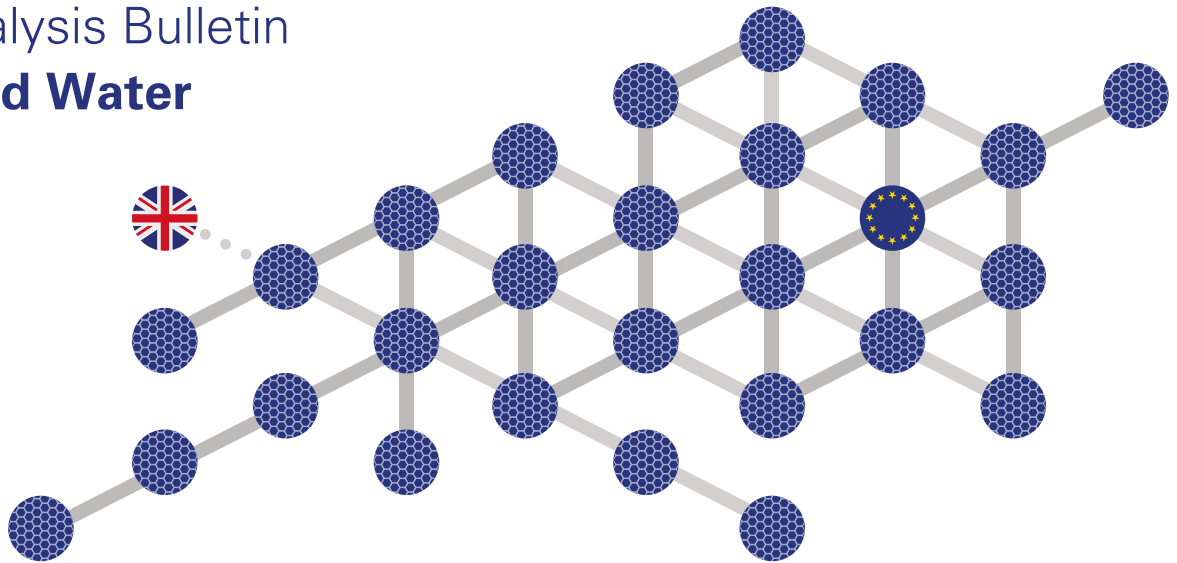


## Brexit Analysis Bulletin

# Waste and Water



Like all aspects of economic life, exit from the European Union could have a profound impact on the strategic direction of the UK water sector. The impact may not be immediately felt – with business plans already set, investment needs defined and major projects commenced. However, the absence of EU Directives driving water and environmental policy could see the UK change focus and diverge from a path that has driven standards for over 25 years. Conversely, the UK may have more flexibility to innovate or to decide to give state financial support to the sector.

For now, the UK is still part of the EU and is subject to exactly the same rules and regulations as before the 24th June. This will be the case until the UK exits the EU.

### The European influence

Market integration of the water and sewerage sector has not happened on the same scale as, for example, the European energy market for a variety of reasons, not least due to the very different physical characteristics of water distribution networks versus electricity or gas networks. There are, for example, no ‘water interconnectors’ between the UK and mainland Europe.

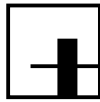
However, through various directives and policies, the EU has driven harmonisation of compliance frameworks across Member States. As a result, the EU has arguably been the driving force behind many investment decisions for well over 25 years in the water and sewerage sector. These standards and drivers derive from Directives such as:

- Urban Waste Water Treatment Directive
- Water Framework Directive, and associated directives, such as;
  - Nitrates Directive
  - Directives relating to dangerous/priority substances and chemical analysis

- Floods Directive
- Groundwater Directive
- Drinking Water Directive
- Bathing Water Directive
- Sewage Sludge Directive
- Environmental Liability Directive

While the above Directives, and their translation into UK law, have had direct impacts on the water and sewerage sector, there have been many other pieces of legislation and policy which have driven industry approaches. For example, provisions relating to industrial emissions, procurement, employment, state aid and competition rules.

Despite all of the above having shaped and influenced how we see the sector today, the delivery of water and sewerage services and industry structures remain diverse across Member States: from liberalised markets to publicly delivered services, and everything in between.



While compliance outcomes and targets are often the product of European Directives, Member States have considerable scope for determining exactly how water and sewerage services are delivered – which is why you can see, for example, a wide variety of strategies and approaches to the management of sewage sludge, with a recent example of shifting policy in Germany, where spreading to land will be phased out.

Of course, the future status of any future reviews of European frameworks, or current UK law which was introduced because of European rules, has been thrown into uncertainty following the UK's vote to leave the EU. Article 50 of the European Treaty outlines the process for the exit of a Member State. Once this is triggered, the UK will have two years to negotiate the terms of exit, unless a longer period is agreed. The UK will need to try to develop and negotiate alternative provisions for establishing trading and cooperation arrangements with European neighbours, which may or may not be possible in parallel to exit discussions, and will take considerable time. There will be a long period of legal and commercial uncertainty.

### **Water industry specific issues: Short to long term**

While the UK has now chosen to leave the EU, there haven't been any changes to the water sector's legal framework as a result, given that much of the environmental and quality requirements which drive water company investment are transposed into domestic legislation, and that formal exit procedures are yet to complete. Once the mechanisms are in place for exit, there will no doubt be a transitional phase, and a period of time where some searching questions take place about the UK's vision for water and sewerage policy, absent the significant direct influence of the EU.

Fundamentally however, price review and business planning processes have been completed for the foreseeable future, with companies now carrying out their investment plans for the next few years at least. The next price review will of course bring with it new challenges. In particular, much will depend on the stability or otherwise of the enduring legal framework that will provide the basis of PR19 investment decisions. Depending on the direction of UK water and environmental policy, there could be change in the UK's domestic legal framework that results in material changes to the inputs and assumptions for PR19.

It is difficult to judge the immediate consequences of Brexit at this early stage. However, below are some points for water and sewerage undertakers to consider as the situation develops:

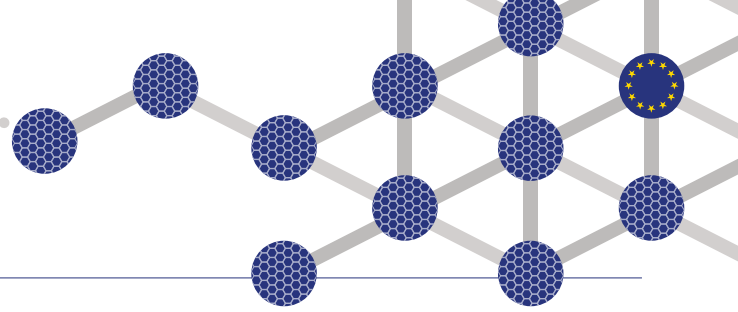
- Has there been a "Relevant change of circumstances" under Condition B of the Instrument of Appointment, which would benefit from a referral to Ofwat for an Interim Determination? This may be too early to tell, but something that appointees will want to keep a close eye on.
- Giving thought to the significant market reform activity in the UK water industry, it is very unlikely that there will be immediate changes impacting the development of non-household retail competition. Competition law requirements in particular still stand, by virtue of the existing domestic legislation, but since UK competition policy is very much linked to EU principles, this could well be an area for future change.
- Market and financial volatility will inevitably alter many of the assumptions that formed the basis of current commercial agreements, investment planning and price control decisions. We would expect all of these to be looked at carefully as the situation develops.

Given that the legislative framework for European water policy has largely been transposed into domestic legislation, it would be a significant task to start picking apart and start from scratch, to say the least. For this reason, it is probably more likely that the future of water policy in the UK lies in subsequent amendments to existing legislation, with aim taken at the more obviously contentious issues. Of course, this will all depend on the transitional provisions to be implemented by the government, which are at this stage far from clear.

Some changes are probably more likely than others. For example, from a public health perspective, it would be politically very difficult for any future government to start degrading existing drinking water quality standards. There could however be uncertainty regarding the future direction of travel for any new quality standards.

On the other hand, it could be more foreseeable that environmental quality standards could be trimmed, particularly under the justification of economic development, growth and jobs. Certainly some of the more contentious areas of the Water Framework Directive, such as the 'one-out-all-out' principle for water body quality, could be revised, assuming it is not abolished completely. Additionally, certain principles such as full cost recovery for water services could receive more flexible treatment in the future, depending on the political direction of a future administration.

Freed from these restrictions, this could potentially pave the way for more development projects getting the consenting green light from environmental regulators. Is this an opportunity for more innovation within the



industry? The question of the environmental cost vs. overall benefits is a tough question for any future policymakers when setting broad policy parameters. While there are numerous possibilities with regard to environmental policy, altering existing environmental standards would of course bring political challenges.

Finally, while the policy direction in the future may be significantly different to that of today, it is important to remember that policy is not created in a vacuum. European policy will continue to develop through technical, academic and policy expertise, and may still influence UK water strategies and policy outside of the EU.

### The broader fundamentals: Four freedoms

The position of European Directives on water quality and environmental standards, for example, may be subject to more long-term evolution, since much of the quality standards are heavily embedded into industry-wide strategy and business planning processes. However the exit of the UK calls into question the position of the four fundamental freedoms.

The below (fictional) example can illustrate this: A UK water company (whose parent company is European-based) is looking to invest in an innovative new sewage treatment process. This case study assesses what might happen if trade barriers increase.

**Goods.** The upgrade to the secondary treatment process requires specialised diffused air blowers from a company in Germany, which are considered the industry standard. The basis on which these can be imported into the UK will need to be resettled post-Brexit. The UK could require the water company to use UK manufactured components which may not be of the same specification, or import duties could be placed on the German goods, making them un-economic.

**Services.** The design consultancy is an Italian based specialist who has developed and patented a brand new treatment process. They are the only company able to deliver this new technology. At the moment the consultancy is free to provide services to the water company without restriction, but a future UK administration could, for example, place restrictions on foreign based service providers for certain industries.

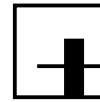
**People.** The design consultancy typically delivers and project manages the deployment of this technology through an in-house subsidiary. The engineers employed by this subsidiary are of various European nationalities. The delivery team typically work on-site and have an excellent track record. Following Brexit, and depending on the immigration policies adopted by a future government, the water company may be obliged to demonstrate that no other suitable capability exists in the UK before being able to engage these consultants. There may also be individual immigration restrictions depending on which countries the team members come from, complicating the delivery process and possibly leading to project delays.

**Capital.** The funds for the investment come from the parent company. The parent wants to ensure that profits can be transferred back from the UK. At the moment capital controls are not permitted under EU law, but a future UK government could impose restrictions on how projects like this are funded. The European investors would also have to consider how they could transfer profits from the UK investment out of the UK.

**What to do now?** It would be prudent to review any existing and long-term contracts and other arrangements which are linked to the four fundamental freedoms: Freedom of movement of people, goods, services and capital. This would be in order to identify where the biggest risks lie should these fundamental principles change in future.

### Conclusion

As with many issues linked to Brexit, the long term impact on the water sector is uncertain. There are some specific areas where change might be more likely, such as environmental quality standards, but even then there are political challenges in changing the principles on which these are based. Changing existing standards may be especially difficult, but a lot will depend on the policies of the UK government, and not on membership of the EU. However, Europe is a significant influential leader in water policy and therefore likely to continue to influence UK policy approaches post-Brexit.



## 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:**



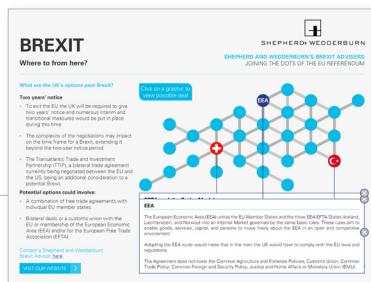
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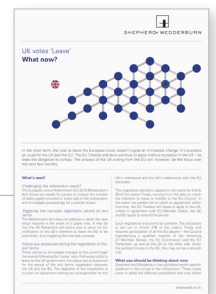
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