KPMG

Brexit and the energy market: Article 50 has been triggered, but what happens next?

A new free trade agreement will be needed to maintain the current tariff-free trading on gas and electricity

March 2017

Simon Virley CB

Simon Virley CB is Partner and Head of Power & Utilities at KPMG in the UK. He was previously Director General for Energy Markets and Infrastructure at DECC (2009-15).

simon.virley@kpmg.co.uk

At a glance:

- The UK is leaving the Single Market
- The prospects of reaching a new FTA on energy
- What happens now?

The starting gun has fired and the clock is now ticking. The Prime Minister has triggered Article 50, formally notifying the Commission and other Member States of the UK's intention to leave the European Union. The two year period for any deal to be reached has begun.

So what does all this mean for the energy sector?

The short answer is that nobody knows for sure how all this will pan out. We too are in uncharted territory.

But there are some things we do know. Let's start with the position of the UK Government.

The UK is leaving the Single Market

The Prime Minister made clear in her speech on 17 January that the UK will be leaving the EU Single Market. Little has been said on energy explicitly, as it is not a top tier issue for the Brexit negotiations. But the implication is that the UK will also be out of the Internal Energy Market, since the rules governing how that market works are set out in European legislation ('the acquis') and subject to the jurisdiction of the European Court of Justice (ECJ). The Government has also said in the European Union (Notification of Withdrawal) Act that the UK will leave the Euratom Treaty, which governs the handling of nuclear fuels and nuclear waste across the EU.

The logic of the UK Government's position is that it will now need to negotiate a new Free Trade Agreement (FTA) to ensure that harmonised tariff-free trading of gas and electricity can continue.

This was hinted at in a recent Government response to the BEIS Select Committee[1], which said that:

"We will therefore seek to ensure that arrangements are in place that facilitate efficient cross-border trade and avoid any market distortions arising from differences in UK and EU rules."

The Government response also acknowledges that it may not be possible for the UK to retain full membership and voting rights of the various organisations that set the rules for how these trades occur, saying that "The Government must take care to ensure that resultant gaps in domestic network codes are filled". These bodies include ACER (the organisation that brings together energy regulators from across the EU), ENTSO(E) and ENTSO(G), which govern the EU network codes for electricity and gas respectively. Assuming the UK cannot maintain full membership, a fall-back might be to secure observer status and/or participation in working groups that support these decision-making bodies.

The closest parallel that currently exists to such an arrangement between the EU and adjacent country is the Swiss model, where a Committee appointed by the Swiss Government can decide whether to adopt new EU rules on the operation of the Internal Energy Market on a case by case basis.

The prospects of reaching a new FTA on energy

How likely is it that a deal like this can be reached?

There are some reasons to be optimistic:

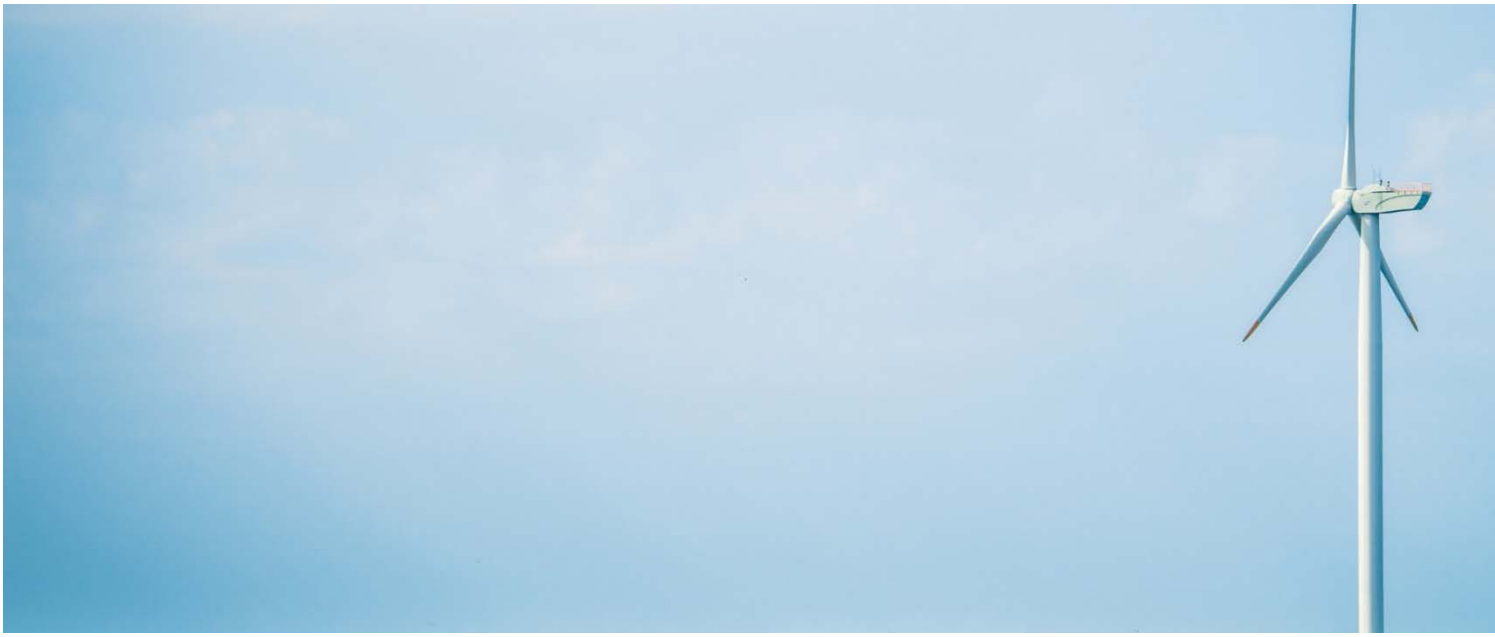
- The UK Government has made clear that it wants to maintain harmonised trading arrangements for energy, and that it remains committed to greater interconnection with the GB market, saying that this is in the best interests of UK consumers as it keeps energy bills down and increases security of supply.
- The EU does not charge import duties on electricity. Formally, it does have a tariff on imported gas (0.7%), but it has chosen not to apply this in practice. Under WTO rules, which would apply after two years if no deal is reached, there are no tariffs on gas or electricity.
- There are strong commercial incentives for such trading arrangements to continue.#
- The French regulator has recently approved the IFA2 interconnector project, saying that Brexit has not changed the case for it.
- The Commission has already drafted a legislative clause about third Party participation in the Internal Energy Market (which was leaked in December 2016). This was drafted with Switzerland in mind, but could form the basis of an energy chapter in any overall FTA.
- Crucially, Ireland will be pressing for such a deal to be done quickly, as the Irish energy market depends on the free flow of gas and electricity through the GB market.

So there are reasonable grounds for optimism that a deal on a new FTA covering energy can be reached.

However, there are three main reasons for pessimism:

- **Timescales**: any new FTA is very likely to take more than two years to negotiate. The Canadian FTA took seven years. The Swiss have been negotiating their various deals for more than 10 years. Moreover, no serious negotiations are likely to start until the end of this calendar year, once the outcome of the French and German elections are known. So some transitional arrangements will be needed. Many in the sector would argue for the current trading arrangements to continue until the new FTA is in place.
- **Complexity**: it won't just be a case of the new FTA agreeing that the tariff rate will be set at zero on gas and electricity.

Note: (1) Government Response to the ECC's Third Report of Session 2016-17, published 17 January 2017.



It will need to cover a range of detailed, technical issues, including arrangements for harmonised trading (e.g. settlement periods on electricity, or gas quality standards); what happens in a 'system stress event', such as when there are multiple outages across connected energy markets; what sanctions exist and should these agreements be broken?; and what institutions resolve any disputes (assuming the UK wants to avoid cases going to the ECJ)? There is also the question of what arrangements are put in place to replace the Euratom Treaty on nuclear fuels; and whether the UK will or will not participate in the EU Emissions Trading Scheme (EU ETS) in the future.

— **Conditions**: a new FTA will require unanimity from the 27 remaining Member States and agreement from a total of 38 Parliaments across the EU. It is possible that the Commission (or the European Parliament) will impose some conditions for agreeing to a new FTA. For example, the Commission's leaked legislative clause talks about needing to agree to 'the environmental rules with relevance to the power sector'. This might be acceptable for rules the UK has already signed up to (as will be the case once the 'Great Repeal Bill' has passed into law), but agreeing to future renewables targets for example, may well be a red line for this Government.

So it is all to play for. But one thing seems highly likely – that it will take more than two years to put any substantive new agreement in place.

What happens now?

In the immediate term, the answer is 'not much', as the UK remains an EU Member State for now.

In the absence of any political interference, the gas and electricity should continue to flow on 'Day 1' after the UK leaves the EU, even if an overall deal has not been reached, because of the various private contracts that exist between market participants and between National Grid and their TSO counterparts. But this position will get harder to maintain over time as policies and rules start to diverge.

The hope remains that a technocratic solution can be found to resolve these issues quickly.

However, by sweeping energy into the wider negotiation and therefore subjecting it to the general approach of leaving the Single Market, there is a risk that energy gets caught up in the wider politics of the overall negotiation surrounding the UK's exit from the EU.

Industry and investors should therefore be braced for a prolonged period of uncertainty, when the exact rules governing the way gas and electricity are traded, emissions limits are applied and the handling of nuclear fuels, are subject to differing interpretations. Private contractual arrangements will need to be robust to ensure value is not eroded throughout this period. It could take some time for the fog to clear and we may get back to where we started, with the UK part of the Internal Energy Market. Even if that does happen, it is likely to take some years to complete the circle.

kpmg.com/uk