Brexit Monitor
A European view
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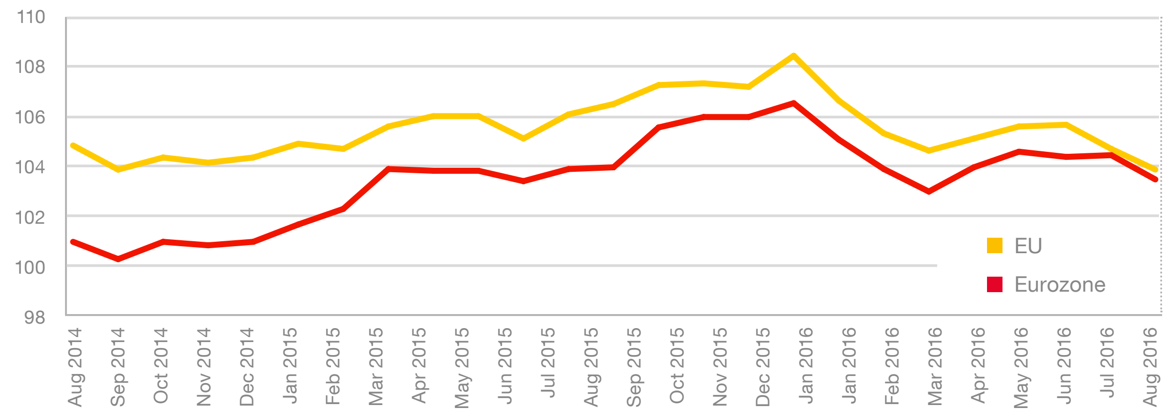
European sentiment and a Brexit impact on the energy sector

August has seen some decline in economic sentiment in both the EU and the Eurozone. Nonetheless, as sentiment is still above its long-term average we remain moderately optimistic about economic growth in Europe. In this issue of the PwC Europe Brexit Monitor we look at the Economic Sentiment Index (ESI) that is reported monthly by the European Commission, and we take a closer look at the Brexit impact on the energy sector.

Overall the ESI showed a decline in August. For the European Union the ESI fell 0.9% to 103.8 in August from 104.7 in July this year, while the ESI for the Eurozone declined with 1% to 103.5 in the same period[1]. In case of the Eurozone this index value represents the lowest level since March this year. Noteworthy is that the smaller decline in the ESI for the EU and in comparison to the Eurozone, can be attributed to an improvement of sentiment in the UK (+1.4% to 104).

Economic Sentiment Indicator (seasonally adjusted)



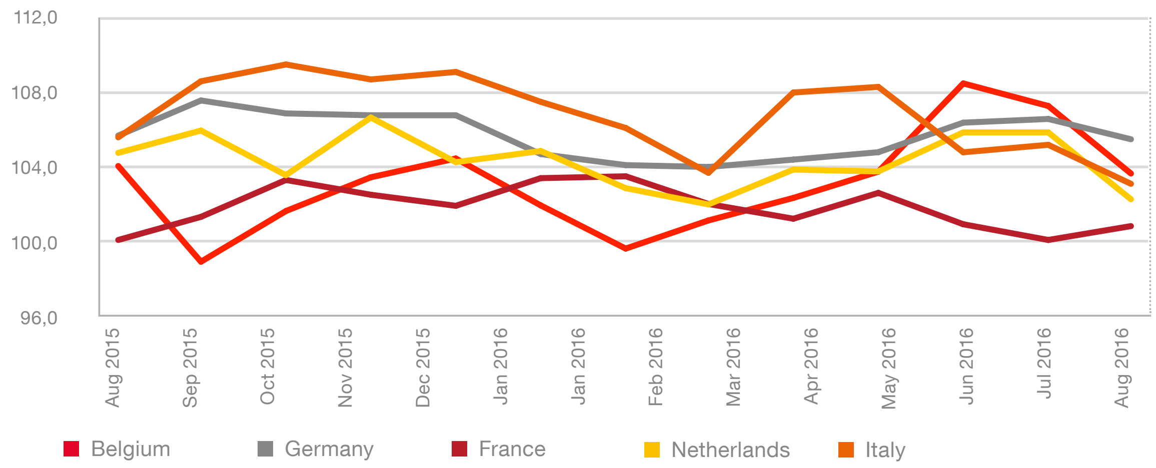
Source: European Commission. Note: long-term average (1990-2015) = 100.

[1] European Commission, Business and Consumer Survey Results, 30 August 2016.

The decline in sentiment in the EU could largely be attributed to confidence in industry and construction[2]. Within industry, the "production trend observed in recent months" component deteriorated significantly in August, while the (export) order books component also weakened. As such, both backward and forward looking indicators showed weakness in August. Employment expectations improved however, and stocks in finished products remained the same. In services forward looking indicators, like evolution of demand and employment for the next three months weakened only mildly. All in all, services remain resilient and counterbalance weakness elsewhere.

With respect to the Eurozone, the deterioration in business sentiment was broad based, as it was influenced by almost all sectors, only construction held up relatively well[3]. On a national level (see the graph on the right) the decline of ESI was more pronounced in the Netherlands and Belgium (-3.6 points), and smaller in Germany (-1.1 points), while sentiment actually improved somewhat in France (+0.8 points). In Belgium weakness was broad based, and particularly retail trade showed a marked deterioration. The Netherlands was more of a mixed bag with weakness in industry, but strength in retail trade and construction. A decline in the order book component was partly to blame for weakness of the German industry component, but not at a cost of production and employment expectations, which improved. The relative strength of sentiment in France was mainly due to an improvement in the services component. In Italy, where some banks struggle with non-performing loans, sentiment deteriorated further to the lowest level in 18 months.

Economic Sentiment Indicator for selected countries



Source: European Commission.

The decline in economic sentiment contrasts with the increase in the Composite Purchase Manager Index (PMI) for August, that we reported about last week. Can the decline in ESI be attributed to the UK referendum outcome? This is hard to substantiate. As the graphs show, sentiment can be volatile, and can be related to various factors.

[2] Idem.
[3] Idem.

The decline in August may also be seen as a continuation of a downward trend since December last year, when concerns about Chinese economic growth were elevated. This time it may not only be Brexit and its (possible) aftermath, but also worries about Italian banks, geo-political events such as increasing tensions between Ukraine and Russia, the threat of terrorism and concerns about growth momentum in Europe, as e.g. support from lower oil prices is abating. Regardless of all these factors, sentiment is still above its long-term average and points to positive economic growth.

Merkel's Europe tour

Last week the German Chancellor met with 15 EU leaders over the course of five days in a diplomatic 'tour de force' aimed at preparing next month's Bratislava Summit – a meeting which will convene the 27 member states that will remain in the EU once the UK leaves, and which will address the growing gap between the EU and its citizens. After meeting her French and Italian counterparts on the island of Ventetone outside Naples last Monday, Angela Merkel headed onwards to Estonia and the Czech Republic, followed by Poland, where she held both bilateral talks with the Polish Premier, as well as multilateral talks with the Visegrad group of countries (comprised of Poland, Czech Republic, Slovakia and Hungary). Following this were meetings in Berlin with the new northern European core of the Netherlands, Denmark, Sweden and Finland, as well as the south-eastern flank of Slovenia, Austria, Bulgaria and Croatia.

The focus on the EU's eastern members is no accident, but part of a concerted plan to bridge the growing gap in the EU after the UK's vote to leave the bloc. Following the UK vote, Eastern European member states were quick to express strong concerns over further and deeper integration of the EU, while older members, led by France and Italy, have urged the EU to push ahead with further integration efforts. At the same time, the electorates in Central and Eastern Europe remain among the most pro-European and many people fear the disintegration of the EU, which has provided prosperity and stability in the region. This does however not translate into support for a vision in which more powers would be transferred to EU institutions.

As the divide in the EU deepens, Central and Eastern European member states dread being left out and shun any development which would lead a two-speed Europe, where the Eurozone would integrate even further, but other member states would be left out. In a potential attempt to avoid a divide along those lines, economic issues have been conspicuous by their absence during last week's string of meetings. Instead, the focus has been on what Europe can do within its current powers to become more relevant to its citizens.

In parallel to the German Chancellor's meetings, the Greek prime Minister, Alexis Tsipras, has called for a meeting of southern European member states in an attempt to form a consensus between them before the Bratislava Summit.

Merkel's suite of meetings is an important signpost not only because of the alliances starting to form, but because it once again signals the importance of national politics in forthcoming discussions on the future of the EU, as representatives of Brussels based EU institutions were absent in the meetings. As such it is national capitals, and most of all Berlin, that will be in the driving seat in an EU post-Brexit. This complicates matters for a number of reasons. Most importantly, a surge in anti-establishment parties across the EU has made governments increasingly preoccupied with domestic politics, sparing very little political capital for the EU project, and failing to agree even on the EU's most acute challenges such as the migrant crisis. If anything, the strong role of national capitals in a post-Brexit EU, as well as in the exit negotiations with the UK, would make it even harder to agree on the way forward for the EU.

The energy sector

Brexit impact on the energy sector

Heightened uncertainty has been the most direct effect of the UK's vote to leave the EU. While the impact on stock markets was short-lived and the FTSE100 recovered already in the week immediately following the vote, uncertainty has had a more sustained impact on the pound sterling exchange rate and has put some larger investment projects on hold.

That said, the energy sector is a truly globalised industry with big companies that have proven to be able to resist external shocks. The oil and gas industry for one, is inherently cyclical and used to dealing with uncertainty. Large companies in the energy sector are used to navigating political uncertainties and mitigate risk, from the deltas of Nigeria to sectarian wars in Yemen. Brexit related risks may therefore be the biggest for smaller niche players that are less diversified, and also if they are largely exposed to the UK. Large players will be able to weather eventual shocks.

Likewise, the vote has had limited impact on European and global energy markets, and we predict that the effects of Brexit on for example oil and gas prices, will likely be minimal. The most visible consequence of the Brexit vote in the immediate future is therefore on UK energy import costs. For the rest of the EU business will continue as usual in the period that the EU and the UK negotiate the UK's exit terms and until the UK leaves the European Union. The terms of the exit and the subsequent relationship to be agreed between the EU and the UK will instead dictate longer-term impacts. Below we look at the economic effects in the short-, medium- and long-term, as well as the political and regulatory effects and a few topics of common interest to the wider energy industry.

In the short term Brent crude prices seem unaffected by the vote.

Europe Brent crude spot price US$ per barrel

Source: Reuters

Economic effects

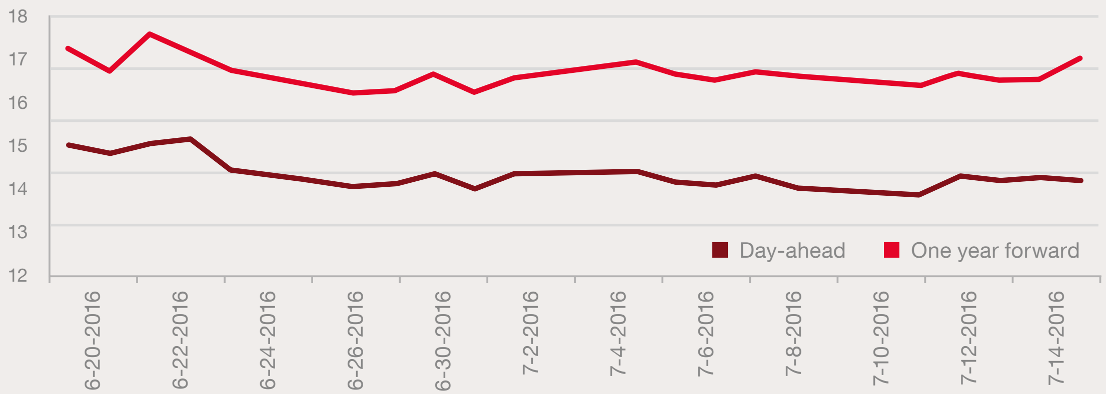
The energy sector

Short-term: the exchange rate

For the UK the most immediate effect of Brexit is increased energy costs due to a weaker pound, as the UK is a net importer of energy, and imports petroleum, gas, coal and electricity.[4] While the 20% value loss for the pound sterling that some predicted before the vote has not come true, the current loss is significant enough for effects to feed down the supply chain. This is particularly true for oil imports. UK gas contracts on the other hand are stipulated in pounds which has led to an increase in UK gas exports in recent months, with trading on the UK's National Balancing Point (NBP), up by around 3.3% for July and August contracts respectively. However, in the longer term the UK's departure from the EU may mean that the NBP loses is position as a European trading hub and this short-term pattern may reverse.[5]

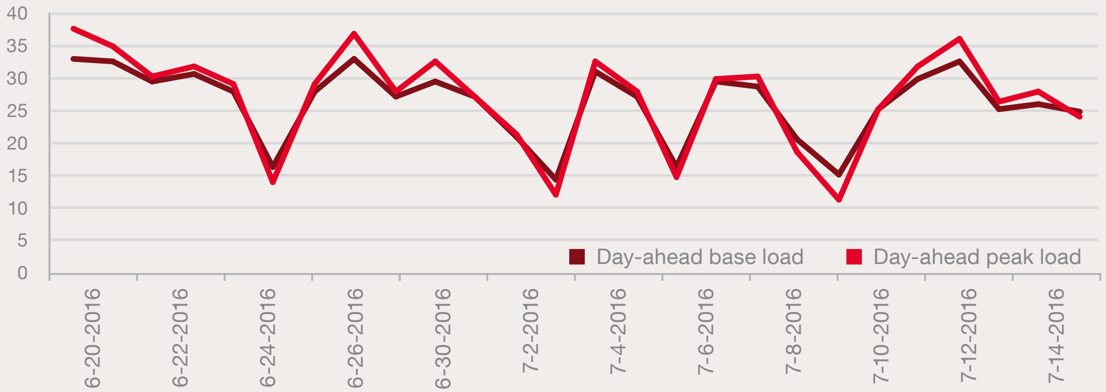
However, for EU players the effects are much more subdued. The UK mainly imports electricity and gas from mainland Europe and both exports and imports electricity to/ from Ireland, varying according to wholesale price differentials. There are currently electricity interconnectors between France and the UK (IFA, 2GW capacity), between the Netherlands and the UK (BritNed, 1GW capacity), as well as between Ireland and the UK (EWIC, 500MW capacity). ElecLink (1GW capacity) and NEMO (1GW capacity) are both

The Netherlands wholesale gas prices (€/MWh)



Source: Reuters.

Germany wholesale power prices (€/MWh)



Source: Reuters.

[4] Its net import dependency rate was 38.6% in 2015.
[5] There has been some speculation suggesting that the Netherlands' Title Transfer Facility (TTF) could stand to benefit from such a develoment.

The energy sector

due to come online in 2019, connecting the UK and France and the UK and Belgium respectively. Gas interconnectors currently connect the UK to Belgium (IUK), the Netherlands (BBL) and Ireland (Moffat). Net imports of electricity remains a very small proportion of UK total primary energy supply, while gas imports are more substantial. Yet, in our estimations, it would take a much lower pound to make EU imports become unaffordable for the UK and hence increase domestic production and/ or alter import-export patterns.[6]

Medium-term: the business cycle

Likewise, as the UK economy slows, energy demand would be expected to decrease leading to price drops and/or consequences for the EU countries that export energy – mainly power and gas – to the UK. So far such effects are conspicuous by their absence as UK sentiment has held up – both consumer confidence as reported in issue 6 of this Monitor, as well as the ESI index reported on this week. As such prices have remained stable in key European power and gas markets, but the medium-term effects could yet trickle through.

Likewise, uncertainty surrounding both growth and regulation affects investment. However, again those effects are mostly felt in the UK where a lower pound may result in investment being put on hold or cancelled. For UK companies imported commodities has already become more expensive. The scale of planned infrastructure investment in the UK for example in the electricity sector over the next decade means that even small increases costs could have large consequences for total investment costs.

For EU projects though, the UK's vote to leave has no immediate effects except for cross-border projects. For the time being and during the negotiation period with the EU, the UK remains a full member of the European Union with full access to EU sources of funding such as the EIB. In the longer term however, post-Brexit, UK projects, or cross-border projects involving the UK, would no longer qualify for some types of EU funding. However initiatives such as the European Fund for Strategic Investments (EFSI) could at least in theory support cross border projects also with neighbouring countries.

Long-term: Labour mobility and skills

In the longer term decreased mobility and a shortage of skills, particularly in the oil and gas industry, could be exacerbated when the UK leaves the EU. Restriction in mobility for EU and UK workers as a result of Brexit can become a concern for both workers and companies. In the oil and gas sector this would be particularly true where companies have "off-shored" teams or use shared service centres that currently cover all of the EU, including the UK. In the future, separate centres and locations may need to be set up for the EU versus the UK.

Nonetheless, in the grand scheme of things the energy industry is largely a global industry used to dealing with both uncertainty and regulatory complexity. As such, smaller companies that operate more locally and are less diversified are the most exposed. For the industry giants our expectations are that they will be able to adapt rather quickly to an environment post-Brexit as they regularly move staff across borders outside and inside of the EU already today.

[6] We estimate below parity.

Politics, regulation and tax

The energy sector

The UK's role in European Energy Markets

In this context the biggest impact of Brexit for Europe may for the EU project as such. With the UK's departure the EU would lose an important liberal voice in the debate, also in relation to energy policy and European market integration. The UK has been an important proponent of liberalised EU energy markets and the EU's Third Energy Package, a legislative package aiming to liberalise European gas and electricity markets. Given that the UK government has been at the forefront of efforts to liberalise and develop cross-border energy markets, it is likely that the UK would continue to implement and be supportive of many aspects of the Third Energy Package. For example, the unbundling requirements, which require the separate ownership and operation of electricity/gas transmission systems from any generation, production and supply interests; the level playing field; and the standards of transparency. The UK appears committed to market-based interventions in energy markets and supports EU initiatives such as market coupling. It might therefore be that the UK continues on a policy trajectory set out by the EU also post-Brexit, and that differences in regulation remain minimal, at least in the short-term.

On the other hand, without the UK, EU energy policy may get a stronger regulatory focus. So while the UK may continue its policies towards more liberalisation it may be that in the EU new initiatives may focus more on market regulation. In the longer term regulation may therefore diverge between the EU and the UK and companies operating across Europe may encounter more red-tape in an EU where the UK voice is absent.

For the UK to be able to participate in the European internal energy market following Brexit, it would need to negotiate an appropriate partnership with the EU, and adopt and comply with the relevant European legislation. One way in which this could be envisaged, would be similar to the agreement between the EU and the countries in South East Europe and the Black Sea region that are part of the so called Energy Community, which aims to extend EU internal Energy market rules and principles outside the EU's borders.[7] Yet, the UK would not have a say in the political process to formulate EU policies and regulations. Only if the UK would manage to negotiate to remain part of the institutions which interpret and co-ordinate EU energy regulations, such as ACER, ENTSO-E and ENTSO-G, would the UK have some say in shaping the direction of the future EU energy markets.

Trade between the EU and the UK

Likewise, once the UK has left the EU, trade between the UK and the EU will be impacted, including energy trade. There are a number of outcomes possible for the future relationship between the UK and the EU, and how the two parties can structure the UK's access to the broader EU energy market and it is yet early to predict.

Nonetheless, it is unlikely that the energy sector would be hit by high tariffs post-Brexit. Non-tariff barriers such as increased regulation and limitations on the mobility of staff is likely to be a larger puzzle for cross-border activity in the energy sector. However, for the UK, the oil and gas industry remains the largest industrial investor in capital expenditure even at today's oil prices and it would be concerned if import tariffs rose even marginally. There is also some concern about the ability to influence EU policy on critical areas such as steel tariffs which make up a very large part of costs for capital expenditure in the oil and gas sector, for example. Tariffs and transfer pricing are already complicated issues for pan-European groups and depending on the nature of future EU-UK trade relations, Brexit may complicate things further.

[7] The Energy Community is an international organisation which brings together the European Union and its neighbours to create an integrated pan-European energy market. The key objective of the Energy Community is to extend the EU internal energy market rules and principles to countries in South East Europe, the Black Sea region and beyond on the basis of a legally binding framework. Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Moldova, Montenegro, Serbia and Ukraine are contracting parties. Armenia, Georgia, Norway and Turkey hold observer status, with Georgia presently in the process of joining.

On everybody's lips

The energy sector

Carbon pricing

EU carbon pricing slumped in the direct aftermath of the UK's referendum vote and continued to fall in July. At the end of July analysts cut their ETS price forecasts by 9-18%. The UK is the second-largest emitter of greenhouse gases in Europe and as a result its utilities are among the largest buyers of permits in the ETS scheme. In the past, the UK has also been a stark promoter of measures to drive up prices, but will no longer have influence to shape future regulations. Nonetheless, most analysts expected Britain to remain in the EU ETS and as such the current trend should be seen as a loss of confidence rather than a radical change in ETS market fundamentals. In addition, the EU is currently working on market reforms that will reduce the share of free carbon permits handed out after 2020 as part of an effort to remedy the oversupply in the system and boost prices.

Hinkley point

Hinkley point may be the most discussed casualty of the UK's decision to leave the EU, albeit the least easy to assess. The re-assessment of the Hinkley point plan remains a political decision by the government in the UK, and while the new government came into power after the Brexit vote, it is unclear what role the nuclear power project will play in the UK's broader energy agenda post-Brexit, or whether decisions regarding the project may play a part in the UK's negotiations with the EU.

The UK North Sea: Oil and gas exploration

The outlook for North Sea oil and gas production will continue to be impacted mainly by the oil price recovery trajectory and UK regulatory policy, so yet again Brexit impacts will be contained. However, the exchange rate may impact costs and margins. For UK oil and gas operators this is not all bad news as a sustained depreciation of pound sterling may benefit those actors that will operate from a lower cost base relative to US dollar denominated oil and gas prices.

Uncertainty about how the decoupling process from the EU will happen, could however increase perceived risk for operators in the North Sea and potentially deter or defer large, new investments. Particularly for the oil and gas sector in the North Sea, another concern will be the access to skilled labour and how new visa regimes might complicate conditions by removing access to a flexible workforce that can be easily shifted between European projects.

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