Industry Insight

Oil & Gas

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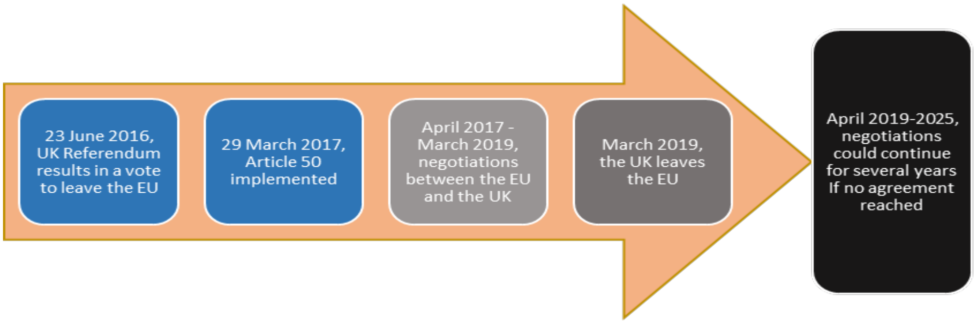
Post-Brexit Implications for the UK Gas Industry

"What's next now that Article 50 has been triggered?"

Summary

The Prime Minister has triggered Article 50 which means that the UK will cease to be a Member State of the EU by March 2019. In this Industry Insight article, IPA Advisory examines some of the key short and medium-term challenges and potential opportunities facing the UK gas sector, and asks: "despite all the warnings of economic catastrophe and uncertainty, could it be business as usual?"

Executive Summary



The UK government aims to negotiate over the next two years a set of agreements governing not only its departure from the EU but also its future relationship with the EU. Some of these will affect the future of the UK gas industry. However, initial indications are that Brexit may have limited impact on the UK's gas supply, although it does not mean that the UK gas industry is immune to the outcome of the negotiations.

Future gas demand will depend more on domestic policies such as carbon price and power fuel mix than Brexit

We expect the UK's power industry to continue on its current path to meet carbon emission reduction targets. The carbon price floor set by the UK government will, therefore, continue to be one of the main determinants of gas prices, affecting the relative competitiveness of the fuel, its role in power generation and its future demand. Nevertheless, gas will remain the bridge to a decarbonised UK.

Hard Brexit will increase reliance on global LNG imports

Current trading arrangements with the EU help to ensure lower gas prices by improving the efficiency and reliability of interconnector flows. IPA considers that, because the energy flows are vital for Ireland, the UK and the Continental Europe, there is a strong case for both sides acting to prevent disruptions, at least in the short term. We consider that, even if the negotiations result in a "Hard Brexit", the UK system is sufficiently flexible to allow global LNG and non-EU imports to increase, limiting any impact on gas prices.

Exchange rates will continue to influence the price the UK customers pay for their gas

The post-referendum devaluation of Sterling against the US dollar and Euro has increased upward pressure on domestic gas prices and this is likely to dampen demand. Given the mix of domestic production and imports required to meet demand, exchange rate movements will continue to have a strong influence of domestic gas prices.

Shortage of skilled resources

One of the greatest uncertainties of Brexit is its impact on companies' ability to recruit and move staff from abroad, with restrictions on this freedom potentially reducing the flexibility of their operations.

Brexit isn't going to be a black and white picture for the gas industry

Brexit has added to the challenges faced by the UK gas industry, which was already grappling with the fall in oil prices. In particular, it has again raised the potential of Scottish independence, an unknown which has further increased uncertainty and which will inevitably affect decision-making.

IPA Industry Insight

What to expect now Article 50 has been triggered

The UK is facing at least two years of negotiations with the EU on the terms of leaving the union and its future relationship with the union. At this point in time, the outcome of the negotiations is impossible to predict. It has been suggested that Brexit could fundamentally change the EU into a more flexible union; it has also been suggested that it could make the EU more protectionist. However, we consider that the possibility that the relationship between the two sides will break down is remote – it is mitigated by the vested interests each side has in the other.

Brexit adds to the challenge of the lower oil price environment

Over the last two years, the UK gas industry has faced turbulent times linked to the collapse in the global price of crude oil. Total revenue across the UK oil and gas supply chain fell by 10% in 2015, with a further estimated fall of 21% in 2016, taking the market to below £30 billion for the first time since 2010. The UK's decision to leave the EU has added another dimension to this already challenging environment. Three of the main concerns for the industry at present are the:

- uncertainty over the outcome of the Brexit negotiations;
- loss of the UK's ability to influence EU policy; and
- distraction the process provides to the government's business as usual running of the economy.

Overall the industry has benefited from the devaluation of Sterling and further opportunities may arise during the Brexit negotiations. However, the vote has unsettled the business community, as uncertainty is hanging over what kind of final deal the UK is able to negotiate. EU officials recognise that a transition deal will partly rest on a shared goal for future relations, yet the EU officials perceive the framework of a trade relationship being more as a political aspiration rather than a legally binding settlement pursued by London.

For this reason businesses are looking for a quick solution in order to shorten the period of uncertainty. In recognition of the importance of providing some certainty, the government pledged in its February 2017 White Paper on Brexit to introduce the Great Repeal Bill. The Repeal Bill, if passed by the two Houses of Parliament, will convert existing EU law into domestic law. With most of the UK gas industry's upstream operations located in Scottish territorial waters, the position of Scotland in a post-Brexit environment will be critical to the industry's future. However, the potential independence of Scotland is a separate issue, and viewed by the industry as factor impacting on post Brexit decision making.

Are we heading for a Hard Brexit?

The Prime Minister's statement on 17 January this year and the subsequent government White Paper suggested that the country was heading for a "Hard Brexit", a view reinforced by her statement that the UK would rather leave negotiations without a deal than take what it considered to be a bad deal. However, her letter implementing Article 50 suggested a more conciliatory tone. The reality is that the most likely outcome of the negotiations, and their impact on the gas industry, is far from clear at present.

A "Hard Brexit" implies that the UK's trading relationship with the EU would be governed by WTO conventions, customs and tariffs. This would have a significant impact in the following areas:

- Future gas flows from and to the EU, including Ireland;
- Investment in the UKCS;
- Domestic gas prices;

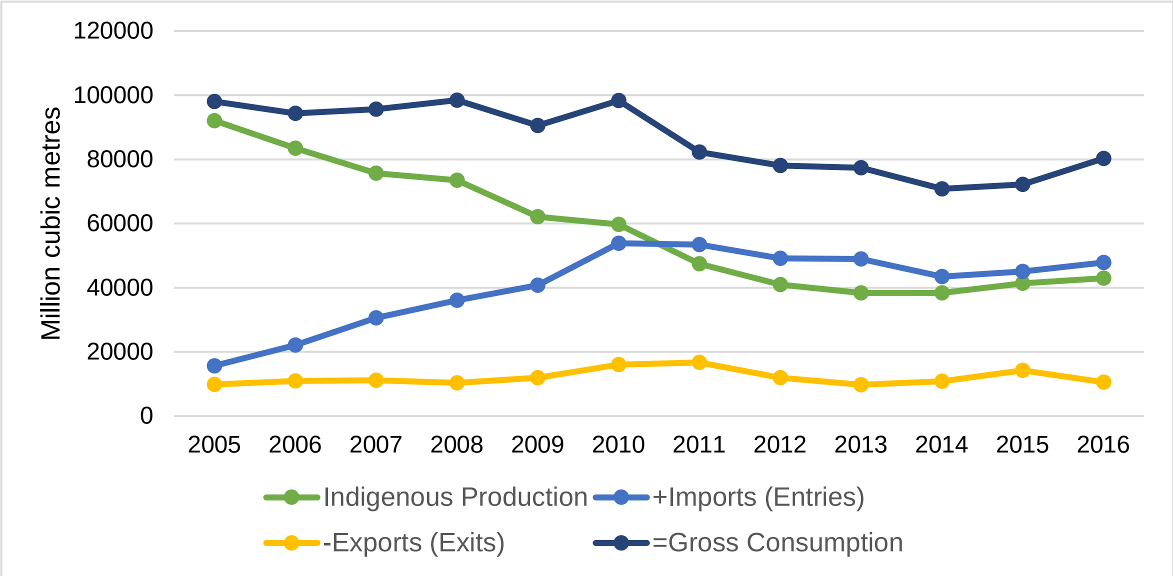
- Exchange rates; and
- Other factors, such as the hiring of labour and professional services.

It is, however, possible that an arrangement comparable to the Norwegian model (in which Norway can export its gas to the EU, is bound by EU regulations but has no ability to influence those regulations) or the Swiss model (which comprises a series of complex bilateral deals) could be adopted at the end of the negotiations. It is considered that both models would reduce the "hardness" of a "Hard Brexit".

British gas industry is robust as EU plays a minor role

At the moment, the UK gas industry, across the value chain, looks less vulnerable to the outcome of the Brexit negotiations than many other industries. This is due to the fact that gas supplies are mainly sourced from the UK's own reserves (54% of domestic demand in 2016), while 46% is imported either from Norway (65% of total imports in 2016) by pipeline or imported in the form of LNG from countries like Qatar (24%). Only 12% of all gas imports were sourced from the EU.

Figure 1: UK Natural Gas Balance, 2005-2016



Source: IEA, 2016 figures preliminary IPA estimate

In the long term, gas is expected to be increasingly sourced through supplies of LNG from other non-EU countries, such as the USA, or pipeline imports. The UK has abundant import capacities, which are largely underutilised, but the question is whether these alternative imports would be LNG or pipeline gas imports from Norway or Russia (via mainland Europe). During the period of peak demand in Continental Europe, the UK has frequently exported gas and also is the primary source of gas supplies to Ireland, which remains a part of the EU.

The UK has always had control of its energy policy or fuel mix, as Brussels has been much more concerned with building the integrated European gas infrastructure and projects of common interest. Yet again something which will have only a limited impact on the UK since most of the connections with the Continent are already in place and largely underutilised. However, in order to ensure the national balancing point (NBP) remains a liquid market, the UK needs to align its market to European hubs closely enough to encourage sufficient participation to ensure the market sends the right price signals.

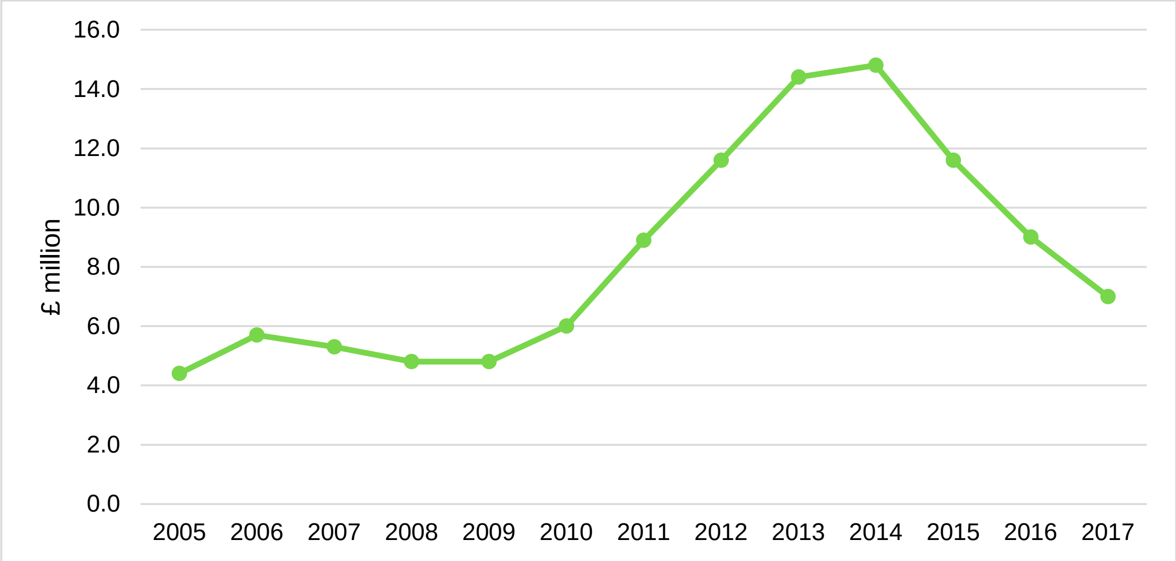
The current trading arrangements help to ensure lower prices and improve security of supplies for both sides by improving the efficiency and reliability of interconnector flows. However, the worst case scenario is isolation of the UK that will have an adverse impact on liquidity of the gas market and could push prices up. The White paper on Brexit published in February this year clearly states that the UK will seek such a solution, which will avoid disruption to the energy flows to Ireland and the Continental EU. So stating that Brexit will have a limited effect on the gas market and supplies, however, does not mean that the UK gas industry will be immune to the Brexit outcome. One interesting factor could be the potential for a separate UK/US trade agreement, but the likelihood of preferential rates for LNG imports from the US are quite distant.

How will Brexit impact the UKCS investment?

One of the most important concerns of the UK gas industry is to ensure that the UK continues to be an attractive place for investment in the post-Brexit era. In practice, this will depend on a combination of economic and policy-related factors.

The stabilisation of UKCS gas production and improvements in efficiency have been attributed to the surge in investment in the industry over the last 5 years (see Figure 2 below) – this is considered to have been mainly driven by changes in oil and gas prices and exchange rate movements. There are currently seven larger gas fields being developed in the UK, four of which (Culzean, Edradour, Glenlivet and Harrier) are expected to come on stream between 2017 and 2019. The commissioning of the other three fields (Tolmont, Fram and Arran) has been put on hold, not due to Brexit but as a result of oil price developments. In addition, there is currently no evidence that companies have withdrawn or postponed their investment in the UKCS because of Brexit.

Figure 2: UK: UKCS Oil & Gas Capital Expenditure, 2005-2017



Source: Oil & Gas UK

In addition to being influenced by oil prices, investors require policy certainty – they need to be certain that the government recognises that the UK oil and gas tax regime needs to be predictable and internationally competitive. Investors have been reassured by the confirmation, in September 2016, that the UK Government still plans to cut the corporate tax rate to 17% by April 2020 (which compares with the EU average of around 24%). In addition, in April 2016, a raft of measures were announced specifically to boost the UK's oil and gas industry. Brexit could provide the UK government with greater flexibility to set commercial terms and levels of taxation. However, there are concerns over whether it will have the will and the time to spend on this matter as it is likely to be focussed on wider negotiations.

One area where Brexit could have a significant impact on investment is through the finance provided to the sector by the European Investment Bank (EIB). Once the UK is no longer a member of the EU, the terms and conditions attached to loans from the EIB are likely to deteriorate. Although there are many other sources of capital, the UK industry's inability to benefit from the EIB's preferential terms will increase its costs.

In aggregate, we consider that oil prices are likely to remain the most important determinant of the level of investment in the UKCS.

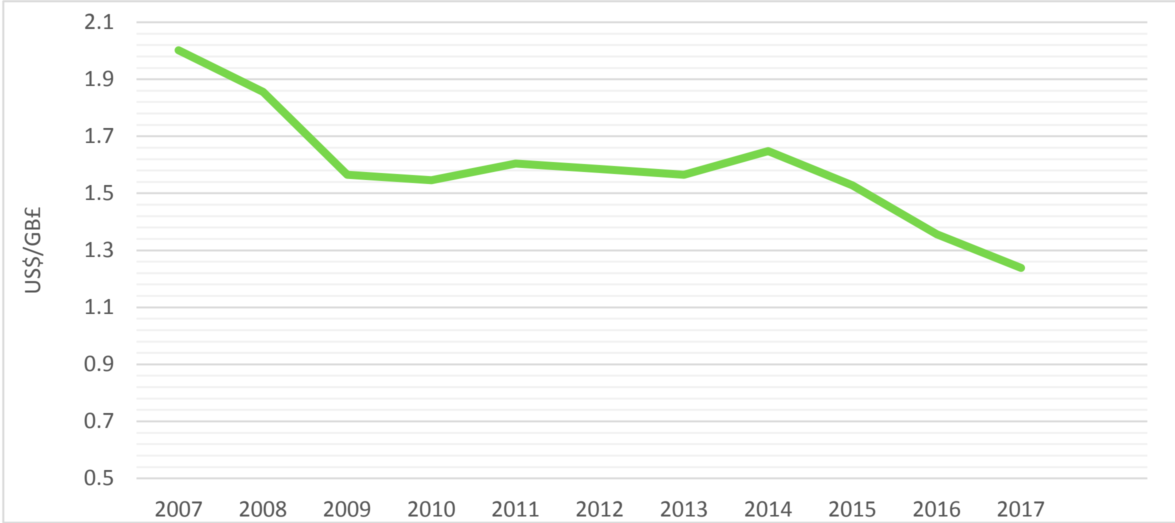
Influences on future gas prices

International commodity prices will continue to be the determinant of the success of the industry. However, gas markets are still regional in nature and gas prices respond to factors unrelated to global oil markets, such as weather-related seasonality in demand, storage capacity utilisation, and the investment cycles in the LNG world, and the strategy of a few major gas exporters. Nevertheless, the oil price will continue to influence the movement of European gas prices, in particular due to inclusion of the oil price in both Asian LNG term contracts and in a (diminishing) number of European long-term pipeline contracts. And, even if the influence of oil prices on UK NBP price formation is gradually going to diminish, the impact of US Henry Hub prices will become a factor following the build-up of US Gulf Coast LNG exports to the Atlantic Basin. Any uncontracted LNG from the US will be available to UK and European hub markets, presenting more arbitrage opportunities between US Henry Hub and NBP / Title Transfer Facility (TTF) markets and could effectively cap gas prices at the NBP.

Exchange rate movements will define ultimate gas prices

As seen in the Figure 3 below the GB£/US$ exchange rate has seen a rapid decline since 2014 and continued to decline in early 2017. Combination of factors, such as slowdown in the UK economy growth, uncertainties surrounding Brexit, postponed increases in UK interest rates, while interest rates are likely to rise in the USA. All combined, this is likely to keep the GB£/US$ exchange rate low to the post Brexit time. These developments will therefore push upward pressure on domestic gas prices in the UK. Effectively the exchange rate between Sterling and the US dollar will have a significant say in the price the UK customers will have to pay for their gas.

Figure 3: Yearly Average Exchange Rate US$ per GB£, 2000-2017



Source: UK Forex

Demand will depend on carbon price and power fuel mix, not Brexit

Future domestic demand for gas will largely depend on the future fuel mix in power generation and that will be determined by the competitiveness of each fuel. The UK's power industry will face exceptional challenges in the coming decades as it strives to meet medium and long-term carbon emission reduction targets. The achievement of these targets will require a substantial expansion of the use of low carbon electricity generation technologies. The EU Emissions Trading System (EU ETS) has been developed to facilitate this change and has been complemented by the UK government's addition of a "carbon tax" on power generators and industry to increase the incentive to switch to lower carbon sources of energy. In Budget 2014 the Government announced that the Carbon Price Support component of the floor price would be capped at a maximum of £18 per tonne/CO2 from 2016 to 2020 to limit the competitive disadvantage faced by business and reduce energy bills for consumers. This was extended to 2021 in Budget 2016. Following the implementation of the Carbon Price Floor in the UK, the European Commission considered, but ultimately rejected, a similar system to reform the EU-ETS.

Targets for reductions in the level of emissions and the use of renewables were set at the EU level, and the UK has been a leading party in promoting these targets, as well as in developing environmental legislation. It currently appears unlikely that the UK would renege upon these commitments in the post-Brexit period – it is considered that such a move would be highly unpopular. Although membership of the EU-ETS remains open to question (and its impact on UK carbon prices uncertain), it is worth noting that the EU ETS has had little impact on the UK gas market. Instead, the carbon price floor set by the UK government alone will continue to be one of the main environmental policy impacting gas consumption. At the moment gas is still seen as a bridge to a decarbonised economy.

The UK influence on Europe will slowly diminish

The EU has been a member of a number of EU agencies, one of them is EU's Agency for the Cooperation of the Energy Regulators (ACER). The UK's membership of ACER will cease once it leaves the EU. The UK has chaired ACER's and the Council for European Energy Regulator's (CEER's) boards for a number of years offering ample opportunity to influence policy and regulatory developments. While most of the tasks of these agencies relate to cooperation among EU Member States, some activities require, or may benefit from, collaboration with regulatory entities in third countries, such as Norway and Russia. This is particularly relevant to infrastructure interconnections. So this would still leave a window opened for a dialog. Also, the UK has been ahead of most of the European Union in liberalising its energy markets and the rest of Europe has been trying to emulate elements of the UK model. In the past this gave the UK a higher profile and created many opportunities for the industry to share its knowledge, both directly and through consultancy services. Post-Brexit one can argue that the dialog will continue but the scale of influence is likely to decline.

Brexit could hamper recruitment of services and labour from abroad

The UK's oil and gas industry is reliant to a great degree on the employment of people (it employs some 300,000 people both directly and indirectly) and the provision of professional services from abroad. As a result, the industry will face significant new challenges if the Brexit negotiations result in restrictions on the employment of expatriates and potentially increased taxes and tariffs on imported goods and services. These challenges may stimulate an increase in the provision of educational and training schemes for local people and the establishment of new service companies in response to the industry's needs. However, it is considered that this will only happen with government support.

An overview of the UK Gas Industry under a "Hard Brexit"

Future Gas Flows

WTO custom and tariffs will apply. Peak shaving flows and imports from the EU will be reduced while domestic demand continues to shrink.

Production from the UKCS will be stabilised due to higher investment encouraged by more attractive investment incentives, which will reduce future requirements.

LNG imports are likely to increase as LNG becomes more competitive against EU gas sources in the UK premium price market.

Investment into the UKCS

International upstream companies whose earnings are mostly in US dollars would invest in the UKCS if tax regime, decommissioning relief and other investment incentives are in place and endorsed by the government.

This is likely to boost domestic gas production. On the other hand, the UK membership in EIB is likely to cease, which may prevent EIB infrastructure funded projects in the UK (e.g. gas distribution network).

Domestic Gas Prices

Assuming increased reliance on US LNG, gas prices are likely to be increasingly influenced by Henry Hub gas prices denominated in USD.

The depreciation of Sterling, combined with the impact of this change on European hubs would mean higher domestic prices.

Higher prices will be detrimental to demand from both household and business customers. Gas used in power generation could also be curtailed.

Hiring Labour and Services

The expected strict restrictions on immigration may hamper recruitment of professional services and labour from abroad. If this occurs it could endanger efficient operation of the industry.

Additional educational and training schemes will therefore be required for domestic resources. This could provide an opportunity to create new companies to provide these services.

Exchange Rate

Hard Brexit will mean the continuation of a suppressed GBP value in the medium term if the expected slowdown in economic growth occurs.

Access to Europe

UK will lose membership in ACER and other EU institutions. This will reduce the UK's ability to influence the EU policy development.

WTO custom and tariffs may apply, which could hinder trade as prices are inflated by additional duties. Companies wanting to access the EU may consider relocating to the Continent.

Upstream Margins

International gas companies could see their margins grow as the exchange rate depreciates – their earnings are denominated in USD while their expenses are priced in GBP.

How can we help?

IPA Advisory provides advisory services along the full oil, gas and LNG value chain, from upstream development to downstream markets. Our experts provide techno-economic, commercial and market fundamentals analysis, as well as regional and global insight. We are supported in our views of the UK and European gas market by our Power market specialists and Policy and Regulatory team experts.

What services have we recently provided?

IPA has helped a range of clients to develop strategies, assess energy markets and identify commercial project risks. We have advised on market entry, commercial arrangements and asset due diligence reviews, assessing competitiveness and risks. We provided everything from bespoke regional and global market insight, price forecasts (gas, oil, power and refined products) to commercial analysis.

IPA's experienced team has vast experience of numerous international gas and LNG projects and downstream acquisitions. We have extensive experience in undertaking project appraisals, economic and financial analysis of the full value chain. Such experience allows us to develop intuitive insights, provide robust and compelling advice, and develop workable integrated solutions and recommendations.

Who have we worked with?

IPA works with governments, national and independent oil and gas companies, utility companies, private equity investors, banks, regulators and lawyers in the UK, Europe, Russia/CIS, the Middle East, Africa and Asia.

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