

BREXIT AND THE ENERGY AND RESOURCES SECTOR

Following the UK's decision to leave the EU, we consider the potential impacts of 'Brexit' on the Energy and Resources sector.

There is no change to the legal or regulatory structure of the sector pending the UK actually ceasing to be a member of the EU. The longer term effects of a Brexit for the UK energy and resources sector, however, could be significant and will depend to a large extent on the precise terms on which the UK leaves the EU, which are yet to be determined.

ENERGY AND RESOURCES SECTOR

UK role in the European Energy Market

The past few years have seen increased interconnection and harmonisation of EU gas and power markets in order to enhance market efficiency and security of supply. If the UK wishes to retain access to the EU's Internal Energy Market (IEM), it will almost certainly have to abide by applicable EU energy law.

Interconnectors

The UK is likely to push hard for full access to the IEM, not least because it already has four interconnectors to Europe and several more in the pipeline. The UK Government has been clear that it views interconnection as a vital part of the UK's future energy security and a cost-effective and efficient way of meeting future energy requirements. Furthermore, interconnectors have had a somewhat protected status under EU rules. Without new interconnection, there would need to be a rapid increase in domestic electricity generation and more efficient demand management if the UK is to meet its energy requirements into the 2020s.

Energy regulation

If the UK opts for a relationship with the EU based on a bilateral agreement, then given the UK's energy dependence on the EU/EEA, the UK would likely be in a challenging negotiating position. More broadly, the UK's influence in shaping international and European energy policy is expected to decrease. To retain a meaningful role, the UK will need to negotiate to remain part of, or at least have some input into, European energy regulators such as the European Network of Transmission System Operators for Electricity (ENTSO-E), responsible for developing cross-border electricity network codes (e.g. for interconnectors), and ACER, the regulator responsible for coordinating the work of national regulators at EU level.

Unbundling

One aspect of EU energy law with which the UK would almost certainly need to comply in full to retain access to the IEM is the Third Energy Package, in particular the ownership unbundling rules. These rules require the separation

of the ownership and control of transmission activities on the one hand and of generation, production and supply activities on the other hand. The aim of the rules is to increase competition within the European energy market and drive down prices for consumers.

If the UK were to give up access to the IEM, opting instead to trade under a bilateral agreement, it would likely dispense with the complex EU rules concerning ownership unbundling. The principle of energy market liberalisation and increased competition is one the UK has long supported. However, should it be in a position to re-design the unbundling regime in the UK, it would likely seek to achieve the aims of liberalisation and competition through more flexible rules. For example, it could exempt financial investors or decide that unbundling restrictions only apply to offshore transmission owners (OFTOs) where there is a physical connection between an OFTO and a generating station, both of which are owned or controlled by the same person.

While the UK has applied the unbundling rules in a pragmatic manner, relaxing the rules in this way could open up investment opportunities to investors who might otherwise be constrained from diversifying their investments across transmission and generation/ production/supply assets. Such a relaxation of the rules could be particularly important in attracting investment in new high value onshore transmission systems which are set to be competitively tendered (in a similar way to OFTOs) from 2017.

Energy trading

EU Emissions Trading System (EU ETS)

Upon leaving the EU, the UK market would lose access to the EU Emissions Trading System (EU ETS). As a UK-only emissions trading scheme is likely to be characterised by market inefficiency and volatility, any replacement scheme would likely still need to be linked to EU ETS. Whether the UK would be entitled to remain within the EU ETS (as non-EU states Iceland, Norway and Liechtenstein are) and on what terms would be a matter for complex negotiation.

EU Regulation on Energy Market Integrity and Transparency (REMIT)

If UK businesses wish to continue to trade in European energy products, they will be required to continue to comply with the EU Regulation on Energy Market Integrity and Transparency (REMIT) and its implementing acts. This legislation requires energy market participants (including entities from non-EU and non-EEA countries) to register and report wholesale energy market transactions, including contractual arrangements and individual executions. The aim of this reporting is to identify, and ultimately prevent, market abuse (in the form of market manipulation and insider trading) in the European energy market. If a market participant is not established or resident in the EU, it is required to register in the member state where it is most active.

Investment and financing

Investor uncertainty

In the short term, the uncertainties associated with Brexit may result in the deferral of some energy projects, either due to uncertainty as to the future direction of domestic energy policy in the UK or due to concerns about potential impacts on cross-border projects, such as the planned power interconnectors with other EU countries. Any delay, or the possible abandonment of new projects, may lead to higher energy costs in the UK.

Similarly, the combination of political, regulatory and economic uncertainties – even if, in the best case scenario, these are only for a relatively short term – presents a challenge to parties seeking to plan, authorise and model new

investments. It is hardly surprising in this context that we are already seeing some indications that investors may 'pause for thought' or 'wait and see' rather than rushing forward with new investments.

Over the longer-term, supply chain and manufacturing costs and locations may be affected by new trade agreements (both tariffs and non-tariff related costs).

EU funding sources

Following Brexit, UK energy projects would no longer benefit from funding sources available to EU members (e.g. the Connecting Europe Facility (CEF)).

The UK is also currently a shareholder in the European Investment Bank (EIB) and a number of major projects in the UK have benefitted from EIB funding. It is anticipated that the UK will relinquish its shareholding in the EIB when the UK leaves the EU (although other arrangements will no doubt be considered). The EIB is permitted to fund projects outside the EU, but it has traditionally done so to a lesser extent than in its shareholder countries, which would mean that EIB funding for UK projects can be expected to decline.

EU State Aid rules

The structure of the current contracts for difference (CfD) allocation process, requiring a competitive tender for established technologies and the need for approval by the European Commission, has been driven by the requirement to comply with EU State Aid rules. The EEA agreement prohibits state aid in the same way as the EU.

Even under a WTO option or bilateral agreement, the UK would be restricted in its ability to grant competition-distorting subsidies. However, this form of Brexit could provide the UK Government with enhanced flexibility to support projects.

ECA supported financings

Lenders in UKEF supported financings, including financings which are fronted by another European ECA and co-insured by UKEF, typically treat their participations as sovereign exposures for regulatory capital purposes, including in terms of credit risk mitigation. The latest rating downgrade by Standard & Poor's of the UK's sovereign credit rating from AAA to AA may impact on regulatory capital requirements.

The export credit terms under the OECD Arrangement on Officially Supported Export Credits will continue to apply.

Climate Change and Environment

Our briefing "[Brexit and the Energy Sector: UK Climate Change and Renewable Policy and Targets](#)" examines the potential impacts of Brexit on climate change and environmental policy in the UK in more detail. Key areas to consider include the following.

Renewables targets

Upon leaving the EU, the UK would no longer be required to comply with EU renewables targets set by the EU Renewable Energy Directive. This would, in principle, provide the UK with enhanced flexibility in how it shapes its energy policy and allow it to delay the closure of certain fossil fuel plants. However, the UK would still be bound by the legally binding (and very challenging) national obligations such as the 80% greenhouse gas emissions reduction target in the Climate Change Act 2008, as well as international commitments, notably those it is required to submit under the Paris Agreement. In addition, most projects implemented to achieve the 2020 targets under the EU

Renewable Energy Directive have already reached financial close and, if not already, will shortly be under construction. Accordingly, barring a change of political will or to the financial resources available to support renewable energy projects, we would expect support for renewables in the UK to continue.

UK Environmental law

Regarding environmental law more generally, much of UK law derives from EU laws that have been put in place over several decades. It is possible that the UK will follow the example of Norway and keep in place most EU environmental laws to provide a basis for coordination on an issue that is clearly not just domestic in nature and to ensure the UK's continued access to the European market. The potential downside to this approach for the UK is that it would have no ability to influence the EU environmental laws with which it would still be required to comply.

An alternative approach would be for the UK to continue its relationship with the EU on the basis of bilateral agreements, and energy and the environment are two areas where there is much mutual agreement as to what is critical. Indeed, the UK has often moved faster towards openness and integration than other EU member states in these areas.

It is at least possible that the UK will seek to roll back some of the protections provided by the Habitats and Birds Directives in relation to greenfield development. In particular, the need to demonstrate an IROPI (Imperative Reasons of Overriding Public Interest) case in the event of potential adverse impacts on the integrity of relevant European protected sites can be very challenging for developers and can require decision-makers to decline to grant permission. However, the UK would still be limited in its ability to implement change in this area as a result of its continuing international obligations.

Large Combustion Plant Directive

The Large Combustion Plant Directive (now superseded by the Industrial Emissions Directive) would cease to apply to the UK upon Brexit. Significantly, the Vote Leave campaign criticised the Large Combustion Plant Directive and it remains to be seen whether there will be calls to end or restrict the limitations on older plants to ensure that they can continue to operate and thereby contribute to security of UK energy supplies. It may be that such debates are overtaken by events, as many of the UK's existing coal-fired plants are closing in any event. But the political manoeuvring around Brexit adds further layers of uncertainty as to the direction of government policy in this area.

Oil and Gas

We expect to see few changes in the legislative framework governing the UK upstream oil and gas sector. The impact of EU legislation in this area has been minimal, and the current Petroleum Act is based on UK legislation going back to 1934. Furthermore, legislation governing exploration and production on the continental shelf and decommissioning obligations is based largely on international agreements to which the UK would continue to be a party.

However, the impact of Brexit in the downstream sector could be more significant. In 2013, around 38%¹ of crude oil refined in the UK came from Europe (primarily Norway). Likewise, in 2014, 57%² of UK gas imports come from Norway (which is in the EEA/EFTA, so has a free trade arrangement with the EU). The EU is also the main destination for UK oil product exports, and

¹ UKPIA Statistical Review 2015

² Department of Energy and Climate Change, "UK Energy in Brief 2015"

the UK is a significant importer of refined petroleum products. The extent of these flows emphasises the importance of a free trade agreement being put in place which avoids the imposition of tariffs on this trade. A failure to achieve this by the time Brexit occurs would likely have considerable implications for this part of the oil and gas sector.

IMMEDIATE CONSIDERATIONS

We have identified below some key pointers for industry participants looking at the terms of existing contracts or considering whether a new approach should be taken to the drafting of any provisions in contracts going forward.

No change in law

As explained in our briefing "[The UK vote to leave the EU - immediate issues and implications](#)", since the referendum outcome, nothing has changed legally. Any contractual provision which relies on a "change in law" trigger (for example, an increased cost clause or an illegality event) will not have been activated by the result. The position may evolve once the UK commences the formal process of withdrawal from the EU.

Market volatility

Market volatility and the consequences (e.g. reduced liquidity of affected banks) may trigger other clauses, such as market disruption provisions in facility agreements or 'market MAC' clauses. However, currently, we see no evidence of this and as the market stabilises, it will become less relevant.

It may also be necessary to consider the impact of any ratings downgrades, since ratings requirements or triggers are sometimes used in contracts across the sector.

English law and English courts

Our briefing "[Brexit and jurisdiction clauses: post-referendum considerations](#)" examines the impact of UK withdrawal on recognition of parties' chosen governing law and jurisdiction in contracts in detail, but the key points for energy and resources sector participants are as follows.

Governing law

Parties should have no concerns about existing or new contracts being governed by English law. If English law was (or would have been) chosen to govern a transaction before the referendum vote, there is no need to change that decision as a result of the referendum and even following Brexit, the substance of English contract law will not be impacted.

English commercial contract law is largely unaffected by EU law. Even in those areas where English law has changed as a result of the UK's membership of the EU (e.g. Late Payment of Commercial Debts (Interest) Act 1998), the efficacy of that law does not depend upon continuing EU membership.

Further, EU courts are required under the Rome I Regulation to uphold the parties' choice of law for contractual obligations; this should not change if the UK leaves the EU.

Choice of jurisdiction

There are many reasons why parties choose the English courts as the jurisdiction for dispute resolution and the factors that play into this decision again are not affected by Brexit, save for one potential change in the ease of enforcement of judgments across the EU.

A judgment given by the English courts is currently enforceable in all other EU member states under the Brussels I Regulation. Whether that will be the case after Brexit will depend upon the continuing relationship agreed by the UK and the EU. Parties may want to consider for specific contracts whether any change in the jurisdiction clause is desirable, in which case further detail is set out in the briefing mentioned above.

In any event, within the energy and resources sector it is very common to choose arbitration (or an arbitration option) as a preferred forum for dispute resolution and arbitration provisions will remain unaffected by Brexit.

EU derived legislation and sanctions

As a Member State, the UK is subject to EU-wide legislation, including, for example, the EU Insolvency Regulation (EUIR) and the Bank Recovery and Resolution Directive (BRRD). The unravelling of UK domestic laws and EU laws will be a significant and challenging aspect of Brexit. For now, parties should retain references to such legislation in their English law governed agreements, as applicable.

As a Member State, the UK is required to implement and enforce any EU sanctions (including export controls) and UK residents and entities are subject to EU sanctions-related obligations. Parties will need to undertake separate assessments of the application of EU and UK sanctions to their transactions, depending on how these are addressed under Brexit.

CONCLUSION

In the short-term, the energy and resources sector is grappling with challenges stemming from political uncertainty, the depreciation of sterling and general market volatility. The medium to long-term effects are harder to gauge and will depend in large part on when and on what terms the UK actually leaves the EU.

The UK Government will need quick and clear guidance from the private sector as to concerns and priorities on the Brexit arrangements, on future trade agreements and indeed in determining what legislation can be safely jettisoned and what needs to be retained. We anticipate that much of this will be undertaken through trade representative bodies, but active developers, financiers and investors will no doubt wish to take control of their own destinies and make representations to the UK Government.

Further Resources

Clifford Chance Brexit Guide:

<https://financialmarketstoolkit.cliffordchance.com/en/topic-guides/brexit.html>

Financial Markets Toolkit:

<https://financialmarketstoolkit.cliffordchance.com/en/home.html>

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