SLAUGHTER AND MAY

# Brexit: potential impacts on energy markets and regulation

November 2016

## Overview

This briefing note reviews the possible impacts of the UK's Brexit vote on energy regulation in the UK, in two scenarios:

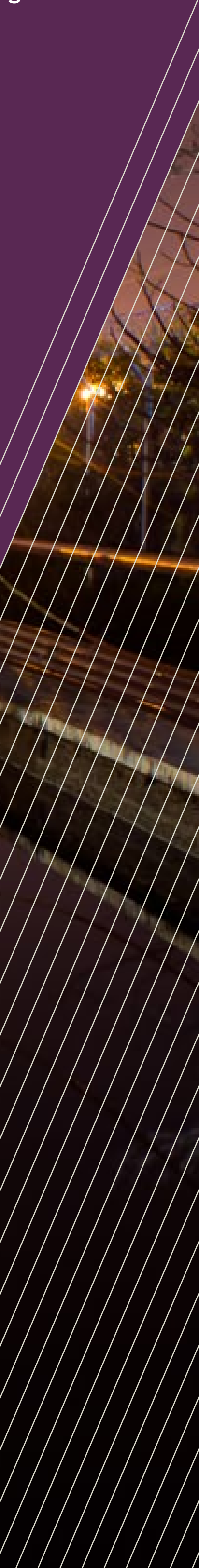
- The UK re-joins the European Economic Area ("**EEA**") through membership of the European Free Trade Association ("**EFTA**"), becoming an EEA EFTA country like Norway, Iceland and Lichtenstein (the "**EEA scenario**"); and
- The UK leaves the EU and EEA, whether through a full exit, a customs union, or joining EFTA without joining the EEA like Switzerland (the "**non-EEA scenario**").

There is uncertainty over both the Brexit model that will emerge from negotiations and the relative priority that the UK Government accords consideration of the EU energy regulatory regimes, bearing in mind that EU policies largely follow principles pioneered in the UK.

Perhaps the biggest question mark hangs over the future development of the markets themselves. Commentators have noted a number of possible effects including that of market uncertainty on risk premia and hence possible delay to some large planned projects (such as interconnectors) and continuing reliance on existing assets; and weakness in sterling putting upward pressure on wholesale gas prices, reducing the attractiveness of the flexible generation that is increasingly needed as a result of rising wind power output.

The UK stands to lose membership of, and funding from, the European Investment Bank and support from the EU low carbon transition budget. There are also important security of supply implications, including for the single market in Ireland and future levels of interconnection, market coupling and liquidity. If some of these effects materialise it could increase pressure on the Government to take a lead in supporting selective investment.

In that context we note that, while in the EEA scenario the EU competition rules would continue to apply to the UK (with some jurisdictional alterations) by virtue of their incorporation in the EEA Agreement, in the non-EEA scenario the UK would no longer strictly be subject to those rules, and would in theory be free, for example, to give State aid without approval from the EU Commission (the "**Commission**"), although it is common for free trade agreements to incorporate some State aid restrictions and the UK may choose or need to impose certain State aid controls for political / diplomatic reasons.



## The unbundling regime

The relevant EU Directives and UK implementing regulations require Transmission System Operators (“**TSOs**”) at both transmission and distribution levels to be independent of production and supply entities.

These restrictions apply across both electricity and gas sectors and regardless of geographical separation (i.e. one cannot generate electricity in one country and transmit gas in another, however remote). Following Commission guidance[1] that the restrictions may be applied flexibly for investors such as pension funds and private equity groups, the UK regulations were amended to give Ofgem discretion to allow relaxation where there is no risk of a conflict of interest. How far this relaxation can be applied and how much reliance can be placed upon it has not, however, been tested.

The Directives are currently in the process of being incorporated into the EEA Agreement, so that in the EEA scenario the UK would continue to be subject to them. In the non-EEA scenario the Directives would cease to apply to the UK. While the principle of unbundling had been applied in the UK through licensing legislation and policy before it was adopted by the EU, Brexit could afford an opportunity to extend flexibility within UK policy confines.

[1] https://ec.europa.eu/energy/sites/ener/files/documents/swd_2013_0177_en.pdf

## Interconnectors

In the EU, interconnectors may either be regulated or exempt from regulation.

- Regulated interconnectors have to comply with all aspects of the Third Energy Package and receive a regulated return.
- Exempt interconnectors have to apply to Ofgem for exemption from regulation, which may only be granted with the approval of the Commission.

These provisions are incorporated into UK law by the same regulations which apply the unbundling rules. They also established the European Network of Transmission System Operators for Electricity (“**ENTSOE**”) and its equivalent for gas (“**ENTSOG**”), to promote the internal market for gas and electricity.

Ofgem has adopted a ‘cap and floor’ regime for regulated electricity interconnectors. Operators must return to consumers any revenues above the ‘cap’, and receive payment from consumers when revenues drop below the ‘floor’. For regulated gas interconnectors, ENTSOG’s Network Code on the Capacity Allocation Mechanism (“**CAM Code**”) requires interconnector capacity to be auctioned by operators yearly, quarterly, monthly, daily and within-day.

The UK’s positions under the EEA and non-EEA scenarios are the same as those for Unbundling. In the non-EEA scenario there could be some scope for the UK to adopt a less restrictive approach to regulating how capacity on interconnectors – particularly existing gas interconnectors – is sold, though this could be limited where the non-UK end of any interconnector falls under the EU regime.

ENTSOE has TSO members from non-EU countries including Switzerland and Norway. TSOs from non-EU countries are admitted to ENTSOG only as observers, so Brexit would reduce the UK’s influence in this forum.

## The European Emissions Trading Scheme ("EU ETS")

The EU ETS restricts the quantity of greenhouse gases that operators in the power and heat generation sector (and various energy-intensive industry sectors) may emit, according to the amount of EU allowances they possess. Operators with an insufficient number of allowances are required to pay a fine (currently 100 Euros) for each excess tonne of greenhouse gases emitted. EU allowances can be purchased at auctions held in each EU ETS member state (currently all EEA member states). All operators covered by the EU ETS must have 'full, fair and equitable access' to any of these auctions. Participating operators are also free to trade allowances.

In the EEA scenario, the UK would continue to be part of the EU ETS. It would also continue to be required to abide by the EU ETS rules, as the EEA Agreement incorporates all the relevant EU legislation. In the non-EEA scenario, the UK would be free to set up a domestic carbon market with its own rules. If it seeks to remain in or re-join the EU ETS, however, it is likely to have to abide by most of the current rules to ensure harmonisation.

Given that under the Climate Change Act 2008 the UK has adopted emissions targets that are stricter than the EU targets, and that being member of a larger carbon market has considerable economic advantages, including greater liquidity, there seems little benefit to the UK in leaving the EU ETS. The EU is also likely to be amenable to the UK remaining in or re-joining the EU ETS – its policy is to conclude agreements with third countries, and negotiations are currently on foot to expand the EU ETS to Australia and Switzerland.

## Wholesale Energy Market Integrity and Transparency

The EU Regulation on Wholesale Energy Market Integrity and Transparency (“**REMIT**”) prohibits insider trading and market manipulation in wholesale energy markets. It requires:

- member states to give national regulatory authorities (“**NRAs**”) powers to enforce REMIT and impose penalties;
- the Agency for the Cooperation of Energy Regulators (“**ACER**”) to collect data on the wholesale energy market, and monitor the market;
- market participants to register with the NRAs where they are resident (or, if not resident in the EU, where they are active), disclose inside information promptly and provide ACER with information on transactions and on the capacity and use of certain electricity and / or LNG facilities; and
- professionals arranging wholesale transactions to report breaches of REMIT.

Like the EU Third Energy Package[2], REMIT and its implementing regulations have not yet been incorporated into the EEA Agreement, although it seems inevitable that they will be. In the EEA scenario, as soon as all the EEA member states have approved the incorporation of REMIT the UK would once again be subject to REMIT. In the non-EEA scenario, the UK would no longer be subject to REMIT and would also likely cease to be a member of ACER. If the UK wished the current REMIT framework to stay in place it would need to re-enact, or otherwise save, the current UK legislation implementing REMIT with the necessary modifications, including replacing references to ACER.

The UK played a leading role in developing REMIT, was one of the first EU member states to implement it, and is currently in the process of strengthening it through the introduction of criminal offences. The UK therefore seems unlikely to abandon or materially weaken the current regime. The UK may also want to stay part of an EU wide monitoring and enforcement system, as a purely domestic system risks creating an enforcement gap in relation to activity that takes place outside the UK but affects the UK market (subject to the final political settlement with the EU).

UK-based market participants with operations in other EU member states will need to comply with REMIT regardless of the UK position. They may therefore wish the UK to remain part of REMIT to avoid the possibility of having to comply with two separate regimes. Firms that do not have operations outside the UK, however, may wish the UK Government on Brexit to lower the administrative burden placed on market participants e.g. by decreasing the scope or volume of records that operators need to retain and provide to Ofgem.

[2] The Third Energy Package consists of two Directives and three Regulations – Directive 2009/72/EC concerning common rules for the internal market in electricity; Directive 2009/73/EC concerning common rules for the internal market in gas; Regulation (EC) No 713/2009 on the establishment of the Agency for the Cooperation of Energy Regulators; Regulation (EC) No 714/2009 on conditions for access to the network for cross-border exchange of electricity; and Regulation (EC) No 715/2009 on conditions for access to the natural gas transmission networks.

## Customs duties and value added tax

***Customs duties***: Under the Common Customs Tariff ("**CCT**"), no tariffs are currently payable on imports of energy products (electricity, gas, oil and coal) into the European Union Customs Union ("**EUCU**"), which comprises all EU Member States (plus Turkey and some others).

In the EEA scenario, the UK could continue to trade in goods on a tariff-free basis with EU Member States and other EEA member states, but would no longer be bound by the CCT so would have to negotiate its own tariffs with countries outside the EU and the EEA.

As an EEA member state, the UK would probably not impose tariffs on energy imports from non-EU countries, as to do so could result in higher costs for consumers and industry and possibly retaliatory tariff-setting.

In the non-EEA scenario, the UK could seek to join the EUCU (the so-called "**Turkish option**"), which would result in the *status quo ante* Brexit. But Turkey joined the EUCU as a precursor to joining the EU, and the option may not be available to an exiting state.

If the UK did not join the EUCU, it could seek access to the EU market under WTO rules. Although this would result in tariffs being imposed on around 90 per cent of the UK's goods exports to the EU, this would not include exports of oil, gas, coal or electricity, as the CCT does not currently impose tariffs on these products. Again, it would be unlikely to be in the UK's interests to impose tariffs on imports of energy products.

Alternatively, the UK could enter into a free trade agreement with the EU on bespoke terms, including the lifting of tariffs, which differ from the WTO standard.

***Value added tax ("VAT")***: In the UK, VAT on gas and electricity for domestic and charity uses is charged at 5 per cent, which is the lowest rate permitted under the VAT Directive. For other uses (e.g. wholesale, business or industrial) it is standard-rated at 20 per cent.

Tax harmonisation is outside the scope of the EEA Agreement. The UK would therefore no longer be bound by the VAT Directive even as a member of the EEA. Following Brexit, the UK would be able, for example, to reduce the rate of VAT on domestic electricity and gas below 5 per cent, or even to abolish VAT on these products (as was advocated by the Leave campaign). This would, however, deprive the HM Treasury of approximately £1.6 billion per year.

## Utility procurement

The current Directives governing procurement and the letting of concessions by EU public sector and utility entities will all imminently be incorporated into the EEA Agreement. Once that has occurred, in the EEA scenario they would continue to apply to the UK.

In the non-EEA scenario, the UK would be free to make the national procurement rules more streamlined and / or to disapply them (e.g. to private utilities). It could also require or allow contracting entities to take into account other factors in procurement decisions, such as the interests of national suppliers.

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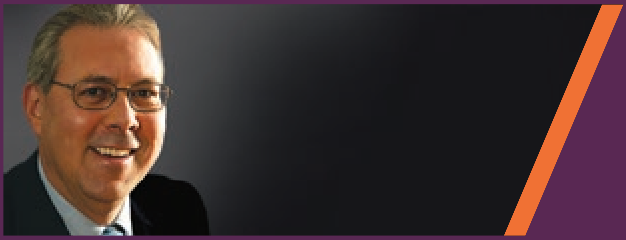

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