

Impact of Brexit for Interconnectors



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Introduction

The electricity market in the United Kingdom (UK) is part of the EU Single Market and the Internal Energy Market (IEM). Great Britain (GB) is connected to continental Europe and the island of Ireland via a number of interconnectors. There are plans to develop more interconnectors in the coming years. The wholesale electricity prices in GB are generally higher than prices in continental Europe thus electricity is often imported into the UK. With the lack of investment and the delay in the bringing online of new substantial generation plants in GB in recent years, the demand to import electricity from continental Europe has grown together with the demand for interconnectors. The UK has had significant influence on EU energy policy and it has been the lead Member State in pushing for liberalisation.

Formal procedures for leaving the EU were introduced by the Lisbon Treaty, which came into force in 2009. A Member State wishing to leave the EU must notify the EU of its intention and this notification would trigger negotiations over a withdrawal agreement between the country and the remainder of the EU. The country would officially exit the EU on the date the withdrawal agreement came into effect or, if no agreement is reached, the country could leave two years after the date of notification. What matters of course is the content of any withdrawal agreement.¹

Several former colonies and overseas territories of European countries, such as Algeria in 1962 and Greenland in 1985, left the European Economic Community (EEC), the predecessor of the EU but no independent European Member State has ever left the EEA or the EU. There is no relevant precedent that can be used to understand the details of how the withdrawal process would work or to shed light on how the EU would treat the exiting country.

This paper attempts to consider some of the options for withdrawal and the potential effect on interconnectors post Brexit.



A snap shot of what Brexit may look like for the UK

1. EEA + EFTA

The UK could join the European Economic Area (EEA) and the European Free Trade Association (EFTA) and continue to have full access to the Single Market. The UK would have to adopt EU regulations and standards but would have no formal role in drafting the policies and would not have a vote in passing them.

The EEA was established in 1994 to give European countries that are not part of the EU a way to become members of the Single Market. The EEA comprises all members of the EU together with three non-EU countries: Iceland, Liechtenstein and Norway.

There are currently four EFTA member states (Norway, Iceland, Switzerland and Liechtenstein). The EFTA was established in 1960 as an alternative trade bloc for European states who were unable or unwilling to join the then European Economic Community (EEC) (which subsequently became the EU). The Single Market rules on energy extend to Norway, Iceland and Liechtenstein as they form part of the Internal Energy Market (IEM). It is unlikely the UK would be offered a differential treatment.

2. Customs Union

The UK could enter into a Customs Union with the EU. Goods could be exported to the EU without tariffs or customs restrictions, but the UK would be required to comply with various EU regulations. The UK would have to adopt various EU regulations and standards but would have no formal role in drafting the policies and would not have a vote in passing the EU regulations and standards. Subject to negotiations, sectors may be excluded from the Customs Union.

The Customs Union has been in place between EU and Turkey since 1995, imposing the Common Customs Tariff on goods imported from outside the EU. Turkey is encouraged to adopt EU regulatory standards for products and EU rules, including energy rules. It is unclear whether as part of the Customs Union the UK could negotiate continued participation of the IEM. If it could, this would require the UK to adopt and maintain substantive parts of EU regulation. A Customs Union is often seen as the pre-access option to full membership of the EU.

3. Bilateral agreements + EFTA

The UK could agree a series of bilateral agreements governing access to the Single Market, sector by sector. It would not get full access to the internal market but also would not be required to comply with various areas of EU regulation. In addition to the bilateral agreements, the UK could become a member of EFTA. Through EFTA membership and agreements covering technical barriers to trade, the UK could achieve a similar level of market integration for goods with the EU, as EEA countries.

Switzerland is a member of EFTA and has negotiated a special relationship with the EU through various bilateral accords and trade treaties (more than 100) that give access to the internal market for goods but not for most services. The network of

agreements are complex and sometimes incoherent. Fresh negotiations need to be undertaken whenever there is a change of EU legislation.

An agreement to have access to the IEM is currently in limbo – Switzerland blocked free movement of labour in 2014 (following Switzerland's referendum on immigration) and the EU refuses to give Switzerland further access to the internal market until a framework agreement is established. It is unlikely that this model will be pursued given the current gridlock between Switzerland and the EU. The EU has said that this model will not be on offer to the UK.

4. Free Trade Agreement (FTA)

A Free Trade Agreement (FTA) would in principle restore the UK's sovereignty over trade relationships. The UK could agree its own free trade agreement with the EU. This could lead to a single comprehensive deal as opposed to piecemeal agreements. The FTA could provide UK access to the Single Market but also may require UK to be subject to EU regulation without a formal role in drafting the policies or a voting right.

In October 2016, Canada signed a free trade agreement (the Comprehensive Economic and Trade Agreement (CETA)) with the EU for goods and services. Canada has agreed to comply with EU standards in areas such as food safety and workers'

rights, liberalisation in some key sectors such as postal services, telecoms and maritime transport and guaranteed inter-corporate transfers. Negotiating the FTA can take many years. The CETA negotiations took over 7 years to conclude.² The UK, the EU and the EEA have very strong and differing interests in continuing to trade in electricity and gas. Whilst trade in electricity and gas would continue, there would be a fundamental change to the ground rules as the economic security of supply and environmental drivers differ for the different parties. It is likely that the UK will still have to implement EU regulations which it has had no role in formulating.

5. World Trade Organisation (WTO)

The UK could rely on the existing World Trade Organisation (WTO) rules. The UK will have full autonomy over its trade policy. Under WTO rules, each member must grant the same 'most favoured nation' (MFN) market access, including charging the same tariffs, to all other WTO members. The only exceptions to this principle are that countries can choose to enter into free trade agreements such as the EU or EFTA and can give preferential market access to developing countries.

If a trade agreement with the EU can't be reached, the UK can seek to apply the MFN tariffs under the WTO, i.e. the EU would apply its standard external tariff rates to imports from the UK and would not be allowed to discriminate by charging higher rates to the UK than to other non-EU countries. Similarly, the UK would apply its standard external tariffs to imports from the EU. The UK may need to negotiate further on some issues, for

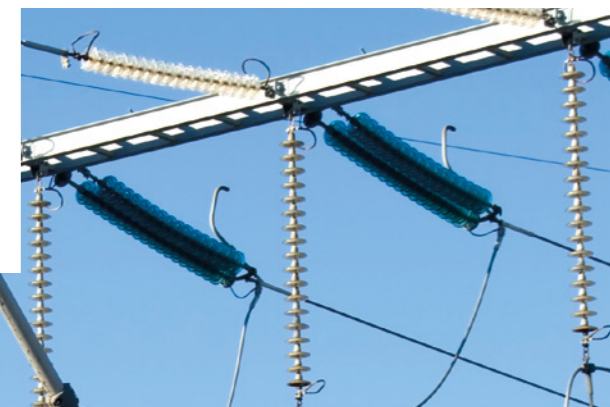
example, concessions and commitments on market and the list of exemptions from the MFN treatment obligation. The outcome of the further negotiations would also have to be accepted by the other WTO parties. The UK may still need to comply with EU regulations to access the EU markets in areas such as standards.

The WTO has 161 members comprising all major economies and most minor ones. The EU comprises of 29 WTO members: the 28 member states plus the EU itself. They have combined "rights" (e.g. to be able to export to other countries and not to be discriminated against) balanced against shared "obligations" (e.g. to open up to imports from them and not to discriminate against them). In the WTO, the EU has agreed to keep its import duties within certain limits. To be an independent WTO member, the UK would be creating its own rights and obligations out of the EU's.

Impact on the energy market of Northern Ireland

The establishment of the Single Electricity Market (SEM) in 2007 for the Republic of Ireland and Northern Ireland has seen one electricity market for the island of Ireland. SEM is to be replaced by Integrated Single Electricity Market (I-SEM) by the end of 2017 - a reform that is largely driven by compliance with EU energy regulation. Brexit raises similar issues for Northern Ireland as it does to mainland GB but with the added dimension of the implication of I-SEM. It is unclear whether Northern Ireland would withdraw from I-SEM or remain in the I-SEM in order to benefit from being in the larger island of Ireland market. Further, the effect on I-SEM would be exacerbated if GB were to withdraw from market coupling, as I-SEM is dependent on the GB market for access, coupled with EU electricity markets. At this stage, this note does not consider the potential effect or options for Northern Ireland.

Energy and the possible models



Access to PCI

The TEN-E Regulation aims to address a number of barriers to investment in cross-border energy infrastructure investment. It establishes nine strategic geographic infrastructure priority corridors in the domains of electricity, gas and oil and three EU-wide infrastructure priority thematic areas for electricity highways, smart grids and carbon dioxide transportation networks. The TEN-E Regulation sets out a bi-annual process, for identifying Projects of Common Interest (PCIs) that meet certain criteria and are deemed to have significant EU impact and will benefit two or more Member States (or a Member State and EEA state such as Norway). A substantial number of UK energy infrastructure plans are currently listed for financial support as a Project of Common Interest (PCI). PCI projects benefit from accelerated procedure and access to financial support from the EU. The inability to benefit from PCI will mean that projects will have lower priority and may delay or make some projects unviable.

As financial support under PCI only applies to the EU member states, if the UK exits the EU, financial support for PCIs between the UK and non EU state will no longer be available. The removal of PCI entitlements could be treated as a breach of the Energy Charter Treaty (ECT). The ECT applies as between the EU and the UK, which are both signatories. Under the ECT, investor may raise an international arbitration dispute with a signatory state.

Interconnectors

Interconnectors require a significant level of cooperation between countries and jurisdictions at each end. The exit of the UK from the EU poses a number of significant challenges for interconnectors as the rules would change and investors and operators might find themselves in a radically different world.

In the short term, whilst the UK government negotiates the new deal, the associated uncertainty will raise the cost of investment. Additionally, a fall in Sterling would raise the cost of electricity and gas imports and could decrease demand for interconnector capacity.

In the longer term the outcomes are dependent on the exit model that would be adopted. The IEM means that there are

no boundaries or restrictions in relation to the flow of electricity or gas between Member States. Common market rules and cross border infrastructure allow for electricity and gas to be produced in one country and exported to another without any import/export tariffs being applied. If the UK stayed in the IEM it would not face significant adverse consequences other than the loss of influence and having a role as an observer rather than a participant with voting rights (save for the issue of PCI³).

Were the UK not to be part of the IEM, the impact could be significant. It seems unlikely that the EU would be willing to see its consumers effectively subsidise cheap electricity and gas exports to a country that has left the EU and the IEM. It is possible that the EU could impose a tariff on the export of gas

and/or electricity to the UK and set product standards (product standard could include how the electricity/gas is sourced). Alternatively, the UK may impose a tariff on the import of cheap electricity and gas, thereby making it expensive for European generators to export into the UK and levelling the playing field. This could potentially dampen the demand for interconnector capacity. There could also be a broader effect in the cost of construction for interconnectors (for example, a large portion of construction equipment comes from Germany). The UK government could require interconnectors building on UK landside to use UK manufactured components where available or export duties could apply, making interconnector construction in UK more expensive.

² The CETA negotiation was officially announced in May 2009.

³ See box for a discussion on PCI.

Potential effect on interconnectors if the UK is part of the IEM

The EEA Agreement includes EU legislation covering the four freedoms (free of movement of goods, people, services and capital) and related policies (competition, transport, energy, economic and monetary cooperation, i.e. the EEA Agreement includes energy). By being part of the EEA, the Customs Union or pursuing a successful bilateral agreement strategy (e.g. the approach taken by Switzerland) the UK could remain the IEM. Under these options, the UK will have to apply a substantial proportion of the existing EU regulation without being able to vote on it. The UK would need to accept EU laws and rules on competition law and state aid and contribute to the EU budget.

If the UK were to remain in the IEM, it would need to implement EU regulations on energy. The arrangements would remain similar to those which are in existence today.

The initiatives to promote and incentivise investment in energy infrastructure will continue to apply: Projects of Common Interest (PCIs)⁴ including the Connecting Europe Facility (CEF), EU Cohesion Policy Funds, the EIB's Project Bond Initiative, the European Energy Programme for Recovery, European Fund for Strategic Investment (EFSI) and financing under the European Structural and Investment Fund.

Financial regulation

The Network Codes provide for the provision of Financial Transmission Rights (FTRs) by Member States. Where market prices in each system are determined so as to ensure that planned flows between them do not exceed the net transfer capacity of the interconnector, congestion will result in price differences thereby producing a revenue surplus. Where there is congestion, the flow across the interconnector will be worth more at one end than that at the other.

The rights to this revenue can be sold to market participants. Market participants can acquire hedges against the price differences and the transmission owner can be compensated by the sale of these rights. Under the Network Codes, the FTRs can be also traded in a secondary market.

Depending on the details of the FTRs, financial regulatory concerns may be relevant. The key European legislation relating to financial services within the EU is MiFID which will be replaced by a successor legislative regime in January 2018 under MiFID II. In broad terms, activities related to "financial instruments" including brokering and trading activities, fall within the purview of MiFID and require a license. Such activities are subject to various conduct of business requirements, with softer requirements in certain instances for wholesale market activity.

MiFID also provides for passporting of authorised firms so as to enable them to carry out regulated activities relating to financial instruments anywhere in the EU whilst relying on one authorisation in the home member state.

If the UK exits the EU, the ability to passport licensed activities relating to FTRs may be affected. Helpfully, MiFID II provides for a means by which UK-based firms could transact with EU-based counterparties provided that the UK is deemed to have a regime equivalent to that of the EU and grants reciprocal access to EU-based firms. This ability is restricted broadly to wholesale market counterparties and where activities are cross border (where there is no physical presence in an EU member state). This can in principle mean that UK-based firms can continue post-Brexit as if they had the passport.

EU regulation relevant to interconnectors

There are several EU regulations that are relevant to interconnectors. They comprise of either Directives or Regulations. Directives are enacted through changes to UK law, whilst regulations have direct effect – they become part of UK law once the Regulation has legal force. Consequently, if the UK leaves the EU, then laws that were passed to implement EU Directives would be unaffected unless the government chooses to change them. But EU Regulations would immediately lose legal force. In order for the EU Regulations to continue to have effect in the UK, the UK government would need to pass legislation setting UK law in areas currently subject to EU Regulations.⁵

EU law relating to the IEM and relevant to interconnectors:

Directive 2009/72/EC concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC

Directive 2009/73/EC concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC

Regulation (EC) No 714/2009 on conditions for access to the network for cross-border exchanges in electricity and repealing Regulation (EC) No 1228/2003

Regulation (EC) No 715/2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005

Regulation (EC) No 713/2009 of the European Parliament and of the Council of 13 July 2009 establishing an Agency for the Cooperation of Energy Regulators

Regulation (EC) No. 1227/2011, Regulation on Wholesale Energy Market Integrity and Transparency (REMIT)

EU electricity network codes and guidelines

EU gas network codes and guidelines

Potential effect on interconnectors if the UK is not part of the IEM

The effect on interconnectors if the UK was not part of the IEM would be significant. Some of the potential flow-on effects would include:

- Implementation of EU energy regulation: The UK would not have to automatically implement existing or new EU energy regulation and agreements. EU regulations can include rules on certification, the application of EU Network Codes, exemption for interconnectors (the UK may return to the exemption process as opposed to the cap and floor regime to incentivise merchant interconnectors), inter-TSO compensation mechanism for hosting cross border electricity flows, congestion management, transmission charges, curtailment of interconnector flows to resolve national issues (curtailment of exports from GB at times of system stress), charges on interconnectors for the use of transmission losses and balancing costs.
- Increased regulatory complexity: Interconnectors face greater regulatory complexity as they operate in two or more jurisdictions. The IEM provided convergence of regulation for interconnectors between interconnectors and required regulating authorities to cooperate with each other for the purpose of integrating their national markets into the IEM. If the UK exits the IEM, there will be greater uncertainty for interconnectors as one terminal will be in the EU Member State and the other possibly in the non-EU UK. The terminal in the EU Member State must still comply with EU regulation. It is uncertain whether the non-EU UK terminal would be bound by EU regulations or whether the UK would implement different regulations. Where regulations diverge between the two jurisdictions, there would be increased complexity and uncertainty.

REMIT

The substantive prohibitions in Remit (market abuse and insider trading requirement to publish inside information) will no longer be directly applicable in the UK if the UK leaves the EU and the IEM. As the UK has gone through a long process of advocating for Remit and the application of criminal sanctions, it is likely that the UK will want to continue to apply provisions similar to Remit in the UK which will require UK legislation. Unless there are (bilateral) agreements, the UK will no longer have access to market monitoring and cooperation arrangements as set out in Remit. Similarly, UK entities will no longer need to report Remit data and ACER will no longer be able to obtain Remit data from UK entities.

- Representation on the various energy committees: e.g. Council of European Energy Regulators (CEER), European Agency for the Cooperation of Energy Regulators (ACER). The UK would cease to be a member of ACER and CEER. It would not have votes or be privy to the information sharing regime.
- Access to initiatives to promote and incentivise investment in energy infrastructure and access to EU capacity market auctions: The initiatives to promote and incentivise investment in energy infrastructure may not apply: Projects of Common Interest (PCIs) including the Connecting Europe Facility (CEF), EU Cohesion Policy Funds, the EIB's Project Bond Initiative, the European Energy Programme for Recovery, European Fund for Strategic Investment (EFSI) and financing under the European Structural and Investment Fund. As the UK is the first country to leave the EU, it is unclear how energy infrastructure projects that have benefitted from the regimes such as the PCIs will be affected. Interconnectors will be subject to bilateral agreements in regards to existing PCIs (potential issues include whether the existing PCI will be removed from the EU list if

they are linked to the UK, and whether projects will have to refund any financial support given before the UK exits the EU and IEM). This could delay the construction of interconnectors not benefiting from the status of PCI and may increase the cost of financing as a result of uncertainty.

- The UK would not be part of the solidarity mechanism: Accordingly, the UK would not benefit from electricity pooling. To ensure security the UK would have to spend more on its own back-up capacity.
- The UK would no longer be subject to the EU state aid rules: In the case where EU state aid rules no longer apply to the UK, the UK would be free to implement mechanisms to replace the gap left by PCI. In regards to export, the UK will need to comply with the WTO subsidy regime and rules on anti-dumping.
- The EU (electricity and gas) Network Codes will no longer have direct effect. This would leave a large gap in the design of GB market and system.⁶ The EU Network Codes largely give legal force to the development of the intra-day and day ahead market arrangements developed by the TSOs

and power exchanges in North-West Europe. Exit from the IEM will lose the legal force for these arrangements and will result in an asymmetry of legal obligation and enforcement powers between GB and the EU counterparty – and therefore affect the risk profile for UK based interconnectors. A bilateral agreement could plug this gap.

- The UK may choose to replicate the substantive elements of the EU Network Codes at the UK level – e.g. the day-ahead market, intraday market and price coupling provisions. The detailed EU Network Code provisions could be implemented at a contractual level between GB's Nominated Electricity Market operator (NEMO), the Transmission System Operators (TSOs), and the EU counterparty level.
- Membership of ENTOS-E and ENTSO-G: UK's membership of the EU is not a precursor to UK's membership of ENTOS-E and ENTSO-G. Following a bilateral agreement (following negotiations with other member states for UK to remain part of ENTOS-E and ENTSO-G), the UK could remain a member of the ENTOS-E and ENTSO-G and continue to influence the development of the EU Network Codes.

Cross-border trading

If the UK is no longer part of the IEM, cross-border energy trading that may be effected include:

- Market coupling: managing cross border electricity flows in order to smooth out the price differential between Member States.
- Cross-border balancing: procuring gas and electricity capacity from across the EU to keep the system in balance in real time to optimise security of supply and reduce balancing costs for the system.
- Capacity market integration: the aim is to ensure future security of supply by paying providers to deliver electricity at times of stress.

Potential effect on interconnectors if the UK is not part of the EU – other considerations

There are further potential effects stemming from non-energy EU regulation in the case where the UK exit of the EU and EU regulations no longer apply to the UK. The key regulations that may affect interconnectors are:

- Exclusion from the market integration initiatives: The UK may be excluded from market integration initiatives such as market coupling (the sale of electricity together with interconnector capacity, as opposed to separately), cross-border balancing (the process with the transmission system operators are able to access energy to balance the difference between supply and demand) and cross-border participation in capacity mechanism (measures taken by Member States to ensure that sufficient electricity is available in the future). This could dampen demand for interconnector capacity.
- Restrictions to supply long term capacity: With the exit from the IEM and therefore EU regulations no longer applying to the UK, the UK will no longer be bound by the restriction on the supply of capacity on a long term basis. Long term contracts decrease fluctuations in the capacity price for interconnectors, thus providing investors with greater certainty of income stream.

Additionally, leaving the IEM may expose the UK to:

- new import taxes and increase in cost of imports when selling into the EU Member States;
- a restriction of movement of people leading to increased cost of labour or delay in project development;
- increased cost of construction as a result of the devaluation of the Sterling.

- In regards to the renewables and emission policy, exit from the EU would mean that the UK is released from the EU Renewable Energy Directive requiring the UK to generate 15% of its energy from renewable sources in 2020 and the carbon emission target (cutting carbon emission by at least 40% from 1990 levels by 2030). This would in principle give the UK more flexibility in its energy and climate change policy and the flexibility on its choice of technologies.⁷ The UK could choose cheaper technologies (e.g. coal) which would help decrease the price of wholesale electricity in the UK market. A decrease in the cost of electricity in the UK would contract the price differential between the UK and continental Europe and thus decrease the quantity of electricity being imported into the UK.

- Leaving the EU would mean that the UK will not need to participate in the EU Emissions Trading Scheme (ETS). This could mean that electricity generators will face a reduction in cost as a result of non-participation. A decrease in the cost of electricity in the UK would contract the price differential between the UK and continental Europe and thus decrease the quantity of electricity being imported into the UK. The UK could however negotiate an arrangement with the EU that links UK ETS scheme with the EU ETS scheme.
- The EU Industrial Emissions Directive 2010 requires new power plants to comply with strict emission limits, while older power plants must close or clean up. Three large coal plants have so far closed during 2016: Longannet, Ferrybridge C and Rugeley. Around 4 gigawatts (GW) of capacity has closed this year, leaving 15GW able to operate today. Remaining existing plants have plans to become compliant, planning part closure, or converting to biomass. Leaving the EU would mean that the UK government could give the existing power plants longer to achieve compliance, thereby decreasing the cost of compliance on coal fired generators.

Access to EU capacity auction

If the UK leaves the IEM, the UK will need to negotiate with the EU to have access to EU Member State capacity auction. Access to EU Member State capacity auction has benefits for the UK as the UK is a net importer of electricity. Access to EU Member State capacity auction would also raise the value of interconnector capacity.

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