



E3G



REPORT April 2017

**BREXIT SCENARIOS
THE IMPLICATIONS FOR ENERGY
AND CLIMATE CHANGE**

SHANE TOMLINSON

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The author is grateful for feedback received from members of the Greener UK coalition on an early draft of these scenarios. The judgements and any errors remain the sole responsibility of the author

About E3G

E3G is an independent climate change think tank operating in the public interest to accelerate the global transition to a low carbon economy. E3G builds cross-sectoral coalitions to achieve carefully defined outcomes, chosen for their capacity to leverage change. E3G works closely with like-minded partners in government, politics, business, civil society, science, the media, public interest foundations and elsewhere. In 2016, E3G was ranked the number one environmental think tank in the UK. www.e3g.org

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EXECUTIVE SUMMARY

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.

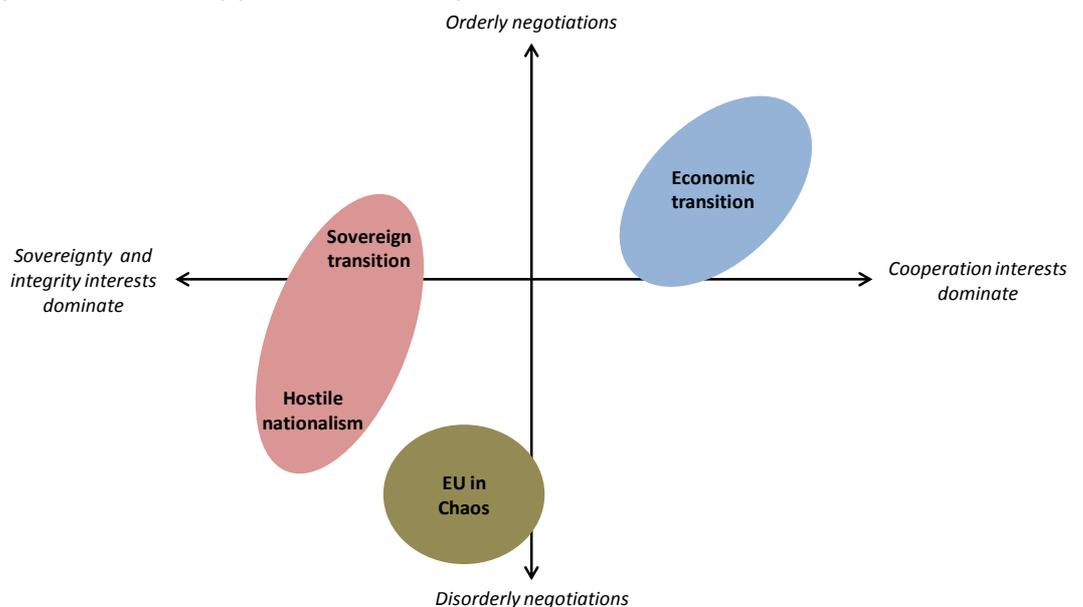
The scenarios are built on four key drivers:

- **How national interests are prioritized by each side:** To date energy and climate change issues have not played a prominent role in Brexit discussions. Instead the UK has chosen to prioritize sovereignty interests to manage immigration and remove the influence of the Court of Justice of the European Union (CJEU) and State Aid restrictions. The EU has so far promoted an integrity agenda focused on maintaining existing rules and norms (such as the four freedoms) and to hold the UK accountable for existing budget liabilities. As the negotiations progress, how these interests interact and evolve will be critical in determining the final outcome.
- **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, such as happened in the final hours of the Copenhagen climate negotiations in 2009. A breakdown of process would undermine trust and make reaching any deal much harder to achieve.
- **The timing and extent of any economic impacts:** So far the economic forecasts of large negative impacts in the UK following the referendum have not materialized. The devaluation of the Pound and the fact that the UK continues to enjoy access to all existing EU trading arrangements is a significant factor in achieving this. However, this does not mean that there will not be economic impacts in the future. The potential for rising inflation and political uncertainty to undermine investment decisions over the next two years is non-trivial. On the EU side the devaluation of the Pound has immediately undermined competitiveness vis-à-vis UK companies. In effect causing them to immediately begin to 'price in' the cost of Brexit. Depending on how the negotiations evolve, the economic outlook in both the UK and remaining EU-27 Member States may shift perceptions on the type of final agreement that would be desirable.

- 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 three year transitional arrangement. Thus the momentum from the Article 50 process will be important for determining future cooperation. There may be a number of stakeholders that will attempt to secure a clean break after 2 years, potentially to prevent any attempts to retreat from a full Brexit deal. On the other hand the desire to avoid cliff edges for business and citizens may lead to other stakeholders seeking to maximize the potential for continuation arrangements in order to allow for the smoothest possible process. 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 emerge as shown in figure 1 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 1: Overview of political scenarios for Brexit



The negotiating dynamics are 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, 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, represents a victory for extremist politicians in other EU countries (such as in the forthcoming 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 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.

The Sovereign Transition, Hostile Nationalism and EU in Chaos scenarios produce very negative outcomes for energy and climate issues on both sides. Any restricted access to the Internal Energy Market (IEM) for the UK increases energy prices and creates access issues for EU Member States such as Ireland. There is significant investment uncertainty and the UK's withdrawal disrupts implementation of the EU 2030 Climate and Energy Package and the Energy Union. Cooperation on energy security suffers and Russia is significantly empowered. The UK's withdrawal from Euratom undermines its civil nuclear programme which also has implications for EU based companies such as EDF. In both the Sovereign Transition and Hostile Nationalism scenarios the negative impacts are larger for the UK than the EU; while the position is reversed in the EU in Chaos scenario. Nonetheless, any of these outcomes is likely to provide a significant challenge to the low carbon transition on both sides of the Channel.

In contrast, the Economic Transition scenario provides a much stronger outcome on energy and climate issues. The inherent benefits of continued cooperation are maximized, providing stability for continued investment and delivery of existing programmes. However, at present this scenario is significantly less likely than either the Sovereign Transition or Hostile Nationalism outcomes.

The probability of a successful outcome on energy and climate change can be increased through the establishment of a cooperation track on these issues within the negotiations. The UK has already signaled that it would like to establish a broad partnership with the EU that goes beyond just future trading arrangements. However, it has so far limited the scope of this agreement to hard security issues. By creating a space to discuss future cooperation on energy, climate change and broader environmental objectives both sides can increase outcomes for these policy areas and reduce the chance of a crash Brexit that would damage everyone.

INTRODUCTION

The outcome of the UK's negotiation to leave the European Union will have major implications for many issues central to people's lives, including energy and climate change. Different outcomes will create very different risks and opportunities for policy and investment as the government continues to manage energy and climate security, environment and competitiveness objectives. Scenario analysis provides a tool to assess a range of different Brexit outcomes, and understand the critical drivers and decision points that influence different results.

The UK's energy and climate change policy is intimately linked with the EU. Energy is a 'shared competence' meaning that the responsibility for policy has been divided between central EU institutions and individual member states. The UK's energy market is physically connected to the EU with Britain importing 7% of its total electricity consumption from the EU.¹ The combination of EU states and Norway (which is a member of the European Economic Area) account for over 70% of all UK imported gas.² The open border between Northern Ireland and Ireland is also an energy border. The future relationship of the UK in relation to the Internal Energy Market (IEM) will be highly significant. The UK's wholesale electricity prices are among the most expensive in the EU. Being able to buy cheaper power from the continent through linked EU electricity markets is saving the UK consumers about £90 million a year at current levels of interconnection; but this is expected to rise to £160 million a year with more interconnectors by the early 2020s. Meanwhile, the demand from the UK provides revenue to EU producers. The arrangement benefits both sides.

Similarly, future growth in renewable use both in the UK and EU-27 Member States will require more system balancing resources. Research shows that sharing balancing resources with the EU could save the UK £3billion a year in system costs.³ More co-ordinated and strategic grid planning across onshore, offshore and cross border regimes could save the UK an additional £1.5billion to £10billion by 2030.⁴

Given the uncertainty of future energy fuel and technology prices, there is also substantial option value to be gained by supporting the development of a flexible electricity system. The existing Energy Community agreement that allows some southern and eastern non-EU Member States to participate in the internal energy market provides a precedent under which the UK could continue to participate in the market. It is important to note that for the UK to fully participate in the Internal Energy Market it would need to be willing to follow the rules of that market, including restrictions on State Aid. EU State Aid rules are designed to prohibit Member State Governments from giving specific companies or sectors an unfair advantage over competitors in other Member States. Such rules are necessary to create a level playing field on which Member States can trade freely. However, as outlined in the scenarios below this may prove to be a contentious issue within the negotiations.

On climate change policy the UK has negotiated collectively on the international stage with other EU countries; submitting a joint Nationally Determined Contribution (NDC)

for emissions reductions by 2030 to the Paris Agreement in 2015. As the collective EU climate change target for 2030 is translated into binding targets for individual member states through the Effort Sharing Regulation the impact of the UK leaving could have significant consequences. Similarly the UK is currently a major part of the European Emissions Trading Scheme (ETS), and so Brexit could have major implications on its future operation and viability.

BACKGROUND AND ASSUMPTIONS FOR THE SCENARIOS

Uncertainty over process

There are many uncertainties around how the Brexit negotiations will progress. Extracting the UK from the European Union is an immense task consisting of not one, but many linked processes of which five key areas are outlined below:

- Process 1: agreeing the UK's terms of withdrawal from the EU under Article 50 of the Treaty on European Union with reference to a framework for future cooperation
- Process 2: agreeing the UK's new trading relationship with the EU
- Process 3: agreeing the UK's new trading relationships with the rest of the world, including over 50 countries with which the UK would need to negotiate new trade arrangements.
- Process 4: changing the UK's domestic regulatory and legislative framework through the Great Repeal Bill and subsequent action
- Process 5: negotiating new cooperative actions/institutions with EU and other multilateral bodies which lie outside the scope of future trade agreements (e.g. covering issues such as air quality)

Some of these processes may be joined together at a negotiating level but several may remain separate and distinct. The overall timeframe of the negotiation is highly uncertain. Triggering Article 50 provides a two year window to conduct negotiations and can only be extended by unanimous agreement of all Member States, something that may be difficult to achieve in practice. However, the other processes highlighted above may take much longer. For example it took Switzerland 12 years to negotiate the majority of its sectoral deals with the EU and it has still not been able to conclude an agreement on energy issues; and the Canada-EU CETA negotiations have been ongoing for over 7 years. As such, in developing scenarios for Brexit it is important to consider the phasing and timeframe of different agreements and the potential 'momentum', either positive or negative, which could emerge after the Article 50 process is concluded.

On the EU-27 side the European Commission will lead negotiations in response to Article 50, guided by Member States (as outlined in figure 2 below), with the European Parliament getting a final vote. The UK Government has also promised a final vote for its Parliament on the deal, however, this will now be a 'take it or leave it' vote at the very end of the process and so may give little scope for adjustment.

Figure 2: Overview of EU Brexit negotiating process (timings are approximate)



Understanding different perceptions of national interest in the UK and remaining EU-27 Member States

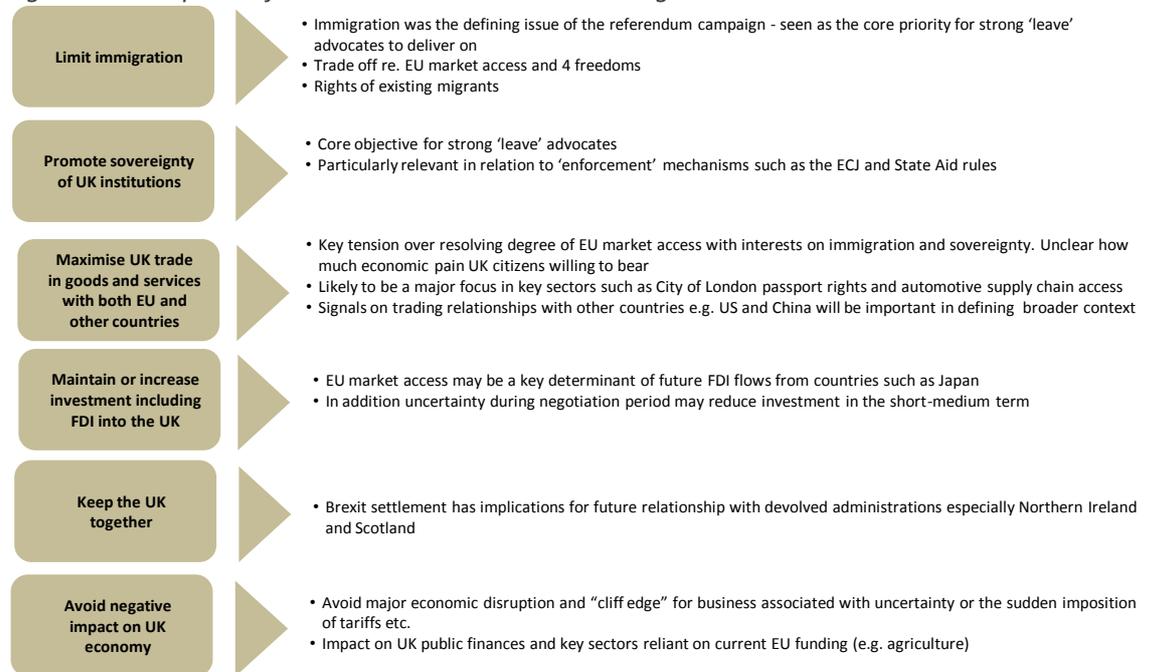
Different models for Brexit are popularly characterized as being on a spectrum between 'hard' options, generally associated with WTO or free trade agreement models, or 'soft' options, associated with the Norway and Swiss models of deeper integration. However, in practice using this terminology can lead to the creation of false choices. The key to any negotiated settlement is the one that reflects the underlying interests of those participating in the negotiation. Thus delivering a 'hard' or 'soft' Brexit is not an end in and of itself, it is how those settlements reflect different national interests over time that will be critical for determining success or failure.

In order to map national interests for both the UK and EU-27 we need to consider several dimensions. The most critical is between the objective measures of a different outcome (e.g. higher or lower GDP, judicial oversight by one body or another) and the weighting different stakeholders place on these outcomes. This may lead to deep divisions between different stakeholder groups within one side or another. The second important dimension is between overall interests that cut across all sectors and areas of policy and those that relate narrowly to energy and climate interests. This is important in relation to trade-offs across different areas. Thus, specific climate and energy objectives may be subsumed within broader negotiations on immigration rights etc. The third is how the perceptions of different stakeholders may evolve over time in response to progress (or lack thereof) in the negotiations or in response to real world events.

The views of many stakeholders at the moment are ‘emergent’ rather than sharply fixed. This is especially true on the EU-27 side where there has been less intense focus on Brexit than in the UK. Politicians, businesses and citizens across the EU have been focused on other events such as the emergence of Donald Trump in the US, the refugee crisis, and domestic factors such as the December referendum which led to Prime Minister Matteo Renzi resigning in Italy and forthcoming national elections, notably in France and Germany. A strong focus on Brexit positioning will only now emerge following the UKs submission of its Article 50 notification, and even then for France, Germany and Czech Republic the prospect of new leadership or coalitions may delay this process until much later in 2017.

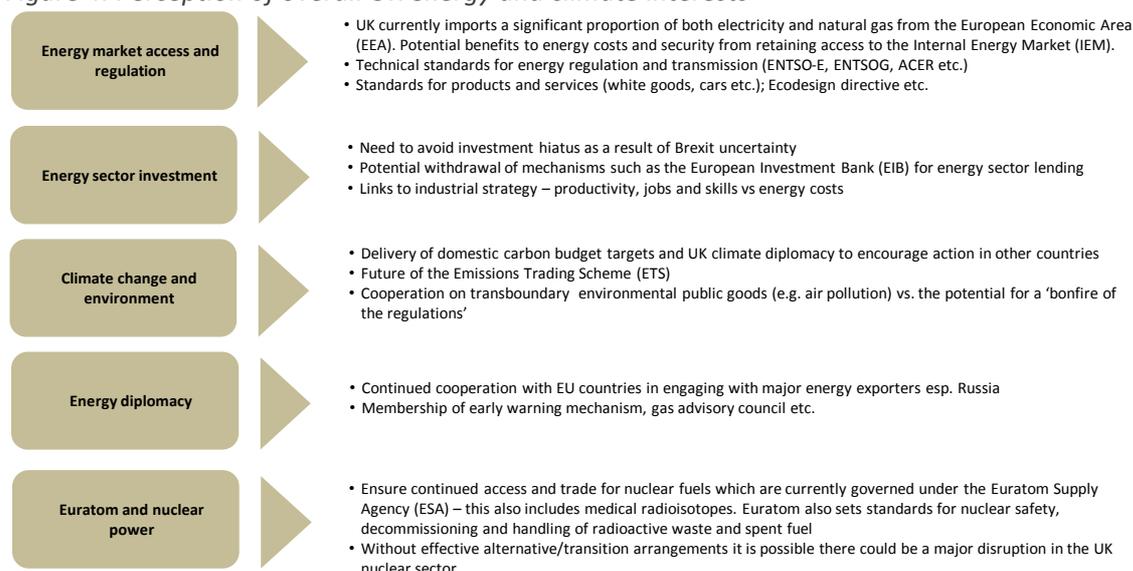
A summary providing a characterization of overall UK and remaining EU 27 country interests in the negotiations is provided in figure 3 below.

Figure 3: Perception of overall UK interests in Brexit negotiations



At present the position set out in the UK White Paper on Brexit puts forward 12 negotiating priorities. This has signaled that the UK is not seeking continued membership of the European Economic Area (EEA) through a ‘Norway’-type model and prioritizes the control of migration and judicial sovereignty over the other priorities. However, the White Paper remains an outline sketch of a negotiation position, and the balance between market access and sovereignty could still change. In addition to the overall interests in relation to Brexit there are a number of specific energy and climate change interests for the UK as highlighted in figure 4 below:

Figure 4: Perception of overall UK energy and climate interests



The UK White Paper on the UK’s Exit from and New Partnership with the EU acknowledges many of these issues but does not set out a particularly clear prioritization, instead saying that “we are considering all options for the UK’s future relationship with the EU on Energy”.⁵ In part, the complexity of the Brexit process has provided a challenge to the UK government in working through deep implications for all policy areas. In particular the new Department for Exiting the European Union will need to manage the interdependent nature of many of these issues, while drawing on the expertise of individual government departments that may be more used to operating in traditional Whitehall silos. This may provide for flexibility in the coming negotiations but also generates significant risks that energy and climate could be subsumed under broader negotiating priorities.

Box: 1 Euratom and the implications of Brexit for nuclear power⁶

The 1957 Euratom Treaty is one of the three founding treaties of the EU and established the European Atomic Energy Community (EAEC). Although the Euratom Treaty is a standalone legal entity, the UK Government has indicated in its White Paper that it also intends to leave Euratom as part of the Brexit process; although it will retain some flexibility and “have the most open mind possible” in discussing future arrangements.

Exiting Euratom could have major implications for the future of nuclear power in the UK. At present the Euratom Supply Agency is responsible for the supply of all nuclear material to the UK with “exclusive right to conclude contracts relating to the supply of ores, source materials and special fissile materials coming from inside the Community or from outside”.⁷ Euratom is also responsible for overseeing nuclear material safeguards and standards in the UK, including inspections of civil nuclear sites in cooperation with the International Atomic Energy Agency (IAEA). Euratom also has its own research and development programme which contributes significant funding to UK projects, including for fusion research.

On leaving Euartom the UK would need to establish a new safeguards and inspections regime through the IAEA and the UK's Office for Nuclear Regulations (or the establishment of a new agency). Suppliers of nuclear materials from countries outside the EU, such as Canada or the United States, will be required by their national laws and obligations to insist that the UK has a sufficiently robust security and safeguards regime in place before any exports could take place. Without either establishing new or transitional arrangements by the end of the Article 50 process it will be extremely difficult for the UK to continue to develop its civil nuclear business.

In a similar fashion to the UK, it is possible to sketch out some overall perceptions of interests and risks on the side of the remaining EU-27 countries and the European Commission as shown in figure 5 for overall issues and figure 6 for energy and climate specifically. As noted above there has been significantly less focus on Brexit in many other Member States so far. Different EU actors are likely to have different interests on Brexit, but so far have presented a highly united public messaging. For example Member States who are net recipients of EU budget payments, in particular Central and Eastern European countries, will be particularly exposed to any budget reduction following the UK exit.

In terms of the rights of existing migrants, Spain and France have particularly high concentrations of UK nationals resident in their countries; while Central and Eastern European Member States have a disproportionate number of their nationals currently resident in the UK. A core test for the EU-27 will be how they manage any tensions or differences over the prioritization of different issues as the negotiations progress, and the relationship between the Commission, Council and Parliament.

Figure 5: Perception of overall EU-27 and European Commission interests in Brexit negotiations

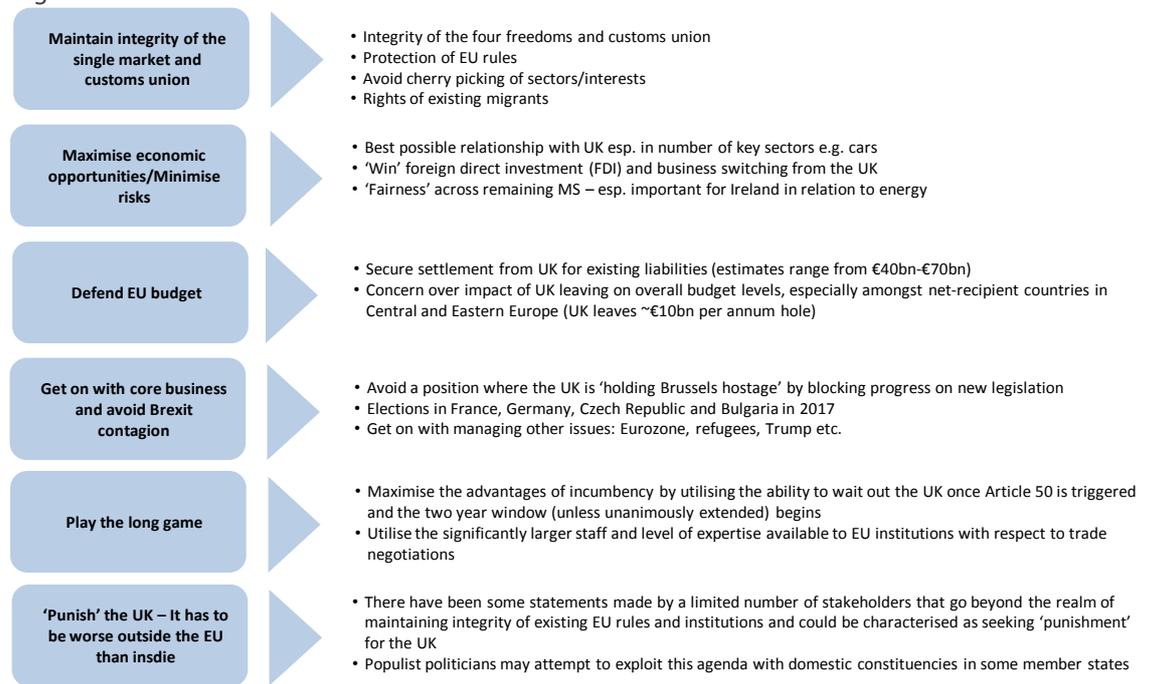
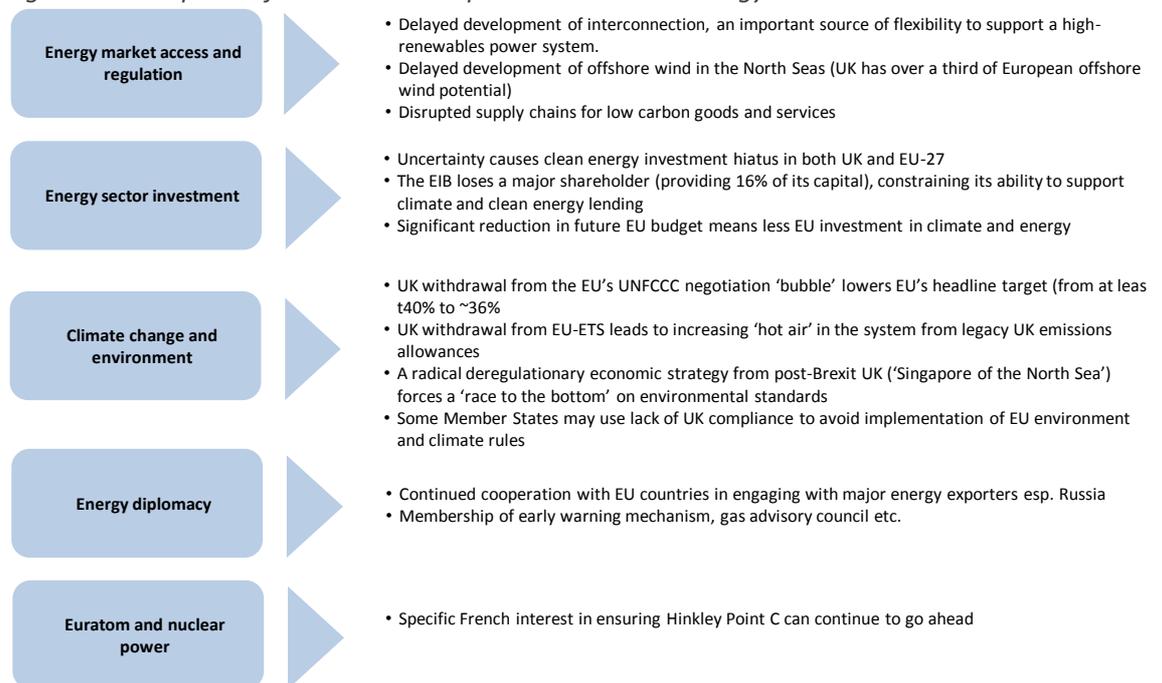


Figure 6: Perception of EU-27 and European Commission energy and climate interests



In particular there is an emerging dynamic between an integrity/punishment agenda that would seek to minimize flexibility in the negotiations and seek to 'win' business and investment switching away from the UK; versus a more cooperative agenda that

would seek to maximize continuing contributions from the UK to the EU budget and protect existing trading relationships.

SCENARIO DRIVERS

From the assessment of different processes and perceptions of national interest, a number of key drivers for future Brexit scenarios stand out.

Scenario Driver 1: Interaction between perceptions of national interest

The first major driver is how the UK and EU chooses to prioritize their perceptions of national interest. As outlined above there is no single view that is shared across all stakeholders on each side of the negotiation. How each side chooses which aspects to promote as core priorities versus what it is acceptable to trade-off in order to achieve them will determine the available space for a final agreement. Given the complexity of Brexit there is a significant risk that mistakes are made in understanding of issues and potential outcomes on either side. Clarity over intentions and the creation of trust will therefore be important in creating a successful negotiating dynamic.

Within the UK the main objective for Prime Minister Theresa May in the short-term is to control her party. As Theresa May personally campaigned for remaining in the EU during the referendum, the pro-Brexit forces within her party are closely watching to ensure delivery of the result. Given the weakness of the opposition Labour Party in the opinion polls, the greater risk to the current government is an internal split, either within her own party or with the devolved administrations, rather than immediate electoral defeat.

There is a strong agreement across the Conservative party on the need to control immigration, and this was a central theme of the referendum campaign. However, the pro-Brexit forces within the UK are a far from homogenous group. Instead there is a spectrum of opinion ranging from a highly deregulatory wing, led by figures such as Liam Fox, focused on maximizing trade and increasing globalization; to a much more protectionist wing which seeks to try and roll back from current globalization trends.

So far in her public statements on Brexit, and the 12 main principles outlined in the Governments White Paper, the Prime Minister has sought to align more closely with the pro-globalization, deregulatory forces within her party. However, there are inherent tensions in this position. In particular pursuing an active global trade agenda has led the Prime Minister to seek a rapid trade agreement with the new Donald Trump administration in the US; at the same time that President Trump is pursuing a strongly protectionist approach to trade and considering options to limit US involvement in the World Trade Organization. Depending on how these efforts to forge new trade relationships in parallel with the Article 50 negotiations play out, along with a range of other factors explained in the drivers below, the UK may decide to evolve its prioritization of national interests.

On the EU-27 side, as noted above, there has been a less public focus on setting out a detailed negotiating position, although this does not mean that preparations have not been developing in private. The main themes to emerge so far are protection of the integrity of existing rules and institutions and seeking a settlement on the EU budget that would see both a ‘divorce’ settlement and potentially continued contributions from the UK for ongoing programmes that it may still participate in once Brexit is complete.

Although statements about ‘punishing’ the UK have been limited to date, it is clear that there is the potential for significant escalation between the two sides. Thus, while many in the EU will start with a position that the UK will end up worse off as a result of leaving, the main focus will be on maintaining integrity. However, a limited number of stakeholders, especially populist politicians in some Member States may go further and actively seek to promote a punishment agenda. This underlying issue could emerge and escalate rapidly in the face of hostility or belligerence from the UK.

There is also a deep sense on the EU side that by playing a long game they can maximize the advantages of incumbency. The two year time limit on Article 50 negotiations massively strengthens the EU’s hand. Although the UK Prime Minister has pledged to ‘walk away’ from a bad deal, in reality there is nowhere realistically to walk to other than the very hardest of Brexits. Game theory suggests that the closer the expiry of the Article 50 window comes the stronger the EU position will be.

Scenario Driver 2: Orderly versus disorderly negotiation process

The second main driver is whether or not the process of negotiation is orderly or disorderly. An orderly process is one in which there is agreement on the sequencing of different processes in the negotiations and there is such a sufficient level of trust that both sides believe the other to be negotiating in good faith. A disorderly negotiation is where there is a breakdown or stalemate in the formal process and/or a breakdown in trust. The Copenhagen climate change negotiations in 2009 are an example of a disorderly process whereby the formal negotiating mechanisms failed, resulting in ad hoc groupings of heads of state meeting in backrooms (while some had to leave early to catch flights back to their capitals), trying to draft text by themselves and ultimately failing to generate sufficient trust to resolve their differences.

Given the complexity and political dynamics involved across the different countries and institutions involved in Brexit, it will be a significant challenge to structure engagement in a manner that is conducive to constructively identifying and resolving differences. Already there may be differences between the UK’s approach set out in its Article 50 letter, which envisages discussing in parallel the terms of withdrawal and a new partnership including a free trade agreement, and the draft EU negotiating guidelines which stresses that sufficient progress must be made on withdrawal issues before work on the new relationship can begin.⁸ How the negotiations are structured will materially impact the potential trade-offs and final outcome. Thus there is likely

to be significant effort invested by both sides in a ‘negotiation about the negotiations’ to determine this structure in the coming months. However, failure to reach agreement on the way forward would significantly undermine trust and entrench hard-line positions on both sides rather than working towards areas of compromise.

There are clear lessons from previous international negotiations (such as in trade, sanctions disputes, environment and climate change) that establishing trust between the main Parties is an essential precursor to concluding a successful outcome. If the Brexit negotiations collapse into a disorderly mess dominated by narrow concerns, this would severely limit the scope of potential agreement. The timing of broader political processes, especially the French and German elections in 2017, will also have a significant impact on the negotiation process. Changes in government (historically it can take several weeks for new German coalitions to be agreed) may lead to new signals and priorities for the European Commission and could mean that the EU may not have finalized its positions on many issues until late 2018. This could further increase the chance of confusion in the process and compress the time for full negotiations.

The desire to present negotiation outcomes as a success at home, can lead to a situation where negotiations are uniquely focused on the areas of leverage instead of those of mutual benefit. In terms of leverage in the negotiation the UK perceives the impact of its withdrawal on the EU budget (approximately €10bn per annum), its contribution to military defence, and the threat of creating a highly deregulated economy on the periphery of Europe (sometimes referred to as “Singapore in the North Sea”) as being central to its negotiating strategy.

For the EU the power of incumbency, the ability to maintain the integrity of existing rules and institutions, and the ticking clock the UK faces once the Article 50 process is triggered are a core source of leverage. There are many areas for mutual benefit and cooperation beyond these issues, such as climate and energy issues, but without skilful diplomacy there is also the potential for the negotiations to quickly become stranded.

An orderly negotiation process would facilitate greater cooperation and understanding of mutual interest. In contrast a disorderly process could limit the scope for agreement regardless of the underlying intent that might exist across the different parties. This is also important in relation to the level of transparency and the involvement of different institutions (e.g. the UK and European Parliaments) at different stages of the negotiation. In any negotiation it is commonplace for parties to attempt to conceal their final ‘red lines’ (the boundary of minimal acceptance) in advance of a deal. However, in most forms of international negotiation attempts to ultimately defeat one or other party are often counterproductive. Agreement comes from establishing whether there is a mutually acceptable space between the different Parties red lines. This is not to exclude forms of political posturing and pressure, this is necessary in order to fully test and explore other parties’ positions; but ultimately a successful resolution is one where both sides can claim victory. Constructing an orderly negotiation process that includes elements on the future relationship

between the UK and EU and broader aspects of cooperation will be important to achieving this.

Scenario driver 3: Timing and extent of economic impacts

A key uncertainty is the level of economic pain that both sides will experience under different outcomes during the course of the negotiations. Economic pain in a political sense is not necessarily the same as simply calculating 'cost', in particular perceptions of public confidence can be very different in relation to avoided gains rather than actual losses. For example an economy that is growing more slowly than it would otherwise will create different political dynamics to one that is in a full recession, even if the economic cost of slower growth is extremely large. In the initial months following Brexit a massive devaluation of the Pound has acted as a buffer in the UK against negative shocks. Although impacts were not uniform across all sectors the projections for an immediate recession following the referendum vote have been proved wrong. However, it is likely to increase domestic UK inflation, which has been at historically low levels since the financial crisis in 2008.

There is an important timing issue within the negotiations. Currently UK exporters to the EU have the dual benefit of maintaining tariff free market access while gaining a competitiveness advantage from the devaluation (the pound has fallen by more than 16% against the Euro, meaning UK exporters could technically reduce euro prices by this amount and still receive the same revenue in pounds as they did before the referendum). In a scenario where the UK suddenly moved to WTO only rules this would mean that the economic impact in the UK would only be realized after the initial Article 50 negotiation had been completed. For the EU the reverse is true: EU exporters to the UK are already undergoing a period of adjustment owing to loss of competitiveness from the fall in the pound and so would likely be less impacted by any future moves to a WTO system. At the same time the full potential benefits of companies or investors switching away from the UK would only be realized after the negotiations had concluded and there is certainty over the new arrangements. In effect it could be argued that the EU is already pricing in the cost of Brexit, while the UK will potentially only do so after the conclusion of the Article 50 process.

The resolution of these different interests and how the uncertainty over economic impacts are valued will therefore be a major determining factor in shaping different Brexit scenarios. However, the result of these impacts is far from certain. Within the UK, if the reality/expectation of economic risks sharply increases this may lead to the Prime Minister seeking a more cooperative outcome and could undermine political support for the hardest forms of Brexit. Alternatively if economic losses are seen as sunk costs this may harden support for cleaner forms of Brexit, and potentially empower nationalist political voices. Thus, although perceptions of economic impact will potentially be a significant driver, it is important not to draw narrow linear interpretations around different impacts.

Scenario driver 4: Momentum after Article 50 negotiations

The fourth major driver of the scenarios is the momentum coming out of any negotiations and the timeframe over which they are undertaken (in game theory terms whether this is viewed as a 'one shot' or 'repeated' game). The complexity of Brexit means that there is unlikely to be a single and neat resolution of all issues within the two year time period from triggering Article 50. Instead there is likely to be an initial settlement and process followed by an extended period of engagement and adjustment based on subsequent events. If the initial round of negotiations end in acrimony and mutual distrust this will make future cooperation much harder. On the other hand, if there is positive momentum and a clear understanding of future priorities this would lead to more productive engagements going forward.

In the UK there have been arguments put forward in support of both a 'clean' Brexit and a 'phased transition' to avoid cliff edges and uncertainty for business. How these views interact will be important in shaping future momentum. The aspiration for a clean Brexit has several potential drivers ranging from a desire to get resolution as quickly as possible and hence limit future uncertainty; to potentially more cynical motives on the need to 'lock in' the result of the referendum before a general election or other factors could lead to remain forces regaining political power. Similarly the arguments for a phased transition cover a spectrum of factors including managing the complex entanglement that exists after 40 years of EU membership; but also as a potential way to manage fears of a hard Brexit.

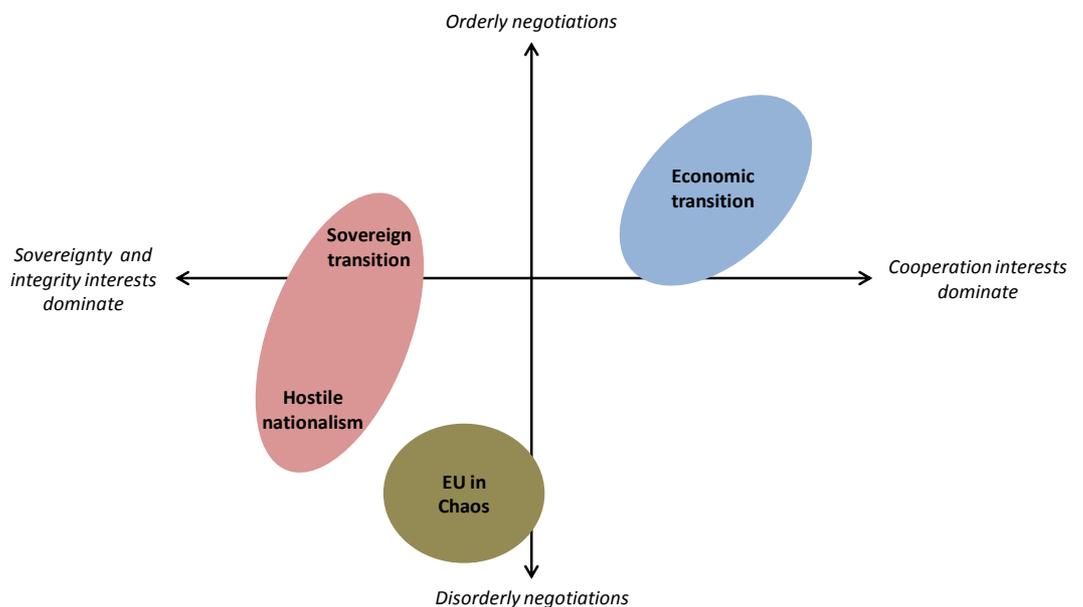
On the EU side initial instincts appear to be in favour of 'playing the long game' as noted above. However, this does not mean that there are no forces pulling in the direction of seeking a quick resolution to Brexit and so allowing them to move on with core business elsewhere. In particular there may be a sense that the EU position will be strongest by pushing the UK into a hard exit, thus strengthening EU power in any future trading negotiations.

What is clear from many policy areas including energy and climate change, but also broader concerns such as defence, crime and digital, is that some form of future cooperation between the UK and EU will be inevitable. How and whether a potential 'cooperation track' around these issues might emerge may be a driver for greater trust and positive momentum following the initial 2 year Article 50 period. The impacts of a cooperation track for energy and climate are discussed in more detail below.

POLITICAL SCENARIOS FOR BREXIT

From an assessment of the key drivers and interests, four main political spaces for landing a Brexit deal within the next 2-3 years emerge as shown in figure 7 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 7: Overview of political scenarios for Brexit



Scenario 1: Sovereign Transition

This scenario is probably the most representative of the current UK negotiating position. The UK would not seek to remain a member of the European Economic Area (EEA) and the four freedoms – enabling it to set an independent immigration policy and restrict freedom of movement from other EU countries.

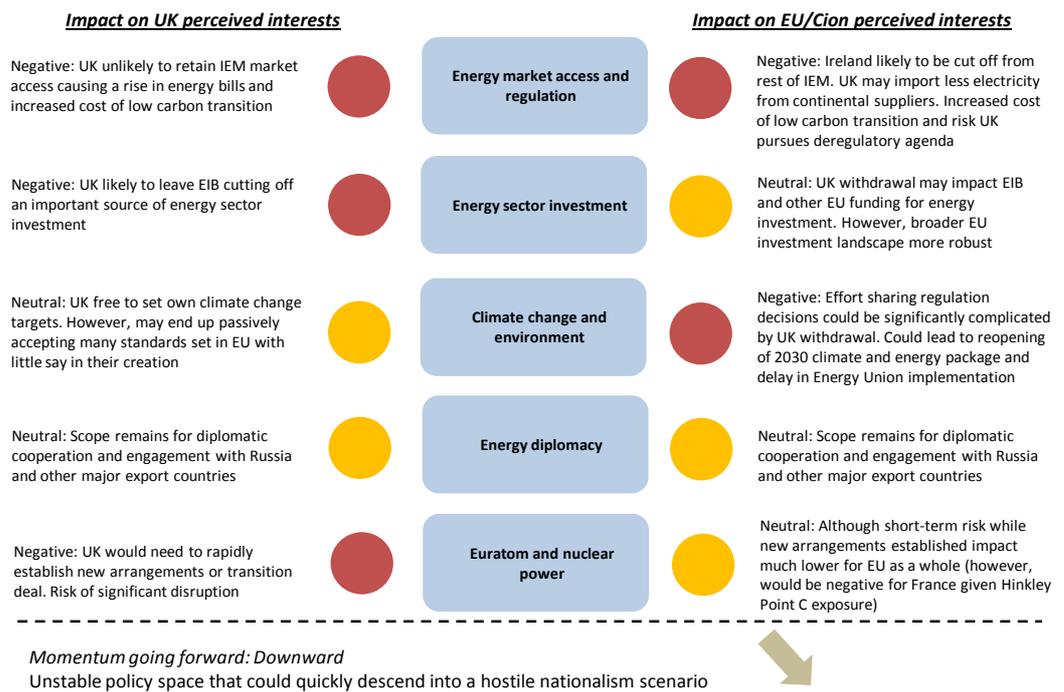
The centre of the negotiations is likely to revolve around the UK desire for either a new free trade agreement (FTA) or a bespoke Customs Union deal, which would enable it to simultaneously sign new trade deals with third party countries (e.g. the US, China or India) while also retaining market access to the EU at low tariffs. For the EU the desire for both settling existing UK budget liabilities (various estimates from

€40billion to €70billion have been proposed) and the potential to seek further budget contributions going forward would be central to its priorities. Other areas of significant focus would likely be on the future role of the CJEU, and in particular its role in future trade dispute resolution mechanisms.

While it is not impossible that this negotiation could move forward it would also create a highly unstable political space. The FTA/Customs Union agreement the UK is seeking would be a major concession by the EU, and would raise a number of concerns over the application of State Aid rules and other avenues for unfair competition. In the absence of EU flexibility the UK could be left with limited options beyond defaulting onto WTO rules. Similarly although the UK Prime Minister has given herself latitude with respect to ‘appropriate contributions’ to any future EU budget, expectations are likely to be significantly below that of the initial EU asks.

Thus there are a number of drivers in this scenario which could create a breakdown in orderly negotiations and a drive towards zero-sum politics. If the negotiations became locked on issues of budget contributions/Customs Union agreement without considering wider cooperation interests this would rapidly shift into a disorderly process and the scenario the ‘Hostile Nationalism’ outcome described below.

Figure 8: Sovereign Transition assessment of climate and energy issues



A Sovereign Transition scenario results in relatively weak outcomes for climate and energy issues on both sides as these policy areas are largely sacrificed in pursuit of high level objectives within the negotiations. The UK desire to have a clean break from the EEA and EU insistence on strong integrity leads to a rapid exit from the IEM with negative consequences for both sides. There is some asymmetry on investment and climate change issues where it is likely that the rapid exit would increase investment

uncertainty in the UK, making it a relatively less attractive venue for investment than the EU. However, the lack of transition arrangements on climate issues could create significant complications for the effort sharing regulation and viability of the ETS for the remaining EU countries. The pursuit of a clean break by the UK also means that there is a risk that either transitional or new arrangements are not put in place with respect to Euratom, which could cause complications in the UK's nuclear policy in the short-term.

The momentum after 2020 from this scenario is downward for energy and climate issues. There are significant risks of economic shocks and other impacts on both sides which could rapidly lead to escalating blame and a breakdown of trust. The emphasis on sovereignty and integrity could be related to greater levels of hostile nationalism going forward and limit the scope for future cooperative arrangements.

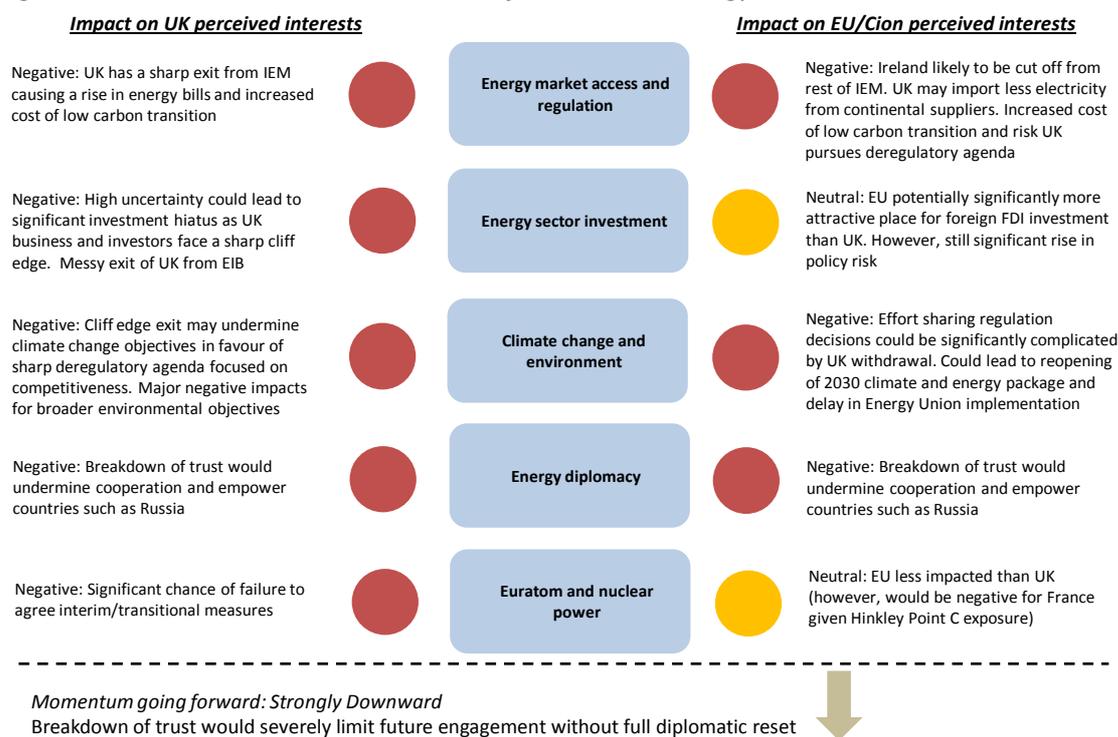
Scenario 2: Hostile Nationalism

This scenario is part of a connected political space with the Sovereign Transition scenario where provocation on both sides leads to a major breakdown of trust and a focus on zero sum politics. Thus although the starting dynamics are very similar to scenario 1 the failure to construct an orderly negotiation process leads to a more negative outcome. For example if agreement on the UK's payment to settle outstanding liabilities cannot be reached or the UK denies any role for the EUCJ in future trade arbitration, it could quickly lead to fragmentation and the negotiation process descending into chaos. The UK threatening to undermine security cooperation with the EU could also lead to a hostile response from the remaining EU-27 countries.

This would create a self reinforcing dynamic which could feed nationalist instincts in both the media and wider population on both sides, promoting ever more intransigent positions. This would rapidly increase the probability that the UK responds by threatening a massive deregulatory agenda to undermine EU competitiveness and refuses to make any payments for outstanding liabilities. The EU then responds in kind and those stakeholders who may want to focus on a 'punishment' agenda in some Member States would be empowered. The UK could, in extremis, also try and block progress on all existing EU legislation which could further entrench EU positions.

In this scenario no successful agreement is reached as the Article 50 time limit expires, leading to UK exiting from the EU in a chaotic default. This creates strong negative momentum and a lack of trust for future engagement with ongoing arguments about outstanding budget liabilities/punitive tariffs etc. This scenario is likely to generate maximum economic costs on both sides.

Figure 9: Hostile Nationalism assessment of climate and energy issues



This scenario leads to highly negative impacts for energy and climate issues. The UK is likely to be particularly damaged as business and investors struggle with a sharp cliff edge as the negotiations descend into chaos. This could lead to a significant investment hiatus in the UK and undermine climate change objectives as competitiveness concerns lead to a focus on deregulation to limit economic damage.

Although the EU would likely remain a somewhat more attractive place for investment than the UK, there would still be negative impacts (especially related to EU budget liabilities and future contributions) as Ireland faces becoming an energy island and the UK exit could undermine effort sharing regulation and the ETS. The threat of a strong deregulatory response from the UK (“Singapore in the North Sea”) could have significant medium term impacts. Continued cooperation on energy diplomacy with countries such as Russia would be significantly undermined in this scenario which could raise energy security risks for both the UK and EU Member States.

The momentum from this scenario is strongly downward. The escalating hostility that leads to a collapse in the negotiations would result in significant bitterness on both sides. Short of a full diplomatic reset there would be little trust to drive cooperation on environment and climate issues.

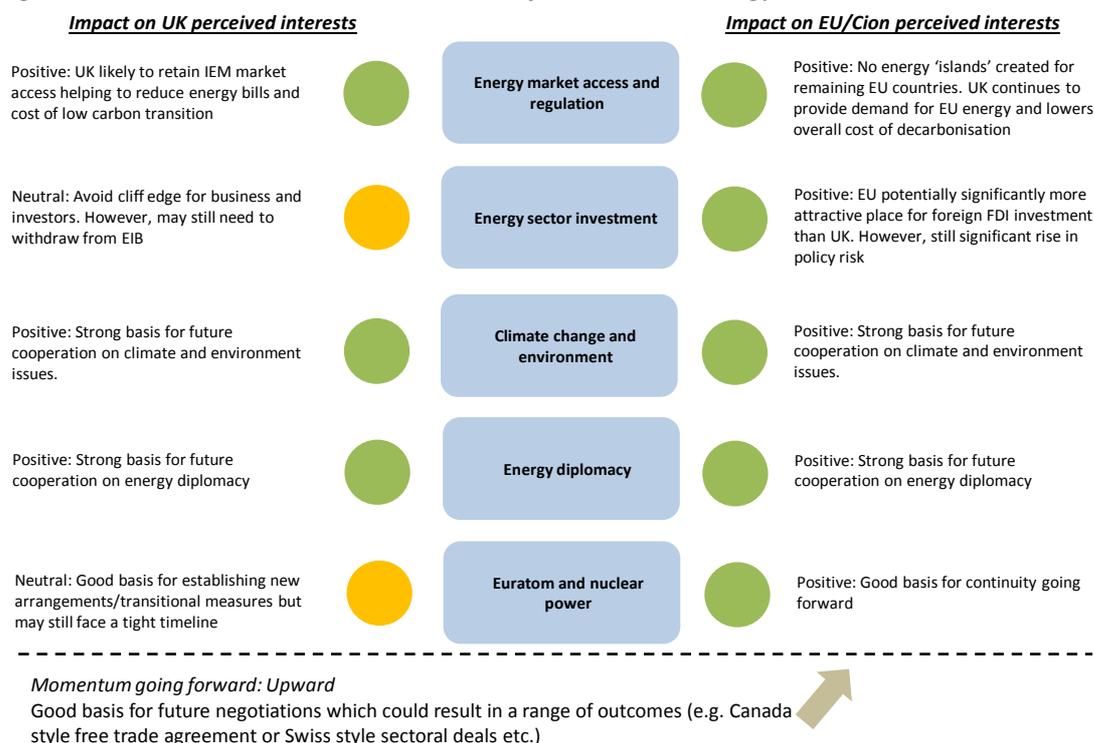
Scenario 3: Economic Transition

There is recognition by both sides that it is impossible to successfully disentangle the UK from EU within a two year timeframe. Following an initial ‘test of strength’ in the negotiations to determine the seriousness of both sides, the UK and EU chose to focus on economic cooperation in the short-term rather than sovereignty or punishment issues. Negotiations therefore focus on creating a set of stable, interim arrangements, after which lengthier negotiations could take place to move towards a more comprehensive solution.

The structure of the negotiations recognize that this is not necessarily a durable settlement in the long-run; but that creating a workable deal that does not generate significant economic harm will likely require a 5-10 year window rather than 2 years. For the UK there is also recognition that securing meaningful trade deals with third countries such as the United States, China and India may also take an extended period of time. This results in the UK retaining membership of the customs union and potentially also full EEA membership in the first instance. It would also require the UK to continue to make some form of contribution to the EU budget, though there may be scope to negotiate new levels.

This scenario does still lead to the UK formally exiting the EU after the Article 50 negotiations conclude in 2019, and so the mandate of the referendum is delivered. However, the focus is on creating a positive momentum to conclude longer negotiations that could eventually result in either a deep ‘Canada plus’ style free trade deal, or Swiss style sectoral arrangements, in the medium to long-term.

Figure 10: Economic Transition assessment of climate and energy issues



An Economic Transition scenario leads to largely positive impacts for energy and climate change issues. This scenario would enable the UK to retain IEM access which would bring both significant domestic benefits but would also ensure countries like Ireland are not isolated. By pooling potential renewable resources and the ability for balancing across the whole EU the costs of decarbonization are reduced for both sides as well.

This scenario provides the most positive basis for investment, although the UK may still have to navigate some issues in relation to membership of the EIB etc. The scenario would also enable active cooperation on energy and climate issues. For the EU this would minimize risks of possible disruption to the current Energy Union and 2030 Climate and Energy package agenda; and provide stability for the ETS. The UK would still have to navigate Euratom arrangements but this scenario provides the most positive backdrop to accomplish this.

The momentum from this scenario is upward for climate and energy issues. By emphasizing economic cooperation and robust transition arrangements there is time and a stable diplomatic relationship to move forward with longer term arrangements.

Scenario 4: EU in Chaos

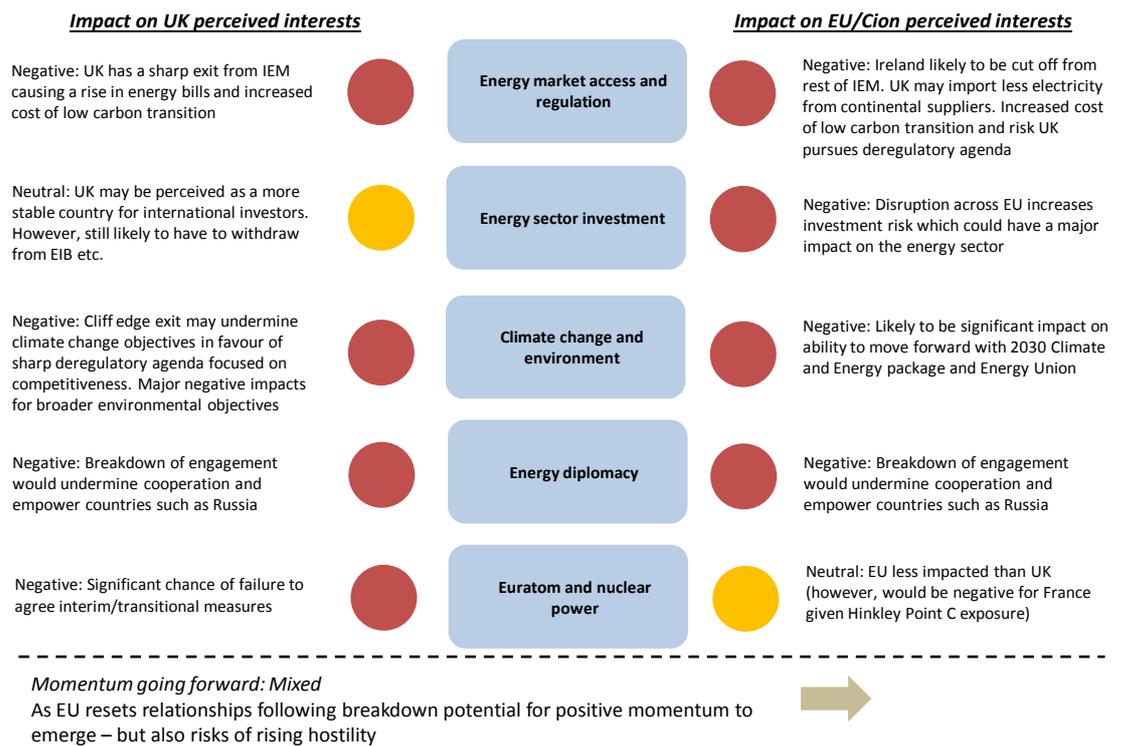
In this scenario political events in other EU Member States precipitate a deep crisis which switches focus away from Brexit. This could be a country such as Italy or Greece suffering a deep crisis in the next two years which eventually leads to exiting the Euro,

or a victory for populist candidates such as Marine Le Pen in the 2017 French elections. The UK attempts to continue orderly negotiations with the European Commission but the process spirals into chaos as no clear mandate is forthcoming from other EU Member States and the future shape of the EU as a whole is put in considerable risk.

In this scenario a large political space opens up for major reform of the EU, but in the short-term crisis management dominates which makes the timing difficult for the 2 year Article 50 process. The ultimate outcome of the highly chaotic negotiation backdrop is uncertain, but it is likely that the UK is not able to negotiate significant new arrangements for a new FTA or bespoke Customs Union agreement etc. and so may end up in a hard Brexit onto WTO rules in the short-term.

Momentum from this scenario is also incredibly volatile. There is lots of potential for negative energy to emerge and make future cooperation challenging. However, if the EU does go through a major reform process this could also provide significant opportunities for the UK to negotiate a new basis for future cooperation.

Figure 11: EU in Chaos assessment of climate and energy issues



This scenario results in a negative short-term outcome for energy and climate issues. The chaotic end to the Article 50 negotiation process is likely to lead to a sharp cliff edge as the UK exits the IEM with significant impacts on both sides. Investment uncertainty in the UK would be very high in this scenario, but relatively speaking the UK might be perceived more attractive than Eurozone countries. This scenario would result in maximum disruption to the EU Energy Union process and Clean Energy for all

Europeans package. It could also significantly undermine climate objectives in the UK as other short-term competitiveness priorities crowd out longer-term objectives. The scenario could lead to a significant breakdown in energy diplomacy and empower exporter countries such as Russia relative to their current position. This scenario would also carry a high risk that the UK was unable to secure either alternative or transitional arrangements with regard to Euratom.

The momentum from this scenario is mixed. Although the scenario is highly chaotic there is not the same level of acrimony between the two sides compared to the hostile nationalism scenario. As the EU rebuilds following a period of chaos there would be opportunities to forge a positive relationship with the UK. Energy and climate may appear to be less politicized issues than trade or security, and so may enable them to act as a pathfinder for rebuilding cooperation. However, this scenario is not without risk and the negative impacts could also empower hostile forces on both sides to promote a destructive punishment agenda.

CONCLUSION: THE NEED FOR A COOPERATION TRACK

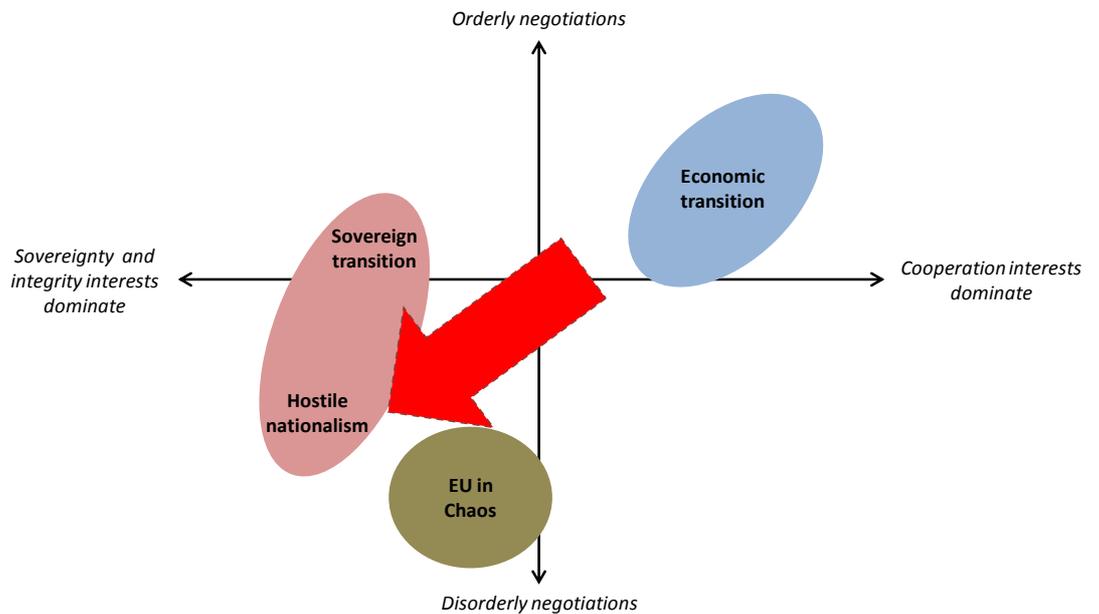
In assessing the outcomes of the different Brexit scenarios for energy and climate change it is clear that there are stark differences between negative outcomes for those scenarios dominated by a narrow ‘one shot’ focus that emphasizes zero sum politics between the two sides; and more positive outcomes from a broader ‘repeated game’ focus that emphasizes cooperation.

Given the strong path dependency (whereby initial choices limit future decisions) from a breakdown in trust and a shift to a disorderly negotiation space it is therefore vital that a cooperative track is established in the negotiations to keep open the political space to build positive outcomes. However, given the potential for narrow interpretations of the Article 50 process to focus mostly ‘on the divorce’, it is by no means automatic that this track will be established. Brexit will be a unique diplomatic event and navigating the different risks and opportunities will require significant statesmanship from both sides.

As illustrated in figure 12 the most likely scenario under current drivers is to move towards hostile nationalism. The initial UK negotiating position is likely to try and move towards a sovereign transition outcome. However, as outlined above this is a highly unstable political space and would require major concessions from both sides. In the absence of those concessions coming forward the most likely result will be an escalation in hard-line positions and a descent into hostile nationalism.

Maintaining an orderly negotiation process will also be a challenge. In particular there may be a number of political forces on both sides of the channel that may think that they could narrowly profit from a disorderly negotiation process: either by ensuring there is no way back for the UK to remain in the EU or because they perceive their country/sector may benefit from a ‘hard Brexit’.

Figure 12: Assessment of most likely scenario under current drivers



The creation of a specific cooperation track for energy and climate issues would be the best way to mitigate the risks of moving towards a hostile nationalism scenario. There has already been some discussion of the need for ongoing cooperation on security, crime and digital issues. Making a cooperation track a reality and expanding it to include energy and climate issues would create a positive pole in the negotiations to build trust and demonstrate progress.

A successful cooperation track for climate and energy will require transparency and accountability on both sides. This is not the same as requiring negotiators to reveal their red lines (final negotiating positions) as some critics have argued. Rather it is creating a space for the voice and involvement from the public, business and Parliament on areas of common interest. In particular four areas stand out:

- **Integrated energy market:** The UK has a deeply integrated energy market with the rest of the EU and a single energy market with the Republic of Ireland. In both cases disentanglement could be technically and politically challenging. The UK has signaled a red line regarding the jurisdiction of the European Court of Justice (ECJ). However, the current UK position is more nuanced as it does not exclude its role in trade arbitration, meaning there could be an interim role for the ECJ. In the long run, new forms of cooperation such as an Energy Union beyond EU borders could also be considered or possible extensions to the Energy Community model. Cooperation on energy diplomacy and energy security in particular with regards to Russia would be part of those discussions.

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- **Climate change targets:** The EU is currently in the process of translating the joint international climate change commitment it made into binding national targets until 2030. As the UK's own legally binding targets from its Climate Change Act are higher than the EU average, the UK can make a positive offer to the EU of continued cooperation on overall 2030 greenhouse gas reduction targets and the EU Emissions Trading Scheme.
 - **Climate diplomacy:** The UNFCCC will launch a facilitative dialogue in 2018 to increase overall ambition. In the context of other major economies such as China and India also taking action, this provides an opportunity for the EU and UK to show continued global leadership. While the UK might want to go its own way in terms of climate diplomacy to place itself more prominently on the international stage, it can potentially become an impactful ally for the EU to build new, climate based global partnerships, e.g. with the Commonwealth countries or Latin American countries such as Colombia, Peru, Chile, Mexico.
 - **Environment:** Nothing technically prevents the UK or the EU from maintaining or increasing standards on trans-boundary impacts currently set by EU directives, e.g. the Industrial Emissions Directive reducing industrial pollution, without formal cooperation. Developing cooperative arrangements however will increase agency beyond their own borders. Neither the UK nor the EU would want to risk a regulatory vacuum about property rights in areas of shared resources such as fisheries or the management of impacts across shared land borders and rivers between Ireland and the UK.

In establishing a cooperation track in these areas there are also a number of different political levels that need to be considered. Firstly, how and in what format will these issues be addressed? Will this be part of the Article 50 process or, perhaps more likely, a parallel process? There would then need to be consideration of how different issues would translate into individual landing points for agreement. Would this involve the creation or modification of institutional bodies, form part of a new free trade agreement etc.? At this point it may be more useful to disaggregate different policy areas and treat them as separate streams within the cooperation track.

Addressing these questions is likely to require decisions by Heads of State. However, it will be important for a range of actors from civil society, business, finance and academia to make the case that a cooperation track can be a successful tool to manage negative risks in the negotiation process.

ENDNOTES

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https://www.entsoe.eu/Documents/Publications/Statistics/Factsheet/entsoe_sfs2015_web.pdf

² DECC (2015) 'DUKES: Foreign Trade Statistics'

3

http://ec.europa.eu/energy/sites/ener/files/documents/20130902_energy_integration_benefits.pdf

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https://www.e3g.org/docs/Transmission_planning_and_regional_power_market_integration.pdf

⁵ The United Kingdoms exit from and new partnership with the European Union (2017) pg.43

⁶ <https://theconversation.com/brexitom-the-uk-will-now-leave-europes-nuclear-energy-authority-72136>

⁷ Euratom Treaty, Article 52, <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A12012A%2FTXT>

⁸ <https://www.gov.uk/government/publications/prime-ministers-letter-to-donald-tusk-triggering-article-50>