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BREXIT SCENARIOS: IMPLICATIONS FOR ENERGY AND CLIMATE CHANGE

QUARTER 2 UPDATE

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Executive Summary

Political events over the last three months, especially the elections in the UK, France and the Netherlands, have had a profound impact on the scenarios for Brexit. The election of President Macron in France and the VVD remaining the largest party in the Netherlands has prevented extreme right-wing Parties gaining power in key European capitals. This has enabled a clear, unified Brexit negotiating mandate to be established across the EU-27 Member States and reduced the likelihood of descending into an “EU in chaos” scenario.

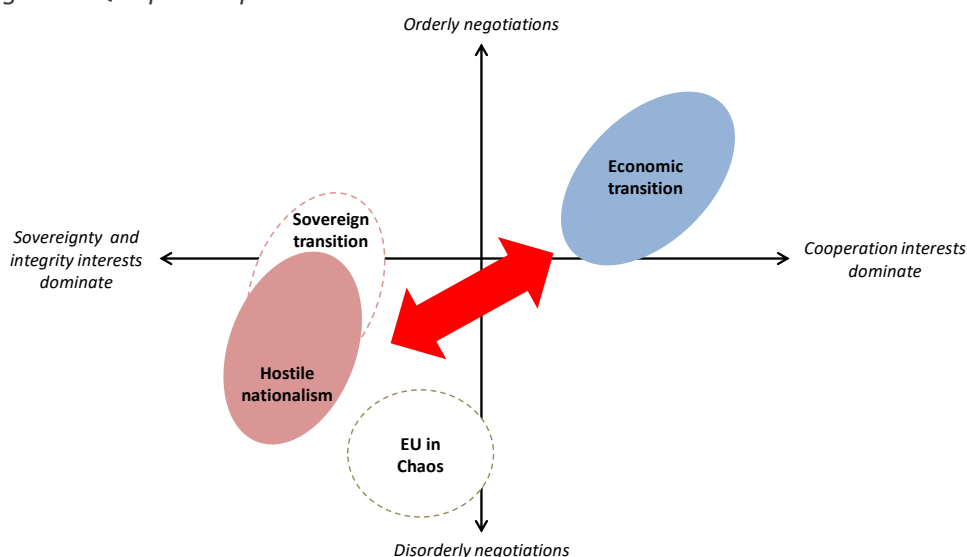
While election results have enhanced unity and stability on the Continent, the surprise hung Parliament in the UK has significantly undermined its authority. Prime Minister Theresa May explicitly called a snap election to enhance her negotiating mandate for a hard exit aligned around promoting national sovereignty over economic cooperation with the EU. Instead the Conservative Party is now left trying to forge a coalition with the Northern Ireland Democratic Unionist Party (DUP), which may prove to be highly fragile. The full implications of the result are still playing out but two clear dynamics are emerging: on the one hand proponents of ‘softer’ forms of Brexit that focus on an economic transition have been empowered to potentially seek a change in the UK’s negotiating position. On the other the instability and weakness of the Government, which may lead to a collapse and fresh elections within the two-year Article 50 period, could result in a crash Brexit outcome and a rise of hostile nationalism as the UK fails to deliver an orderly negotiation process.

There are also indications that inflation in the UK, currently running at over 2.7% following the devaluation of the Pound after the referendum, is starting to negatively impact growth. In the first quarter of 2017 the UK economy grew by only 0.2%, less than half of the Eurozone area average. The Governor of the Bank of England, Mark Carney, has now linked Brexit impacts to falling real incomes in the UK. However,

these Brexit impacts were not a major feature of the UK election campaign and so have not yet fully fed through into the public conversation.

These events have led to revised political scenarios as shown in figure 1 below. The political space has collapsed as the sovereign transition scenario (which represented the UK's pre-election negotiating position) and EU in Chaos options are now less likely to emerge. The current dynamics therefore favour either focusing on an economic transition, which seeks to establish stable transitional arrangements and maximise economic cooperation in the short to medium-term (such as through retaining membership of the Customs Union), or a crash Brexit represented by the hostile nationalism scenario as the most likely outcomes. The crash outcome may not start with hostile nationalism, during the opening negotiations both sides have emphasised trust building, but if there is a collapse it is likely to generate negative attitudes with the public, driven by forces in the media. If 'punishment and recrimination' became a dominant public message this would generate significant negative momentum and make future cooperation harder to achieve.

Figure 1: Q2 updated political scenarios



Assessing the scenarios against five key energy and climate change objectives shows that the economic transition outcome offers positive benefits for both the UK and remaining EU-27 member states, while a crash Brexit would harm both sides (although this outcome is slightly less damaging for the EU-27). As shown in figures 2 and 3 below, an economic transition outcome would be favourable for the UK retaining access to the Internal Energy Market (IEM), reducing energy costs and avoiding the Republic of Ireland becoming an energy island. This scenario would also avoid a cliff-edge for business and investors and provide a strong basis for continued cooperation on climate and environment issues. In contrast, the hostile nationalism outcome would lead to a fragmented energy market, increasing the costs of decarbonisation for both sides, creating significant uncertainty for business and

investors, and undermining cooperation. Major energy exporters such as Russia would be significantly empowered in this scenario. There is also a high likelihood of severe disruption to the UK's civil nuclear programme in the result of a crash Brexit as it may also crash out of the Euratom Treaty without being able to agree alternative arrangements.

Figure 2: Economic transition scenario energy and climate impacts

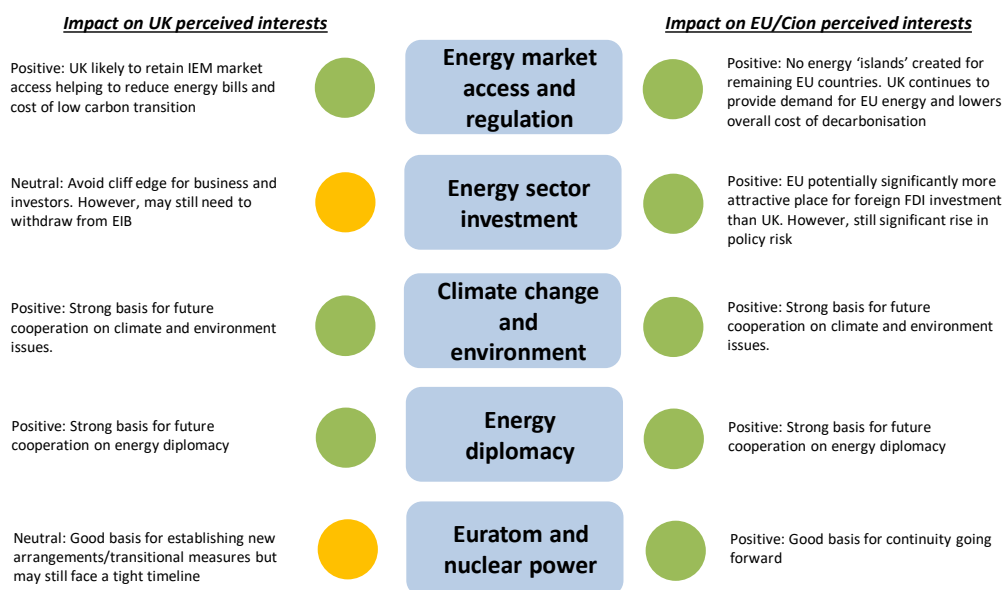
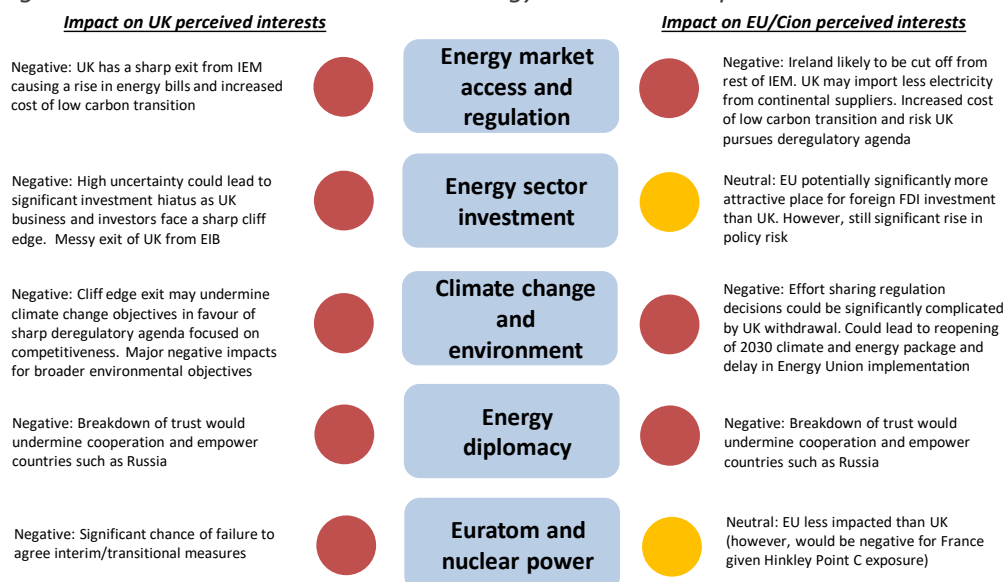


Figure 3: Hostile Nationalism scenario energy and climate impacts





To date energy and climate issues have not been at the centre of the Brexit negotiations. Events over the last three months have polarised potential outcomes. Given a choice between transition or crash there is an urgent need to promote a cooperative track for energy and climate issues. If this could gain widespread support across civil society, business and academic groups it could be a powerful force in driving towards an economic transition scenario.

Introduction: Initial Brexit scenarios

The official submission by the UK of its Article 50 notification on the 29th of March 2017 has started the formal process of Brexit. There is massive uncertainty on how the negotiations over the next two years will unfold. The outcome of this negotiation will have major impacts for all areas of policy between the EU and UK, including energy and climate change. Scenario analysis provides an opportunity to explore how progress in the overall negotiations may impact specific policy areas.

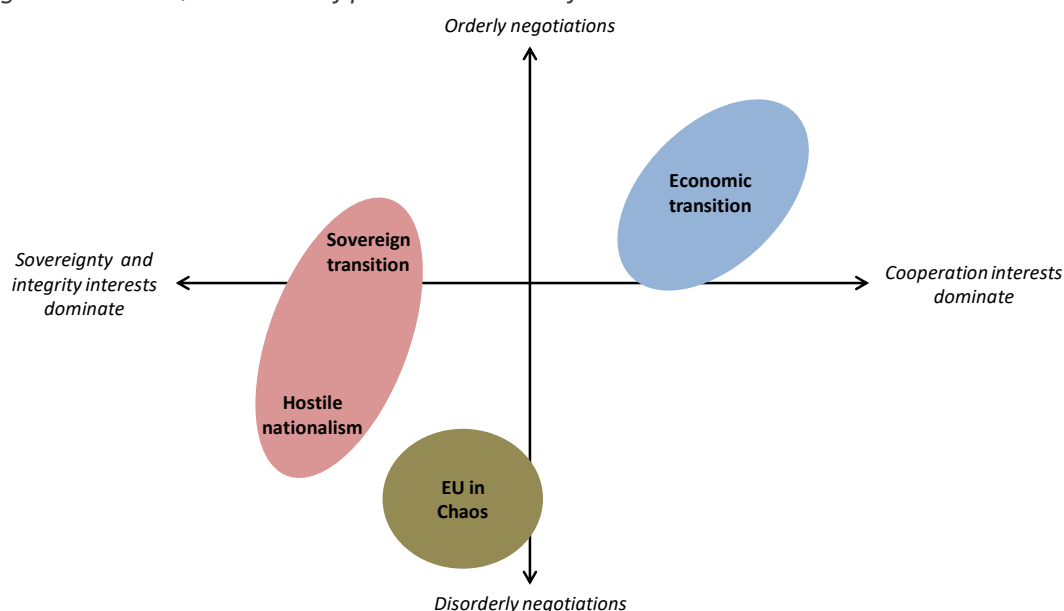
The scenarios are built on four key drivers:

- **How national interests are prioritized by each side:** This encompasses how the UK and EU-27 Member States choose to prioritize different issues within the Brexit negotiation. This includes both issues related to withdrawal agreement such as financial liabilities and the rights of citizens; as well as issues related to the future relationship such as new free trade agreements, membership of the European Union Customs Union (EUCU) and the role of the Court of Justice of the European Union (CJEU). To date energy and climate change issues have not played a prominent role in Brexit discussions.
- **Orderly versus disorderly negotiation process:** There is no precedent for the Brexit process. The massive complexity involved and potential attempts by each side to gain an advantage through the structure and sequencing of how issues are addressed is of crucial importance. An orderly process would facilitate trust building, enable a clear representation of different views and facilitate compromise towards a final agreement. However, there is a significant risk that the negotiations collapse into a disorderly process, undermining trust and hence make reaching any deal much harder to achieve.
- **The timing and extent of any economic impacts:** This includes how factors such as the devaluation of the British Pound, inflation and uncertainty for business and investors shape public attitudes to Brexit going forward.
- **Momentum after the Article 50 negotiations:** There is significant uncertainty over the full timeframe for the Brexit process. Both sides have publicly discussed some form of continuation arrangement, with the UK referencing “implementation periods” and the EU considering the possibility for a two or

three year transitional arrangement. Whether the Article 50 process is viewed as a 'one-shot' or 'repeated' game will significantly impact the final outcome.

From an assessment of the key drivers and interests, four main political spaces for landing a Brexit deal within the next 2-3 years were identified in January 2017 as shown in figure 4 below. The key axes in defining the scenarios are an orderly versus a disorderly negotiation process and whether sovereignty/integrity or cooperation interests dominate national positions. These scenarios are focused on the period to 2020, with an assessment of future momentum (either upward or downward). All of the scenarios are predicated on the UK leaving the EU and do not explicitly consider the potential for a second referendum etc. to totally reverse the current political course. However, they do result in very different levels of cooperation going forward.

Figure 4: Initial Q1 overview of political scenarios for Brexit



The negotiating dynamics were assessed to be initially headed towards a Sovereign Transition scenario whereby the UK continues to prioritize national sovereignty and the EU promotes the integrity of existing institutions. However, it was recognised that this is a very unstable political space. A number of drivers, such as failure to agree on existing UK budget liabilities or the future role of the CJEU, could cause a collapse in the negotiation process and an escalation towards a Hostile Nationalism scenario. In this case there would be a high probability that no final deal is reached at the end of the Article 50 period and both sides would face a messy exit for the UK.

The third scenario, the EU in Chaos, represented a victory for extremist politicians in other EU countries (such as in the French elections) or the potential for a Eurozone crisis to lead to a major country such as Italy or Greece leaving the Euro. In this instance, the EU focuses its attention elsewhere and the Brexit negotiations would once again be reduced to disorder. The Final scenario, Economic Cooperation, would



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require a shift in prioritization of national interests to focus on a longer-term and smoother Brexit. In this scenario the initial focus is on agreeing a set of stable transitional or implementation arrangements, which allow for a much longer negotiation of future UK-EU trade arrangements and cooperation on other areas such as climate, energy and security issues.

Impact of recent events on scenario drivers

UK Elections

The surprise UK election results on the 8th June that ended in a hung parliament will have a major impact on the Brexit scenarios. Prime Minister Theresa May primarily called the snap election to solidify her Brexit negotiating mandate, provide a large Parliamentary majority to push through domestic legislation to translate existing EU powers into UK law, and ensure the House of Lords could not block progress on Brexit issues (by convention the House of Lords does not oppose the government on manifesto commitments). This plan now lies in tatters. The Conservative Party is currently trying to forge a coalition with the Northern Irish Democratic Unionist Party (DUP). Together they would command a slim working majority in Parliament with 328 combined seats out of a total of 650. However, the coalition is likely to be highly unstable. Bringing the DUP into the heart of government could significantly undermine the Northern Ireland peace process. The DUP also hold extreme views on many social issues relating to women's health and gay rights which stand against Conservative Party positions. Rebellion by a small number of MPs on either side could lead to a defeat in Parliament and there is a significant probability that another election may be called before the Article 50 process is concluded.

The surge in support for the Labour Party led by Jeremy Corbyn (which polled over 40% of the vote for the first time since 2005) has meant that if fresh elections happen a change of government is now a real possibility. Initial indications suggest that large numbers of youth voters, who overwhelmingly supported remain in the Brexit referendum, were a core dynamic in this shift. However, the Labour Party remains in favour of Brexit, and supported the triggering of Article 50, but has shown that it is open to considering a range of different Brexit models.

The election was also notable for the collapse in support for third parties. The UK Independence Party (UKIP), which was a catalyst for the Brexit referendum, saw its vote collapse from 12.6% in 2015 to just 1.8%, and it is now questionable whether it will be able to continue as a viable party into the future. The Scottish National Party (SNP) saw a 13% drop in its vote share in Scotland, losing 21 seats, reducing any immediate prospect for a second independence referendum in Scotland.¹

The full implications of the election result are still playing out. However, there are two clear trends emerging with respect to the Brexit negotiations. The first is to increase the probability of prioritising 'softer' forms of Brexit to focus on securing an economic

¹ <http://www.bbc.co.uk/news/election/2017/results>

transition. The second is to increase the prospect of a crash Brexit outcome as chaotic politics in the UK undermine any ability to conduct an orderly negotiation process.

Prior to the election Prime Minister May and key Cabinet colleagues had set out a hard Brexit position based on leaving the single market and Customs Union and removing all influence of the Court of Justice of the European Union (CJEU) in order to promote national sovereignty. In addition the Prime Minister had repeatedly emphasised a “no deal is better than a bad deal” line indicating that the Government would be prepared to walk away from negotiations with the EU if they did not win concessions.² The election result is a significant blow to pushing a very hard Brexit position as the Government may no longer be able to command a majority in Parliament to support such an outcome, especially as the 12 seats the Tories gained in Scotland (which has much lower levels of support for Brexit) are now key to holding the government together. This has empowered voices in the Conservative party that support softer forms of Brexit (such as retaining membership of the Customs Union) who are now calling for a rethink of the negotiating strategy. This potentially opens the door to moving towards an “economic transition” scenario based on establishing a set of stable economic relationships with the EU by remaining in either the Customs Union or EEA, which would then allow for much longer negotiations on a full partnership.

However, the election also raises a serious risk for a crash Brexit outcome. By triggering Article 50 before calling the election the two-year countdown to exit has already begun, and can only be extended through unanimous agreement of all EU-27 Member States. As noted above if the coalition with the DUP collapses then new elections may happen midway through the Brexit negotiation. The timelines for the Article 50 negotiations were already extremely tight given the complexity of issues to be addressed, and the need for ratification processes through the EU and UK Parliaments. Continued political uncertainty in the UK would create a highly disorganised negotiating process that could result in a breakdown of trust if the EU feels the UK can’t negotiate in good faith. This would move negotiations towards the “hostile nationalism” scenario and could result in the UK crashing out of the EU after the two-year Article 50 process if it cannot conclude either exit or transitional arrangements.

EU elections

A key factor in the prioritization of national interests was the impact of elections in key EU-27 countries, especially France and the Netherlands. If the hard-right politicians had been successful this would have created a highly divided Europe and potentially led to further referenda on future EU membership (the so called ‘domino effect’). This was a key feature of the “EU in Chaos” scenario whereby the EU-27 would have been unable to maintain the integrity of a collective negotiating position as it wrestled with these dynamics. Instead the victory for Emmanuel Macron in France, and the VVD remaining the largest party in the Netherlands has removed this

² <https://www.theguardian.com/politics/2017/jan/17/prime-minister-vows-to-put-final-brexit-deal-before-parliament>



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threat. In particular, President Macron is likely to forge a strong and unified alignment with Germany and help maintain a cohesive negotiating position across the broader EU-27 group. As such the “EU in Chaos” scenario will be downgraded as there is little prospect for a domino effect at present.

There are still important elections to be held later this year in Germany, Austria and the Czech Republic; and continuing economic fragility in a number of Eurozone countries, including the sale of Banco Popular in Spain to Santander for a symbolic €1 as it faced collapse.³ As such we will continue to review the likelihood of further disruption within the EU-27 impacting the Brexit process in subsequent scenario updates.

European Commission negotiating mandate

The EU-27 Member States unanimously agreed a Brexit negotiating mandate for the European Commission.⁴ Key features of the approach include:

- Sets out a two-phase negotiating process whereby “sufficient progress” must be made on key areas of the withdrawal agreement (including the financial settlement, citizens’ rights and the relationship between the Republic of Ireland and Northern Ireland) before a second phase would be triggered to focus on the future relationship;
- Indicates that the EU-27 believe the UK will have to leave key institutions such as the European Investment Bank;
- Obligations under international treaties will be covered in the first phase which will likely include climate change obligations under the UNFCCC;
- The first phase sets out some provisions related to Euratom and the future of nuclear power (such as the transfer of ownership of fissile material and safety equipment). However, the majority of energy and climate change issues will wait until phase two of the negotiations

The two-phase structure of the negotiating mandate maximizes the advantages of incumbency for the EU but potentially also increases the risk of a crash Brexit. As noted above, the triggering of Article 50 by the UK has started a ticking clock and ensures the UK is under much greater time pressure to secure a deal before the 2-year expiry date than the EU. Delaying any substantive discussions of the future relationship till after the principals of the financial settlement and other issues have been agreed will maximize EU leverage over the UK. It was initially expected that the UK would push back strongly against this structure during an initial ‘negotiation over the negotiations’ phase, in an attempt to secure parallel negotiations on withdrawal and future relationship issues. However, at the first negotiation session on 19th June the UK fully conceded to the EU, perhaps reflecting its much weaker position following the UK election results.

³ <https://www.ft.com/content/131c0f3a-4c4d-11e7-a3f4-c742b9791d43>

⁴ https://ec.europa.eu/info/sites/info/files/annex-recommendation-uk-eu-negotiations_3-may-2017_en.pdf



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The early treatment of issues relating to the Republic of Ireland and Northern Ireland is particularly pertinent as the DUP become coalition partners with the Conservative Government in the UK. This could result in a breakdown of trust with the other political parties in Northern Ireland and significantly undermine the Good Friday Agreement. This would make progress on these issues extremely difficult in a Brexit negotiation context.

Potential discussions of the UNFCCC in the first phase are also highly relevant following President Trump's decision to withdraw from the Paris Agreement. The UK stood apart from German and French condemnation of President Trump following the recent G7 in Italy, in part because of a UK desire to negotiate a trade deal with the US after Brexit. This led German Chancellor Angela Merkel to say that the EU could no longer depend on the US and UK.⁵ If the UK is viewed as an unreliable partner to fulfil existing obligations under international treaties this could damage trust in the wider Brexit process.

If the negotiation over the first phase proves difficult this would delay the treatment of energy and climate change issues. At best what was already a tight timeline could end up being further compressed. However, if an orderly process can be established which builds in a significant transitional period (such as if the UK prioritises softer forms of Brexit) this would allow for a longer period to discuss and resolve energy and climate issues.

Economic impacts

The latest economic data suggests the UK has experienced a significant slowdown in growth at the start of 2017, as the devaluation in the pound following the Brexit referendum feeds through into rising inflation. Revised figures show that UK GDP grew by 0.2% in Quarter 1 2017 compared to 0.8% growth in Quarter 4 2016, driven by falls in consumer focused industries such as retail sales, as prices rose faster than spending.⁶ This is the lowest quarter on quarter GDP growth since the end of 2014 and the 12 month Consumer Price Index (CPI) inflation rate has now risen to 2.7% in April 2017 up from 2.3% a month earlier.

Growth rates in the UK have now fallen below that of the Eurozone area for the first time since the results of the Brexit referendum in June 2016 as shown in figure 5 below. The Governor of the Bank of England, Mark Carney, has now linked the impact of Brexit to falling real incomes in the UK.⁷ There is now increasing division among members of the UK Monetary Policy Committee (MPC) as to whether to raise interest rates to combat inflation. The last MPC meeting ended in a 5-3 vote to maintain interest rates at their current level. Governor Carney has now publicly hinted he does not favour raising rates in the immediate future given the risks of Brexit to the UK

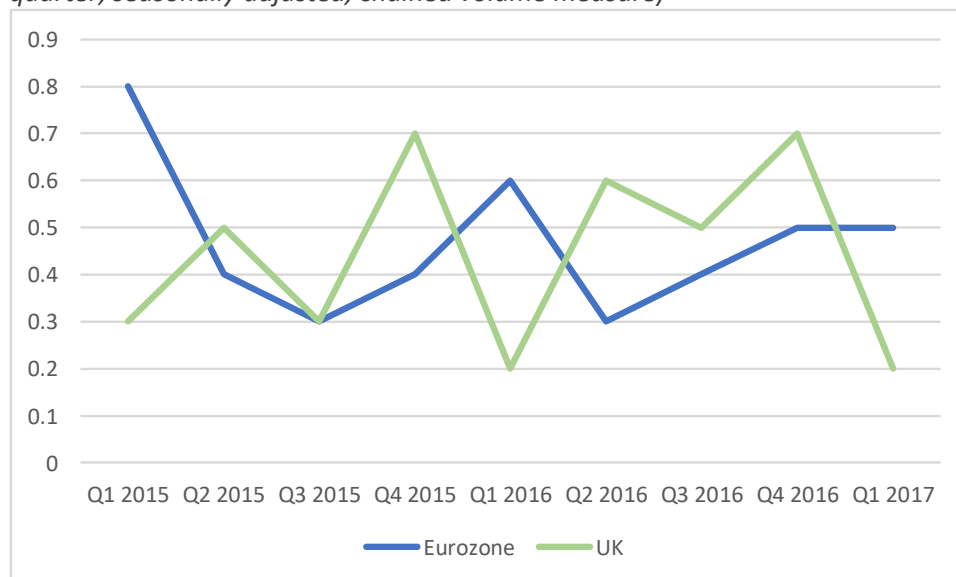
⁵ <https://www.theguardian.com/world/2017/may/28/merkel-says-eu-cannot-completely-rely-on-us-and-britain-any-more-g7-talks>

⁶ Office for National Statistics (2017) *Second estimate of GDP: Jan to Mar 2017*

⁷ <http://www.bankofengland.co.uk/publications/Pages/speeches/2017/983.aspx>

economy. However, this raises the potential for ‘stagflation’ whereby slow growth is combined with high inflation rates.

Figure 5: Comparison of Eurozone and UK GDP Growth Rates % (quarter on previous quarter, seasonally adjusted, chained volume measure)



Source: ONS and OECD (2017)

The timing and extent of economic impacts is a core driver of the scenarios. An understanding of economic interdependencies shaping negotiations in a positive manner can lead to more cooperative outcomes (which also support more positive results for energy and climate issues). However, how these economic signals are interpreted by the general public is important as negative impacts could also be seized on by elements of the media to drive hostile confrontational responses. Economic inequality was a key theme of the UK election campaign but there has been very little direct connection with Brexit issues so far. More time will be necessary to fully assess how these trends play out.

Scenarios update: impact on climate and energy issues

The impact of the new events on the scenario drivers is summarised in figure 6 below. The impact on the prioritisation of national interests for energy and climate issues is broadly positive. The election of President Macron in France and the potential to explore ‘softer’ Brexit positions in the UK may make cooperation on transboundary energy and climate policies easier to deal with through the Article 50 process. However, this is balanced by a negative impact on the negotiating process where the weak government in the UK and political uncertainty may significantly undermine its ability to negotiate effectively. The economic impact and momentum drivers are both mixed and it will require further time to fully assess how these drivers evolve in future.



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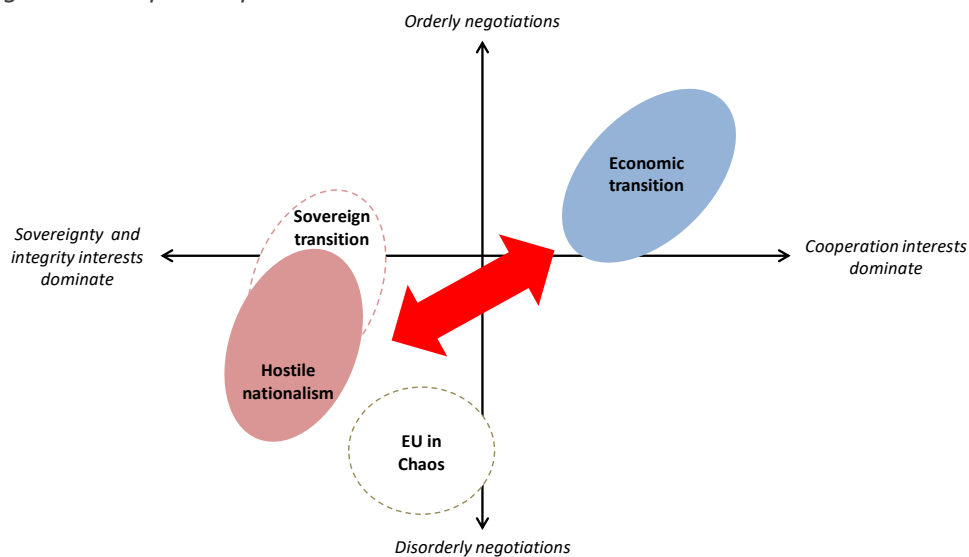
Figure 6: Impact of Q2 events on scenario drivers

	<u>Q2 Events Impact</u>	<u>Notes</u>
Prioritisation of national interests		Positive: EU elections, especially President Macron in France, makes EU in chaos scenario much less likely. UK election result potentially makes a cooperative approach to Brexit more possible (although by no means certain) which would support more positive outcomes for energy and climate change.
Orderly versus disorderly negotiation process		Negative: Although phasing of negotiations has been agreed the weakness of UK government could lead to an extended period of political uncertainty, and potentially fresh elections within the next 2 years, undermining the UK's ability to negotiate effectively.
Timing and extent of economic impacts		Mixed: Inflation as a result of the devaluation of the £ following the Brexit vote starting to impact UK growth. However, little direct connection to public perceptions of Brexit at present.
Momentum after Article 50 negotiations		Mixed: UK election could lead to a stronger focus on securing stable transitional arrangements. However, also a risk of a crash Brexit outcome destroying momentum.

In terms of the scenarios this translates into a significant reduction in probability for either the EU in Chaos or the Sovereign transition scenario as shown in figure 7 below. As noted above a key driver for the EU in Chaos outcome was political events such as the election of Marine Le Pen in France leading to a divided political position in Europe. This has not occurred and there is therefore no immediate driver leading into this scenario. The UK election result also makes the Sovereign Transition scenario less likely. Prime Minister May directly sought a mandate to negotiate for this scenario but this was rejected by the UK public. The UK will now need to balance forces across the splits within the Conservative Party (including the rise of Scottish MPs) and the DUP; and may also face significant scrutiny from the House of Lords.

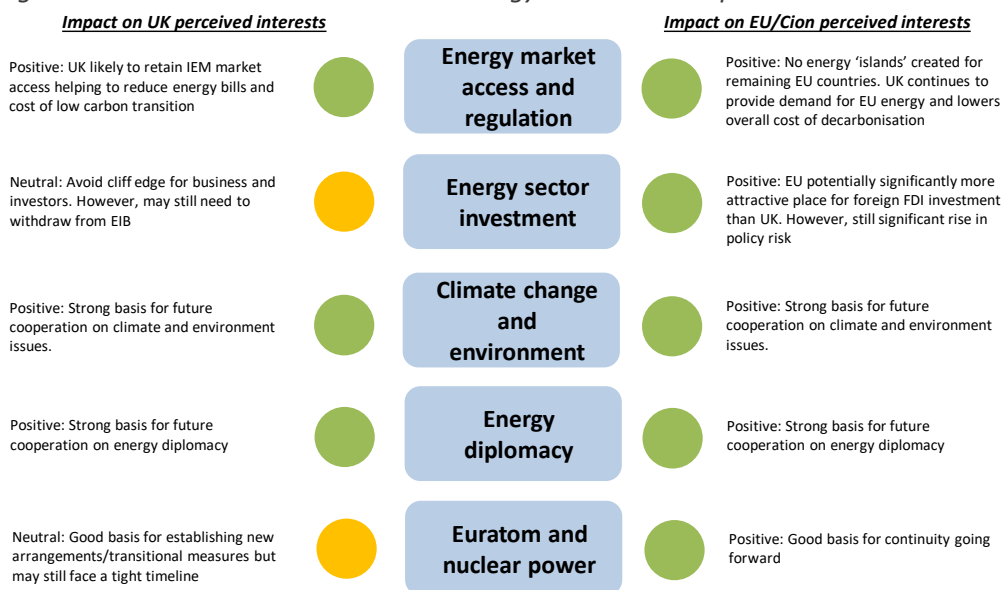
The net result is to collapse the scenario space into two dominant scenarios focused on either securing an orderly process towards an Economic Transition, or collapsing into a crash Brexit and Hostile Nationalism.

Figure 7: Q2 updated political scenarios



In terms of impact on specific energy and climate change interests the economic transition scenario would create broadly positive conditions for both the EU and UK as shown in figure 8 below. There would be a high probability of negotiating arrangements to allow continued access to the Internal Energy Market for the UK which would lower the cost of decarbonisation for both sides. While there would still be some risks for energy sector investment in the UK this scenario would avoid a cliff edge for business. An economic transition arrangement would also provide a basis for strong continued cooperation both on climate change and energy diplomacy issues (e.g. dealing with Russia). There would still be challenges for the UK in terms of Euratom and nuclear power given tight timelines, but again this is a more solid basis to deal with these issues than other scenarios (this would become a positive if the UK changed its position and decided not to immediately withdraw from the treaty).

Figure 8: Economic transition scenario energy and climate impacts



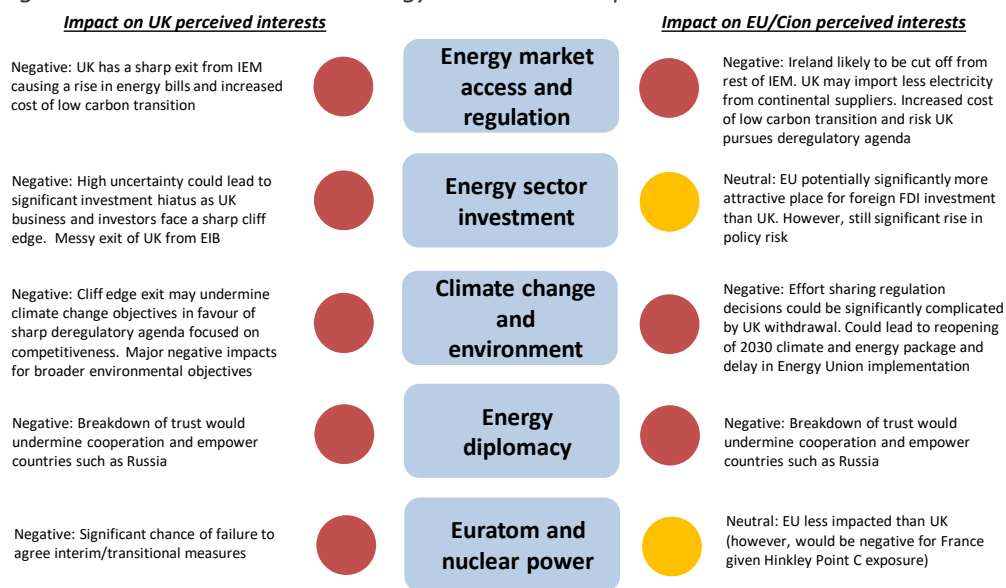
However, while the economic transition scenario provides a broadly positive backdrop for managing energy and climate change issues these outcomes are not automatic. Much careful diplomacy would still be required and it would be essential to clearly articulate the elements of a 'cooperative track' to deal with these issues.

In contrast if forces (particularly in the UK) drive the process towards a crash Brexit outcome this would be extremely damaging for energy and climate change policy as shown in figure 9 below. There would be a sharp exit from the UK from the IEM increasing costs on both sides and potentially leaving the Republic of Ireland as an energy island within the EU. There would be a massive cliff edge for energy investors and high levels of uncertainty in the UK. This could lead to a significant investment hiatus which would be highly damaging. The collapse of negotiations would have a negative impact on future climate change and environment cooperation; and undermine energy diplomacy empowering countries such as Russia. There is also a significant risk that the UK is not able to put in place effective measures for its civil nuclear programme leading to major disruption, especially to the development of Hinkley Point C.



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Figure 9: Hostile Nationalism energy and climate impacts



The narrowing of scenario options over the last 3 months brings sharply into focus what is at stake in the Brexit negotiations. There is more political space in the UK to discuss and promote cooperative outcomes that would support energy and climate objectives. But this is not a certainty and the fragile state of the UK could easily be pushed into chaos. In the coming months it will be important for civil society, business and academic groups on both sides of the channel to articulate a vision that delivers strong energy and climate change outcomes for citizens in both the UK and EU-27 Member States.



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