



BREXIT AND ENERGY: REACHING A UK-EU AGREEMENT ON ENERGY: THE CHALLENGES AHEAD

The UK and EU have now each released their draft texts on a proposed agreement on energy. While there is some alignment between the texts, there are significant gaps between their positions, especially in relation to the arrangements for electricity and gas trading. The distance between the two sides has caused concern in the energy industry as time is running out to reach an agreement by the end of this year. This briefing considers the positions of both sides and the likely challenges in coming to an agreement.

BACKGROUND

While COVID-19 currently dominates public discourse, behind the scenes, Brexit negotiations between the EU and the UK are ongoing (virtually for now) with the aim of concluding a free trade agreement (**FTA**). By way of reminder, the UK's transition period will continue until the end of 2020. Failure to agree an FTA with the EU would mean that, unless the transition period is extended (which the UK Government has consistently stated will not happen), the UK will leave the transition period without a deal on trade.

On 18 May 2020, the UK released its draft negotiating document for an agreement on energy (**UK Draft Agreement**). This follows the release in March 2020 of the EU's draft text of an EU-UK agreement (**EU Draft Agreement**) which also contains provisions covering the energy sector. Comparing the two texts allows us to assess how the two sides see cooperation in the field of energy in the future. While much may change in the negotiations, it is important to note that we are only about six months away from the end of the transition period, and the point at which any new agreed energy framework would need to be operational.

COMPARING THE TWO TEXTS

Different scope

The first thing to note when comparing the two texts is their different focus. The EU Draft Agreement in the energy section covers a very wide range of topics within the broader energy and sustainability field, from energy efficiency targets to safety standards in offshore oil and gas operations, reflecting the EU's commitment to a level regulatory playing field across the energy sector. By contrast, the UK Draft Agreement is largely focused on trading arrangements

Key issues

- UK transition period will end on 1 January 2021.
- EU and UK proposed agreements on energy are not fully aligned.
- Key area of difference is in relation to energy trading and the extent to which markets will continue to be "coupled".
- There is support from industry from both sides for maximum continuity of the existing market arrangements but it is unclear whether the EU will accept the UK's proposals.

for electricity and gas between the UK and the EU, including the relevant governance and dispute resolution arrangements. It is no surprise that the UK would choose a narrower focus than the EU in its push for regulatory independence following Brexit. This also reflects the wider approach of both sides, with the EU proposing a single framework for the future relationship with the UK, and the UK seeking to adopt sectoral agreements that are negotiated separately. However it remains to be seen whether the EU can persuade the UK to incorporate more areas for regulatory alignment or control into the FTA as negotiations progress.

Areas of alignment

On a positive note, the parties seem to be aligned in respect of the general energy market rules. Both texts reaffirm the parties' commitment to market-based rules for the trade in electricity and gas products, including maintaining third party access rules. This is not surprising, as the UK has been one of the biggest proponents over the last few decades of EU market liberalisation and harmonisation in energy. We would not therefore expect a divergence in relation to the principles underpinning the existing EU energy market rulebook. There is also very similar language used in both documents in relation to cooperation and establishing formal communication channels between transmission system operators (**TSOs**) and regulators in the UK and their counterparts at EU level.

It is also positive that there is alignment in respect of both parties' commitment to fighting climate change, both in terms of implementing the Paris Agreement and in terms of coordination on initiatives at a global level. However, it is notable that while the EU Draft Agreement contains strict terms requiring the UK to abide by the Paris Agreement, the UK's position takes a softer approach of simply affirming the parties' commitment to the Paris Agreement, reflecting its preference for regulatory independence.

Area of likely disagreement

Market Coupling

Market coupling, which refers to the integration of national electricity markets (across all time periods: day ahead, intraday and balancing markets) thereby creating a single EU electricity market, is likely to be an area of divergence.

Market coupling is primarily achieved through the development of the "hardware" (grid infrastructure and interconnections between markets), as well as through regulatory harmonisation which develops the "software" for efficient, implicit (i.e. where transmission capacity and energy are traded together) algorithmic trading of energy products. These tools combined allow for the cost-effective flow of electricity across the continent to areas with the greatest demand. Market coupling (and the expansion of interconnection capacity in general) is a key tool for integrating the now very large shares of variable renewable electricity on European grids, as electricity can be shifted around the continent on a minute-by-minute basis when there is either a surplus or a shortfall of generation (which is inherently harder to predict with large shares of renewable energy).

Great strides have been made over the last few years to connect many of the EU Member States' electricity markets. The UK, primarily through National Grid (the GB system operator), has played a key role in this and has continued to expand its physical interconnector capacity with neighbouring countries such as Belgium, France, Ireland and Denmark.

However, the two draft agreements take a very different approach to market coupling issues. The UK, acknowledging the benefits to its own economy, sets out detailed terms, conditions and methodologies for single day-ahead and intraday coupling and access to balancing platforms. On the other hand, the EU Draft Agreement only implicitly touches upon market coupling in the context of the efficient use of interconnectors. The draft texts point to the following thorny issues that might come to the fore in the upcoming negotiation rounds:

Decision-making process

The UK has proposed to maintain the drive towards market coupling but within a new framework falling outside the remit of the European Court of Justice (**ECJ**). Decisions would instead be taken in a newly established Energy Cooperation Group made up of representatives from both sides. By contrast, in the EU Draft Agreement, the only mention of market coupling is a footnote at Article 25, which states that the UK's role in coordinating capacity through interconnectors "*shall not imply participation in the EU's capacity allocation platform.*" As the UK Draft Agreement envisages a supranational governance arrangement in relation to the trade in electricity and gas (and to other sectors too), the EU (which from an economic perspective supports the idea of continued market coupling) may not be inclined to allow market coupling without at least some oversight from the relevant EU bodies, such as ACER (Agency for the Cooperation of Energy Regulators) and the ECJ.

Equal voting power on the approval of TSO methodologies

Another area of likely disagreement is the UK's position that it will have an equal say (with all EU Member States combined) on terms, conditions and methodologies prepared by TSOs in the EU, which are required for market coupling. The UK Draft Agreement provides the UK with an equal vote on such terms, conditions and methodologies under a proposed supranational arrangement and no longer on the basis of the existing EU dispute resolution mechanism and decision-making process. It is questionable whether the EU will accept this proposal for two reasons. Firstly, the EU has historically been very protective of tribunals or courts other than the ECJ interpreting EU law. Secondly, it would be unlikely for the EU to accept that the UK would have an equal "on par" vote with the remaining 27 Member States.

While the EU (and especially Member States neighbouring the UK such as Ireland and France) are probably very keen on UK energy markets continuing to be coupled with the EU single market, the principles and rules governing such an arrangement are likely to be fiercely negotiated by the EU. It is worth noting that the UK heavily relies on energy imports from the EU or EEA (in 2018 around 5% of electricity and 40% of gas were imported through interconnectors) and therefore has much to lose by inefficient trading arrangements.

ENTSO Membership

The UK Draft Agreement provides that the UK electricity TSOs shall have the right to be members of the European Network of Transmission System Operators for electricity (**ENTSO-E**) and observers of ENSTOG (the equivalent of ENTSO-E for gas) ie. the EU statutory bodies designated to draft the detailed, technical codes on cross-border trade in energy. By contrast, the EU Draft Agreement explicitly states that the framework for cooperation between the TSOs "*shall not involve or imply membership of ENTSO-E or ENTSG by United Kingdom transmission system operators.*" It is, therefore, likely that the EU will only allow UK TSOs to participate in ENTSO-E and ENTSG meetings as observers, as is the case with TSOs from other non-EU countries, such as

Turkey and Albania. As the technical rules for cross-border trade are created in such fora, it is seen by the UK energy industry as important for UK TSOs to maintain some form of influence over the development of these rules, however, the level of membership will likely be dictated by how closely the UK aligns with EU energy law going forward.

Northern Ireland

The UK Draft Agreement does not cover arrangements for the electricity market in Northern Ireland (**NI**) as this has already been dealt with in the Northern Ireland Protocol of the Withdrawal Agreement. As the Northern Irish electricity market is separate to that of Great Britain (**GB**) and part of the Irish Single Electricity Market with the Republic of Ireland, the Northern Ireland Protocol provides for the continuation of this arrangement. This means that Northern Ireland will continue to be a separate electricity market to that of Great Britain, and importantly will continue to be subject to EU electricity market rules. That said, agreement will need to be reached between the parties on market coupling for GB and NI to continue to seamlessly trade electricity.

CONCLUSION AND NEXT STEPS

While the two sides may have progressed with the negotiations and found more common ground since the draft texts were originally prepared in March 2020, the key concern for the energy sector in Europe is that time is running out to solve the remaining bottlenecks with the end of the transition period approaching. This was also acknowledged on 2 June 2020 by trade bodies representing the largest electricity and gas companies across the UK and EU (including EnergyUK and Eurelectric) who issued a [joint statement](#) urging both sides to come to an agreement, including on "*cost-effective trading over interconnectors*."

As for immediate next steps, the Political Declaration agreed between the UK and EU in October 2019 provides that in June 2020 both the UK and the EU will convene to "*take stock of progress with the aim of agreeing actions to move forward in negotiations on the future relationship*." Further UK/EU negotiating rounds are expected to take place between July and October 2020, with a view to concluding negotiations ahead of the European Council summit on 15-16 October. Assuming an agreement is reached by then, this should provide sufficient time to ratify it in both the European Parliament and the UK Parliament by the end of 2020.

As the joint statement from the energy trade bodies mentions, the UK and EU have been working together on a large number of policy areas within the energy sector, including on climate change, electricity and gas trading and the proposed North Sea Wind Power hub. It is therefore critical that an early and comprehensive agreement on energy is reached between the UK and EU in order not to lose momentum on these important projects and areas of cooperation that will help both parties reach their ambitious decarbonisation goals.

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