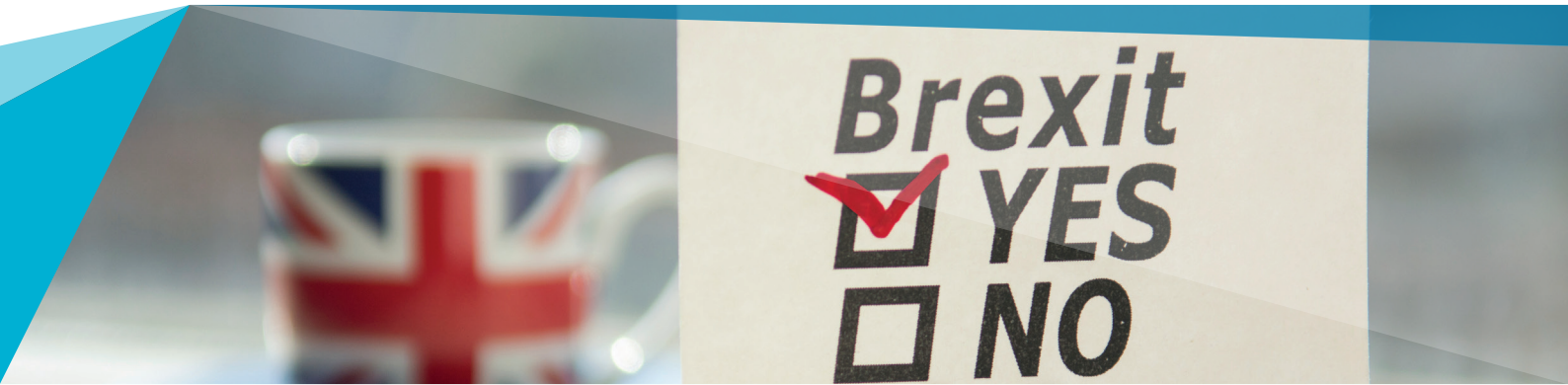


BREXIT: UK POWER'S WATCHING BRIEF



European energy and power markets have become increasingly interconnected over recent decades, during which time the UK has been largely supportive of securing more comprehensive integration. At present, the European Union (EU) and individual member states have equal legal jurisdiction¹ for energy and power; only the EU, however, has legal jurisdiction over the European Internal Energy Market (IEM), a series of legislative packages designed to create a more competitive and secure energy landscape through the direction of infrastructure, markets, and system operation.

POST-BREXIT RISK DRIVERS

In the absence of a clear political pathway following the decision to leave the EU, the future direction of UK energy policy ultimately depends on the actions and success of the new Government. Therefore, Brexit remains a watching brief for the UK power sector. But preparation is vital and organisations should begin to consider their risk profiles against several scenarios – how existing exposures might change, what new risks may emerge as an exit is negotiated, and the potential impact on both corporate strategy and risk financing, as well as on wider organisational resilience.

Of course, there is an inherent circularity and subjectiveness to many of the considerations, with focus centring on three key areas:

1. Market Integration

Market coupling minimises cross-border price differences, improves grid capacity balancing (important as more renewable energy comes online), and enhances security of supply. Yet remaining within the IEM would see the UK lose some or all of its influence over future EU energy policy, and while EU membership is not a prerequisite

for participation, maintaining freedom of movement is. However, the UK imported 46% of its net energy requirements in 2014, and there is a significant volume of new interconnected electricity capacity planned. To leave the IEM would create several immediate issues: bilateral agreements in place for interconnected supply would most likely need renegotiating, while projects in development, modelled on a coupled market basis, would also need reviewing.

As an island nation, there are tacit implications for negotiating new energy market agreements. This situation is mirrored in Ireland, which currently operates a single electricity market between the North and Eire and has two interconnectors with Britain (1GW). Exit considerations and negotiations must therefore run across multiple fronts – Northern Ireland and Eire, as well as Northern Ireland and Great Britain – and different power market models may eventually emerge.

2. Generation Mix

The UK must continue to strike a path that will best manage its energy trilemma: security of supply, equity (cost and access), and environmental sustainability. The EU has had no binding direction over national generation portfolios

¹ National law should not contravene EU legislation however.

– any influence on the natural appetite and economics of the sector has been at the bequest of the UK Government. Future direction must remain conducive to broader environmental considerations – carbon emission reduction targets, which remain bound by international obligations, for example – and negotiate long-term security of supply. Of course, there is an increased risk of short-termism – a focus on cheaper/easier deployment (such as gas and nuclear) or a U-turn on the closure of unabated coal-fired power stations to meet short-term demand. On the other hand, fewer state restrictions may enable the UK Government to better support emerging technologies and minimise the execution risks associated with such projects.

3. Funding

Post-referendum uncertainties may weaken investor appetite, leading to a contraction in availability and an increase in the cost of finance. While EU state aid control, often seen as unnecessarily restrictive, may be rejected, similar international guidance (such as the World Trade Organisation's subsidy regulations) would still apply. State aid will also be a key component of any bilateral trade negotiation. Furthermore, it is unclear if Projects of Common Interest (PCI) support – the fast-tracking and funding for projects integral to creating an integrated energy market – will extend to the European Economic Area (EEA).

Few anticipate a significant reversal of national policy in the UK, although a relaxing of some regulation is to be expected. However, sustained political turmoil and uncertainty could create a UK energy paradox in the medium-term, potentially defined by:

- A stifling of much needed infrastructure investment and falling investor confidence.
- Compromised availability and security of supply at a time when demand is expected to rise.
- A lack of progress in any direction – protracted negotiations may lead to very little change in the final analysis.
- Less autonomy over UK energy policy rather than more (membership of the IEM).
- Ongoing contribution to the EU budget, but with potentially less access and qualification for EU funding.

NEAR-TERM RISK MANAGEMENT AND INSURANCE CONSIDERATIONS

Firstly, insurers are highly regulated and can be expected to weather any economic turmoil in the months ahead.

The near-term impact on corporate insurance programmes – insurer appetite, capacity, and pricing – is expected to be limited.

However, it is important that you engage with your insurance/risk adviser to understand your primary and secondary exposures, consider possible transition outcomes, and discuss any change in your insurance requirements. For example:

1. Understand your changing risk profile – How might existing exposures change and what new risks may emerge as an exit is negotiated? What are the implications of political deviation from the EU's freedom of movement of goods, services, people, and capital across primary and secondary supply chains?
2. Consider uninsured risks – For example, the input availability over the lifetime of an asset, equipment availability, planning delays, etc. How might this impact on corporate strategy and your financing of risk? How can risk management help you enhance your organisational resilience?
3. Review sums insured – A weaker pound and medium-term currency fluctuations could mean that reinstatement values for plant and equipment sourced from Europe become too low, thereby under-insuring the assets.
4. Check whether you are using core capital (debt, equity) to fund meaningful insurance deductibles and provide cheap contingent capital. How this might change in the future?
5. Understand any project exposures – For example, investor withdrawal, cost and availability of finance, profitability modelling, tightening the risk and insurance requirements, etc.
6. Review energy contracts against anticipated legal changes, to ensure they are fit-for-purpose and minimise any contractual liability exposures.
7. Understand any international operations currently underwritten.
8. Engage with your broker early for programme renewal and ensure the timely, accurate collation of all data required.

Marsh will continue to work with insurers and the European power industry to further understand what Brexit will mean, and will issue further guidance as necessary.

Should you have any questions, please email:
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