Brexit: Why the UK is better off inside the EU Internal Energy Market

Continued access to the IEM will help keep bills down and maintain security of supply

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At a glance:

- Harmonised tariff-free trading does not mean signing up to all future EU energy and climate rules
- Different parts of energy sector will have different Brexit exposures
- Current lack of focus on energy within Brexit debate could play to sector's advantage

The media and public might be more focused on new runways and high-speed rail links right now, but it is Britain's energy sector that needs more infrastructure spending than any other[1]. Much of the capital required to fund that investment will come from abroad. Before committing those funds, investors will want more detail about Brexit. Crucially, is Britain still part of, or outside, the EU's Internal Energy Market (IEM)?

The IEM enables harmonised, tariff-free trading of gas and electricity across Europe. The UK has been a leading force in designing the IEM over many years, consistently arguing for the opening up of markets to reduce costs for consumers.

Maintain access to the IEM, and little changes. UK consumers would continue to benefit from access to lower wholesale prices in many neighbouring countries, as well as increased diversity (and therefore security) of supply. This will become ever more important as Britain's own North Sea energy supplies decline. Step outside the IEM and these benefits would be put at risk.

The bespoke alternative

Some have argued for bespoke arrangements to be set up with bilateral deals with each neighbouring country governing each gas and electricity interconnector. However, these deals would be highly complex and technically detailed. Based on the experience of other countries, like Switzerland and Canada, that have

[1] National Infrastructure Delivery Plan, HM Treasury, 2016

negotiated bilateral deals with the EU, these deals would take many years to put in place, and create considerable uncertainty and blight for projects currently under development.

Any introduction of tariffs or customs duties, or dislocation of trading arrangements – such as different settlement periods, or quality standards – could inhibit the trading of gas and electricity across borders. The result would be higher consumer bills and risks to security of supply.

Agreeing to continue with harmonised, tariff-free trading arrangements on gas and electricity should *not* mean signing up to all future EU energy and climate legislation, such as future targets on renewable energy.

However, it *will* mean the UK seeking to maintain membership of the key regulatory and industry bodies, like Agency for the Cooperation of Energy Regulators (ACER), European Transmission System Operators (ENTSO) electricity, ENTSO gas, and Council of European Energy Regulators (CEER), which help shape the rules and network codes that govern energy trading arrangements in Europe. Some of these bodies already have representatives from non-EU countries, but if full UK membership to some of these bodies is not possible once the UK leaves the EU, then (as a minimum) the UK should still look to participate in the working groups that support them and secure observer rights to the key decision-making fora.

The second thing to note is that the UK's membership of the Internal Energy Market isn't just a big deal for the UK. Ireland, an EU member state, is heavily dependent on the free flow of gas and electricity through the GB market. Indeed, the creation of the Single Electricity Market in Ireland – linking the Republic of Ireland and Northern Ireland – and close co-operation on energy between the UK and Ireland stems right back to the undertakings in the 1998 Good Friday Agreement. So the stakes here are very high indeed.

The impact of Brexit will vary by sub-sector

Access to the IEM is therefore a key issue. But as investors consider the wider impacts of Brexit on the energy market, it is important to recognise that some parts of the energy sector will be more affected than others.
For example:

- **Upstream oil and gas** is a global market, with global players, where the key variable is the oil price. Assuming existing EU legislation on issues like safety and environmental protection is passed into UK law as part of the 'Great Repeal' Bill, then the impact of Brexit on its own may be relatively limited on the upstream oil and gas sector. (This is not withstanding the much broader question about Scottish Independence.)
- **Regulated networks:** Similarly, for those network companies that have existing regulated settlements overseen by Ofgem, the impacts may be fairly marginal.
- **Power generation:** The impacts could be more significant here, given the significance of EU law in determining the way the power sector operates. For example, EU targets, such as the 2020 Renewables Targets, have been a significant driver for the growth in renewable energy in the UK over the past eight years. Will this drive continue as Britain leaves the EU?
- **Interconnection:** A big question is whether the drive for much greater interconnection between the GB and EU markets continues once Britain is out of the EU. The commercial incentives for greater interconnection remain, given the price arbitrage that exists between the UK and EU/EEA countries, but what is unknown at this stage is whether the political imperative for greater interconnection with the GB market will remain as Britain leaves the EU.

Whitehall watch

The final thing investors will need to assess is the likelihood of changes in the new Government's policy on energy and climate change. Take, for example, renewables. Will the government do away with the 2020 Renewables Target, once the Great Repeal Bill is passed into law? This might present an opportunity to focus efforts on the least-cost pathways to the 2030 and 2050 decarbonisation goals, rather than the technology specific targets required by the EU's 2020 target. Will we maintain membership of the EU Emissions Trading Scheme? What about future collaboration and funding on energy innovation? Answers to these and other policy questions will be crucial in shaping how the British energy market develops over the next few years.

There is precious little detail for investors to go on right now. Moreover, it could be some time before we have much clarity on these questions. The Prime Minister has said that she will trigger Article 50 before the end of March 2017. Even after then, elections in the Netherlands, France and Germany could thwart any really substantive negotiations on future arrangements until the end of 2017.

Even when the key players do get to the negotiating table, energy won't be a front line issue. It was not one of the six priority sectors listed by the Prime Minister during her Party Conference speech in October.

In a way, this could be helpful. Ideally, Britain's continued access to the IEM should be kept out of the political debate as far as possible and a *technocratic* agreement reached that current trading arrangements on gas and electricity continue for the benefit of all sides.

Investors will be weighing up a long list of factors in making their future investment decisions. The sooner the UK can reach an agreement about continued access to the IEM, the better it will be for consumers and investors alike. If the Prime Minister has one point on energy in her brief for the forthcoming Brexit negotiations, then that should be it.

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