Baker & McKenzie

Effect of Brexit on the Energy markets

Referendum background

On the 23rd June 2016, a small majority of the British public (51.9%) voted to leave the European Union. At a point yet to be determined, the UK Government will trigger Article 50 of the Treaty on the European Union, the formal process by which a member state notifies the European Council of its intention to leave the Union.

This notification will begin a two year countdown within which the UK and the remaining EU Member States will have to negotiate a withdrawal agreement. The form of such withdrawal agreement will depend on negotiations and there is no guarantee that the UK will be able to withdraw entirely on its own terms. The newly inaugurated Prime Minister, Theresa May, has said the government will not trigger Article 50 until early 2017.

Currently and after Article 50 is triggered, all EU legislation that currently applies to the UK will continue to apply while the two-year period of negotiations are ongoing. The exact impact on the Energy Markets Union will not be known until the Government begins its negotiations with the European Union. However, it is likely that the UK will repeal the European Communities Act 1972, under which the UK is obliged to follow EU law. This will mean that from the date of its repeal, the UK will no longer be subject to directly applicable EU Regulations.

However, much of EU law is implemented through Directives whereby member states are obliged to create national law to give effect to those Directives. It will be up to the British Parliament whether it decides to repeal or amend UK law that was originally created to meet European Law requirements. Given the vast amount of domestic legislation that implements European Directives and the current Government's policy priorities, it is unlikely that Parliament will begin amending legislation that significantly affects the energy sector before 2020.

Post-Brexit options

The exact impact of Britain leaving the European Union and its effect on the Energy Markets will depend greatly on the settlement which is negotiated with both the Union and remaining Member States, as well as other countries around the world.

It is not yet clear what position the Government will take during these upcoming negotiations and whether it will want to keep Britain within the European Economic Area (EEA) or want the UK to join the European Free Trade Agreement (EFTA), for example. Before the referendum politicians, journalists and commentators highlighted broadly five 'models' that Britain could adopt on leaving the European Union.

1. The Norwegian model

Following Norway's agreement with the EU would mean Britain would become a member of the EEA with full access to the single market, however it would be obliged to make a financial contribution to the EU and accept the EU's four fundamental freedoms (including free movement of people). It is worth noting that although the EU's Third Package (gas and electricity legislation aimed at loosening restrictions on the European energy market) came into force in 2009, it has still not been incorporated into the EEA Agreement.

2. The Swiss model

Britain could become members of the European Free Trade Association, with restricted access to the EU single market. It will still have to make a financial contribution but would not have to accept all EU laws. Britain would still have to negotiate certain bilateral agreements (e.g. in areas such as financial services).

3. The Turkish model

Britain could join the EU's Customs Union, meaning Britain would face no quotas on industrial goods it sends to EU countries. However, the UK would only receive partial access to the single market and financial services are excluded.

4. The Canadian model

Canada has been negotiating a free trade agreement with the European Union for the last seven years. If

approved, it will remove 98% of the existing tariffs between Canada and the EU. It is possible that Britain could negotiate a similar agreement but based on the Canadian example, this could take several years.

5. The World Trade Organisation (WTO) option

If Britain is unable to negotiate a deal with the European Union, all of its trade with the EU and most of its international trade will be governed by WTO rules. In this case, the UK would be subject to EU tariffs and vice-versa.

Climate Change Targets

The Climate Change Act 2008 (CCA) set a domestic target for the country to achieve an 80% reduction in greenhouse gas levels (compared with levels in 1990) by 2050. There is an interim target to reduce emissions by at least 34% in 2020. It was introduced to ensure Britain met its obligations under the Kyoto Protocol targets and, in fact, goes beyond the EU's target of at least 40% reduction in greenhouse gas emissions by 2050 (from 1990 levels).

During the referendum campaign period, it appeared unlikely that Britain's climate change goals would change post-Brexit. The Department of Energy and Climate Change said it did not expect the government to repeal the CCA as it was passed with overwhelming parliamentary support.

However after the referendum result, the new Prime Minister announced that the Department of Energy and Climate Change was to become the Department for Business, Energy & Industrial Strategy. Critics have commented that the removal of an official government department for climate change indicates that the new government is not as committed to reducing climate change as its predecessor.

At COP21, the 21st session of the Conference of the Parties to the UN Framework Convention on Climate Change (UNFCCC), 195 countries adopted the Paris Agreement. Through this Agreement, the participating countries agreed to drive efforts to limit the global increase in temperature to 1.5 degrees Celsius above pre-industrial levels and achieve zero net emissions between 2050 and 2100.

It is unlikely that Britain will leave the UNFCCC considering it has been a member since its inception in 1992, and that all United Nations member states are members of the UNFCCC. Notwithstanding this, Britain's individual target will need to be broken away from the EU's combined target.

Renewable Energy targets

In 2009, the EU passed a directive to reduce greenhouse gases and increase the use of renewable energy and biofuels. The directive was implemented in the UK by the Promotion of the Use of Energy from Renewable Sources Regulations 2011 and Britain became subject to two targets:

1. 15% of overall energy consumption (electricity, heat and transport fuels) must come from renewable sources by 2020.
2. 10% of Britain's transport energy consumption must come from renewable sources (such as biofuels) by 2020.

Given the targets have been implemented into domestic law, Britain remains bound by these targets until they are repealed by Parliament. In the past, the UK has lobbied for decarbonisation targets in favour of renewable energy targets and this may be an indicator of future UK renewable energy policy.

Industrial Emissions

The Industrial Emissions Directive 2010 ("IED") consolidated and replaced seven directives on pollution from industrial buildings. The IED is implemented into UK legislation by the Environmental Permitting regime.

Industrial and combustion plant operators are obliged under the IED to obtain permits that are granted subject to conditions, with the aim to control and gradually reduce emissions and the generation of waste.

It is expected that some plants will close as compliance with the IED may not be cost-effective (e.g. the cost of pollution reduction equipment is too costly).

It is not yet clear whether the government intends to repeal the IED in order to reduce the financial burden on industrial buildings. However, the former Secretary of State for Energy and Climate Change, Amber Rudd, announced at the end of 2015 that the government would close all British coal-fired power plants by 2025 in favour of investing in nuclear energy and gas.

EU Emissions Trading System (ETS)

The EU scheme seeks to reduce greenhouse gas emissions by requiring operators of energy-intensive buildings (e.g. oil refineries and electricity generators) to buy and sell emission allowances (i.e. the right to emit greenhouse gases).

Companies that are expecting to fall short of their emissions allowance can sell on their 'right' to emit gases and companies who are expecting to exceed their emissions limits may purchase them.

In the UK, the ETS is primarily implemented through the Greenhouse Gas Emissions Trading System Regulations 2012. The UK is the EU's second largest emitter of greenhouse gases, as well as being one of the largest buyers of carbon allowances amongst EU member states.

If Britain follows the Norway model then Britain would remain a part of the EU trading system. If Britain does not remain a member of the EEA, it is still possible it will be able to negotiate entry into the EU ETS. For example, Switzerland (which is neither a member of the EU or the EEA) has just concluded four years of negotiations with the European Union to link its national emission trading scheme with the ETS. It would also be possible for Britain to develop its own domestic scheme.

Interconnectors

Britain has a number of electricity and gas interconnectors, such as IFA (with France) or BritNed (with the Netherlands), and is in the process of developing more of these interconnectors.

At present there are two broad methods for the regulation of interconnectors; the regulated route and the exempt (or 'merchant') route.

The regulated route operates a 'cap and floor' regime whereby an interconnector developer’s exposure to both the up- and downsides of the investment is limited. If a developer’s revenues exceed a maximum (the cap) then the excess is returned to consumers. Similarly, if revenues fall below a minimum (the floor) then consumers top up the developer’s revenues to the level of the floor. Created by Ofgem, the rationale for this regime is that it encourages interconnectors to be built as it reduces a developer’s exposure to the potential significant loss.

Under the exempt (or 'merchant' route) interconnector projects receive exemption from aspects of the EU's Third Energy package (such as third party access, unbundling and approval of tariffs). This means that the developers can protect themselves against regulatory intervention, a cap on profits or changes to the basis on which capacity can be sold.

It is possible that after negotiations with the EU are complete, the exempt route will fall away as interconnectors will no longer be subject to the EU's Third Energy package. Similarly, the 'cap and floor' model could be subject to change as Ofgem may no longer be bound by EU regulations.

Energy Projects and Project Finance

In 2015, the European Investment Bank (EIB) made investments totalling €7.8bn in the UK, with energy projects accounting for 24% of this figure, and transport and water making up 22% and 21% respectively.

In addition, areas of the UK where the GDP is less than 75% of the EU average, have received significant funding for infrastructure improvements from the European Regional Development Fund. For example, the Cornwall and Isles of Scilly Growth Programme, running from 2014–2020, is worth €100m per year to the region.

It is unclear how Brexit will affect projects that have received or, perhaps more importantly, expect to receive funding or guarantees from EU institutions. It is very probable that the UK will have to replace much if not all of the project and infrastructure finance originating from the EU institutions.

Given the uncertainty of UK Energy Policy over the next few years and the volatile currency rate, the UK may be a less attractive destination for project investment in the short term.

State Aid

As an EU Member State, Britain must comply with European Union State Aid regulations. Where a member state wishes to provide State Aid of over €200,000, permission from the EU Commission is often required in advance. These rules have threatened a number of British projects, including those in the biomass and nuclear sector.

The exact impact on State Aid will be determined by the upcoming negotiations. For example, if the UK chooses the Norway Model and joins the European Economic Area, Britain will be subject to EU competition rules. The EFTA Surveillance Authority will regulate State Aid matters in a similar fashion to that of the European Commission's regulations.

If the UK chooses the Swiss model, the State Aid rules will be less clear. Switzerland has individual bilateral trade deals with the EU regarding State Aid, for example, on aviation. It will then be up to the British government to negotiate State Aid rules across various sectors.

If the UK chooses the Canadian model (i.e. a comprehensive free trade agreement with the EU), it is possible that Britain will not be subject to any State Aid regulations. For example, in the proposed Comprehensive Economic and Trade Agreement with Canada, Canada is not subject to EU State Aid regulations.

If the UK were to abandon the prospect of a tailored trade agreement of any kind with the EU after Brexit, World Trade Organisation State Aid rules would apply instead. These rules are less extensive than their EU equivalents.

It is worth noting that in the past, per capita State Aid in the United Kingdom has been less than half the amount provided in other EU member states. It is not yet clear whether becoming free of EU State Aid regulations will result in the government providing more aid or whether it will continue to provide similar amounts of aid as it has done up until now.