allowances in 2012. It requires EU Member States to implement certain elements of the regulation to allow relevant categories of persons to bid in auctions of emissions allowances across the EU.

Member State implementation is required to allow credit institutions,<sup>1</sup> authorised by the FSA under the Capital Requirements Directive (2006/48/EC) and investment firms, authorised by the FSA under the European Markets in Financial Instruments Directive (MiFID) to bid in the auctions on behalf of their clients. These changes are also required to allow a further category of persons, currently exempt from MiFID (mainly commodities brokers), to bid in auctions on their own account or on behalf of others.

Implementing these elements of the AR will result in the FSA gaining powers to authorise relevant persons to bid in auctions of emissions allowances. This involves amendments to the secondary legislation related to the Financial Services and Markets Act (2000) and minor amendments to the Act itself.

### The options considered

There are three possible options:

- Do nothing
- Implement the minimum requirements
- Implement changes that go slightly beyond the minimum requirements with regards to certain non-UK bidders (the proposed option)

#### Do nothing

Not implementing the regulatory framework required by EU regulations would prevent relevant UK based persons from bidding in auctions of emissions allowances across Europe. This would impose an

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<sup>1</sup> Primarily banks and investment banks



unjustified constraint on the activities of some UK based persons such as banks and investment banks and damage London's position at the heart of the carbon market.

### Implement the minimum requirements

Implementing the minimum requirements would result in the FSA possessing different enforcement powers for certain offshore firms. While the usual powers would be applicable to EU investment firms and credit institutions the FSA would be without these powers with regards to MIFID-exempt EU firms. Therefore this is not the recommended option. The costs of this option would be the same as for the favoured option (and are costs to UK firms only). The benefits of this option would be largely similar except that the powers in place would be inconsistent as described above.

### Implement changes that go slightly beyond the minimum requirements with regards to certain non-UK bidders (the favoured option)

This is the favoured option and is explained in detail below.

## **The proposed approach**

### The Financial Services and Markets Act changes

The AR identifies the following broad groups as persons eligible to apply for admission to bid in auctions of carbon emission allowances:

- (i) Operators of installations or aircraft operators covered by the emissions trading scheme (essentially users of emissions allowances who need to buy allowances for compliance purposes) or groups of such operators or public bodies that control them
- (ii) Investment firms or credit institutions authorised under the MiFID or the Capital Requirements Directive (2006/48/EC)
- (iii) Persons who are covered by the exemption from MiFID for dealing on own account in financial instruments where this is ancillary to their main business

Entities under (i) above can bid without authorisation (although it may not always be practical for them to do so), but for entities falling within (ii) where auctioned products are not financial instruments, and (iii), their eligibility to bid depends on the Member State in which firms are located having enacted legislation enabling the relevant competent authority in that Member State (in the UK, the FSA) to authorise the firms to bid on their own account (for entities falling within (iii)) or on behalf of clients (for entities falling within (ii) and (iii)).

It is necessary to make some changes to provisions regarding regulated activities in the Financial Services and Markets Act 2000 and related legislation to ensure that all the groups identified in the AR are in a position to be able to apply for admission to bid in auctions. The approach taken has been to keep changes to a minimum. The reception, transmission and submission (whether as agent or principal) of a bid at an auction of investments is made a specified activity in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 with appropriate exemptions, e.g. for (i) above. Changes are also made to allow the FSA to exercise its powers in relation to a person who is authorised to provide bidding services.

### Amendment to the Recognised Auction Platform Regulations 2011

New provisions are added to the Recognised Auction Platform Regulations 2011 to give effect to requirements in the AR for the competent authority to have the power (and the procedure to be applied when exercising the power) to impose civil penalties for contraventions by auction platforms in certain circumstances relating to grounds for refusal or suspension of admission to bid, and monitoring the relationship with bidders.

### Changes to the Money Laundering Regime

Article 59 of the AR sets out rules for persons authorised to bid on behalf of others or on their own account. The Regulations provide that competent national authorities are responsible for authorising such persons to bid, and for monitoring their compliance with the rules. Amongst others, it provides that the authorities shall only authorise such persons where they comply with the requirements of the national legislation transporting the EU Third Money Laundering Directive. In the UK the relevant national



legislation is the Money Laundering Regulations 2007 (MLRs), Schedule 3A to the Terrorism Act 2000 and Schedule 9 to the Proceeds of Crime Act 2002.

Under the AR, most persons or firms eligible to apply to bid in auctions of emissions allowances – investments firms and credit institutions - are already subject to the Money Laundering Regulations. However the category of businesses currently subject to an exemption under Article 2(1)(i) of the Markets in Financial Instruments Directive (MiFID) are not covered. These firms are those for which the provision of commodity derivatives services, while connected to their core business, is not their core business, so they currently benefit from the exemption.

In order to allow these specific MiFID-exempt firms to bid in auctions of emissions allowances, they must be subject to anti-money laundering requirements.

In order to implement this option, the Government proposes to legislate so that MiFID-exempt firms who want to apply to bid on their own account or on behalf of others have to comply with the requirements of the MLRs when carrying out those activities.

This will provide legal certainty with regard to the extent and nature of the bidder's anti-money laundering obligations. Under this option all firms falling under MiFID article 2(1)(i) which engage in bidding for emission auctions would need to comply with all the requirements set out in the MLRs including on Customer Due Diligence, record keeping and monitoring of transactions. They would be subject to anti-money laundering supervision and to the range of regulatory and criminal sanctions related to the MLRs. Under this arrangement, the FSA will have statutory powers and the mandate to supervise and sanction accordingly in line with the current arrangement under the MLRs.

This would create a level playing field in that MiFID-exempt bidders failing to comply with the MLRs will be subject to similar supervision arrangements and sanctions as others non-MiFID exempt bidders which are already supervised and subject to all MLRs obligations.

#### Micro organisations

Micro organisations have not been excluded as the EU regulation does not provide any basis for us to do so. In practice we consider it highly unlikely that any micro firm would ever wish to become authorised in auctions of emissions allowances as it would be contrary to all our experience. In general we only expect much larger organisations to apply for authorisation.

#### Going slightly beyond the minimum EU requirements with regards to certain non-UK bidders

The proposed approach implements the minimum EU requirements except in the area of FSA powers where the proposal is to go slightly beyond the minimum requirements with regards to certain non-UK bidders. A strict reading of the AR would result in the FSA having its usual powers with regards to firms from the rest of the EU falling within categories (i) and (ii) above but without powers regarding EU firms falling within category (iii). It is not desirable for the FSA to have different powers regarding EU firms engaging in the same activity but dependent on the specific nature of the firm in question. Therefore we propose going slightly beyond the minimum EU requirements.

The gold-plating of the regulations in this proposal only applies to firms from other EU countries and therefore does not present an additional cost to UK firms.

## **Monetised and non-monetised costs and benefits of implementing the proposed approach**

### **Costs**

These costs will only apply to relevant persons who wish to bid in auctions of emissions allowances. The majority of these persons are already authorised by the FSA for their other activities and therefore the additional costs imposed by these new regulations will be marginal (including the costs imposed on the FSA).

It is worth noting that the relevant persons will only seek authorisation to bid in auctions of emissions allowances if they consider it will provide a financial return (through trading allowances or providing bidding services to their clients). They are not required to purchase allowances for compliance purposes.



## Number of persons

The AR sets out who the relevant persons are. In broad terms they are investment firms authorised as such by the FSA, credit institutions authorised as such by the FSA and certain categories of persons that are specifically exempted from regulation by the EU framework (such as commodities brokers).

Data from the FSA show there are around 2,500 investment firms and around 100 credit institutions currently authorised by the FSA. Estimating the number of persons specifically exempted from regulation under MiFID is more difficult as we do not hold this data. Whether business is non-MiFID depends on the type of product and the nature of the firm wishing to bid and is set out in the EU Auction Regulation. Nevertheless, based on our knowledge of regulated firms and our operational experience of auctioning in the current phase of the EU ETS, we assume that in total only around 50 firms will seek authorisation to bid in auctions of emissions allowances. This is because:

- Only around 90 of the regulated firms are involved in commodities trading of any type, of which, 50 are specialised in non-carbon commodities. Based on our experience in auctions of emissions allowances we judge 40 of these firms will wish to bid in the auctions on behalf of clients. Respondents to the FSA consultation did not comment on this assumption and informal FSA conversations with industry have suggested it is reasonable. We therefore keep it as our best estimate.
- Estimating the number of firms exempt from regulation under MiFID is more challenging. Nevertheless we have assumed that 10 of the MiFID-exempt will seek authorisation (of which 5 currently hold no authorisation and the other 5 hold some form of authorisation)

## One off costs

There will be one-off costs to relevant persons of completing an application to become authorised by the FSA to bid in the auctions.

The FSA have assessed that the fee charged to relevant firms (which broadly reflects the cost borne by the FSA when authorising firms) currently conducting MiFID business will be around £250. This is consistent with the FSA's existing fee structure, as well understood by industry. The 5 MiFID-exempt firms currently holding no authorisation will pay £1500 with the other 5 holding some form of authorisation paying £750. Each year the FSA consults on its fees. These fees reflect the cost to the FSA of conducting various different types of authorisation. The requirements of the Commission Auction Regulation have been included in this framework and when the FSA consulted on these specific fees, industry made no comment.

The FSA consider that demonstrating compliance with requirements would likely consume two full-days' work at an assumed total cost of £1,200 for relevant firms (£600 per day). This figure includes the accepted average £200 cost of applying to approve a person under the FSA's approved person's regime. We have assumed that on average, two persons might need to be approved. It is not anticipated that professional advice would be needed. It also includes the cost of work to demonstrate compliance with FSA prudential and money laundering requirements (the other £800).

Therefore the total one-off costs to all 50 businesses of applying to become authorised to bid in auctions of emissions allowances are estimated to be £81,250.

The fee estimates have been provided by the FSA and explicitly consulted on by them. The FSA received no substantive responses from their consultation therefore these remain our best estimate.

## Ongoing costs

We anticipate the ongoing compliance costs of the money-laundering requirements to equate to around two days' work annually. The FSA do not believe this requirement to be overly burdensome beyond normal prudent business management. Indeed after the first year, the burden is likely to fall. Allowing another two days to ensure compliance against the prudential requirements this gives a total ongoing cost of no more than £120,000 annually across the 50 firms or £2,400 per firm (£600 per day).

## Total direct monetised costs

The total monetised costs are therefore estimated to be £81,250 in the first year and £120,000 each year after that.



## Non-monetised costs

We do not expect any non-monetised costs as a result of these changes.

## Assumptions

As set out above the key assumption is around the number of firms that will seek FSA authorisation and that these firms will already be regulated by the FSA. Assumptions have also been made on the time it will take to complete an application. Respondents to the consultation did not comment on these assumptions. We therefore keep them as our best estimate.

## Benefits

The benefits stemming from this increased regulation of bidders in carbon auctions are difficult to quantify. They will essentially be increased confidence in the carbon market and the ability for certain firms to provide services to their clients in relation to auctions of emissions allowances.

Relatively speaking the carbon market is still in its infancy. Recent challenges faced by the market have included fraudulent attacks on the secondary market and phishing scams attacking the registry system (the accounts that hold the allowances). These have threatened to undermine confidence in this emerging market. There are several work streams at EU level to bolster security in the carbon market. These regulatory changes implement a more robust pan-European regulatory framework with regards to bidders in the primary carbon market. It has not been possible to monetise these benefits.

The other key benefit and the reason these changes are likely to be welcomed by stakeholders are because they will enable UK-based persons to provide services to their clients in relation to auctions of emissions allowances by being able to bid on their clients' behalf. These are services that these firms currently provide to their clients which they would be prevented from providing without these changes. It has also not been possible to monetise these benefits although any decision to become authorised by the FSA to bid on behalf of others in auctions of emissions allowances would be a commercial decision for the firm.

These benefits will benefit the UK by helping to preserve and strengthen its central role in the carbon market. The UK is a world leader in the carbon market with an 80% global share.

## Annual profile of direct costs of the favoured option – (£m) constant prices

Costs have been set out to 2020 as this is when the relevant phase of the EU ETS ends. EU rules regarding the next phase of the EU ETS have yet to be decided.

	2012	2013	2014	2015	2016	2017	2018	2019	2020
Initial authorisation	0.08125								
Annual on-going compliance costs		0.12	0.12	0.12	0.12	0.12	0.12	0.12	0.12
<b>Total costs</b>	<b>0.08125</b>	<b>0.12</b>	<b>0.12</b>	<b>0.12</b>	<b>0.12</b>	<b>0.12</b>	<b>0.12</b>	<b>0.12</b>	<b>0.12</b>

## Impacts on competition

As these changes will increase those eligible to bid in the auctions of emissions allowances it is anticipated these changes will increase competition.

## Equality Impact

There will not be any impacts on equality.

## Implementation plan

The FSA is the delivery body for these changes. We have been working closely with them to ensure the proposed approach works effectively. The FSA has now consulted on the changes needed to their rulebook.

We are aiming to implement these changes by end Q2 2012 in order for them to be in place prior to the relevant auctions being held.