



# Summary: Analysis & Evidence

# Policy Option 1

Description: Cost estimates are based on discussions with exchanges and FSA estimates of their regulatory costs.

## FULL ECONOMIC ASSESSMENT

Price Base	PV Base	Time Period	Net Benefit (Present Value (PV)) (£m)		
Year 2012	Year 2012	Years 6	Low: n/a	High: n/a	Best Estimate: -£0.774
COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)	
Low	n/a	1	n/a	n/a	
High	n/a		n/a	n/a	
Best Estimate	0.049		0.165	0.774	
<b>Description and scale of key monetised costs by 'main affected groups'</b> There will be one-off costs to operators of completing an application for Financial Services Authority authorisation and annual costs of complying with the ongoing regulatory requirements. The total one off costs are estimated to be £49,000. The total annual costs are estimated to be £165,000 per annum. These figures are based on responses to the consultation and FSA estimates.					
<b>Other key non-monetised costs by 'main affected groups'</b> 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	n/a	
High	n/a		n/a	n/a	
Best Estimate	n/a		n/a	n/a	
<b>Description and scale of key monetised benefits by 'main affected groups'</b> It has not been possible to monetise the benefits from this increased regulation of the primary carbon market as they will essentially be increased confidence in the carbon market.					
<b>Other key non-monetised benefits by 'main affected groups'</b> 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.					
<b>Key assumptions/sensitivities/risks</b>			<b>Discount rate (%)</b>	3.5	
As there are currently six RIEs in the UK, of which only one has an interest in carbon, we have assumed that only one RIE will apply to become authorised to auction EU emissions allowances. Costs have been estimated over a period of six years. Potential platforms will become authorised by the FSA in 2012 and the EU Auctioning Regulations only allow for a contract of a maximum of five years from 2013.					

## BUSINESS ASSESSMENT (Option 1)

<b>Direct impact on business (Equivalent Annual) £m:</b> Costs: 0.140      Benefits: n/a      Net: -0.140			<b>In scope of OIOO?</b> No	<b>Measure qualifies as</b> NA
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## Evidence Base (for summary sheets)

The policy objective is to ensure that UK Recognised Investment Exchanges (RIEs) are able to bid to become auction platforms for EU carbon emission allowances under the regulatory framework set out in the European Auctioning Regulation. This will help preserve and strengthen London's position at the heart of the carbon market, of which London currently enjoys an 80% global share. These changes are welcomed by market participants and implement the minimum EU requirements necessary to provide the basis for RIEs to become eligible to bid to become auction platforms.

### The policy context

#### The EU Emissions Trading System

The 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. EU Emissions Allowances (EUAs) 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.

The UK currently auctions EUAs through the Debt Management Office (DMO). Changes to the EU ETS in Phase III mean that, from 2013, national auctions must take place on regulated markets within the meaning of the Markets in Financial Instruments Directive (MiFID). RIEs are the UK form of MiFID "regulated markets". The DMO is not an RIE.

It is worth noting that aviation will be joining the EU ETS from 2012. The auctioning of aviation allowances must also take place on regulated markets.

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

The European Auctioning Regulation (AR) sets out the regulatory framework for auctioning EUAs during Phase III and aviation allowances from 2012. It requires EU Member States that are potential hosts of auction platforms to extend national laws, implementing specific elements of the European financial regulatory framework, to the activity of auctioning EU emissions allowances. As well as MiFID, the EU instruments which contain provisions that need to be applied are the Market Abuse Directive (MAD) and the Anti-Money Laundering Directive.

In the UK, the relevant implementing provisions are set out in the Financial Services and Markets Act (2000) (FSMA), and related secondary legislation, and the anti-money laundering regulations (MLR).

Appointments of auction platforms will be subject to a competitive procurement process. According to procurement rules bidders must be legally capable of auctioning emissions allowances. This requires the host Member State to implement the financial regulations as set out in the AR.

The AR provides for the appointment of a common auction platform by EU Member States and the European Commission. It also permits individual Member States to opt out of the common platform by appointing their own national auction platform provided they notify the Commission by the deadline (which has already passed). The UK, along with Germany and Poland, has informed the Commission that it will exercise this opt out and appoint a national auction platform.

### The options considered

There are three possible options:

- Do nothing
- Implement changes that go beyond the minimum requirements
- Implement the minimum requirements (the favoured option)

#### Do nothing

Not implementing the regulatory framework required by EU regulations would prevent UK based operators from taking part in the various EU-wide procurements for auctioning platforms to auction EU emissions allowances. This would impose an unjustified constraint on the activities of UK based exchanges and damage London's position at the heart of the carbon market.

### Implement changes that go beyond the minimum requirements

This option has not been considered as it would constitute 'gold plating'.

### Implement the minimum requirements

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

## **The proposed approach**

The proposed approach is to make the minimum regulatory changes possible to implement the EU requirements. The proposed changes mirror, as far as is possible, the regulations RIEs already face in the secondary market, in order to minimise additional regulatory burden.

### Recognised auction platforms

Member States must ensure that competent national authorities (the Financial Services Authority (FSA) in the UK) are able to authorise and supervise auction platforms.

The AR requires a separate authorisation process for regulated markets to become auction platforms for the purposes of the AR. It is therefore proposed to create a new category of "recognised auction platform". This would be a RIE for which a recognition order as an auction platform has been made by the competent authority. The requirements applying to RIEs will be applied with modifications as appropriate to provide the basis for recognition as an auction platform.

The key recognition requirements for becoming a recognised auction platform are set out in the draft regulations. The specific elements of the national measures transposing the provisions of MiFID that the AR requires Member States to apply in order for a platform to be established in that Member State include matters such as organisational, monitoring, transparency and access requirements.

In order to make the process as efficient as possible and minimise the regulatory burden imposed by these regulations, compliance by an applicant with the recognition requirements applying to it as an RIE will be taken as evidence that the applicant satisfies any equivalent recognition requirements for being an auction platform. This will negate as far as possible any need for repeating elements of the process already undergone in becoming an RIE and minimise costs.

The AR requires that in the process of appointing an auction platform, provision is made for a choice between two-day spot and five-day futures (both forms of tradable carbon credits – futures are for delivery in the future whereas spots are delivered to a much shorter timescale). The final selection of the auctioned product is made on the basis of a competitive tender and value for money.

The UK transposition of the regulatory framework under MiFID specifically applies to trading, as opposed to auctioning, and only to financial instruments such as five-day futures but not to spot products. As the AR allows for a choice between auctioning emissions allowances in the form of futures or spots, they must both be subject to regulation.

### Modifications to elements of FSMA

Certain provisions of FSMA are modified in their application to ensure they build on the existing regulatory requirements but reflect the new requirements of the AR. These include ensuring that the exemption from the general prohibition on undertaking regulated activity by way of business will, in the case of an RIE which is a recognised auction platform, apply equally both to its business as an RIE and as an auction platform.

Separate provision is also made for applications for recognition as an auction platform and for the revocation of recognition orders, modelled on the equivalent provisions in FSMA, but reflecting the provisions of the AR. It is made clear that revocation of an order recognising an RIE as a recognised auction platform does not necessarily affect its recognition as an RIE. Provision is also made enabling the FSA to give directions requiring a recognised auction platform to take steps to comply with recognition requirements or other obligations, again modelled the relevant sections of FSMA.

Sections on liability in relation to recognised body's regulatory functions, the publication of information by recognised investment exchanges and the notification requirements are modified to ensure that they will apply appropriately to RIEs which have also received recognition as a recognised auction platform. The FSA's power to require information to satisfy itself that a RIE is complying with directly applicable community legislation made under MiFID is also extended. This is so the FSA can check that an RIE recognised as a recognised auction platform is complying with the AR.

Similar modifications are made in relation to the obligation for the FSA to make arrangements for investigation of complaints about recognised bodies. In the case of an RIE which is also a recognised auction platform, a "relevant complaint" will be not only a complaint which the FSA considers is relevant to the question of whether it should remain an RIE, but also a complaint which is relevant to the question whether the exchange concerned should remain a recognised auction platform.

Modifications also clarify that HM Treasury's power to confer functions on the Tribunal in respect of disciplinary proceedings of an investment exchange also applies in relation to proceedings under the rules of investment exchange made in relation to an auction platform. Modifications also ensure that the provisions regarding control over recognised investment exchanges work appropriately in relation to an RIE which is also a recognised auction platform. The FSA will be required to consider whether a proposed acquisition in relation to an RIE will not threaten the sound and prudent management of any financial market, or any auction platform operated by the investment exchange.

Elements of FSMA relating to Competition Scrutiny are not being applied to recognised auction platforms. The UK will be appointing a single recognised auction platform. Accordingly, provision for competition scrutiny would be of limited relevance. However, the exclusion from the prohibition in the Competition Act 1998 provided for in FSMA will apply to the regulatory provisions and practices relating to a recognised auction platform as they apply to other regulatory provisions and practices of an RIE.

The section on passport rights given to EEA Operators to make arrangements in the UK to facilitate access to, or the use of, a specified regulated market it operates outside the UK also apply in relation to arrangements for access to a specified auction platform it operates outside the UK. Equally, modifications are made in relation to RIEs making the same arrangements in another EEA state to facilitate access to an auction platform operated in the UK. The obligation on the FSA to comply with a request for information under MiFID is extended to requests made under that provision as applied to auction platforms under the emission allowances auctions regulations.

### Market abuse

The framework for dealing with market abuse also needs to be applied, with modifications, to the auctioning of emissions allowances. In the UK, the EU Market Abuse Directive (2003) (MAD) is also transposed into national law in FSMA.

As MAD only applies to financial instruments, existing market abuse provisions do not extend to auctioned emissions allowances that take the form of two-day spot transactions. (Five-day futures however are defined as financial instruments so are already covered.)

Consequently the AR makes provision for an equivalent market abuse regime which cover auctioned products that are not financial instruments within the meaning of MAD. These articles reflect the provisions of the existing MAD in order to produce a harmonious and effective framework for the treatment of either two-day spot or five-day futures.

In addition, further modifications are required to the transposition of MAD in FSMA to reflect the different nature of emission allowances and the fact that they will be sold by auction. MAD is largely secondary market focused, whereas auctioning is a primary market activity. Modifications are therefore needed in order to satisfy the provisions of the AR and to ensure that the existing market abuse provisions work effectively in relation to auctioning emissions allowances.

The proposals to modify the UK's market abuse provisions to include the auctioning of emissions allowances seek to apply the existing UK provisions on market abuse to emission allowances offered for sale on auction platforms and expand the necessary definitions to encompass emissions auctions.

The AR effectively recreates the provisions of the EU MAD for two-day spots so as to apply the EU market abuse regime to these types of instruments. The AR is directly applicable. By contrast, as carbon futures are classified as financial instruments under MiFID, the market abuse provisions already apply to them as well as any domestic measures imposed by Member States.

To note, the UK currently has in place a slightly wider definition of market abuse than that of the EU Market Abuse Directive 2003 (MAD). This is because the UK's domestic framework for market abuse, which was established in 2001, preceded the European Commission's legislative vehicle in this area. The Government has committed to aligning the UK and wider EU market abuse frameworks once MAD is reviewed in October 2011. Consultation with industry has indicated that to alter the UK regime now to then face further disruption at the end of the review would pose unnecessary costs and complexity on market participants who are familiar with the UK's existing market abuse regime. Notably, the bodies bidding to become auction platforms are recognised investment exchanges, already subject to these

existing requirements. No additional cost will be imposed on them by complying with the UK market abuse regime and no concern was raised directly in the consultation, where this issue was explored extensively with industry.

## Money Laundering

The AR sets out certain anti-money laundering rules which must be applied by auction platforms when auctioning emissions allowances. To achieve this Member States must apply their domestic measures implementing certain provisions of the Third Money Laundering Directive (3MLD) to platforms auctioning emissions allowances. The 3MLD is implemented in the UK by the Money Laundering Regulations 2007 (MLR), the Proceeds of Crime Act 2002 (POCA) and the Terrorism Act 2000 (TACT).

### Amendments to the Money Laundering Regulations

The MLR are modified to include auction platforms as a 'relevant person' as required. The regulations require relevant persons to have in place policies and procedures in order to prevent activities related to money laundering and terrorist financing, to take appropriate measures to train employees and required measures for supervision and enforcement.

The AR requires that auction platforms are supervised for compliance with the anti-money laundering provisions it contains. The MLR are amended so that the FSA is the supervisor for auction platforms. The FSA must monitor the compliance of auction platforms with customer due diligence, monitoring and record keeping, and notification requirements of the AR. They may also monitor compliance with the relevant regulations of the MLR.

The MLR are also amended so that the FSA may impose a civil penalty on an auction platform which fails to comply with the customer due diligence and monitoring and record keeping requirements of the AR, or the relevant regulations of the MLR. The penalty imposed may be of such an amount as the FSA considers appropriate – which for these purposes means effective, proportionate and dissuasive – in line with the penalties which may ordinarily be imposed by supervisors for breaches of the MLRs.

### Amendments to Proceeds of Crime Act and Terrorism Act

The AR requires that domestic legislation implementing various requirements of 3MLD, including provisions relating to the reporting of suspicious activity and breaches of the reporting requirements, is applied to auction platforms. These provisions are contained in POCA (in relation to criminal property) and TACT (in relation to terrorist property), which contain requirements and offences specific to "the regulated sector" – equivalent to those persons who are relevant persons for the purposes of the MLRs.

The definition of a business in the regulated sector for the purposes of POCA is amended to include platforms auctioning allowances in accordance with the AR. The definition of business in the regulated sector for the purpose of TACT is similarly amended.

## **Monetised and non-monetised costs and benefits of implementing the minimum requirements**

### **Direct costs**

These costs are likely to only apply to one market participant, as no others have indicated an interest in becoming a UK based Regulated Auction Platform. It is worth noting that although the costs will be imposed on the market participant, the AR provides for the auction platform to recover its costs through fees on bidders in the auctions.

### One off costs

There will be one-off costs to operators of completing an application to become regulated by the FSA. Based on discussions with the market an application is assumed to take 8 hours to complete. The average hourly costs are assumed to be £75 which reflects the average of various staff of sufficient seniority to complete and review the application. It has also been assumed that there will be a £5,750 cost for professional advice in relation to the application. This results in a total cost to the platform of making an application of £6,350. This has been rounded up to the nearest £1,000 to allow for a contingency.

There will also be one off costs to the FSA of considering an application. The FSA will recover these costs through the application fee the market participant will be required to pay. In their associated consultation on implementing these changes, the FSA has proposed to set the application fee at £35,000. This reflects their assessment of the complexity and amount of work they anticipate will be required to consider the application and includes time costs for each relevant specialist area of the FSA.

and the necessary governance arrangements. The fees are minimised by the requirement for an auction platform to also be an RIE and therefore its ability to overlay an auction process on its existing services.

Operators will also face costs of reviewing and amending their internal systems, processes and rulebooks in order to ensure compliance with the new regulations. Data received from exchanges during the consultation process indicated that this review and associated amendments would take 8 hours and consequently cost £600, based on the salary of individuals qualified to undertake such a review. There will also be costs of professional advice of £5,750. This results in a total cost to the platform of reviewing and amending their systems of £6,350. This has been rounded up to the nearest £1,000 to allow for a contingency.

Therefore the total one-off costs of applying to become authorised to auction EU emissions allowances are estimated to be £49,000.

#### Ongoing costs

There will also be annual ongoing costs of complying with the regulatory requirements however since RIEs already comply with MiFID, MAD and MLR, as transposed nationally, for their other activities these costs would be an incremental increase to ensure compliance with the auction platform requirements. These costs would not be necessary until the start of auctioning so would impact in year 2 (the year after the application is made).

These ongoing compliance costs consist of staff costs to complete the regulatory processes such as customer due diligence, record keeping and supervision of the auctions. It is expected that an exchange will need a full-time member of staff to be responsible for these activities. It is estimated the annual cost of this staff member will be £115,000 based on requiring someone of sufficient seniority to complete the required activities.

There will also be ongoing costs the FSA of supervising the auctioning platform. Again these costs will be recovered through annual fees imposed on the auction platform. The FSA has proposed an annual fee of £50,000 in their associated consultation on implementing these changes. This reflects the amount of regulatory resource required in similar areas.

#### Total direct monetised costs

The total monetised costs are therefore estimated to be £49,000 in the first year and then £165,000 per annum.

#### **Indirect costs**

In the event that a UK based operator were to decide to obtain FSA authorisation as an auction platform in order to bid in the various procurement processes there would be other associated indirect costs. These would include the costs of producing a bid and the set up, testing and running costs of the auctioning platform itself. This would be a commercial decision for the operator and not directly related to compliance with these new regulations.

#### **Non-monetised costs**

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

#### **Assumptions**

As there are currently six RIEs in the UK, of which only one has an interest in carbon, we have assumed that only one RIE will apply to become authorised to auction EU emissions allowances.

#### **Direct benefits (non-monetised)**

The direct benefits stemming from this increased regulation of carbon auctions are difficult to quantify as they will essentially be increased confidence in the carbon market.

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 regulatory framework for the primary carbon market.

There will also be benefits stemming from the introduction of a harmonised pan-European regulatory regime to replace the inconsistent.

It has not been possible to monetise these benefits.

## Indirect benefits

The primary reason these changes will be welcomed by market participants are because they will enable UK-based exchanges to compete in the various procurements across Europe. Therefore indirect benefits will depend on the outcome of these procurement processes.

It is standard practice on the secondary carbon market for fees to be charged per allowance exchanged. The EU regulations prevent auction platforms imposing fees that exceed those on the secondary market.

Broadly speaking, fees on the secondary market tend to be around €0.003 per allowance although there is some complexity due to the interaction between fees for exchange membership and fees per allowance. This would indicate that, depending on the number procurements UK based platforms are successful in, the total fees could be at least €6m per year although we cannot pre-empt any pricing strategies that bidders in any of the procurements may adopt. Furthermore the platforms costs would have to be subtracted from these fees. This would be a commercial decision for the operator and not directly related to compliance with these new regulations.

There will also be indirect benefits from increased activity on a platform's secondary carbon market stemming from their involvement in the primary carbon market. Anecdotal evidence suggests exchanges view these benefits as significant.

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

## The do nothing option

Not implementing these changes would avoid imposing the costs outlined above on UK-based operators that wished to become authorised to auction EU emissions allowances but would also prevent them from experiencing any of the benefits set out above.

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

These costs have aggregated over a 6 year period. This is because any potential platforms will have to become authorised in 2012 and then the maximum contract period allowed in the AR is 5 years from 2013. All figures have been rounded up to the nearest £1,000 to allow for a contingency. The benefits have not been included as it has not been possible to monetise them.

	2012	2013	2014	2015	2016	2017
Platform costs of completing an application	0.007	0	0	0	0	0
FSA costs of reviewing an application	0.035	0	0	0	0	0
Platform costs of reviewing systems	0.007	0	0	0	0	0
Platform ongoing regulatory costs	0	0.115	0.115	0.115	0.115	0.115
FSA ongoing supervisory costs	0	0.050	0.050	0.050	0.050	0.050
<b>Total costs</b>	<b>0.049</b>	<b>0.165</b>	<b>0.165</b>	<b>0.165</b>	<b>0.165</b>	<b>0.165</b>

## Wider impacts

This change has no impact on small or micro firms as no RIEs fall into these categories and this is not expected to change.

## Impacts on competition

These changes are designed to increase competition in the various procurements for auction platforms. Without these changes UK firms would not be able to compete as they are required under EU law.

## Equality Impact

These changes are not expected to have an impact 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 been consulting on the necessary changes to their rulebook alongside HM Treasury's consultation on the new financial regulations.

We are aiming to implement these changes as soon as possible as the various EU procurements are due to commence by the end of 2011 or in early 2012.