# Brexit

## Key issues for energy markets and energy policy

**8 October 2020**

### Background

The UK left the EU on 31 January 2020 (**exit day**). However, this profound change has so far had limited impact on UK law and regulation. Under the agreement on the UK's withdrawal from the EU (the **Withdrawal Agreement**), the UK continues in most respects to be treated as if it were still part of the EU from exit day until 31 December 2020 (the **implementation period**). The Withdrawal Agreement provided a mechanism to extend the implementation period but it has not been used. It therefore appears that the full legal consequences of Brexit will begin to be felt from 1 January 2021.

The Withdrawal Agreement does not regulate future trade between the UK and EU, or any other area of potential future EU-UK cooperation, except to a limited extent in relation to Northern Ireland. It remains unclear if a deal on future UK-EU relations will be agreed by 31 December 2020. In some areas, there is an obvious legal fall-back framework in the absence of a deal (for example, if agreement is not reached on tariff-free trade, "WTO rules" will apply); in other areas there is not. Whatever happens, those trading between the UK and EU will face significant regulatory changes (for example, in relation to customs). It also seems likely that, if the UK and EU reach a deal in the coming weeks, it may be a fairly "thin" agreement, meaning that negotiations on some aspects of the UK-EU post-Brexit relations may continue well beyond 2020.

For more detailed background, click **here**.

### Brexit and the energy sector

Over much of the period between the 23 June 2016 referendum (when the UK voted to leave the EU) and exit day, energy policy and market issues have not been at the forefront of public debate and commentary on Brexit.

In many areas, the UK has played a key role in shaping EU energy policy. Much UK regulation of the energy sector either directly implements EU law, or has grown up with EU law as an integral part of the context in which it operates. Although EU membership may have constrained UK policy choices from time to time, it has often been assumed that the UK's departure from the EU will not result in a major shift in UK energy policy or regulation.

On the other hand, businesses that interact with the energy sector only as consumers have generally – and probably correctly – assumed that even a "no deal" outcome at the end of the implementation period will not affect the UK's energy supplies anything like as disruptively as it could affect trade in some other sectors.

Only time will tell how far either or both of these assumptions is accurate.

### No deal

As noted above, some aspects of UK-EU trade will change whether or not there is a deal, and it makes sense to start by looking at how these could affect your business. However, for any business, including those in the energy sector, it is also prudent to consider the possible impacts of "no deal" at the end of the implementation period. If you are prepared for that, you are prepared for what is likely to be the most disruptive outcome. The detailed risk assessment for each business will be different, but one possible way of identifying the most pressing issues and trying to manage them might be to use the generic risk assessment matrix at the end of this note.

In some respects, the energy sector is like any other in the sense that the effects of no deal are, at least in the short term, a more intense version of the changes that will occur with or without a deal. This can be illustrated by reference to UK-EU supply chains. If you are engaged in the construction of a wind farm in the UK which partly relies on parts shipped from the EU, the arrival of those parts in the early months of 2021 could be delayed if the ports, customs authorities and haulage companies struggle to operate under the new regime of customs checks, export declarations and other formalities that will apply to such supply chains for the first time on 1 January 2021. Even if you have mastered the new bureaucracy of UK-EU trade yourself, the arrival of your shipment may be delayed by the cumulative impact of those who have not. If such delay leads to failure to hit predetermined construction contract milestones, a range of contractual claims (or attempts to invoke contractual flexibilities, such as force majeure clauses) may arise across the overall project supply chain. In this situation, the absence of a deal could add a further dimension if, as well as delay, you face an additional cost because the parts imported from the EU, on which no tariff is currently payable, are subject to a tariff after 31 December 2020 under the new UK Global Tariff arrangements, because there is no agreement between the UK and EU on tariff-free trade.

However, the most distinctive consequences of Brexit for the energy sector all revolve around its impact on sector-specific regulation, and in particular the measures that comprise the EU's internal energy market (IEM). At present, the UK exports and imports significant amounts of electricity and gas over interconnectors with its EU/EEA neighbours. IEM rules facilitate this trade. There is compelling commercial and policy logic on both sides for the continued operation of those interconnections in a no deal scenario, but the current basis on which they operate will lack legal underpinning once the implementation period comes to an end, and the UK not only is no longer an EU member state, but is no longer effectively treated as if it were still a member state...

It is not expected that UK-EU trade in electricity and gas would cease, or even necessarily diminish, in a no deal scenario. However, once the implementation period expires, the UK (outside Northern Ireland) would no longer participate in the EU's electricity "market coupling" arrangements and the "implicit auctions" that govern electricity interconnector flows. These are at the heart of the efficiency of current UK-EU electricity trading. If there is no deal, then whatever alternative arrangements are found to plug the legal gaps that would be left at this point in order to allow cross-border trade to continue, would inevitably be less efficient, leading to an increase in trading costs, even though it is unlikely that any tariffs would be payable on the exports or imports of gas and electricity themselves. For the majority of non-energy sector businesses in the UK outside Northern Ireland (NI), which are simply consumers of energy, the most significant likely impact of Brexit in the energy sector is this possible increase in energy costs.

The distinction between NI and the rest of the UK (Great Britain, (GB)) arises because the electricity and downstream gas markets of GB and NI operate and are regulated separately from each other, and the NI electricity market participates in a Single Electricity Market (SEM) for the island of Ireland. Since October 2018, the operation of the SEM has been based, explicitly, on IEM rules, and for this reason, the SEM is the subject of special provisions in the protocol to the Withdrawal Agreement that deals with Ireland and Northern Ireland (INIP).

There are a number of areas where INIP provides that certain elements of EU law must continue to apply to and in the UK in respect of NI, beyond the expiry of the implementation period. The "generation, transmission, distribution and supply of electricity, trading in wholesale electricity or cross-border exchanges of electricity" is one such area (along with other single market rules on goods, VAT rules and EU state aid rules). Accordingly, the relevant EU electricity market laws are listed in Annex 4 to INIP as continuing to apply. This includes the continuing jurisdiction of the European Commission and Court of Justice, and an obligation to implement amendments or replacements of those EU laws listed in Annex 4 that are adopted or enter into force after the expiry of the implementation period.

For the moment, then, and at least as far as trade within the SEM (rather than trade with GB) is concerned, participants in the SEM, and consumers generally in the island of Ireland, are insulated to a significant extent from the potential no deal inefficiencies that could affect GB electricity market participants and consumers. However, INIP provides a mechanism by which the application of these EU laws may not continue indefinitely, but depends for its continuation on the consent of the NI Legislative Assembly. If the Assembly votes by the requisite majority to continue with the package of regulatory alignment that includes the EU wholesale electricity market rules, then it shall continue in force; otherwise, it will lapse after two years. But the earliest time at which such consent can be expressed is four years after the end of the implementation period – i.e. at the end of 2024, which means that the EU laws that support the operation of the IEM / SEM will remain in force in NI until at least the end of 2026.

We now have a fair degree of visibility as to how the UK regulatory framework is to be adapted in a no deal scenario.

As with EU law generally, the existing body of EU rules relevant to the energy sector will be carried over into UK law on Exit Day by the European Union (Withdrawal) Act 2018 (**2018 Act**), with various modifications to that body of rules being set out in secondary legislation made under the 2018 Act.

Central to this exercise are six sets of regulations on IEM issues made under the 2018 Act. Listed below, these make many pages of amendments to existing GB and NI legislation and to existing EU Directives and Regulations as they will apply in future in the UK.

They are:

- The Electricity and Gas etc. (Amendment etc.) (EU Exit) Regulations 2019
- The Electricity Network Codes and Guidelines (System Operation and Connection) (Amendment etc.) (EU Exit) Regulations 2019
- The Electricity and Gas (Market Integrity and Transparency) (Amendment) (EU Exit) Regulations 2019
- The Gas (Security of Supply and Network Codes) (Amendment) (EU Exit) Regulations 2019
- The Electricity Network Codes and Guidelines (System Operation and Connection) (Amendment etc.) (EU Exit) Regulations 2019 (subsequently amended by the Electricity Network Codes and Guidelines (System Operation and Connection) (Amendment etc.) (EU Exit) (No 2) Regulations 2019 to reinstate the application of three network codes already implemented in GB but which otherwise would have fallen outside the category of "retained EU law")
- The Electricity Network Codes and Guidelines (Markets and Trading) (Amendment) (EU Exit) Regulations 2019

Further amendments have been made to the pre-existing legislation or to one or more of the above by:

- The Gas Tariffs Code (Amendment) (EU Exit) Regulations 2019
- The Electricity and Gas etc. (Amendment) (EU Exit) Regulations 2020
- The Electricity and Gas (Internal Markets and Network Codes) (Amendment etc.) (EU Exit) Regulations 2020

Like much of the secondary legislation made under the 2018 Act, the first six of these regulations are expressed to come into force on exit day. The European Union (Withdrawal Agreement) Act 2020 provided that they would instead come into force on "IP completion day", i.e. at the end of the implementation period, and this has now been made explicit by amendments in some of the later Regulations. They are supplemented by the Electricity and Gas (Powers to Make Subordinate Legislation) (Amendment) (EU Exit) Regulations 2018, which maintain some flexibility for the future by effectively transferring to the Secretary of State (within GB) the European Commission's power to make "tertiary legislation" under the IEM framework.

For the purposes of "onshoring" EU IEM and related law, some instruments (such as the Regulation on Capacity Allocation and Congestion Management in the electricity sector, which provides for market coupling) are revoked in their entirety; others are subjected to numerous, fairly mechanical, changes designed to reflect that the UK is no longer in the EU, and that EU institutions no longer have a role in the UK industry.

For those seeking a short cut to the key policy objectives behind the new regulations, BEIS published a helpful letter from the then Energy Minister Claire Perry, with an annex that summarises each of the principal sets of regulations on one page. The explanatory memorandum published alongside each set of regulations is another useful way to get a general sense of how they work.

On several occasions during 2019, Ofgem published decisions approving modified access rules for individual UK interconnectors to be used in the event of no deal. The most recent decisions, relating to the IFA, Nemo Link, BritNed, IFA2 and ElecLink interconnectors, were published on 18 December 2019.

Meanwhile, the development of the IEM continues at EU level. In particular, on 5 June 2019, the final pieces of the EU's Clean Energy Package, first proposed in 2016 and comprising significant reforms of the principal IEM legislation relating to electricity, were finally adopted. Most of the provisions in the new legislation do not fall to be implemented by member states until 2020 or later, but, under the Withdrawal Agreement, the UK will be required to implement all of them in respect of NI, and some of them in respect of GB. There are also brief government guidance notes on electricity trading and gas trading if there is no deal.

It is of course not just the IEM EU legislation that is of particular relevance to the energy sector and requires to be adjusted as it is "onshored". Another area of EU regulation that is of fundamental importance to UK energy and non-energy companies is the EU Emissions Trading System (EU ETS). This is a "cap and trade" system where permits and emissions allowances regulate the greenhouse gas emissions of many power stations, oil refineries, steelworks and other installations. Allowances are tradable and administered through a central EU registry.

In a no deal scenario, the default position would be that the UK ceases to be part of the EU ETS on 31 December 2020. This has important practical consequences for those UK businesses that may still have allowances in accounts in the UK section of the EU ETS registry, to which they will lose access at that point. The government has published some guidance on this and related matters. However, the guidance does not yet explain exactly how things will be managed in relation to those electricity sector participants in the EU ETS in Northern Ireland who will remain within the EU ETS on 1 January 2021 as part of the INIP arrangements designed to protect the integrity of the SEM.

At the time of writing, there is also an open question about what will regulate the emitters that are currently subject to the EU ETS in the rest of the UK in place of the EU ETS. There appear to be two, or possibly three, alternatives.

One option is a UK ETS closely modelled on the EU ETS, and which the government hopes could be linked to the EU ETS. For this purpose, following consultation, draft legislation has been prepared and published, but the process of its approval by Parliament and the devolved legislatures had not been completed at the time of writing. Moreover, once it has been approved, it is not certain that this is the path that the government will follow. In parallel with the development of a UK ETS regime, the government has consulted on, and made provision in outline in the Finance Acts 2019 and 2020 for, a carbon emissions tax. This has been presented as one of two fall-back options if the EU does not agree to the UK ETS being linked to the EU ETS – the other option being to go ahead with the UK ETS on an unlinked basis. However, it seems to be envisaged that either an unlinked UK ETS or the carbon emissions tax would continue to track the evolution of the EU ETS in various ways. Clearly, a decision will need to be made one way or the other, and businesses brought up to speed with their new compliance obligations, in a relatively short time frame.

The approach taken in respect of the EU ETS is of course consistent with the UK's own climate change policies. However, it also reflects the fact that, if the UK wants, in the longer term, to be permitted once more to participate fully in the IEM, and not merely to be able to trade with EU counterparties on a less efficient basis, it is likely to have to commit to continue to follow many of the EU's rules – not only on energy market structures but also on key related policy areas such as state aid and environmental protection – to ensure a "level playing field".

A final area worth noting is the guarantees of origin issued in respect of electricity generated from certain cogeneration and renewable sources (commonly referred to as GoOs or, in the UK context, REGOs). Regulations in respect of these have been made under the 2018 Act in 2018 (separately for cogeneration and renewables) and 2020. After 31 December 2020, UK-issued GoOs will no longer be recognised in the EU. The government has said that for the moment it is reserving its position as to whether to continue to recognise EU GoOs in the UK after that date if there is no equivalent obligation on EU member states in respect of GoOs issued in the UK.

**Deal**

What can the UK (or at any rate, GB) expect by way of a "deal" on energy with the EU after the implementation period expires? In some slides published on 15 January 2020, the European Commission summarised the position as follows:

- "*Not business as usual - UK will leave the EU’s Single electricity market and its tools;*
- *New EU-UK mechanisms in some selected areas, taking into account FTA proposals to other third countries;*
- *New framework requires strong level playing field guarantees*".

Broadly speaking, a similar approach can be seen in the draft EU-UK agreement that the EU published in March 2020. By contrast, the Draft Energy Agreement published by the UK government as part of its proposals for future EU-UK relations in February 2020 came closer to an attempt to recreate single market-like arrangements. The UK appears to be aiming for the kind of arrangement that Switzerland has been attempting to agree with the EU for some time..

Indeed, it appears likely that the precedents for future UK-EU relations in the energy sector are not to be found in the pattern set by the UK's years of EU membership or the continued application of EU rules under the Withdrawal Agreement and INIP. As well as the proposed bilateral agreement between the EU and Switzerland, possible models include the agreements between the EU and the other members of the Energy Community (which comprises the EU, various Balkan states, Ukraine and Georgia). Both of these show that for a country outside the EU or the EEA to participate fully in the IEM, it must enter into an agreement with the EU that would require, amongst other things, adherence to other EU energy legislation and state aid rules. However, the question of state aid has emerged as something of a sticking point in the UK-EU talks. In short, there is no guarantee that any deal that the UK and EU reach in the coming months will result in the GB electricity market being any more closely integrated with that of the EU than would be the case in a no deal outcome.

## Other considerations

We have focused in this note mostly on legislative and regulatory matters. However, for many energy sector businesses (and others), the most immediate impacts of exit day or the end of the implementation period may not turn entirely on legislative or regulatory change. Brexit will, for example, affect the interpretation of contracts, and a number of other practical everyday aspects of commercial life. It is important to review any clauses in contracts (existing or under negotiation) where rights or obligations could be triggered either by the legal changes of exit day or the end of the implementation period, or by events that take place as a result of those changes.

Provisions relating to "change in law", "material adverse change" and "force majeure" are obvious starting points; other parts of contracts likely to need review include provisions relating to interpretation, pricing and payment and dispute resolution. Other areas to focus on more generally include the impact on employees and their families (EU citizens working in the UK and UK citizens working in the EU) and, for those engaged in the export and import of goods between the UK and the EU, the need to master new customs arrangements.

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## (GENERIC) OUTLINE BREXIT RISK ASSESSMENT MATRIX

| Outline of risk and example | Likelihood of occurrence | (Certainty as to) timing | Ability of business/others to mitigate | Severity of impact |
|---|---|---|---|---|
| Uncertainty about interpretation of existing contracts after the end of the transition / implementation period adversely impacts business.<br>E.g. how to read contractual references to/apply EU legislation, given the complexities of how "retained EU law" is to be treated in the UK going forward; exposure to adverse action by counterparty under material adverse change/change in law clause. | High (almost certain to be some cases of this) – regardless of the extent of any post-Brexit deal(s) between the UK and EU. | More likely to occur after the end of the transition / implementation period than before.<br>Some cases may emerge straight away, others may be latent for years. | High to mitigate going forward; lower to address cases that may have arisen as a result of contracts entered into between Referendum and now.<br>Amendment may provide a solution, but requires agreement. Government unlikely to provide solution. | High (but not in all cases). |
| Uncertainty about future UK law/policy in areas no longer subject to EU control.<br>E.g. UK courts, Minister, Parliament or regulators depart from EU precedents that they have previously followed. | Probably no more than medium in most cases, but will vary with sector and whether there is a deal/what its terms are. | Unlikely to occur before the transition / implementation period ends.<br>Some cases may emerge straight away, others may be latent for years. | Limited ability for business to mitigate by legal means (as opposed to lobbying). | Could be high in some cases, but very difficult to generalise meaningfully. |
| Business <u>cannot</u> operate in EU markets/trade with EU counterparties.<br>E.g. failure to agree on successor to current EU civil aviation regime for UK operators, leaving their planes grounded. | Low in most sectors. | Only likely to occur if there is no deal or at the end of a transition period where negotiations have gone very badly. | Probably only HMG/EU can mitigate effectively in these cases, by reaching appropriate agreement. | High. |
| Business faces extra costs/obstacles in operating in EU markets/trading with EU counterparties.<br>E.g. increase in costs as a result of new customs arrangements; EU rules mean business must relocate some operations, or terminate existing contracts with third party suppliers, to keep selling into EU; need to start dealing with an EU, rather than UK-based entity in order to put products on the EU market (e.g. for registration or conformity assessment purposes); higher costs to enforce "free trade" rights against EU member states/ counterparties indirectly via government action as compared with direct enforceability of EU rules by businesses. | Will vary strongly (high to low) between sectors, but in the short term, at least, any business operating physical UK/EU supply chains may face disruption because of general lack of preparedness (including on the part of others) for having to cope with new customs formalities etc. | Unlikely to occur until the end of a transition period. | HMG/EU have postponed (through transition period) and can to some extent mitigate by agreeing a "good deal" for future EU/UK relationship. But some additional "friction" is inevitable after the end of the transition period, as no future EU/UK agreement will make trade as easy as EU membership, and it will take time for IT solutions that should facilitate compliance with the new bureaucracy of customs checks and export declarations etc when trading between UK and EU to bed in.<br>Serious contingency planning essential if businesses want to prepare for no deal, when (in some sectors at least) EU tariffs may present a further obstacle. | High (in some cases), but more likely to be medium or low in most cases (at least most of the time). |