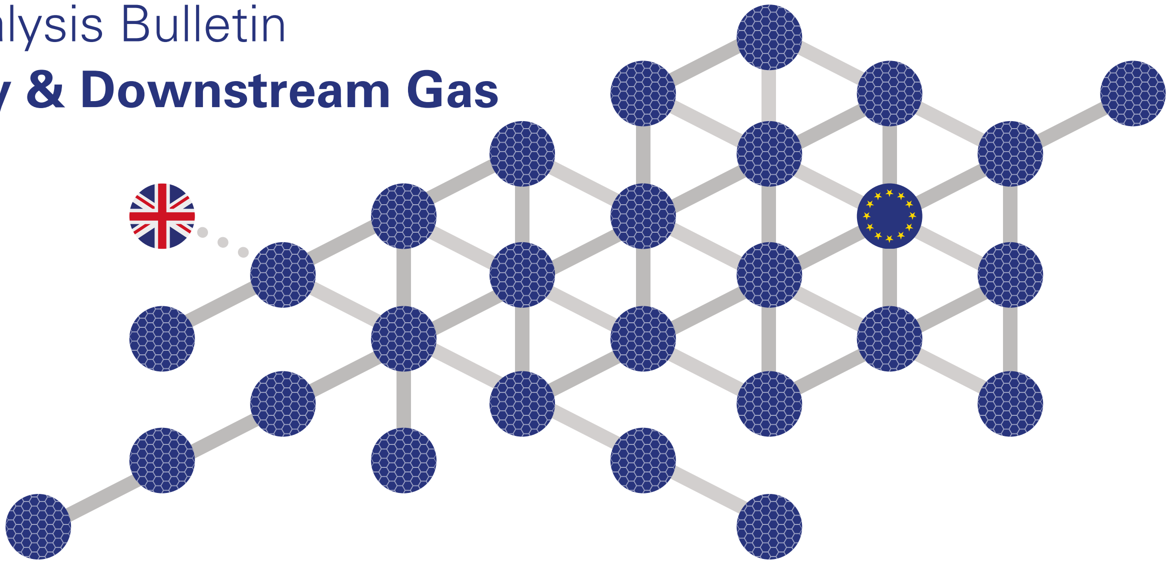
First published 08/03/16
Updated 29/06/16

SHEPHERD+ WEDDERBURN

Brexit Analysis Bulletin
Electricity & Downstream Gas



There is no doubt that Brexit will have a potentially profound effect on the UK's gas and electricity sector. The purpose of this note is to explore some potential impacts of Brexit now that the UK has voted to leave the EU.

Where are we now? The markets are integrated

The UK's energy markets are connected to the EU even though there is no single EU electricity and gas market. Electricity markets are physically connected by interconnectors from Britain to France, the Netherlands and the Republic of Ireland (ROI), and also via the Moyle Interconnector and the interconnectors between Northern Ireland (NI) and ROI. The gas market is linked with interconnectors to Belgium, the Netherlands, ROI and between ROI and NI.

The integration is not just physical. There is significant European investment in the UK by European energy groups, major cross UK/NI/ROI investment by SSE, Centrica and ESB, and much of the energy market is worldwide.

It follows that this is not an area where the 27 remaining Member States should be "tough" with the UK. If they are they may harm their own significant investments in the UK energy industry. Disrupting the current energy arrangements may significantly harm investor confidence not just in the UK, but in Europe as a whole.

Where are we now? EU law and policy plays an important role…but Member States still have a lot of power

EU law sets critical ground rules for the EU energy markets. A live example is state aid. EU rules control how Member States support renewables, capacity mechanism schemes, (to keep the lights on), and preferential tariffs to energy intensive industry. State aid rules are a central consideration in the context of new nuclear stations. More widely, EU competition law plays a key role in matters such as the supply of gas from Russia.

Be that as it may, significant power still resides with Member States. Recent Member State decisions not to build new nuclear generation and to stop fracking are material and have had a significant impact on investors and consumers.

What happens next? It is all about negotiation

Against this background, what impact will Brexit have on the UK energy industry? No-one has explained what the post Brexit EU/UK relationship will be. This is something that has to be developed. What is clear is that the UK must negotiate replacement arrangements and the terms of exit, not only with the EU, but also our neighbouring Member States such as the ROI. However, it is possible at this stage to identify some key points for negotiation.

The key topic for negotiation: what replaces the four freedoms?

The negotiations will have to clarify the position of the four core freedoms: movement of goods, services, people and capital. **To take a simple fictional example:**

An EU power company is refurbishing a CCGT gas power station in the UK. At present it can exercise the four freedoms without question to complete the project. The position may be different after Brexit.

> **Goods** The new turbines come from Germany. The basis on which imports can take place from the EU will have to be agreed after Brexit. The UK could, for example, require the company to use UK manufactured components where available or import duties could apply to the turbines making them more expensive.

> **Services** The company uses a Paris based engineering consultancy with particular expertise in this type of project. The consultant is free to provide services in the UK at the moment. However after Brexit there may be a requirement to use GB consultants if available or it may be difficult for the French engineers to obtain visas.

> **People** The company employs a Spanish engineer who has led two similar projects in Europe. They want her to lead this project as her track record is first class. Post Brexit immigration controls may require the company to demonstrate that there is no suitable alternative UK national before engaging her.

> **Capital** The company plans to use European profits to fund the project, on the basis that it will deploy the profits across the EU. It will want to get its profits from the CCGT out in the future. However, when the UK leaves, replacement arrangements may include capital controls, something that is normally unlawful under EU law. That may make getting money from the EU into UK and then getting it out much more difficult.

The point here, of course, is that these are not energy specific issues. These issues will have to be agreed on a macro basis. However the potential impact on the energy sector is obviously profound. The reality is that it is not possible at present to predict the extent to which the four freedoms will be altered.

What about specific energy matters: will the UK be able to diverge from Europe?

The UK has significant influence on EU energy policy. It has been a lead Member State in pushing for liberalisation. Much European policy is consistent with UK's domestic policy, e.g. unbundling, gas market arrangements and the promotion of renewables. Replacement arrangements would likely involve significantly less UK political influence over the regulation of our neighbouring energy markets. The UK would not only lose its EU votes, it would cease to be a member of ACER and the CEER. The clear risk is that policy changes in Europe harm the UK energy industry because of a loss of influence.

On the other hand, when the UK leaves it would have greater freedom over energy policy. How would this be exercised? Some key examples are as follows.

State Aid: more subsidies to generators? The UK may no longer have to comply with EU state aid rules, which have a material influence over investments under the CfD and Capacity Mechanism, (e.g. Hinkley). However one may ask how much would policy differ? UK policy is to reduce the cost of new capacity and consumer bills. One tool is the use of auction mechanisms. EU state aid policy is consistent with this. Another tool is the abolition of subsidies – which is Government policy in some areas. There is already a significant debate about the cost of new generation capacity.

Energy security: going it alone? The UK may not have to comply with developing EU law on energy security. However, practically, the UK depends to some extent on the EU for energy security. This is not limited to imports through the interconnectors. There are also perceived benefits in being part of a bloc when negotiating with states such as Russia. This will have to remain an area for co-operation.

Abolish the 2020 renewables target? The UK has to meet the 2020 target under EU law. Parliament cannot override this, EU law is supreme. So, for as long as the UK remains part of the EU, this target is most difficult to change. This provides investors with some security. There is also a question as to whether the UK will meet it. Contrast this with domestic climate change targets. Parliament is not bound by its own Acts of Parliament and can repeal them. However in the long run the UK supports emission reduction and the Paris Agreement implies a significant increase in renewables. The GB renewables industry is significant. Increased deployment of renewables way above the 2020 target is inevitable.

Control our own markets? The EU is intensifying efforts to integrate markets. There is progress towards regional intra-day markets and regional system balancing. Steps e.g. to regulate the LNG market might have a profound effect on the UK's gas market. The EU is now looking closely at the consumer side, where Member States have much greater freedom to act at the moment. The UK may prefer freedom to regulate its own consumer markets: as ultimately consumers are voters. But a key EU policy is greater demand side involvement. This is consistent with UK policy in many material ways.

An independent regulator or a more powerful Secretary of State?

It is sometimes suggested that Ofgem should be abolished and that Government should play a much larger role in policy. EU law requires that Member States create independent regulators such as Ofgem/GEMA and avoid political interference. For so long as the UK is a part of the EU, Ofgem, or a similar body must exist. Regulatory independence is a protection for investors, in particular as energy has become much more political in the UK. Brexit might lead to greater political involvement and therefore risk.

So what will happen?

There is scope for divergence. However, this might be overstated. As an example, it is difficult to see how the UK can avoid EU law and energy policy after Brexit. The interconnectors land in the EU, and so are subject to EU law.

The more compelling point is that the wider economic and commercial background means that it is highly likely that the UK energy market will continue on its path to greater integration with the EU market, whatever the outcome of a referendum.

The reality, however, is that the true impact of Brexit will only become clear once negotiations start. These negotiations will take a significant amount of time. Energy investment is long-term and investors may proceed more cautiously until the position becomes clearer. An investment pause at this stage may bring its own more immediate generation capacity related difficulties – given GB's tight margins. The price for adequate capacity may now be higher. This is part of a wider issue. Uncertainty in the UK will most likely increase the cost of capital making new energy investment more expensive. Inevitably that will put upward pressure on consumers' costs.

It is important for market participants to consider how Brexit may affect their businesses, and ensure that the UK and European Governments and regulators are aware of the energy industry's key issues. An orderly transition is essential so that security of supply and carbon reduction challenges are not put at risk.

However, it is important to bear in mind that the real key issues are not specifically energy related. The key issues are "macro" – the replacement of the four freedoms and the time it will take to put in place the UK's new arrangements with the 27 Member States.

SHEPHERD AND WEDDERBURN'S BREXIT ADVISERS

JOINING THE DOTS OF THE EU REFERENDUM

What next?

Shepherd and Wedderburn has been for many years offering balanced and impartial advice on how the different scenarios might play out in the event of constitutional change.

Now that the vote has been cast to leave the EU, members of our dedicated Brexit group continue to interrogate the regulatory and commercial issues and to advise clients on next steps and outcomes.

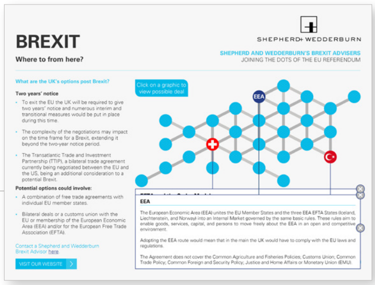
For further information in the first instance, please contact:

Gordon Downie
Partner
T +44(0)131 473 5162
M +44(0)771 863 7298
E gordon.downie@shepwedd.co.uk

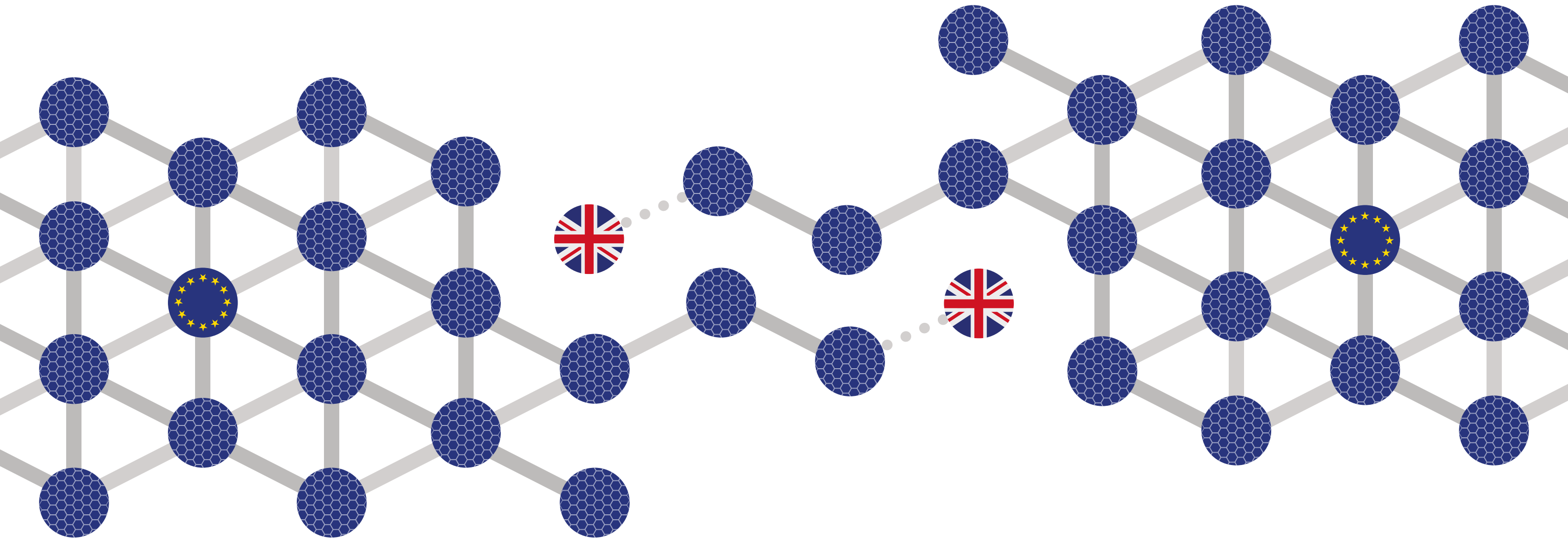
John Grady
Partner
T +44 (0)131 473 5411
M +44(0)752 567 9605
E john.grady@shepwedd.co.uk

Bookmark our Brexit Advisers page for a comprehensive collection of Brexit updates and guidance

Click here to view our 'Where to from here' Brexit infographic.



Click here to read our 'What now' Brexit bulletin.



First published 08/03/16
Updated 29/06/16