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Legal Update
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The impact of Brexit on the energy sector

Introduction

Over the years, the United Kingdom (**UK**) has exercised a significant influence over the European Union ("EU") energy policy and has been at the forefront of liberalisation initiatives. Following a referendum held on the 23 June 2016, it has been announced that the United Kingdom has decided to leave the European Union ("Brexit").

It is not the intention of this paper to put forward the potential rights or wrongs of "Brexit". However, below, we begin to consider what Brexit could look like and what it may mean for the energy sector in the UK.

Possible post-Brexit scenarios

1. There are a number of possible relationships that the UK could now have with the EU post-withdrawal. Three such relationships include:

   - **The UK joining the European Free Trade Association ("*EFTA*") and the European Economic Area ("EEA")**, following the model of Iceland, Lichtenstein and Norway. The EEA Agreement includes EU legislation covering the **four freedoms** and cooperation in other areas, including **energy**. The EEA and EFTA States are part of the **Internal Energy Market ("*IEM*")** (*i.e.*, the creation of an internal market for gas and electricity) and there is currently an ongoing process of incorporating the **Third Energy Package**, in force since September 2009, into the EEA Agreement. Thus, if the UK remains in the IEM, arrangements for the energy sector would remain similar to those which are in existence today.

     However, it is doubtful whether the UK would pursue this option, as it would need to apply a substantial proportion of the existing EU legislation, without being able to **vote** upon it. In addition, the UK would have to accept EU laws and rules on competition policy and state aid, and contribute to the EU budget.

Key aspects of the Third Energy Package

- **Unbundling energy suppliers from network operators,** i.e., the separation of energy supply and generation from the operation of transmission networks.
- **Strengthening the independence of national regulatory authorities ("NRAs"),** e.g., by ensuring that they are free from influence of both industry and government.
- Establishing the **Agency for the Coperation of Energy Regulators ("ACER")**, an independent EU agency established to help cooperation between NRAs and to ensure the smooth functioning of the internal energy market.
- **Cross-border cooperation between transmission system operators** and the creation of the **European Network for Transmission System Operators for Electricity ("ENTSO-E")** and the **European Network for Transmission System Operators for Gas ("ENTSO-G")**, which (i) develop standards and draft pan-European network codes to help harmonise the flow of electricity and gas across different transmission systems and (ii) coordinate the planning of new network investments and monitor the development of new transmission capabilities.

- **The UK signing bilateral agreements (under EFTA membership)**, following the model of Switzerland, an EFTA State which is not part of the EEA. In that case, the UK would not automatically have to implement new EU legislation and agreements would be negotiated on a **case-by-case basis**. Indeed, Switzerland has negotiated a series of **bilateral agreements** with the EU that give access to the internal market for goods but not most services. Except in specific cases, it does not accept EU competition law and state aid rules, but it does contribute to the EU budget. An agreement on the free movement of citizens was also in force until recently, but has been limited after Switzerland launched an anti-immigration referendum in 2014. The network of (more than 100) agreements is complex and sometimes incoherent, and fresh negotiations have to be undertaken whenever a change in EU legislation occurs. This leads to uncertainty for businesses.

  There are ongoing negotiations between Switzerland and the EU to conclude an **energy agreement** which would regulate cross-border electricity trading, harmonise safety standards, secure free market access and guarantee Switzerland's membership in the various committees. The negotiation mandate encompasses the latest legal developments in the EU, including the **Third Energy Package**. Nevertheless, the danger of such a relationship is highlighted by the fact that the deal remains **blocked** after Switzerland's referendum on immigration, and the EU refuses to give Switzerland further access to the internal market until a **framework agreement** is established. It is therefore doubtful that the EU would be willing to establish a similar relationship with the UK.

- **The UK negotiating a single bilateral free trade arrangement with the EU** (as for example, South Korea or Canada). This would entail the negotiation of a free-trade deal with the EU post-withdrawal, in order to gain access to the internal market (for goods and, in whole or in part, for services). The framework agreement, concluded within WTO limits, would not require observance of all EU rules and would involve no contribution to the EU budget. On the other hand, it would leave the UK with little influence over internal market rules. The UK would also need to negotiate its own free-trade deals with non-EU countries, which may prove challenging. The deal would probably take a long-time to negotiate and its precise outcome would be uncertain. As with South Korea, the deal could involve cooperation with regard to climate change and energy security.

2. In the last two scenarios, the UK could specify that the EU Energy rules no longer apply to it and would have increased power to devise its own rules. Some commentators fear, if the UK were to lose its influence over the EU energy legislation, that the EU single energy market could move away from further liberalisation, restructuring and transparency.

3. However, the current UK Government has been reported as being unlikely to want to reverse the trend for more transparency and a level playing field at EU level, which is currently being implemented by the Commission's **Third Energy Package** and by the 2015 Framework for Energy Union[1].

Impact of Brexit on each individual aspect of EU Energy Policy

1. The impact of Brexit must, in reality, be examined for each aspect of the EU energy policy.

2. Under all three scenarios mentioned above, several sources, including a study conducted by Vivideconomics for National Grid in the UK,[2] stress that the uncertainty created by Brexit risks giving rise to higher costs of investment in energy infrastructure and/or to the deferral of such investments.

1 UK House of Commons Briefing Paper dated 12 February 2016 "*Exiting the EU: impact in key UK policy areas*" p.73, accessible at : http://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-7213#fullreport

2 Study by Vivideconomics "*The impact of Brexit on the UK energy sector*" dated 29 March 2016, accessible at: http://www.vivideconomics.com/wp-content/uploads/2016/03/VE-note-on-impact-of-Brexit-on-the-UK-energy-system.pdf

3. Under the last two scenarios mentioned above, where the UK exits the IEM, each of the following aspects of EU Energy policy is likely to be affected:

   - **Regulatory bodies**: after Brexit, the UK would exit the two EU regulatory bodies dealing with energy markets, i.e., the Council of European Energy Regulators ("***CEER***") (a not-for-profit organization through which national regulators cooperate and exchange best practices) and ACER. In order to retain influence over Energy Policy in the internal market, the UK would have to negotiate to remain part of those bodies. It could also reach an agreement to remain in ENTSO-E and ENTSO-G, which would enable UK transmission system operators to be able to influence the development of network codices.
   - **Availability of EU funds**: a substantial number of British energy infrastructure plans are currently listed as eligible for financial support as **projects of common interest ("PCIs")**, *i.e.,* a list of key infrastructure projects which may benefit from an accelerated procedure and access to financial support from the EU. Brexit may lead to those projects being reviewed as PCIs and/or receiving lower priority, and may impact the deployment of such projects (*e.g.,* offshore wind projects).
   - **State aid**: State aid rules would no longer apply to the UK. Therefore, subsidies granted by the UK government would not fall foul of EU State aid rules and the UK would have greater independence and freedom with regard to its energy policy. Nevertheless, with regard to exports, the UK would still need to comply with the WTO subsidy regime.
   - **Market integration**: if the UK remains outside the IEM, it could be, to some extent, excluded from market integration initiatives, such as **market coupling** (*i.e.,* selling electricity together with interconnection capacity, instead of separately, in order to integrate electricity markets in different areas), **cross-border balancing** (*i.e.,* the process through which transmission system operators ensure that they are able to access a sufficient amount of energy to balance the differences between supply and demand that occur in every electricity transmission system) and **cross-border participation in capacity mechanisms** (*i.e.,* measures taken by Member States to ensure the availability of sufficient electric energy resources). Leaving the single market could also open the UK to new import taxes and increase the cost of imports (when selling into EU Member States), for example as a result of currency devaluation, restrictions on the movement of people, or differing rules and regulations. In any case, Brexit may affect the UK's negotiating strength with external countries, as it will no longer be able to negotiate as a block.
   - **Energy security**: although it seems that Brexit would not, in principle, affect existing gas and power interconnections with EU Member States, which are subject to bilateral contractual agreements, it might create uncertainty about the future development of these interconnections. Investment in new interconnectors may also be affected and some of the contract/deal terms may have to be renegotiated. In addition, as one terminal of such interconnectors will be in the EU, EU policy and requirements may still be applicable. There will be difficult questions as to whether or not interconnectors continue to be bound by, for example, restrictions on selling capacity on a long-term basis.

     – Concerning electricity, if investments in interconnectors between the UK and its neighbours are affected, alternative and more costly options to maintain electricity supply security may have to be explored.

     – Concerning gas, the Vivideconomics study stresses that Brexit may have a lesser impact in the short term, as the UK has domestic production of gas, gas markets are already well integrated between the UK and Europe and price differentials are small. In addition, the UK has excess storage capacity and a diversified source of supply with many import facilities (*e.g.,* pipeline gas from Norway and liquefied natural gas ("***LNG***") from Qatar and potentially the USA). Nevertheless, there could be supply security risks in the longer term, where the UK could find itself excluded from EU "solidarity principles" or when additional gas is needed for peak demand (*e.g.,* cold weather). There may be a need for investment in new indigenous sources of gas (*e.g.,* shale gas), new UK gas storage and LNG facilities. Similarly such investment, which may prove difficult without significant changes in UK Government policy as in recent years as climate change policy has driven investment in renewable and nuclear energies.

- **Renewables and emissions policy**: the EU Renewable Energy Directive (RED) requires the UK to generate 15% of its energy from renewable sources by 2020. In addition, the EU has agreed a target for cutting carbon emissions across the continent by at least 40% from 1990 levels by 2030. If not part of the IEM, the UK would be released from EU renewable targets and emissions limits. This would in principle, give the UK more flexibility with regard its energy policy and its choice of technologies. Nevertheless, the UK would still be bound by national and international obligations:
  - First, the UK would be subject to the United Nations Framework Convention on Climate Change ("UNFCCC") and the Paris agreement, and will need to submit its own national emissions target. As a consequence, a new (lower), EU-wide target for 2030 will probably need to be adopted as the UK is today largely contributing to the EU's target to bring emissions down by 40% by 2030. Alternatively, other Member States may have to agree to make greater emission cuts.
  - Second, at the national level, the Climate Change Act 2008 states that the UK must cut its carbon emissions by 80% on 1990 levels by 2050 and is required to set "carbon budgets" every five years. There could be, however, a lower emphasis on renewables as a means to cutting emissions.
- **EU Emissions Trading System ("ETS")**: if the UK is outside the IEM, it may not directly participate in the ETS. However, transitional arrangements and arrangements linking a UK scheme to the ETS could be negotiated.
- **The EU Industrial Emissions Directive 2010 ("IED")** requires new power plants to comply with stricter emission limits on pollutants, while older plants have to close or clean up. This has an impact on UK coal-fired power plants and older gas plants which are expected to close by 2023. The UK government has indicated that it may choose to allow longer lifetimes for some older plants. However, it has recently announced plans to close all coal-fired power stations by 2025.

If you have any questions or require specific advice on any matter discussed in this update, please contact:

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