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Brexit basics

Energy sector

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The UK has been a leading force in designing the EU's energy policy, advocating for the opening up of markets to reduce costs for consumers. The EU in turn is a significant contributor to the UK's energy infrastructure — the European Investment Bank (EIB) invested US$3.7 billion in UK energy projects in 2014. Let's see how Brexit will impact the energy sector, and what this means for business.

What does it look like now?

EU legislation currently has a significant impact on the operation of the energy market in the UK. The EU has exercised its shared competence under Article 4 of the Lisbon Treaty to establish the Internal Energy Market (IEM), which enables harmonized, tariff-free trading of gas and electricity across Europe in the following ways:

- A genuine internal market for the products and services of the energy sector
- Removal of barriers and establishment of common rules to open up energy markets
- Convergence of the real rates of excise taxes
- Introduction of competition in sectors where public monopolies persist
- Development of energy trans-European networks
- Notification of investment projects
- Full application of EU internal market law.[1]

The UK may seek to remain in the IEM by joining the Energy Community Treaty (between the EU and eight neighboring territories) in its own right, or through bilateral free trade or association agreements.[2] An agreement to continue with harmonized, tariff-free trading arrangements on gas and electricity could mean the UK remains subject to EU energy and climate legislation, but with minimal influence over its development. The UK will likely try to retain membership of (or at least a voice at) the key regulatory and industry bodies that shape the rules and network codes governing energy trading arrangements in Europe (such as ACER, ENTSO-E and ENTSO-G).

A series of EU directives and legislation has largely liberalized and harmonized the market, allowing new gas and electricity suppliers to enter other member states' markets, and industrial and domestic consumers to choose their own suppliers. Other EU policies relate to the security of the supply of electricity, gas and oil, and trans-European transport networks for electricity and gas.

What will it look like post-Brexit?

This depends of whether the UK will still be part of the EU IEM, which will impact on the degree of access to the European gas and electricity markets and influence over EU energy policies (noting that the UK would regain a measure of national sovereignty over the sector). What could 'in' or 'out' look like post-Brexit?

Bespoke arrangements may be set up for the UK through bilateral deals governing each of the gas and electricity interconnectors. But these deals would be highly complex and technically detailed, and there are no guarantees. The experience of Switzerland (where long-running negotiations for its membership of the IEM are currently blocked by discussions around free movement of people, and the agreement to link carbon emission trading schemes awaits ratification) shows that these deals could take many years to put in place, creating considerable uncertainty for projects currently under development.

'In' — FTA	'Out' — WTO
— Release from state aid rules, no access to EU funding — Dependent on FTA — e.g. CETA provides access to procurement in utilities markets that are not public monopolies, and requires parties to 'pay special attention' to the removal of trade barriers in support or renewable energy and climate mitigation, and cooperation in environmental protection.	— Governed by GATT (for energy goods) and GATS (for energy services) — Compliance with WTO subsidy regime (similar to EU state aid rules).

1. www.europedia.moussis.eu/books/Book_2/6/19/02/01/?all=1
2. Energy is largely excluded under a Customs Union model. The UK has indicated it will rescind membership of the Single Market and as such, is unlikely to remain in the IEM through participation in the European Economic Area.

What does 2017 look like for energy and natural resources?

Geopolitical risk expert Eurasia Group predicts that…

- **OPEC production will decline** by about 1 million barrels per day (bpd) as member cuts take hold and Venezuela declines on underinvestment. In general, the **OPEC market management role** is expected to be short lived and not a lasting reversal.
- A more pro-industry stance in Washington and debottlenecking of pipeline buildouts will **facilitate US energy exports, especially** for refined products and LNG
- As the US **backtracks from its climate commitments** at home and abroad, 2017 will provide crucial indicators of backsliding in other countries, including in Europe.

Which sub-sectors will be affected the most and why?

A change to the UK's access to IEM may impact on:

Upstream oil and gas: 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, the impact of Brexit on its own may be relatively limited on this sub-sector (notwithstanding a broader question around Scottish independence).

Regulated networks: 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. EU targets (for example, 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 in the UK as it exits the EU?

Interconnection: A critical outstanding question is whether the drive for greater inter-connection between Great Britain and EU markets continues once the UK has exited. The commercial incentives remain, given 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 interconnectedness will remain.

Spotlight on

Climate change

Brexit may require a split of EU/UK emissions reduction commitment and the UK's submission of its Nationally Determined Contribution on climate actions under the Paris agreement. Participation in the EU Emissions Trading Scheme will depend on the future UK-EU relationship.

Renewables

Unless the UK follows the EEA + EFTA model, it may gain greater autonomy in setting relevant policies — it will continue to be bound by national and international obligations, but will no longer be subject to the EU's Renewable Energy Directive and state aid restrictions. The loss of access to EU funding may impact on its ability to meet these targets.

Energy and commodities trading

It would be prudent to start preparing for MiFID II since it will apply from January 2018. This will have a significant impact on EU energy and commodity markets, that may see firms requiring regulatory authorization to continue existing activities or existing product lines, amending operating models, or even relocating certain business out of the EU. Post-Brexit, overseas energy and commodity firms with a regulated UK entity trading derivatives will no longer be able to use the MiFID II passport to provide investment services and activities, and may need to look to the third country regime or establish a MiFID-compliant EU branch or subsidiary.

What does this mean for business with operations with or in the UK?

The UK's energy sector requires more infrastructure spending than any other, and much of the capital required will come from abroad. Before committing those funds, investors will want more details about Brexit.

Maintain access to the IEM and little changes. UK consumers would continue to benefit from access to lower wholesale prices in many neighboring 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. For distributors or consumers of electricity within the UK, Brexit could impact on cost or availability. The introduction of tariffs, customs duties or dislocation of trading arrangements could inhibit the cross-border trading of gas and electricity, driving up cost of business, with some risk to security of supply (noting that the UK has mitigation strategies in place with respect to gas).

It is likely that the majority of EU energy regulations will be preserved in UK law in the short term, given the UK has been a key driver of recent liberalization (although the future of some of the renewables targets may be less certain). But there is a risk of regulatory divergence if sovereignty over energy and environmental policy is returned to the UK — not only between the EU and the UK, but also potentially within the UK itself.[3] For suppliers, operation under dual or more regimes can represent a real cost to business.

And it is not just a big deal for Britain. Ireland is heavily dependent on the free flow of gas and electricity through the Great Britain market. 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. The potential stakes are very high indeed.

Why is it worth following the debate?

Investors in the UK will need to assess the likelihood of changes in the new Government's policy on energy and climate change. Take 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 decarburization goals, rather than the technology specific target required by the EU by 2020.Will the UK 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 the British energy market over the next few years.

It could be some time before we have much clarity on these questions. Energy won't be a front line issue at the negotiating table, nor does it appear to be a sector prioritized by May's government. In a way, this could be helpful. The UK's continued access to the IEM could be kept out of the political debate as far as possible and a technocratic agreement reached that current arrangements on gas and electricity continue for the benefit of all sides.

What should you be thinking about now?

It is worthwhile planning for a number of different scenarios — not much change if the UK remains in the IEM, but if they leave, what will it mean for your business and how would you need to respond?

It is not about having the right answers, right now. The next best thing to having all the right answers is being able to ask the right questions. Think through the possibilities, and prepare your organization to respond to the signals of major change in this increasingly Volatile, Uncertain, Complex and Ambiguous (VUCA) world.

3. Westminster retains jurisdiction over energy on behalf of Scotland and Wales, but only nuclear energy in the case of Northern Ireland. Environmental policy is fully devolved to the administrations of Scotland, Wales and Northern Ireland.

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