THE IMPACT OF BREXIT ON THE UK ENERGY MARKET
Current position of the UK within the EU energy market

The current position of the UK is that it remains a member of the EU and a member of the IEM and shall remain a member of the EU and IEM for the near future.

It appears that Article 50 may not be triggered until early 2017 at the earliest and there is then up to two years of negotiation after which the UK will leave the EU.

The IEM is the EU's internal energy market and was created through a series of legislative packages introduced and adopted between 1996 and 2009 addressing numerous issues and setting regulations governing:

► market access;
► transparency and regulation;
► consumer protection;
► supporting interconnection; and
► ensuring adequate levels of supply.

The objective of the IEM is:

"to ensure a functioning market with fair market access and a high level of consumer protection as well as adequate levels of interconnection and generation capacity".

The UK's membership of the IEM is the critical factor in future of the UK energy market.

If the UK remains in the IEM there will be relatively few changes. However if the UK leaves the IEM there is significant long term risk.

The UK would miss out on the benefits from market initiatives, such as:

► market coupling;
► cross-border balancing; and
► capacity market integration.

Options after Brexit

There are multiple options available to the UK after leaving the EU. The route the UK will take will be dependent on political factors and subject to the Article 50 negotiations. The three main options are:

► The UK adopting a similar model to Norway, joining the EFTA and the EEA. The UK would remain in the IEM which would maintain the current status quo. However the UK would have no influence on the creation of new rules and regulations with which the UK would be required to comply.

► This option, while economically attractive, is not ideal politically. It reduces UK sovereignty which was a key aspect of the Brexit vote and leaves the UK bound by laws and regulation which it did not have a hand in creating.

► A Customs Union with the EU, in a model similar to Turkey. This option would allow the UK to maintain some sovereignty over regulation of the energy sector and remain

| GLOSSARY | 
|---|---|
| BEIS | Department for Business, Energy and Industrial Strategy |
| CCC | Committee on Climate Change |
| EEA | European Economic Area |
| EFTA | European Free Trade Association |
| EU | European Union |
| IEM | Internal Energy Market |
| LNG | Liquid Natural Gas |
| Third Energy Package | The EU legislation governing the EU energy market. |
connected to Europe's continental grid. However the UK would not automatically gain access to the IEM.

► If the UK remains part of the IEM then the UK would have to maintain and continue to adopt the relevant EU legislation. The EU would be able to set terms and requirements for the electricity generated by the UK which it exports to the EU. However as the UK imports more energy than it exports this may not be a major issue.

► A 'Free Trade Agreement' with the EU, in a model similar to Canada. This option would restore UK sovereignty over energy regulation, being the most politically attractive option, granting the UK full autonomy in respect of regulating the UK energy market and importing and exporting energy.

► Economically and geographically this option is not as desirable as joining the EEA or negotiating a Customs Union, as the UK would not be a part of the IEM, limiting its ability to trade electricity with EEA countries. The UK's ability to connect to different countries outside of the EEA is limited by geography and this reduces its negotiating position when importing and exporting energy.

► The UK would be required to continue to deal with EU member states and as such would be required to have equivalent legislation in place to regulate the UK's energy market and be able to trade with the EU member states.

<table>
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<tr>
<th>CONTRIBUTION TO GAS AND ELECTRICITY SECURITY</th>
<th>ACCESS TO EU FUNDS FOR INTERCONNECTORS</th>
<th>INTERNAL ENERGY MARKET</th>
<th>CONTROL OVER EXTERNAL TRADE</th>
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<tr>
<td>EEA (European Economic Area)</td>
<td>Unclear</td>
<td>Yes</td>
<td>No</td>
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<tr>
<td>Customs Union</td>
<td>No</td>
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There is a fourth option to enter into the same model which Switzerland currently operates. A series of bilateral agreements with the EU which allow access to the single market for certain sectors. However this option would be met with opposition as the EU has made it clear that it does not like the Swiss model and it is unlikely that this option would be on offer during the exit negotiations.

**Legislation**

In leaving the EU there are a number of regulations which, should the UK wish to remain part of the EFTA, the EEA and the IEM, would have to be entered into UK law. The most up to date regulations are contained within the Third Energy Package being:

► Directive concerning common rules for the internal market in electricity\(^1\);

► Directive concerning common rules for the internal market in gas\(^2\);

► Regulation on the establishment of the Agency for the Cooperation of Energy Regulators of ACER\(^3\);

► Regulation on conditions for access to the network for cross-border exchange of electricity\(^4\); and

► Regulation on conditions for access to the natural gas transmission networks\(^5\).

Following the UK's leaving the EU these regulations, would no longer bind the UK. However if the UK wants to continue to trade energy with the EU and remain a member of the IEM, compliance with these regulations will almost certainly be required and new UK legislation will be needed to enforce the regulations.

The Paris Agreement which the UK signed in April 2016 reaffirming the UK's commitment to tackling climate change, still needs to be ratified. Baroness Neville Rolfe, minister of

\(^{1}\) Directive 2009/72/EC  
\(^{2}\) Directive 2009/73/EC  
\(^{3}\) Regulation (EC) No 713/2009  
\(^{4}\) Regulation (EC) No 714/2009  
\(^{5}\) Regulation (EC) No 715/2009
state at BEIS has said that climate change will be at the heart of BEIS and that the UK intends to ratify the Paris Agreement as soon as possible\(^6\).

The Committee on Climate Change (CCC) has in its most recent report\(^7\) commented that the UK's vote to leave the EU does not change the need for the UK to reduce emissions or the scale on which it must do so. However Brexit may have an impact on the way in which the UK's meets its carbon budgets.

## Renewables

Renewable energy accounts for almost a quarter of the UK's electricity generation in 2015, however due to the fluctuating output the benefit of interconnectivity with the EU increases the more renewable energy production the UK has. The UK is able to sell energy electricity at times where production outpaces demand and buy energy when demand outpaces production.

Under the 2009 Renewables Directive\(^8\) the UK has a target for overall renewable energy use of 15% by 2020. In 2015 the UK's overall renewable energy use increased to 8.3%, from 7.1% in 2014\(^9\). This shows that while the UK is increasing its use of renewable energy the UK will need to nearly double the amount of renewable energy used, as a percentage of overall energy use, in the next four years.

The subsidies for renewables while implemented through national legislation, are underpinned by EU law.

![UK Electricity Consumption](image)

The Government has more freedom and could choose to amend relevant national legislation to further soften renewables targets.

On the other hand, the UK could have an administration more in favour of renewables and therefore there would be a better outlook for the UK's renewable energy industry, the direction the sector will take will depend on the policy of the new government.

The UK has committed more than £500 million to supporting new energy technologies, including storage and renewables which demonstrates the government's commitment to renewables and clean energy alternatives.

## Investment

In the short term it is expected that there will be reduced funding and investment in energy projects due to the uncertainty around Brexit and increased cost of funding. The potential softening of the UK's target of 15% of overall energy from renewables by 2020 could reduce the level of investment in renewable energy projects if there is no longer the pressure from the EU. However membership of the IEM would necessitate the UK retaining the renewable energy target, which could require continued investment in renewable energy projects.

The UK will, until it formally leaves the EU, retain access to the portion of the EU's current budget allocated to it, being:

- €1.9bn for climate change adaption; and
- €1.6bn to support transition to a low-carbon economy,

however it is unlikely that the full budget will be assigned to UK energy projects.

The higher costs for investors in UK energy infrastructure may be the largest risk for the UK energy sector following Brexit as given the level of planned infrastructure investment, small increases could compound and have a significant impact on the overall cost of the investment.

The devaluation of the pound will also have a negative impact on energy investments as while inward investment may appear more attractive, the projects themselves will cost

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\(^6\) Carbon Budget Order 2016, 19 July 2016, Volume 774, Motion to Approve


\(^8\) Directive 2009/28/EC

\(^9\) DECC, Renewable Energy in 2015, Table 3
more due to less favourable exchange rates. This will also have a negative impact on existing projects increasing the cost of purchasing materials from outside the UK.

In the long term it is expected that investments will pick up with the possibility of discounts being available for domestic or foreign investors willing to trust that the political instability surrounding Brexit will not damage the policy support already granted to existing projects.

The formal go-ahead of the Hinkley Point C nuclear power station signals that the government is committed to continue to develop the UK’s energy generation network and demonstrates that foreign investors are still willing to invest in UK energy projects.

The liberalisation and increasing competition of the energy markets is a long standing UK position that and should the UK elect to not push for retained access to the IEM this could be achieved through more flexible rules than currently in place under the EU's Third Energy Package, making investment in the UK more attractive.

**Electricity**

The National Infrastructure Commission identifies £14-19 billion of investment per year in the UK’s electricity sector up to 2020\(^\text{10}\), which amounts to 60% of total UK infrastructure spending to 2020.

However the above figures are based on pre-Brexit financing. Even small changes to the cost of funding could result in millions, possibly hundreds of millions of pounds in increased costs.

The depreciation of the pound and fluctuating currency exchange rates could have a significant impact on planned infrastructure. One example of this is that more than 50% of expenditure associated with offshore wind projects are from foreign companies.

Exclusion from the IEM would result in less favourable rates/terms when trading energy. It is estimated that “the potential forgone benefits from exclusion from the IEM and full market integration as up to £500m per year by the early 2020’s”\(^\text{11}\).

However there may be opportunities from the UK leaving the EU. The UK would be able to have more flexible regulations which may encourage investment in UK energy infrastructure and allow investment in different more diverse technologies.

**Gas**

The risks associated with Brexit are nominal for gas in the nearer term. The UK has diverse gas supply and significant storage capacity, more than 60% of gas sources would need to be lost for there to be a disruption to the service to domestic customers.

Unlike in the case of electricity the UK and EU gas markets are well integrated and the difference in price, while present is small. The UK also maintains significant non-EU sources of gas:

► pipeline gas from Norway; and

► LNG from Qatar.

The capacity of LNG has not been fully utilised and this could be increased for additional supply security if the UK does not join the IEM.


\(^{11}\) Vivideconomics, The impact of Brexit on the UK Energy Sector, 29 March 2016

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11 Vivideconomics, The impact of Brexit on the UK Energy Sector, 29 March 2016
Brexit could if the UK leaves the IEM have an impact on the supply security of the UK's gas in the long term as the UK could find itself cut off from the EU member states in the event of a gas supply crisis and not be able to acquire supply from its European neighbours.

Interconnectors

There has been a decline in the UK's natural energy resources, specifically, North Sea oil and gas, as a result of this an increasing demand the UK imports increasing quantities of its energy:

- around half of its gas (predominantly from Norway); and
- around 6.5% of its electricity consumption.

Interconnectors benefit both the UK and other participants of the IEM to which they are connected. Interconnections allows the UK to buy cheaper electricity from the EU in order to make up any shortfall in domestic supply when output levels from fluctuating renewable resources are not sufficient. This promotes continued interconnectivity between the UK and the EU. The map shows current interconnectors between the UK and Europe.

This interdependence is a factor which will be considered when negotiating the UK's continued membership of the IEM and will be key given the UK's pro-active policy towards interconnectivity with there being several interconnectors planned and 4 currently active.

This will require the UK to continue to comply with the EU energy regulation, though current interconnector projects are likely to be put on hold until there is greater certainty on the route the UK will take and the funding available.

Conclusion

There will be short term uncertainty in the UK energy market and currency exchange rates due to political uncertainty on the route the UK will take following Brexit. This may result in a slowdown of investment in UK energy projects and increased costs in the short term, specifically when importing energy from other countries. However this should reduce once it is clear which route the UK will take post Brexit.

Given the timeline for the UK triggering Article 50 the UK will continue to have both internal and external investment and access to EU funding. In addition while there may be an increase in energy prices this should not be long term given the global nature of the market and the UK's interconnectivity and interdependence with the EU.

The medium to long term implications of Brexit are still uncertain, there is no precedent for withdrawing from the EU. Membership of the IEM will be the key consideration on the effects to the UK's energy market. Remaining would preserve the status quo while leaving would result in significant changes, many of which will be determined on the agreements made with other nations both within and outside of the EEA.

All options will be limited by the UK's geography and while the UK can leave the EU it cannot leave Europe, the members of the EEA will remain the UK's biggest market. It is in the interest of both the UK and the EU for the UK to remain interconnected, the UK benefits from the cheaper wholesale energy prices from the EU and increased security of supply. The EU benefits from the UK being a ready consumer of its excess energy which given the steady generation from France and other EU member states is available, however such trading would be hampered should the UK leave the IEM.
Contacts

RICHARD GOODFELLOW
Partner, Head of Energy & Utilities
07775 586409
richard.goodfellow@addleshawgoddard.com

ROB THOMPSON
Legal Director
07738 047109
rob.thompson@addleshawgoddard.com

MATTHEW BROWN
Managing Associate
07725 734884
matthew.brown@addleshawgoddard.com
Doha, Dubai, Hong Kong, Leeds, London, Manchester, Muscat, Singapore and Tokyo*

*a formal alliance with Hashidate Law Office