

Title: REMIT Criminal Sanctions IA No: DECC0164 Lead department or agency: DECC Other departments or agencies: Ofgem, FCA	Impact Assessment (IA)
	Date: 24/06/2014
	Stage: Consultation
	Source of intervention: EU
	Type of measure: Secondary legislation
	Contact for enquiries: Arvin Jeboo/ Ben Tirunawarkarisu
Summary: Intervention and Options	RPC Opinion: RPC Opinion Status

Cost of Preferred (or more likely) Option				
Total Net Present Value	Business Net Present Value	Net cost to business per year (EANCB in 2009 prices)	In scope of One-In, Two-Out?	Measure qualifies as
-£1.3 m	£0 m	£0 m	No	N/A

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

1. The Government said in the Annual Energy Statement that it wants to see strong sanctions against those who manipulate energy markets and that it intended to consult on criminal penalties, such as those already in place in financial markets, for such actions. The consultation will provide additional evidence in relation to the costs and benefits and test the rationale for a criminal sanctions regime.
2. Competition, transparency and market integrity are key drivers of good consumer outcomes. It is important that we have efficient wholesale energy markets that allow participants to compete fairly and without discrimination.
3. In addition to distorting the price of specific gas and power products and so causing loss to other market participants, market abuse – market manipulation and insider trading – can undermine confidence in the markets and undermine market participants' willingness to trade, decreasing liquidity, distorting competition and increasing costs. It could also, ultimately lead to higher prices for domestic and business consumers and undermine the public's confidence in the fairness of energy prices.
4. EU Regulation on wholesale market integrity and transparency (REMIT) introduces new prohibitions against market manipulation and insider dealing in energy markets and new requirements in relation to information provision. The Regulation gives Member States discretion as to whether to use civil sanctions, criminal sanctions or both. Other member states are taking a range of approaches to its implementation with some using civil law, others criminal and some creating both criminal and civil sanctions. Decisions are driven by each member state's overall legal and regulatory framework.
5. The Government has already legislated to create a civil enforcement regime, but there are cases in which the threat of civil sanctions is not sufficient to deter offending behaviours. The availability of criminal sanctions will give consumers assurance that Ofgem is able to address any issues as they arise and will create an effective deterrent. Because of the importance of alignment with the UK financial services regime which has already criminal sanctions for market abuse the Government believes that the creation of the additional criminal sanctions for energy market abuse is necessary to comply fully with the requirements of REMIT.

What are the policy objectives and the intended effects?

1. The policy objective is to put in place a criminal sanctions regime for energy market manipulation and insider trading in order to:
 - have strong sanctions available to Ofgem for those who break market rules as soon as possible;
 - address difference in treatment between financial markets (where criminal sanctions are already in place for these offences) and energy markets and remove any incentives to act improperly in energy markets compared to financial markets; and
 - ensure that there is a suitably dissuasive and proportionate regime for all types of improper conduct and market participant.
2. The objective is to create criminal sanctions as soon as possible in order to ensure Ofgem has effective, proportionate and dissuasive tools to deter wrong-doing and ensure that criminal sanctions are available in the event of offences being committed. The civil sanctions are not a sufficient deterrent against the full range of possible infractions; criminal sanctions are more dissuasive in a number of important cases.
3. Using regulations would address the gap in energy market regulation (compared to the financial market regulation of similar offences) in a timely manner. It would, however, enable a maximum prison sentence of only two years whereas the maximum sentence for similar financial sector offences is seven years. We are mindful of the continuing disparity that would be created by this lower maximum sanction so are proposing to keep the relationship between energy and financial markets under review as the regulatory regime around financial markets develops.

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

Three options have been considered at this stage.

0. Do nothing (the base case option in which no new criminal sanctions would be made and breaches of REMIT prohibitions and requirements would continue to attract civil sanctions).
1. Limited new criminal offences for breaches of the central offences in REMIT Article 3 (insider dealing) and Article 5 (market manipulation). Such offences would be created through secondary legislation under s.2(2) of the European Communities Act. This means a maximum prison sentence of two years for these offences compared to seven years in the financial services sector.
2. New criminal offences in relation to all REMIT requirements and prohibitions – that is the prohibitions in Articles 3 and 5 and the requirements created by other REMIT articles, most notably those created by Article 8 (the provision of information to ACER) and Article 9 (registration with Ofgem).

Option 1 is the preferred option because:

- The limited approach focussing on the offences of insider dealing and market manipulation provides the best balance of strong and effective deterrence to market abuse with minimal burdens on market participants and meets the requirements of the EU REMIT regulation without gold-plating.
- Option 0 does not address the policy objective.
- Option 2 has a risk of higher costs without significant additional benefits.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 06 / 2018

Does implementation go beyond minimum EU requirements?			No		
Are any of these organisations in scope? If Micros not	Micro	< 20	Small	Medium	Large

exempted set out reason in Evidence Base.	Yes	Yes	Yes	Yes	Yes
What is the CO2 equivalent change in greenhouse gas emissions? (Million tonnes CO2 equivalent)			Traded: N/A	Non-traded: N/A	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: Date:

Description: This option is to create new criminal offences around insider dealing and market manipulation in energy markets (in line with Articles 3 & 5 of REMIT) to be available to Ofgem alongside civil offences. The offences would be created using regulations and would therefore have maximum sentences of 2 years imprisonment.

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2015	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -34.6	High: -0.6	Best Estimate: -1.3

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0	0.08	0.6
High	0	4.0	34.6
Best Estimate	0	0.15	1.3

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

- The main affected groups are:
 - Ofgem as energy market regulator
 - Energy market participants – in particular those with trading activities
 - Market participants investigated for potential breaches of REMIT
- We do not expect criminal sanctions for offences of market manipulation and insider dealing to impose new burdens on market participants, because Ofgem would use information that is already required under the existing Civil Sanctions regime.
- We expect costs for Ofgem of around £150,000 a year, for investigation and handling of suspicious cases depending on the number of criminal investigations undertaken.
- We expect the cost to compliant business to be £0.
- If criminal cases are prosecuted there would also be costs to defendants and to the criminal justice system through sentencing costs. There is a high threshold to cross before any prosecution.

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

All identified costs have been monetised.

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'

No benefits have been monetised, see below for non-monetised benefits.

Other key non-monetised benefits by main groups

1. Main benefit to wholesale energy market participants and consumers is the deterrence effect on market abusive behaviour meaning that fewer people will lose money to unfair trading.
2. Increased market confidence from the operation of a market free from improper practices is likely to have non-quantifiable competition benefits including increased participation, more liquidity and better price formation.
3. Government is expected to benefit from better alignment between energy market regulation and financial market regulations, reducing unnecessary regulatory burdens and costs.

Key assumptions/sensitivities/risks

Discount rate (%)

3.5

1. Effective enforcement and that there will be no additional costs to compliant businesses.
2. Similarity to the legal process for financial market manipulation and insider trading.
3. Assumptions of costs to the regulator for enforcement and transition costs to a new regime, and costs assumed for court costs and sentencing costs assumed in the sensitivity analysis.
4. The discount rate used for future costs and benefits is 3.5%, the Her Majesty’s Treasury (HMT) Green Book social discount rate.
5. The policy impacts are appraised over 10 years in line with the HMT Green Book.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 0	Benefits: 0	Net: 0		

Description: This option is to create criminal offences in line with all the prohibitions and requirements in REMIT. It would therefore include the offences set out in option 1 and add further offences most notably around the provision of information and registration to Ofgem (articles 8/9 of REMIT). As with option 1, sentences would be limited to a maximum of 2 years imprisonment.

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2015	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -34.6	High: -0.6	Best Estimate: -2.6

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0	0.08	0.6
High	0	4.0	34.6
Best Estimate	0	0.3	2.6

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

- The main affected groups are:
 - Ofgem as energy market regulator
 - Energy market participants – in particular those with trading activities
 - Market participants investigated for potential breaches of REMIT
- We do not expect criminal sanctions for all prohibitions of REMIT to impose new burdens on market participants because Ofgem would use information that is already required under the existing civil sanctions regime.
- We expect costs to Ofgem of £300,000 a year for investigation and handling of suspicious cases, depending on the number of criminal investigations undertaken.
- If criminal cases and prosecutions occur there would also be costs to the criminal justice system through sentencing costs.

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

All identified costs have been monetised.

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'

No benefits have been monetised, see below for non-monetised benefits.

Other key non-monetised benefits by main groups

1. Main benefit to wholesale energy market participants is the deterrence effect on market abusive behaviour meaning that losses due to unfair trading are reduced.
2. Increased market confidence from the operation of a market free from improper practices is likely to have non-quantifiable competition benefits including increased participation, more liquidity and better price formation
3. Government is expected to benefit from resulting better alignment between energy market regulation and financial market regulations, reducing unnecessary regulatory burdens and costs.

Key assumptions/sensitivities/risks**Discount rate (%)**

3.5

1. Effective enforcement and full compliance with REMIT regulations is assumed in line with the Impact Assessment Toolkit.
2. Similarity to justice process for financial market manipulation and insider trading.
3. Sensitivities exist around the assumptions for costs to the regulator for enforcement and transition costs to a new regime, and costs assumed for court costs and sentencing costs assumed in the sensitivity analysis.
4. The discount rate used for future costs and benefits is 3.5%, the Her Majesty's Treasury (HMT) Green Book social discount rate.
5. The policy impacts are appraised over 10 years in line with the HMT Green Book.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 0	Benefits: 0	Net: 0	No	N/A

Background

1. The Government said in the Annual Energy Statement that it wants to see strong sanctions against those who manipulate energy markets and that it intended to consult on criminal penalties, such as those already in place in financial markets, for such actions. Although cases of market abuse are likely to be rare, their impact can be significant.
2. The EU Regulation on wholesale market integrity and transparency (REMIT) prohibits insider dealing and market manipulation (behaviours considered as “market abuse”) in wholesale energy markets and establishes a monitoring regime for wholesale energy trades. It came into force in December 2011.
3. The Government created a civil enforcement regime for energy market abuse in June 2013. Under the civil enforcement regime the UK energy market regulator, Ofgem, has the ability to require information; carry out inspections. Under the regime trades will be reported to ACER and that information will be available to Ofgem, and market participants will have to keep records and comply with investigations. Ofgem will be able to impose unlimited fines for insider dealing and market abuse and other breaches of REMIT. Under that regime the powers create a strong deterrent but do not enable Ofgem to bring criminal proceedings. The original costs for REMIT civil sanctions were considered in a separate regulatory triage assessment in April 2013.
4. The civil GB REMIT enforcement regulations came into force on 29 June 2013. The civil regime is not yet fully in place because implementing Articles 8 (Data reporting) and 9 (registration of market participants) of REMIT is dependent on the publication of Implementing Acts. The Commission intends to adopt the Implementing Acts by autumn 2014.

Objectives

5. The policy objective is to put in place a criminal sanctions regime for energy market manipulation and insider trading in order to:
 - have strong sanctions available to Ofgem for those who break market rules as soon as possible;
 - address difference in treatment between financial markets (where criminal sanctions are already in place) and energy markets and remove any incentives to act improperly in energy markets compared to financial markets; and
 - ensure that there is a suitably dissuasive and proportionate regime for all types of improper conduct and market participant.

Rationale for government intervention

6. There are three key reasons for adding criminal offences to the GB REMIT civil enforcement arrangements for energy market manipulation and insider dealing.

The most serious breaches can lead to significant harm and therefore need strong sanctions.

7. The wholesale energy markets can be opaque as they are operated by numbers of highly skilled organisations and individuals using sometimes very technical financial instruments and agreements. This coupled with the huge significance of energy for the economy and consumers and the very large sums of money involved, means that, though the risk of wrong-doing is small, its impact could be great.¹
8. The wholesale energy markets for Great Britain have a value of between £299.1bn and £333.5bn a year, and the notional value of trades in the gas and power markets for the period February 2013 to January 2014 were for gas: £254.87bn and power: £41.5bn.² Additional to these values, a significant volume of trading of European energy products is done through London-based brokers. A proportion of these trades take place on market places regulated by the Financial Conduct Authority (FCA, the UK financial services regulator) so are subject to criminal sanctions for market abuse. Wholesale

¹ A joint investigation between Ofgem and the FCA into alleged gas market manipulation in 2012 reflected the seriousness of such actions- <https://www.gov.uk/government/news/edward-daveys-response-to-conclusion-of-investigation-in-to-alleged-uk-gas-market-manipulation>

² Actual brokered over the counter energy data was used (Source: London Energy Brokers Association), APX and N2EX auction data for 2013, plus the additional estimated proportion of that market that is not OTC (Source: Trayport Euro Commodities Market Dynamics Report 2013). Estimates calculated based LEBA's data, using simple averages of the daily prices for baseload month ahead ICE NBP price

energy market prices are significant not only because they affect market participants, but they also form the basis for retail prices eventually faced by household and industrial consumers and users of energy with associated cost of living and business competitiveness implications. It is also important for market participants, consumers, and the government to have confidence and trust in the integrity of wholesale energy markets as this is a prerequisite for competitiveness and confident investment decisions by market participants.

9. Unfair or manipulative market practices may increase energy price volatility and, as such, deter market entry and investment, which could have an adverse effect on long-term security of energy supply. In addition, it may have adverse implications for short-term security of energy supply if market prices are not driven by true supply and demand fundamentals.
10. Estimating the benefits of reducing illegal activities such as market abuse is very difficult. Evidence from the UK financial services sector, although not conclusive, suggests that the introduction of criminal sanctions for market abuse could have reduced the level of abnormal price movements ahead of regulatory takeover announcements and acted as a deterrent against insider trading.^{3/4}
11. The potentially significant economic impacts of insider dealing and market manipulation, coupled with the opaque nature of the wholesale energy markets make criminal sanctions for the most serious instances a proportionate regulatory response.

Distortion arising from the existence of criminal sanctions for insider trading in, or manipulation of, some energy-related markets or products but not others

12. Alignment with financial services regulation is a key priority because, while there are products that are clearly physical energy products or are clearly financial products, there is a significant amount of trading in products that can come under REMIT or financial regulation depending on the platform on which they are traded. Roughly 30% of gas volumes and 3% of electricity volumes take place on markets regulated by the FCA. Articles 3 and 5 of REMIT do not apply to all wholesale energy products because some of them are treated by regulations as financial instruments. Because of this closeness between the two sectors there is a risk that a difference in the penalties available for insider trading or market manipulation creates incentives that direct market abuse towards the energy sector.
13. The example of gas market manipulation by the hedge fund Amaranth Advisors LLC in the US in 2006 shows how the interactions between energy and financial markets creates potential for market abuse. As a European commission staff paper on REMIT⁵ notes:

“Amaranth accumulated natural gas futures positions on NYMEX with the view to sell these contracts in a very short period of time right before the futures contract in question expire and go in delivery. In fact, it sold large amounts of contracts on February 24, March 29, and April 26, 2006, the days on which the respective futures for March, April and May expire. The transactions were designed to produce artificially low “settlement prices”. Considered in isolation, this trading would be economically irrational because by driving down the settlement price, Amaranth made less on the sales of these contracts. However, Amaranth had previously taken positions several times larger in various financial derivatives on ICE, an organised marketplace in the US, and in the over-the-counter trade the value of which increased as a direct result of the decrease in the settlement price of the NYMEX natural gas futures contract. Thus, for every dollar lost on its sales of the NYMEX natural gas futures positions, it would gain several dollars on its derivative financial positions. According to a report of the Federal Energy Regulatory Commission of the US⁶, Amaranth profited by a total of at least \$59,000,000 and perhaps as much as \$168,000,000 on these three settlement days as a direct result of the manipulation.”

14. To illustrate the potential for similar activity in the UK, consider the case of a trader who needs to buy a contract for delivery of gas in October 2014. The trader could choose either of the ICE gas futures⁷

³ This market estimate is for the market from February 2013 until January 2014. Estimates calculated based on the data published by LEBA with the average of the month-ahead ICE NBP price.

⁴ <http://www.fca.org.uk/your-fca/documents/annual-report/fsa-annual-report-201213-section-3-delivering-market-confidence> and page 58 of European commission staff paper on criminal sanctions for insider dealing and market manipulation-http://ec.europa.eu/internal_market/securities/docs/abuse/SEC_2011_1217_en.pdf

⁵ EU Commission staff paper on regulation for energy market integrity and transparency, page 16, http://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2010/sec_2010_1510_en.pdf

⁶ 120 FERC ¶ 61,085, UNITED STATES OF AMERICA FEDERAL ENERGY REGULATORY COMMISSION, Order to show cause and notice for proposed penalties; Docket No. IN07-26-000, issued July 26, 2007.

⁷ <https://www.theice.com/productguide/ProductSpec.shtml?specId=910>

(regulated by the FCA with potential criminal sanctions for market abuse) or the CME Gas forward contracts⁸ (regulated by Ofgem under REMIT civil sanctions for market abuse) for this trade. Both products are settled at 1600 to 1615 London time every day and the last trades are permitted two business days before the first calendar day of the delivery period, which creates potential that these products could be manipulated in the same way. The different sanctions for market abuse may make it more likely to push this sort of trading using CME Gas forward contracts.

15. The FCA has the power to bring enforcement action (both civil and criminal) against traders who breach the regulation on energy derivatives in a regulated market. However if a similar energy derivative was traded on a platform that comes under the REMIT regulation, Ofgem can currently only seek civil sanctions. This lack of criminal sanctions in energy markets for almost identical misbehaviours to those that could receive a criminal sentence in financial markets creates a risk that wrong-doing is directed towards the energy sector. The offences we are proposing for energy have therefore been designed to fit well with the UK financial regime context and the two regulators work closely together.

Criminal sanctions create important additional deterrent effects including for individuals who would be less influenced by civil sanctions.

16. The civil sanctions with significant potential penalties are likely to dissuade wrong-doing and influence sound oversight practices in organisations that expect to trade regularly or have funds that could be targeted by fines.
17. Criminal sanctions are more dissuasive where:
 - a. The market participant is not likely to be a repeat player, for example someone with one-off information about an energy infrastructure problem;
 - b. A criminal conviction has a particular additional impact on the ability of a person or organisation to conduct business, for example in terms of participation in certain markets or reputational damage from a criminal record; or; and where
 - c. Financial incentives are not sufficient (for example a person who is already in financial difficulties and feels that they have little money (or little anticipation of future legitimate earnings) to lose). Some individuals and businesses may not be deterred by even unlimited fines. They may have limited funds that could be targeted or may assess that the potential exposure is worth the potential gain. This is likely to be particularly true where individuals are committing offences such as insider dealing, perhaps in collusion with others, and where their employer is not complicit.
18. In UK financial markets, criminal sanctions are considered by the regulator to have a stronger deterrent effect for market abuse than that of administrative sanctions alone⁹. Evidence from competition regulation¹⁰ also indicates that criminal sanctions have a stronger effect regarding deterrence compared to financial and other penalties, and businesses view criminal penalties as the strongest motivator for compliance¹¹ compared to other types of penalties.

Timing of Regulation

19. The Government's objective is to legislate as soon as practical. Not to do so leaves open the possibility that abusive behaviour might occur without an appropriate sanctions regime being in place, given there may be some cases where civil sanctions do not provide a sufficient deterrent.
20. The use of s.2(2) ECA to make the regulations will however mean that sentences could not exceed 2 years and it may be necessary to review the regulations in the light of any revision of UK financial markets legislation in order to align sentences for similar offences.

⁸ <http://www.cmegroup.com/europe/clearing-europe/membership/files/uk-nbp-factsheet.pdf>

⁹ In a speech to the Financial Service Authority (FSA, predecessor to the FCA) Enforcement Conference on 18 June 2008, the UK FSA Director of Enforcement Margaret Cole said: "We feel that the threat of civil fines hasn't worked as well as we would have liked. We're convinced that the threat of a custodial sentence is a much more significant deterrent. The good news is that in this area stakeholders and commentators all seem to agree with us."

http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0618_mc.shtml

¹⁰ "An assessment of discretionary penalties regimes" Office of Fair Trading, October 2009: <http://londoneconomics.co.uk/wp-content/uploads/2011/09/30-An-assessment-of-the-UK-Discretionary-Penalties-Regime.pdf>

¹¹ The report also cites an OFT survey of companies which found that: "companies' average ranking of the factors which motivate compliance was: (1) criminal penalties (2) disqualification of directors (3) adverse publicity (4) fines and (5) private damages actions." (p24)

Alternatives to regulation

21. The alternative to regulation for criminal sanctions is relying on existing civil sanctions and on the wider criminal law as it applies to trading. There are some instances where those offending are unlikely to be deterred by civil sanctions, for example, those who do not feel they have much to lose from civil penalties. It is not always possible to apply wider criminal law on, for example, fraud to market abusive behaviours.
22. Specific prohibitions are likely to lead to better compliance regimes (because businesses are clear as to what behaviour they need to guard against) and clarity for the regulatory authorities as to whether prohibitions have been breached. Voluntary measures such as companies' own internal cultures and procedures that are important in preventing market abuse are unlikely to provide sufficient safeguards by themselves and are strengthened by having effective legal sanctions in place.

Description of options considered

Option 0 – Do nothing (base case option in which no criminal sanctions for REMIT are implemented)

23. This option reflects the business as usual case where there is no further government intervention in the arrangements for preventing market abuse in wholesale energy markets. Under this scenario energy markets would be subject to a civil sanctions regime for REMIT as enforced by Ofgem. This is the base case scenario for this impact assessment and will be referred to as "Option 0" throughout the text.
24. Under this arrangement, Ofgem has the ability to request relevant information; carry out onsite inspections; and impose unlimited fines or require restitution for breaches of the REMIT prohibitions on insider dealing and market abuse and the requirement to publish inside information. Market participants would also continue to need to act within the wider criminal and civil law, for example on fraud and anti-competitive practices. Please see annexes A and B for a description of the REMIT civil sanctions regime and other relevant regulations.
25. While these powers create a strong deterrent for most market participants, they do not enable Ofgem to bring criminal proceedings specifically for insider dealing and market manipulation. As noted above there is a case for ensuring the strongest possible sanctions that address the gap with financial services offences and target the full scope of possible unlawful behaviour.

Option 1: Criminal sanctions for Article 3 (inside information) and Article 5 (market manipulation)

26. This option would create, in addition to the existing civil and criminal law set out in Option 0, new criminal sanctions for the most serious offences under REMIT- which are insider dealing (Article 3) and market manipulation (Article 5). These may have serious financial impacts on market participants and on the wider confidence in the operation of gas and power markets distorting competition and deterring market entry.
 - *Article 3- persons who possess inside information in relation to a wholesale energy product are prohibited from buying or selling relevant energy products or disclosing the information or making someone else buy or sell the products*
 - *Article 5- Market manipulation can be broadly defined as any deliberate attempt to interfere with the fair and open operation of a market to artificially change the market price, or the appearance of the price, of a security, commodity or currency*
27. Criminal sanctions only around these central prohibitions of REMIT would be proportionate implementation and would closely align the energy markets with financial market trading. In order to ensure these offences and the benefits are in place as quickly as possible we would make secondary regulations through section 2(2) of the European Communities Act 1972¹². This would enable us to create criminal sanctions of up to two years imprisonment for insider dealing in or manipulation of energy markets.
28. Creating new criminal sanctions for REMIT will not place additional compliance burdens on business because registration, monitoring, investigatory powers have already been established through regulations made in June 2013. Criminal sanctions for Articles 3 and 5 of REMIT are appropriate to meet UK obligations under the regulation and do not go further than its requirements.

¹² Section 2:2 of the European Communities Act 1972- <http://www.legislation.gov.uk/ukpga/1972/68/contents>

Option 2: Criminal sanctions for breaches of all the main requirements and prohibitions of REMIT (See Annex A for summary of all prohibitions of REMIT)

29. In addition to the central prohibitions in articles 3 and 5, REMIT sets out a range of requirements on market participants, for example around registration with Ofgem and the reporting of data. We have therefore considered the creation of criminal sanctions for breaches of all prohibitions and requirements in REMIT (i.e. not just articles 3 and 5 as per option 1). The REMIT articles on registration and data reporting are:
- *Article 8: Data reporting:* Market participants (or persons listed on their behalf) are required to provide the Agency with a record of wholesale energy market transactions, including the orders to trade. This includes the precise identification of the product; price and quantity agreed and dates and times of execution.
 - *Article 9: Registration of market participants:* Market participants who are required to report to the agency (in accordance with article 8) will need to register with Ofgem.
30. Ofgem already operates a licensing regime under the Electricity Act 1989 and the Gas Act 1986. Under this regime, it is a criminal offence to carry out activities without being licensed, whereas subsequent contraventions (such as breaching the Standard Licence Conditions) only incur civil sanctions.
31. Option 2 would make it a criminal offence to enter into transactions in wholesale energy products without being registered and to fail to provide the required information to Ofgem. This will be in the form of new regulations, possibly under Section 2(2) of the European Communities Act 1972.
32. The offences could be:

Article 8

An offence for failing to report prescribed REMIT data to ACER would be committed if a person fails to report, or intentionally or recklessly provides false or misleading information when reporting data to ACER. A person commits the offence if he knows that the information is false or misleading or is reckless, and he intends to cause gain or loss to himself or anyone else.

Article 9

An offence of failing to register would be committed if a person fails to register, or intentionally or recklessly makes a false or misleading statement when registering their details with Ofgem. A person commits the offence if he knows that the statement or impression is false or misleading or is reckless, and he intends to cause gain or loss to himself or anyone else.

Cost and Benefits

33. This section identifies and analyses the costs and benefits of the proposed options for implementing REMIT criminal sanctions, and then compares these options on the basis of benefits relative to costs.

Costs and benefits by options considered:

Option 0: Do nothing (business as usual in which no criminal sanctions regime is implemented)

34. Option 0 would mean there is no change to the current arrangements for preventing market abuse so energy markets would be subject to the civil sanctions regime as enforced by the regulator. In light of there being no changes to the current regulatory regime there therefore would be no additional costs or benefits incurred to any businesses, groups, individuals or government from pursuing this option.

Option 1: Criminal sanctions for breaches of Article 3 (inside information) and Article 5 (market manipulation)

Costs

Costs to businesses

35. We anticipate there would be no additional transitional or on-going costs to compliant businesses from implementing criminal sanctions for insider dealing and market manipulation. This is because under a criminal enforcement regime for Articles 3 and 5 of REMIT there would be no additional obligations for businesses as these would already exist under Option 0. Requirements around information would not have changed compared to the base case scenario. It is possible that businesses may undertake changes or improvements to their compliance and reporting processes due to the stronger enforcement regime, and we discuss the possible cost implications of this in the risks and sensitivities section. The main business groups that would be affected are wholesale energy market participants¹³.
36. The implementation of civil sanctions and the accompanying regulatory regime for REMIT was not intended to impose any significant additional costs on market participants.¹⁴ To the extent that there are non-compliant businesses those businesses may be incentivised to improve compliance in the light of the stronger sanctions. These are costs that should already have been accounted for by REMIT generally and the creation of the civil sanctions regime.

Costs to government

37. Market participants being monitored or investigated by Ofgem will be subject to the same requirements and requests under the regime with criminal sanctions as they would be under the solely civil regime. We do however anticipate that there would be additional on-going costs to Ofgem in implementing a new criminal sanctions regime over and above those created by the existing civil regime. These would be incurred by working investigations of suspicious transactions up to a sufficient standard of evidence as required for criminal court cases. Ofgem already has criminal enforcement powers in other areas aside from those covered by REMIT, so the additional cost from introducing new criminal enforcement powers for REMIT could be expected to be a proportion of the cost to Ofgem of ensuring it has the appropriate skills and equipment needed to conduct criminal investigations across all its criminal sanction powers.
38. It is likely that the decision as to whether a case should be prosecuted or dealt with through the civil sanctions regime or other enforcement route (such as fine for a breach of licence condition) is likely to be made by Ofgem some way into the investigation. We would not expect the investigation process to generally increase costs for Ofgem or business with the exception of any additional requirements in terms of handling evidence. Under criminal investigations cases would require a high level of specialist input to handle trade and other data, potentially obtained from hard-drives, and other electronic equipment, to a standard that would be able to stand up in court.
39. Ofgem have estimated this cost to be on average an additional £75,000 per criminal investigation undertaken, based on quotes they have received in this area. We have assumed that Ofgem would undertake two criminal investigations a year,¹⁵ equating to £150,000 a year in costs. In our central case we have assumed these cases would not be taken to court¹⁶ and therefore have not assumed

¹³ Wholesale energy participants include: power exchanges; energy traders/suppliers/brokers, electricity generators.

¹⁴ Civil sanctions implementation main aim was to establish an effective, proportionate and dissuasive penalty and enforcement regime for Ofgem.

¹⁵ Annex D summarises the rationale and analysis for estimating 2 criminal investigations per year

¹⁶ This is a simplifying assumption, consistent with 2.3.47 of the Better Regulation Framework Manual, which states “When planning to introduce a regulatory measure, costs and benefits should assume 100% compliance, unless there is evidence of the

any additional costs to Ofgem aside from those for conducting investigations. This assumption is discussed and tested later in the risks and sensitivity analysis section where we explore implications for costs from the possibility of investigations leading to prosecutions.

40. Any business that is prosecuted, but acquitted is likely to have to meet costs and may also suffer non-quantifiable reputational damage. It should be noted that the threshold for prosecution is high and that the FSA has a high success rate when prosecuting the same offences in financial markets, but there remains the possibility, considered in the risks and sensitivities section that a small number of prosecutions will not succeed. We further discuss this and the possible impacts in the risks and sensitivity section.
41. There are expected to be no additional transitional costs to Ofgem as REMIT enforcement for articles 3 and 5 is covered by the civil sanctions regime and the only additional costs are for the increased requirements in terms of specialist input, standard of evidence etc. incurred on a per criminal investigation basis.
42. The present value of these costs at 3.5% over 10 years is approximately **£1.3 million**.¹⁷ Please see annex C for more details of the cost calculations.

Benefits

Benefits to businesses

43. The changes could bring benefits to businesses which are market participants and to those that are consumers of energy. The possibility of criminal sanctions for REMIT infractions is expected to lead to an increased deterrence rate for market participants for the reasons set out in paragraph 18.
44. The risk of non-compliance raises risks associated with operating in the energy market as market participants might not have confidence in prices. Criminal sanctions for market abuse may be expected to increase confidence in reduced instances of asymmetric information (e.g. from inside information) and greater certainty that prices reflect demand and supply fundamentals rather than distortions or increased volatility arising from market manipulation. Reducing these risks through criminal sanctions would then be a benefit for businesses. Increased confidence could also lower the risk premia in prices, leading to lower wholesale energy prices under a criminal sanctions regime.
45. Reduced market abuse, increased confidence and lower price volatility is also likely to reduce transaction costs in the market, raising incentives to enter and trade in the market. A higher number of market participants and lower transaction costs would then be expected to have a positive effect on liquidity as participants would be more likely to make trades and assume higher levels of risk. The reduction in insider trading – which generally benefits the inside trader disproportionately to or at the cost of other traders – would also place all traders on a level playing field in terms of information and the distributional effects of trades.
46. Evidence from financial markets indicates that greater market integrity decreases the levels of risk in prices faced by market participants. O'Hara (2001)¹⁸ outlines:

“Price discovery refers to the ability of the market to find the efficient price. Efficient prices reflect the underlying prospects of a firm, and as these prospects change, so too should the price. How well, and how quickly, prices adjust to fundamental values is an important metric for all exchanges. There are two main factors that influence this efficiency. One is simply the fairness and integrity of prices. Exchange monitoring to prevent manipulation and front-running, as well as general regulation to prevent fraud and self-dealing, ensure greater price integrity....”

“Investors care about the efficiency of price discovery because it influences the risk of holding stock. In particular, if information can be asymmetric, then traders with private information can benefit at the expense of traders who know only public news. Easley and O'Hara (2000)¹⁹ show that uninformed traders, knowing they are possibly at a disadvantage, will demand higher compensation to hold stocks with greater private information risk, a result confirmed empirically by Easley et. al. (2002)²⁰. Evidence consistent with this effect is also provided by Botosan (1997)²¹ who shows that greater disclosure reduces the cost of capital for her sample of firms by 28 basis

contrary. However, differing levels of compliance should also be investigated through sensitivity analysis.” We explore differing levels of court cases and prosecutions in the risks and sensitivities of costs and benefits section.

¹⁷ As per institutional economic theory, industry-wide cultural changes can take between one and ten years to implement- 10 years represents the optimum level.

¹⁸ O'Hara, M., 2001 “Designing Markets for Developing Countries”, International Review of Finance, 2(4), pp205-215

¹⁹ Easley, D., and M. O'Hara (2000), “Information and the Cost of Capital”, Working paper, Cornell University

²⁰ Easley, D., S. Hvidkjaer and M. O'Hara (2002), “Is Information Risk a Determinant of Asset Returns?”, Journal of Finance

²¹ Botosan, C. (1997), “Disclosure Level and the Cost of Capital”, The Accounting Review, 72, 323-49

points, and by Bhattacharya and Dazouk (2000), who find that enforcement of insider trading laws lowers the cost of capital.”

47. The 2012/13 annual report for the Financial Services Authority²² (FSA – the predecessor regulator to the FCA) states that “*after remaining stable for the four years to 2009, the level of abnormal preannouncement price movements²³ declined to 21.2% in 2010, 19.8% in 2011 and to 14.9% in 2012. This is the lowest level since 2003. The fall took place in a year of weak takeover activity and against a backdrop of the FSA’s continuing focus on market abuse and enforcement activity in this area*”. Whilst this is not conclusive evidence regarding the deterrence effect of criminal enforcement for market abuse, it suggests that such regulatory measures can be effective in deterring abnormal price volatility in markets.

Benefits to government

48. The existence of “regulatory arbitrage” – trading on a market with less stringent regulation to avoid the stricter regime - potentially imposes costs for government in terms of additional monitoring requirements, duplication between agencies regarding enforcement, and unnecessary expenditure to cover gaps in regulation between energy and financial markets. Thus removing this is likely to offer a benefit to government regarding efficiency and effectiveness of regulation and avoidance of expenditure. This would lead to more efficient outcomes overall as differences in regulatory treatment will not influence trading decisions or commercial choices.

Benefits to consumers

49. The direct costs of insider trading and market manipulation are difficult to ascribe to any one group because they are likely to vary on a case by case basis. Therefore no attempt is made in this IA to quantify the direct benefits of a reduction in the prevalence of market abuse and/or insider trading. However in all cases there are likely to be losers as a result of insider trading.
50. In addition to any direct beneficiaries of reduced insider trading and market abuse, consumers could benefit indirectly from the increased deterrence of market abuse brought from implementing criminal sanctions. Increased market transparency and reduced frequency of market abuse could result in lower wholesale energy prices relative to the base case (see section above under benefits to businesses) which could then be passed through to lower retail energy prices for consumers.
51. More cost reflective prices, associated reduced barriers to investment, reduced costs of trading and resulting improved competition could also reduce costs to end users relative to the base case with associated positive cost of living and business competitiveness implications, benefiting households and commercial energy consumers.
52. According to Ofgem data²⁴, wholesale energy market costs account for over 46% of a typical UK consumer’s energy bill. Therefore, as a purely illustrative example in terms of quantifying the benefit of lower prices more generally, a 1% reduction in wholesale energy prices which then reduces bills by 1% from the effect of criminal sanctions could save UK households over £160 million per year. We do not formally monetise this benefit in our net present value analysis due to the uncertainty and lack of evidence over the degree to which this measure would reduce wholesale prices.

Option 2: Criminal Sanctions for prohibitions of all of REMIT

53. In addition to market manipulation and insider dealing prohibitions, REMIT also places other obligations on market participants, particularly around registration and the provision of data (articles 8 and 9). This section sets out the costs and benefits expected under criminal enforcement powers for all prohibitions and requirements in REMIT.

Costs

Costs to businesses

54. We anticipate there would be no additional transitional or on-going costs to compliant businesses from implementing criminal sanctions for all prohibitions and requirements of REMIT. This is because under a criminal enforcement regime there would be no additional requirements for businesses to

²²Financial Services Authority Annual Report 2012/13, Section 3 “Delivering Market Confidence”, <http://www.fca.org.uk/news/firms/fsa-annual-report-2012-13>

²³ As part of its market monitoring activity, the FSA analysed the scale of share price movements in the two days ahead of regulatory takeover announcements and identified movements that are abnormal compared to a stock’s normal movement. However, it is important to note that the level of such abnormal pre-announcement price movements (APPMs) does not provide a precise measure of the level of suspected insider dealing.

²⁴ “Understanding Energy Bills”, Ofgem 2013, <https://www.ofgem.gov.uk/information-consumers/domestic-consumers/understanding-energy-bills>

fulfil their obligations under REMIT as these would already be satisfied under the counterfactual scenario of a civil sanctions regime.

Costs to government

55. We expect there to be additional on-going costs to Ofgem from Option 2 for criminal enforcement of REMIT. As explained under Option 1 above these costs are likely to include costs for gathering evidence to the standards of proof required for criminal cases. Ofgem has estimated the cost of specialist data handling for REMIT under a criminal sanctions regime to be £75,000 per investigation, on average.
56. We assume that there would be a higher proportion of criminal investigations for option 2, as Ofgem would investigate cases of failing to register and/or failing to provide data in addition to those for insider dealing or market manipulation. On an assumption that there would be two additional cases for failing to register per year on top of two cases for market abuse,²⁵ and using the same calculation methodology and all other assumptions as under Option 1, the additional costs to Ofgem would be £300,000 per annum.
57. There are expected to be no additional transitional costs to Ofgem as REMIT enforcement is already covered by the civil sanctions regime and the only additional costs are on a per criminal investigation basis as described above.
58. The present value of these costs discounted at 3.5% is **£2.6 million**. Please see annex C for more details of the cost calculations.

Benefits

59. As with Option 1 above there are expected to be benefits to business, government and consumers from introducing criminal sanctions for all prohibitions of REMIT.

Benefits to business

60. The benefits to business listed under Option 1 would also apply to Option 2 since articles 3 and 5 of REMIT are covered within this.
61. The potential benefits to market participants of breaching the registration and data provision requirements are less than the potential benefits from engaging in market abuse, due to greater potential financial gains from market manipulation and insider dealing. Therefore we anticipate the civil enforcement regime for registration and provision of data would have sufficient deterrence regarding encouraging the required behaviour, and there would be no additional deterrence benefits to businesses from criminal enforcement for articles 8 and 9 of REMIT.

Benefits to government

62. The benefits to government as identified under Option 1 would also apply under this option, since the elimination of regulatory arbitrage between financial and energy markets regarding market abuse is expected to reduce unnecessary regulatory burdens on government.
63. We expect there to be no additional deterrence effect and no additional benefit to government from criminal enforcement of registration and provision of data compared to the civil sanctions regime, due to the greater incentives for market participants to engage in market abuse. However there is uncertainty over this and it is possible that threat of criminal investigation for prohibitions of these requirements may increase the culture of compliance, which may then benefit government.

Benefits to consumers

64. The direct costs of insider trading and market manipulation are difficult to ascribe to any one group because they are likely to vary on a case by case basis. Therefore no attempt is made in this IA to quantify the direct benefits of a reduction in the prevalence of market abuse and/or insider trading. However in all cases there are likely to be losers as a result of insider trading.
65. In addition to any direct beneficiaries of reduced insider trading and market abuse, consumers could benefit indirectly from the increased deterrence of market abuse brought from implementing criminal sanctions. Increased market transparency and reduced frequency of market abuse could result in lower wholesale energy prices relative to the base case (see section above under benefits to businesses) which could then be passed through to lower retail energy prices for consumers.
66. More cost reflective prices, associated reduced barriers to investment, reduced costs of trading and resulting improved competition could also reduce costs to end users relative to the base case with associated positive cost of living and business competitiveness implications, benefiting households and commercial energy consumers.

²⁵ Annex D outlines the rationale for assuming 2 criminal investigations per year

67. According to Ofgem data²⁶, wholesale energy market costs account for over 46% of a typical UK consumer's energy bill. Therefore, as a purely illustrative example in terms of quantifying the benefit of lower prices more generally, a 1% reduction in wholesale energy prices which then reduces bills by 1% from the effect of criminal sanctions could save UK households over £160 million per year. We do not formally monetise this benefit in our net present value analysis due to the uncertainty and lack of evidence over the degree to which this measure would reduce wholesale prices.

Risks and sensitivities of costs and benefits

68. Under our central scenarios, when estimating the costs and benefit impacts of the options considered we have assumed no criminal cases for infractions are brought to trial or prosecuted²⁷. We recognise there is a risk that this assumption would not be satisfied if investigations subsequently proceeded to trial. There is then a resulting risk that the costs and benefits of the policy options might not be realised as we anticipate.
69. Below we identify and discuss factors that may affect the magnitudes of our assessment of the costs and benefits of the policy options and offer sensitivity analysis to illustrate how the impacts might change under different assumptions leading to exploration of high and low cost scenarios.

Sensitivity analysis of costs

70. Although we do not expect there to be any additional costs to business and a cost of £1.3m to the regulator in present value terms from the intervention there is uncertainty over this. The key driver of these expectations is the assumption that there are no investigations which lead to criminal court cases under the new enforcement regime.
71. In addition, our cost estimates for Ofgem are sensitive to assumptions regarding the number of investigations conducted as part of criminal enforcement, and the costs assumed for those investigations.
72. We anticipate that businesses face no additional costs because their reporting requirements and the associated costs would not change under REMIT criminal sanctions. There remains a possibility that businesses may decide to improve their compliance procedures in light of the stronger sanctions. This could be done in a variety of ways, for example improving the robustness of procedures and processes, acquiring improved electronic systems, increased legal costs, or training staff to improve familiarisation with REMIT. Due to uncertainty over exactly what additional improvements might be needed and on what scale, it is difficult to quantify these potential increases in costs to businesses. The consultation therefore raises this issue and seeks feedback on it from business.

Low cost scenario

73. It is possible that we could observe fewer criminal investigations than we have assumed each year. Our central assumption has been that there would be 2 investigations per year under option 1 and 4 under option 2, yielding an NPV of costs of £1.3 million and £2.6 million, respectively.
74. We consider 1 investigation per year under both options as a reasonable lower bound assumption. This can be justified on the basis that Ofgem will still need to be seen to enforce the regulation (and hence the assumption cannot be zero). Assuming the same additional cost of data handling for REMIT under a criminal sanctions regime, this equates to an additional cost to Ofgem of £75,000 per year and a present value of **£650,000**.

High cost scenario

75. In the central scenarios we have assumed no criminal cases would be brought to court and therefore no costs to the criminal justice system from sentencing, no additional costs to Ofgem for investigation, enforcement, or court cases, or additional costs to businesses.
76. There is considerable uncertainty over how many prohibitions of REMIT would take place or would eventually lead to court cases and convictions, so there is resulting uncertainty over cost impacts. Costs may then be greater or lower than we have indicated in earlier sections.
77. Information from Ofgem on expectations of costs under civil and criminal REMIT enforcement regimes, information from the FCA regarding past financial markets cases, and published information

²⁶ "Understanding Energy Bills", Ofgem 2013, <https://www.ofgem.gov.uk/information-consumers/domestic-consumers/understanding-energy-bills>

²⁷ This is a simplifying assumption, consistent with 2.3.47 of the Better Regulation Framework Manual, which states "When planning to introduce a regulatory measure, costs and benefits should assume 100% compliance, unless there is evidence of the contrary. However, differing levels of compliance should also be investigated through sensitivity analysis."

from the National Offender Management Service (NOMS) on prison costs allows us to make assumptions and then indicative cost estimates for scenarios of partial compliance and differing numbers of investigations.

78. Information sourced from recent successful FCA prosecutions for insider dealing indicates a total of around £1.2 million was claimed in costs across eight court cases. This implies, approximately, possible costs of using counsel to Ofgem of around £100,000 per case once other costs claims are deducted. Ofgem estimate the additional costs of data handling requirements per REMIT criminal case to be £75,000.
79. FCA information on past financial market abuse court cases indicate an average of around one trial a year over twelve years, with over 90% of cases resulting in successful prosecution. The average number of individuals per case was between one and two.
80. Published data from the Ministry of Justice and NOMS²⁸ on the costs of prison places from their annual report and accounts for 2012-13 indicates that the average cost of providing a prison place for that period was £36,808²⁹.
81. This information allows assumptions regarding the frequency of investigations and court cases, costs to Ofgem from investigations and counsel, and sentencing costs to be formed, as shown in the table below:

Table 1: Assumptions used to estimate costs with one criminal trial a year assumed.

No. of criminal investigations a year	Average no. of cases brought to trial per year	Average counsel costs per trial (£)	Average no. of successful cases per year	Average no. of individuals per case	Average sentence length (years)	Prison costs per place per year (£)
2	1	100,000	1	1.5	2	36,808

82. Using these assumptions, an indicative estimate for the additional annual cost to Ofgem and the prison system is £350,200. Ofgem incur annual case handling and investigation costs of £150,000³⁰, counsel costs of £100,000 per year, and prison costs are £100,200 per year.
83. The present value of these costs, discounted at 3.5% over 10 years, is approximately £3 million.
84. Costs to Ofgem are potentially higher or lower than above due to potential variability of several factors including; the number of suspicious cases investigated, investigation costs, numbers of court cases and costs of counsel per case. The costs to the criminal justice system outlined above could be lower or higher depending on the number of convictions, lengths of sentences, prison places costs, and the number of individuals tried and sentenced per case.
85. For example if we changed the above assumptions to those listed in table 2 below with only half of cases brought to trial successfully prosecuted, Ofgem incur case handling and investigation costs of £375,000 per year³¹ and counsel costs of £2 million per year (£500,000 per case), counsel costs of the defence of £1 million (£500,000 per acquitted case) are reimbursed by Ofgem and the costs of prison places for convicted individuals are £441,696.
86. We have also assumed acquitted parties claim an additional £100,000 on average per successfully defended case for additional non-legal expenses, which are paid by Ofgem. This is a simplifying assumption as there is considerable uncertainty over the magnitudes involved and whether or not these would be claimed for in actual criminal cases that may arise.
87. Under this scenario the additional cost would be approximately £4 million per year. In present value terms (over 10 years, discounted at 3.5%) these costs are **£34.6 million**.

²⁸ Costs per place and costs per prisoner - National Offender Management Service

Annual Report and Accounts 2012-13 - Management Information Addendum, October 2013, Ministry of Justice

²⁹ Cost per place is the average cost of providing a prison place for the year. It is the direct resource expenditure or Overall resource expenditure divided by Baseline Certified Normal Accommodation.

³⁰ £75,000 handling and investigation costs per case, for two cases investigated per year.

³¹ £75,000 investigation and handling costs per case, for five cases investigated per year.

Table 2: Assumptions used to estimate costs with, five investigations undertaken, and four criminal trials assumed a year with higher counsel costs and sentences.

No. of criminal investigations a year	Average no. of cases brought to trial per year	Average counsel costs per trial (£)	Average no. of successful cases per year	Additional costs claimed ³² per unsuccessful case (£)	Average no. of individuals per case	Average sentence length (years)	Prison costs per place per year (£)
5	4	500,000	2	100,000	3	2	36,808

88. There may be legal costs incurred by innocent parties taken to court who are subsequently acquitted. If this is the case we expect that Ofgem would be liable to pay these costs back to those parties. There may also be additional costs claimed by innocent parties regarding non-legal costs, e.g. internal resources used to obtain evidence and justifications on trading behaviour. However we consider that these costs would be no different compared to the baseline scenario.

Sensitivity analysis of benefits

89. As outlined above under Options 1 and 2, there are potentially benefits to business, government and customers as a result of reducing the likelihood of any market abuse or insider trading. However, it is possible that these will be realised to a greater or lesser degree. Given that these benefits were unquantified, we have not conducted sensitivity analysis around these benefits.

Wider Impacts

Competition

90. It is expected that proposals for criminal sanctions for insider dealing and market manipulation would not directly affect the number of producers or suppliers in either the wholesale or retail energy markets, and would not directly affect the underlying market structure.

Summary and preferred option

91. Option 0 is insufficient to meet the stated policy objectives because there is a risk that the deterrent effect on REMIT prohibitions from civil enforcement would not fully mitigate the differences in regulation between energy and financial markets regarding market manipulation and insider dealing because the civil sanctions are not sufficiently deterrent compared to criminal enforcement. Thus we believe doing nothing would not satisfy the policy objectives.
92. Comparing between options 1 and 2, it is our view that option 1 offers greater benefit for the costs on the basis of the additional deterrence effect of criminal sanctions for the market abuse prohibitions in REMIT (articles 3 and 5), and lower enforcement costs to government compared to Option 2. Option 2 provides the same benefits as option 1 but creates risk of higher additional costs to government because of the potential for a greater number of criminal investigations to cover the wider range of prohibitions.
93. The risk exists that there are market participants who are intent on committing insider dealing or market manipulation because they are insufficiently deterred by the current civil sanctions. Criminal sanctions including potential imprisonment for prohibitions of articles 3 and 5 of REMIT would create an important additional deterrent effect for these offences.
94. We considered the requirements to register and provide data, as per articles 8 and 9 of REMIT in terms of the regulator's ability to monitor trading, and whether existing civil sanctions would be sufficient for this.
95. Under option 1 market participants who are identified by Ofgem as committing insider dealing or market manipulation would be subject to possible criminal sanctions whether or not they have registered with the regulator. There are greater potential financial gains to market participants from engaging in market abuse than failing to register or provide data, and therefore greater incentives to breach the market abuse prohibitions compared to registration and data provision requirements of REMIT. Thus criminal sanctions under option 2 would create potentially disproportionate additional costs to government with no additional benefit compared to option 1.

³² Costs claimed per defendant.

Table 3: Comparison of impacts of proposed policy options

	NPV of monetised impacts	Non-monetised costs and benefits
Option 0	0	No additional costs and benefits as no intervention.
Option 1	-£1.3m	Additional deterrence effect on market participants tempted to engage in insider dealing or market manipulation behaviour who are not deterred by the present civil regime (breaches of articles 3 and 5).
Option 2	-£2.6m	As for Option 1 deterrent effect for criminal penalties regarding breaches of articles 3 and 5. The administrative requirements for registration and data provision created by articles 8 and 9 are already fully supported by deterrence under the civil regime. No additional deterrence effect from criminal enforcement for the registration and information requirements.

96. Table 3 above illustrates our analysis that option 1 provides greater deterrence benefits than exist under Option 0 and the same as those provided by Option 2 but with lower costs to government. We believe that creating criminal sanctions around article 3 (insider dealing) and article 5 (market manipulation) creates an appropriate and proportionate addition to the regulatory regime for energy markets.
97. We do not therefore currently see a case for extending the criminal sanctions beyond the core prohibitions for market abuse covered in Option 1. Therefore Option 1 is our preferred option.

One in Two Out (OITO)

98. Creating these criminal sanctions for energy market abuse and insider trading would be consistent with the minimum implementation that is required by REMIT and would not therefore be gold-plating or fall under the OITO requirement.
99. Remit creates requirements and prohibitions mainly on market participants trading wholesale energy and requires Member States to create penalties for breach of the regulation that
- “are proportionate, effective and dissuasive, and reflect the gravity of the infringements, the damage caused to consumers and the potential gains from trading on the basis of inside information and market manipulation. The application of these penalties should be carried out in accordance with national law. Recognising the interactions between trading in electricity and natural gas derivative products and trading in actual electricity and natural gas, the penalties for breaches of this Regulation should be in line with the penalties adopted by the Member States in implementing Directive 2003/6/EC.”³³*
100. REMIT does not set out how Member States should create penalties for breaches of the regulations. On the subject of penalties REMIT states
- “The Member States shall lay down the rules on penalties applicable to infringements of this Regulation and shall take all measures necessary to ensure that they are implemented. The penalties provided for must be effective, dissuasive and proportionate, reflecting the nature, duration and seriousness of the infringement, the damage caused to consumers and the potential gains from trading on the basis of inside information and market manipulation.”³⁴*
101. When the civil regime was created it was acknowledged that the absence of criminal sanctions at that point created a small risk that the implementation could be considered incomplete given the existence of criminal sanctions in UK financial regulation. This possibility was weighed against the benefits for consumers and energy market participants of having a regime to address market abuse in place earlier. A criminal regime removes that small risk and tackles some potential behaviour that

³³ REMIT paragraph (31) <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:326:0001:0016:en:PDF>

³⁴ REMIT Article 18 <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:326:0001:0016:en:PDF>

a purely civil regime does not. The use of the ECA means we can address these issues as soon as possible.

102. The UK already has criminal sanctions to address insider dealing and market manipulation in financial markets so this option would align REMIT implementation with good principles of financial regulation. The limited criminal offences we are proposing are proportionate given the potentially serious nature of the offences and evidence on the deterrent effect of similar measures in financial services regulation suggest that our proposed offences would be effective in deterring insider dealing and market manipulation.
103. Criminal sanctions create important additional deterrent effects including for individuals who would be less influenced by civil sanctions. For this reason, and because of the seriousness of the offences, we consider criminal sanctions, in addition to the civil regime, to be necessary to meet the requirements of REMIT, to meet our policy objective of strong sanctions to address the worst examples of market manipulation, and to close the gap with the financial markets regime.

ANNEX A – SUMMARY OF REMIT REGULATIONS & CIVIL POWERS

1. EU Regulation on wholesale market integrity and transparency (REMIT) is intended to create a regulatory framework which ensures traded wholesale energy markets in the EU function properly – In particular, that energy market prices and outcomes are not distorted by abusive market behaviour, but reflect market fundamentals. It represents the first time insider dealing and market abuse prohibitions have been applied to energy wholesale trades at EU level.

Existing Civil sanctions under REMIT

2. The Government has already regulated to create a civil enforcement regime in June 2013 for market abuse. Those regulations gave Ofgem the following powers (among others):
 - To require regulated persons and others to provide information to enable it to monitor compliance within REMIT and investigate suspected breaches;
 - To levy unlimited financial penalties against those in breach of REMIT;
 - To require restitutionary damages to be paid in respect of profits accrued from or losses suffered as a result of failure to comply with REMIT requirement; and
 - Enforcement powers, including warrants to enter premises.
3. Ofgem is required to cooperate at regional level with The Agency for the Cooperation of Energy Regulators (ACER – an EU agency) in carrying out the monitoring of wholesale energy markets. Ofgem may also monitor trading activity in wholesale energy products at national level. We are also required to cooperate with ACER and with National Energy Regulatory Authorities (NRAs) of other Member States at regional level to detect trading based on inside information and market manipulation.
4. Ofgem is required to inform ACER of suspected breaches of REMIT either in GB or in another Member State and is required to cooperate with ACER, with other NRAs and certain other authorities, including the Financial Conduct Authority

Table 7: Summary of REMIT Articles

Article	Description
Insider dealing (Article 3)	Insider trading is the trading of a public company's stock or other securities (such as bonds or stock options) by individuals with access to non-public information about the company. In various countries insider trading based on inside information is illegal. This is because it is seen as being unfair to other investors who do not have access to the information. Within REMIT, this means that persons who possess inside information in relation to a wholesale energy product are prohibited by REMIT from buying or selling relevant energy products or disclosing the information or making someone else buy or sell the products.
Prohibition of market manipulation (Article 5)	Prohibition of market manipulation (Article 5) in wholesale energy markets across the UK. Market manipulation is a deliberate attempt to interfere with the free and fair operation of the market and create artificial, false or misleading appearances with respect to the price of, or market for, a security, commodity. Market manipulation can be broadly defined as any deliberate attempt to interfere with the fair and open operation of a market to artificially change the market price, or the appearance of the price, of a security, commodity or currency
Data monitoring- Article 8	A monitoring regime for wholesale energy trades (Article 8)- Market participants (or persons listed on their behalf) are required to provide the Agency with a record of wholesale energy market transactions, including the orders to trade. This includes the precise identification of the product; price and quantity agreed and dates and times of execution.
Registration of market participants- Article 9	<i>Registration of market participants:</i> Market participants who are required to report to the agency (in accordance with article 8) will need to register with Ofgem.
Article 4	Article 4 - Obligation on market participants to publish inside information in an effective and timely manner (which may exceptionally be delayed in certain circumstances, subject to an obligation to report to ACER and Ofgem, where Ofgem is the relevant National regulatory authority.

Article 7- market monitoring	Ofgem will monitor trading activity in wholesale energy products
Article 10	sharing of information between the Agency (ACER) and other authorities
Article 13	Implementation of prohibitions against market abuse
Article 15	Any persons professionally arranging transactions in wholesale energy products who suspect that a transaction might breach Articles 3/5 must inform Ofgem
Article 17- professional secrecy	Any confidential information received, exchanged or transmitted to the regulation shall be subject to professional secrecy
	The other articles of REMIT are: Article 1 (subject matter, scope); Article 2 (definitions); Article 6 (technical updating of definitions of inside information and market manipulation); Article 11 (data protection); Article 12 (operational reliability); Article 14 (right of appeal); Article 16 (cooperation at Union and national level); Article 18 (penalties); Article 19 (International relations); Article 20 (exercise of the delegation)

ANNEX B- SUMMARY OF FINANCIAL SERVICES LEGISLATION

The relationship between financial services regulation and introducing criminal sanctions in energy

1. The UK's regime governing market abuse and inside information in the financial sector consists of both civil and criminal sanctions which are set out by the Financial Services and Markets Act (FSMA) and the Criminal Justice Act (CJA) which enable regulators to seek criminal sanctions of up to seven years' imprisonment for market manipulation and insider dealing.
2. In EU law, the implementation of Market Abuse Directive (MAD) in 2005 created an EU-wide market abuse regime and a framework for establishing a proper flow of information to the financial markets. It was designed to improve confidence in the integrity of the integrated European market and greater cross border co-operation.
3. The FSMA implements MAD in the UK. It introduced a statutory prohibition on market abuse in relation to particular investments on a prescribed market, enforceable by civil penalties. It supplemented the criminal offences of insider dealing and market manipulation because existing criminal and regulatory sanctions, especially in relation to insider dealing did not address all forms of abusive conduct. REMIT definitions of inside information (Article 3) and market manipulation (article 5) are very similar to those in MAD/FSMA. Market Abuse Regulation (MAR) will now replace Market Abuse Directive (MAD). The draft text was agreed by the European Commission in June 2013 but could not be adopted until certain definitions were agreed through the negotiation of MiFID.
4. It is anticipated that MAR will come into force in 2016. MAD (and, in the future, MAR) covers the trading of certain financial instruments. The scope of REMIT is partly determined by that definition of financial instruments; REMIT's scope will change when MAR replaces MAD. The date of the adoption of MAR is still to be decided.

Table 8: Summary of legislation

Legislation	Brief description
<p>Criminal Justice Act 1993 (UK law, implementing Insider Dealing Directive - which preceded MAD)</p>	<p>The CJA sets out the offence of insider dealing. An individual who has information as an insider is guilty of insider dealing, if he deals in defined securities, encourages another person to deal in such securities, or discloses inside information to another person</p> <p>Insider dealing under CJA has a narrower scope than the civil market abuse regime for REMIT.</p>
<p>Financial Services Act 2012 (UK law)</p>	<p>The FSA 2012 transposes enforcement powers under the FSMA 2000 from the FSA to the FCA.</p> <p>Part 7 of the FSA 2012 repeals the misleading statements offence at s.397 of FSMA and creates three new offences including one of misleading statements in relation to relevant benchmarks as well as misleading statements and impressions relating to financial services. These new offences are based on dishonest or reckless conduct but do not require proof of actual market manipulation.</p> <p>The REMIT prohibition of market manipulation has close parallels with the FSA 12 in its reference to misleading statements and impressions.</p>
<p>Market Abuse Directive (MAD) (EU law)/Financial Services and Markets Act 2000 (UK law, implementing MAD), Market Abuse Regulation (MAR)(draft EU law)</p>	<p>The implementation of MAD in 2005 created an EU-wide market abuse regime and a framework for establishing a proper flow of information to the market. It was designed to improve confidence in the integrity of the integrated European market and greater cross border co-operation.</p> <p>The FSMA 2000 implements MAD for the UK. It introduced a statutory prohibition on market abuse in relation to particular investments on a prescribed market, enforceable by civil penalties. It supplemented the criminal offences of insider dealing and market manipulation because existing criminal and regulatory sanctions, especially in relation to insider dealing, did not address all forms of abusive conduct. REMIT definitions of inside information (Article 3) and market manipulation (article 5) are very similar to those in MAD/FSMA.</p> <p>MAR will replace MAD. The draft text was agreed in June 2013 but could not be adopted until certain definitions were agreed through the negotiation of MiFID. MAD (and, in the future, MAR) covers the trading of certain financial instruments. The scope of REMIT is partly determined by that definition of financial instruments; REMIT's scope will change when MAR replaces MAD.</p>
<p>Criminal Sanctions Market Abuse Directive (CSMAD) (EU law, not yet in force)</p>	<p>This sets minimum rules on criminal offences and on criminal sanctions for market abuse. The directive defines the offences of insider dealing and market manipulation. It strengthens MAR.</p> <p>It limits the application of criminal sanctions to intentional insider dealing and market manipulation. It requires that criminal sanctions be applied to companies as well as individuals.</p> <p>HMT will announce in June 2014 whether it will opt in or out of CS MAD. In any case, it has publically committed to reviewing criminal sanctions for market abuse whatever that decision. HMT would have to implement CSMAD by June 2016. We anticipate that you will re-consider REMIT criminal sanctions alongside that wider review of the financial markets regulations.</p>
<p>Markets in Financial Directive (MiFID II) (draft EU law)</p>	<p>MiFID II improves transparency in the EU around access to trading venues and central counter parties, as well as to benchmarks for trading and clearing purposes. MiFID II</p> <ul style="list-style-type: none"> • introduces a market structure framework which closes loopholes and ensures trading wherever appropriate takes place on a regulated platform. • Increases equity market transparency • Provides for strengthened supervisory powers • A new framework to improve conditions for completion in trading and clearing of financial instruments <p>For the purposes of REMIT, MiFID II will provide the definitions of financial instruments for the purposes of MAR, which in turn carves certain financial instruments out of REMIT.</p>

ANNEX C – COSTS AND BENEFITS CALCULATIONS AND NPV ANALYSIS

Calculation of costs and benefits

1. The costs for Options 1 and 2 are based upon the additional costs to Ofgem for investigating REMIT prohibitions under a criminal regime and the number of criminal investigations expected to take place each year. Ofgem have indicated that any suspicious case would be considered for investigation under both civil and criminal proceedings and only proportion of these would eventually be taken forward as criminal investigations. Ofgem expect the additional cost of a criminal investigation above that of a civil investigation to be £75,000 per case, largely for specialist data handling requirements. In the table below we outline the assumptions and calculations for the costs to Ofgem under Options 1 and 2.

Table 4: Assumptions and cost calculations for Ofgem under Options 1 and 2.

Additional criminal investigation costs (per case)	£75,000
Option 0	
Number of criminal investigations per year	0
Ofgem annual incremental costs	£0
Option 1	
Number of criminal investigations per year	2
Ofgem annual incremental costs	£150,000
Option 2	
Number of criminal investigations per year	4
Ofgem annual incremental costs	£300,000

2. As explained in the main text we expect the additional transitional and on-going costs to business from criminal enforcement for REMIT would be zero as there already would be requirements for business to comply with the civil sanctions regime (Option 0) with no additional intervention.
3. The additional deterrence effect from criminal sanctions could reduce wholesale energy prices via increased liquidity, lower risk and increase in market confidence. UK consumers could then benefit from this if the price reductions were passed on to household bills. In the text, as a purely illustrative example, we estimated that a 1% reduction in bills as a result of lower wholesale prices could save consumers just over £160 million. We do not formally monetise this benefit in our net present value analysis due to the uncertainty and lack of evidence over the degree to which this measure would reduce wholesale prices. Table 5 below outlines the components of that calculation.

Table 5: Assumptions and calculations for consumer benefits (illustrative only)

Wholesale costs as a proportion of UK dual fuel bill	46%
Reduction in wholesale energy prices	1%
Reduction in household bills	1%
Cost of a typical dual fuel bill per UK household (£)	£1,357
Reduction on a typical dual fuel bill (£)	£6.24
Number of UK households (m)	26.4 ³⁵
Bill reduction for all UK households (£m)	£164.79

³⁵ Based on 26.4 million households, from ONS Statistical Release "Families and Households, 2013)
http://www.ons.gov.uk/ons/dcp171778_332633.pdf

Net Present Value analysis

4. The table below shows the net present value (NPV) calculations of monetised costs and benefits of the various options. Discounting for the calculations was performed using the social discount rate of 3.5% over a period 10 years as recommended by Her Majesty's Treasury Green Book.

Table 6: Net present value calculations

	Option 0	Option 1	Option 2
Monetised benefits per annum	£0	£0	£0
Monetised costs per annum	£0	£150,000	£300,000
Sum of discounted benefits over 10 years	£0	£0	£0
Sum of discounted costs over 10 years	£0	£1,291,153	£2,582,306
Net Present Value (£)	£0	-£1,291,153	-£2,582,306