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BDO FOCUS ON...

BREXIT & ENERGY AND NATURAL RESOURCES

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THE RISKS AND OPPORTUNITIES

Although it is too early to know what the future EU-UK relationship will look like, some things are already clear.

The UK will continue to determine its own energy mix, as is the case today. However the UK Government will need to determine whether a new balance is required and deal with the consequent impact, primarily on renewables and nuclear. Oil and gas prices will continue to be set on international markets; and the UK will continue to need to trade energy with its European partners, not least to make up for its own power shortfall.

The EU's focus is on creating an Energy Union by developing regional infrastructure and an open market for energy across the European Union. The UK's exit from the EU will have little or no effect on the continuation of these plans.

Indeed, sources amongst senior policymakers have suggested that only two EU countries will be affected by a Brexit, the UK itself, which would potentially be excluded from these developments, and Ireland which would effectively become an energy island unless it is able to develop energy interconnections with another EU country.

In addition, as the UK loses its ability to influence European energy, climate and environment policy, the EU will lose a market-led, pro-business heavyweight, which may lead to a more interventionist approach in policymaking by the EU. The departure of the UK also means the loss of a strong voice for a market-based transition to a low-carbon energy system. Consecutive UK Governments have been strong proponents of ambitious climate policies.

For companies working in the UK energy and natural resources sectors, it will be important to take every opportunity to influence the future direction of policy in this area both at EU and UK level.

Those with an interest in maintaining the current trajectory of policy – or something resembling it – need to work to ensure that these areas are not amongst the victims of areas of policy being reviewed in the UK as a result of the referendum result and any UK Government changes.

Currently, 15 projects on the third EU list of Projects of Common Interest (PCIs) involve UK infrastructure developments. These projects are eligible for EU funding under the Connecting Europe Facility (CEF). However, after Brexit it is uncertain whether they will be able to demonstrate "significant impact on the market integration of at least two Member States". This is a pre-condition for receiving CEF financing for non-EU countries.

UK access to European Investment Bank (EIB) loans is also likely to be reduced given that 90% of the bank's funding goes into EU Member States on the basis of its priorities.

EUROPE'S ENERGY MARKET

Participation in the EU's energy markets looks likely to remain an option given the UK's increasing dependency on those markets for electricity and gas, and the growing integration between national markets overall. If the UK agrees a Norway-style partnership with the EU (by choosing to remain a part of the European Economic Area-the EEA), it will be able to trade easily with the EU as Norway does today, based primarily on commercial rather than political deals.

The cost of this participation is compliance with the relevant EU legislation without having a say in its formulation. It would therefore be important for the UK to negotiate retaining a seat at ENTSO-E and ENTSO-G, the networks of electricity and gas transmission system operators, and possibly also at the Agency for Cooperation of Energy Regulators (ACER).

If the UK were instead to leave the single energy market it fought so hard to liberalise, access to EU markets and access for EU energy to the UK markets would be major issues to resolve.

WHY WE FACE A PERIOD OF UNCERTAINTY

Whatever the shape of the new EU-UK relationship, the regulatory and market uncertainty that is going to follow the UK's decision to leave the EU is likely to have a negative impact on investment in energy infrastructure in the UK, and could lead to an increase in investment costs and delays in investment decisions.

The period of uncertainty that will prevail until an exit agreement can be negotiated is likely to be further prolonged by changes to domestic legislation.

The UK's existing interconnectors and commercial trading links with Member States are not expected to be impacted initially, but it is likely that there will be more uncertainty as to their future development, not least as new interconnections would have reduced access to EU funds. This in turn would impact the possibility of developing an advanced European power grid across the North Sea which is one objective of the EU's Energy Union project.

If the UK loses access to the energy market it will be essential to the future of these electricity and gas interconnectors to agree a reliable alternative regime, and this too may have an impact on costs.

It would raise complex questions about whether the interconnectors continue to be bound by the current restrictions on the price at which interconnectors can sell their capacity under bilateral contracts. As a net importer, it might also affect the UK's security of supply.

RENEWABLE & NUCLEAR

With its own ambitious GHG emissions reduction targets to meet, it seems likely that renewable and other low carbon energy sources would continue receiving some level of support.

However, this is an area of uncertainty for investors, including because, among other things, the possibility that a new Conservative Government could decide to repeal the Climate Change Act containing these legally-binding targets.

A full Brexit would remove the UK's obligations to meet the EU 2020 renewables targets under the Renewable Energy Directive or the 2030 renewables target of 27% and the governance framework currently being negotiated for national energy policy plans. This could allow support for renewables to continue to be reduced in the UK's energy policy.

In addition, the incoming UK Government will make its own choices regarding changes to existing levels of subsidy and state support. The current Government has been a strong supporter of new nuclear facilities, tolerating significant cost increases with the Hinkley Point C project, for example. The new Government may pursue other options.

FREEDOM TO CHOOSE TECHNOLOGIES

Similarly, outside the EU, the UK would no longer be bound by EU state aid rules which would give it more freedom to choose which technologies and energy forms to support. Subsidies would still need to comply with the WTO regime which is similar in its intentions to the EU state aid rules.

If the UK remains part of the European Economic Area, the EU state aid rules would continue to apply to energy infrastructure and support schemes as they do today.

COAL-AND GAS-FIRED POWER PLANTS

Under the EU Industrial Emissions Directive (IED), operators are required to hold environmental permits that are granted according to conditions around reducing emissions into the environment. Where power generators cannot meet the requirements through abatement technology, or when this is not cost effective, plants must close down. This primarily affects coal-fired power plants and older gas plants which are expected to close by 2023. Brexit is unlikely to affect these rules, not least as the UK Government is considering closing all unabated coal-fired power stations by 2025.

THE EFFECT ON ENEGRY SAVINGS

A number of other pieces of energy legislation will need to be reassessed under the terms of the UK's new relationship with the EU. The EU's ambitious energy savings targets (20% on projected use by 2020 and 27% by 2030) will fall if the UK exits the single energy market but will remain in place if not.

Energy efficiency in buildings has been another area where EU legislation has driven UK legislation and action, including the introduction of energy performance certificates and display energy certificates, and the requirement for all new buildings to be nearly zero energy certified by end of 2020. Although these are unlikely to change substantially, a full Brexit would allow the UK to replace them with something more tailored to the UK market.

Likewise the Energy Labelling and Ecodesign Directives, which require manufacturers to label and decrease the energy consumption of their products, are likely to stay in place no matter what the final EU-UK relationship looks like, in order to retain access to the EU market for these products and to meet both supply chain obligations and consumer demands.

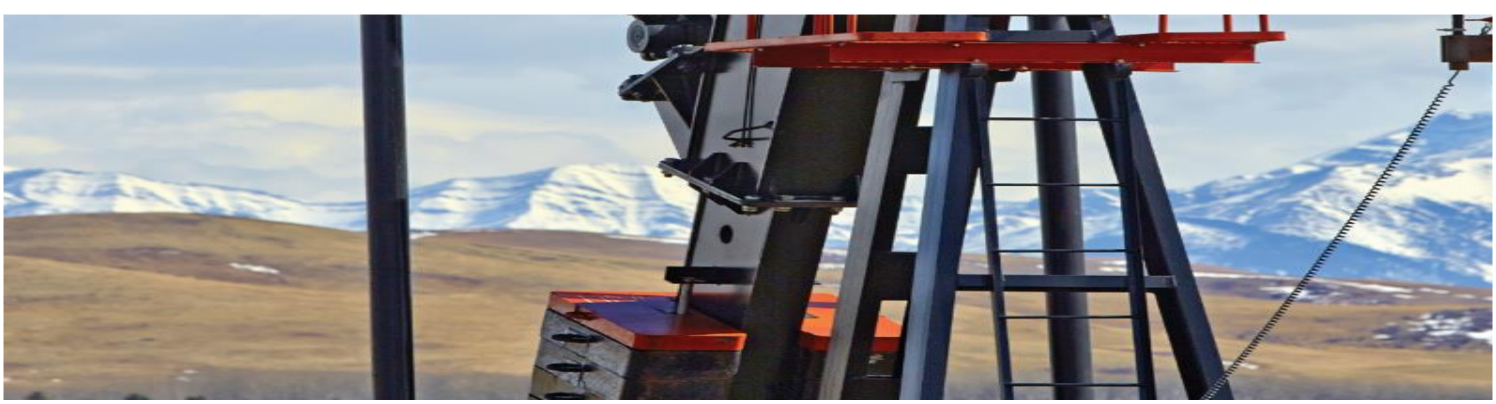
CLIMATE CHANGE AMBITIONS COULD BE HIT

On exit the UK will no longer be bound by the EU's 2030 greenhouse gas (GHG) emissions reduction target of 40%. However, since the vote, the UK has announced (30 June 2016) a new carbon target of reducing emission by 57% on 1990 levels by 2030 – even more ambitious than its EU commitments.

At global level, the UK will have to submit its own emissions reduction target under the Paris Agreement. Given the latest national announcement, it is not expected to backtrack on the commitments taken under the EU Intended Nationally Determined Contribution (INDC). It is possible, however, that the EU target or the share of contributions between Member States will need to be reviewed as a consequence.

It is not clear whether the UK would remain within the EU Emissions Trading Scheme (ETS) or whether it would seek to re-establish its national scheme. In the former case, the International Emissions Trading Association has said that there are legal precedents for non-EU member countries to participate in the EU ETS. In the latter case, arrangements would be necessary to link the UK scheme with the EU ETS.

The UK has been a strong advocate of liberalised energy markets and strong climate ambitions in the EU. The balance of power in EU negotiations on these issues could shift towards the other end of the scale as a result of the UK leaving the EU,



possibly leading to the adoption of more interventionist policies and the scaling down of climate ambitions. Finally, the UK has also been one of the main supporters of the development of carbon capture and storage as a way to avoid emissions of greenhouse gases in the atmosphere. Brexit will diminish support at EU level for this technology.

THE IMPACT ON ENERGY BILLS

The impact on domestic energy bills was heavily disputed during the referendum campaign. However, Vote Leave campaigners pledged to cut VAT on domestic fuel once the UK had regained the ability to determine its own rates. To achieve this, the UK will need to negotiate an exit from the VAT directives and regulations as part of its departure deal, and develop its own domestic rules to replace them.

QUESTION MARKS OVER ENVIRONMENTAL LAW

The bulk of current UK environmental law is the result of EU legislation. If the UK negotiates an EEA-style relationship with the EU, most of these rules would stay in place unchanged. If not, a comprehensive review of this body of legislation will need to be conducted to determine whether legislation should be left in place as it is, amended or replaced. Given the sheer volume of EU environmental legislation, however, the majority of these rules are unlikely to be reviewed in the short term.

Whatever the relationship with the EU, environmental directives in areas such as water, air, waste, chemicals and noise will continue to apply in the interim given that they have been implemented through national legislation. This will not automatically be the case for EU regulations that are directly applicable in Member States.

Parts of the EU environmental acquis was adopted by the UK against its will, for instance in the area of water. In waste management, UK industry has heavily criticised the EU approach for being too prescriptive and rigid. The new UK Government is likely to be under pressure from industry and politicians to ease or at least simplify some of the rules. Even senior Remain politician George Osbourne criticised EU environmental legislation during the referendum campaign by stating that rules under the Habitats Directive were placing a “ridiculous” cost on businesses.

Unless the UK adopts an EEA-like relationship with the EU, it could use its freedom to determine its approach to environmental policy to revise some of the applicable legislation, in particular in areas where particular EU legislation has been unwelcome in the UK. It may not want to backtrack on environmental standards that have already been implemented, however, not least because sustainable development is likely to remain a priority for British citizens and future governments, and it would be politically difficult to significantly worsen quality standards across several areas of environmental law.

WHAT NEXT?

Undoubtedly, Brexit will increase the EU’s dependence on non-EU oil and gas producers. It will also further decrease the already declining indigenous production of oil and gas as the UK is home to the largest remaining reserves within the EU, of both oil and natural gas. In 2015 the UK produced 35% of all natural gas and 72% of all crude oil produced in the EU.

Brexit will also likely lead to a smaller pro-nuclear camp in the EU and result in the biggest planned construction of nuclear power plants in Europe being outside the EU.

It will also mean the departure of the main supporter of shale gas developments in the EU with consequences for EU policymaking in this area.

The political situation is of course very fluid at the time of writing and doubtless there will be further developments and clarity as the months go on. Now is the time for clients in the energy and natural resources sector to identify with their BDO expert advisers, opportunities and risks arising from this fluid situation. It is also the time to engage and lobby at UK Government and EU member state level. Governments will need help to understand and try to mitigate the impact of Brexit on this key sector. It should not be assumed that a future UK Government will necessarily see the benefits or weaknesses of the pre-referendum energy landscape or seek to maintain it. It will be important therefore that the energy industry in the UK takes every opportunity to ensure that a new government prioritises this policy area in decisions to come and its exit negotiations.

The regulatory and public policy team at the BDO Global Office, in conjunction with external consultants, prepared this short paper to help you begin to understand the impact of Brexit on this sector in the short, medium and long term.

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