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Special Report

U.K.'s Vote to Leave EU and Its Implications for Economy and Energy[1]

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Foreword

The United Kingdom in a national referendum has voted to leave the European Union. The U.K. vote came as a great shock to the world, triggering a global stock market plunge. Future developments following the vote are attracting great attention. This special report summarizes the background of the U.K. vote and its implications for the world economy, crude oil prices, energy situations and energy policies, based on information available at present.

1. Referendum results and future developments involving U.K. leave from EU

In the U.K. national referendum on the country's leave from the EU on June 23, the Leave campaign finally won a thin majority of 51.6% over 48.1% voting to remain in the EU. Polls just before the referendum indicated a close race between the Leave and Remain campaigns. As votes were counted, the race stayed close, with voters and observers waiting breathlessly. On June 16 ahead of the referendum, Jo Cox, a member of the House of Representatives, was killed after supporting the Remain campaign. Then, polls temporarily indicated the Remain campaign's lead. Eventually, however, the Leave campaign won the race. A survey on the referendum day indicated that 73% of voters aged 25 or less voted to remain in the EU, while 60% of those aged 65 or more voted to leave the EU. This meant great differences between age brackets. Given the very close race, differences between generations, and gaps between regions, including Scotland's dominant support for the Remain campaign, the U.K. was deeply divided over the matter. Prime Minister David Cameron, who has supported the Remain campaign, vowed to resign in response to the referendum results, saying that voters' will should be respected. Furthermore, Jonathan Hill offered to resign as European Commissioner for Financial Stability, Finance Services and Capital Markets Union.

[1] The authors have received a vast amount of knowledge from IEEJ colleagues for making this report. However, the authors are responsible for errors in this report, if any.

In accordance with Article 50 of the Treaty on European Union, the U.K. will notify the European Council of its will to withdraw from the union. Later, it will negotiate with the European Council in line with a policy decided by the council on an agreement on the withdrawal while considering a framework of future U.K.-EU relations covering from trade rules to regulations. Basically, the negotiations will be held over two years. The two-year period will represent an important deadline, although the period may be extended through unanimous approval by all EU members. Even if the U.K. launches the withdrawal procedure, it will remain bound by EU law during the two-year period from the notification of the withdrawal.

2. Leave decision came as great shock to world economy

The victory for the Leave campaign in the national referendum came as a great shock shaking the world economy and international financial markets. While the race between the Leave and Remain campaigns was understood as very close, polls just before the referendum were dominantly interpreted as indicating the Remain campaign's thin lead over the Leave campaign. There were predictions or hopes for U.K. voters to choose to maintain the status quo, leading market players to be rather optimistic or loose. As vote counting began to suggest a lead for the Leave campaign, markets were shocked and plunged into a kind of panic amid fear-driven market psychology.

Given that the U.K. is the second largest economy within the EU, its withdrawal from the EU could exert negative impacts on its own economy, the EU economy and the entire world economy. While the U.K.'s withdrawal chosen in the referendum is set to come two years after the commencement of withdrawal negotiations, markets always try to see beyond. However, market players failed to accurately foresee how great the abovementioned negative impacts would be, adding fuel to their insecurity. As a result, the British pound sterling was sold heavily, declining nearly 10% against the dollar to a 31-year low. As investor psychology went in the risk-off direction, money flowed out from risky investment targets, with selling stimulating further reactive selling. Such developments hit the London market first and led to a global stock market decline.

Stock prices fell 5% on the London market on June 24. Drops on other major European stock markets were even greater, including a record 13% fall in Italy and a record 12% drop in Spain. Stock prices also plunged 8% in France and 7% in Germany. The U.S. Dow Jones industrial average fell 3.4%, the largest decline in four years and 10 months. The 225-issue Nikkei average dropped 8%, as fast as European markets. In the meantime, money flew into less risky investment targets including German, U.S. and Japanese government bonds, gold among commodities and the yen and Swiss franc among currencies. The dollar rapidly depreciated against the yen, slipping below 100

yen briefly. The yen's rapid appreciation led to insecurity about the future course of the Japanese economy and the prediction of earnings deterioration for export-oriented sectors, serving as a major factor behind the abovementioned sharp fall in the Nikkei average.

3. Downside pressure on crude oil prices

Amid insecurity about the world economy and the risk-off trend, strong downside pressure came on crude oil prices. On the London market on June 24, the Brent futures price (the closing price for the front-month contract) lost $2.50 per barrel or 4.9% from the previous day to $48.41/bbl. On the New York market, the West Texas Intermediate futures declined $2.47/bbl or 4.9% to $47.64/bbl.

After the WTI futures fell below $27/bbl in February in the third dip since the start of the crude oil price plunge in the second half of 2014, the price rose back to around $50/bbl as a moderate increase in oil demand was coupled with a U.S. shale oil output decline, slowing non-OPEC oil production and supply interruption in some oil-producing countries to moderately improve the supply-demand balance. Most oil market participants expected that the market will go in the direction of rebalancing with the oil glut diminishing in the second half of 2016. Then, the U.K. referendum results came as a great shock to the oil market.

As explained above, the U.K. vote to leave the EU does not mean the U.K.'s immediate withdrawal from the union. On the crude oil futures market, however, market psychology seeing beyond plays a great role in pricing crude oil. In this sense, market participants have various negative effects of the U.K.'s planned leave from the EU on the real economy in their mind. The financial market confusion and concerns about the real economy's deterioration lead oil market players to expect the deceleration of the entire world economy and a subsequent slowdown in oil demand. In a short-term development, the risk-off trend paves the way for crude oil futures as risky assets to be sold easily. We must remember that the abovementioned third dip in crude oil prices, as well as the second dip in August 2015, came on a global stock market decline and growing world economy risks triggered by a Shanghai stock market plunge. In this sense, a focus of attention for the immediate future is whether global economic fears would coincide with stock and oil market plunges.

The future crude oil price trend will depend on underlying global oil supply and demand fundamentals. Over a short term, the trend will depend on whether stock and other international financial markets will be stabilized or not. In this sense, we will have to closely watch next week's developments in Asian, European and U.S. markets including the Tokyo market that will open first.

Governments and central banks in major countries will consider and implement market stabilization measures. Given that how great the impacts of the U.K.'s decision to leave the EU would be and how far the impact would expand are uncertain, it may not be easy to contain market fears.

As far as risk sentiment lingers in stock and other financial markets, therefore, crude oil prices may remain unstable and nervous. An important point in this respect is that once a market change accelerates, it may not be easy to stop the change. When crude oil prices plunged in the past and started a downward trend, they tested further lower levels. In this sense, we must pay attention to market developments from June 27.

4. Implications for U.K. energy projects

The pound's depreciation and growing U.K. economic risks may affect fundraising costs for U.K. companies. How far they may affect fundraising costs is difficult to predict. Basically, however, fundraising cost hikes may push up overall energy infrastructure costs, leading to higher energy prices. New large investment deals may become difficult to implement. The U.K.'s leave from the EU may also make it difficult for U.K. companies to get European loans including those from the European Investment Bank. Under the Energy Union strategy of the European Commission, the EIB has proactively promoted loans for the development of offshore wind power generation plants and grid networks in EU member countries. If U.K. companies fail to receive such EIB loans, it may become more difficult to raise funds for major energy projects.

5. U.K. energy policies and their relations with EU

Meanwhile, the U.K. may become free from EU targets in drafting energy policies and selecting energy technologies. In the U.K., the large-scale shutdown of old coal power plants under EU directives related to SO_x and NO_x emissions has become a policy challenge leading to a remarkable fall in electricity supply capacity. If relevant EU directives are not applied to the U.K., London may have to consider how best to use coal power plants to secure sufficient capacity over a short term. Regarding coal power plants, the U.K. Department of Energy and Climate Change in November 2015 released a policy of withdrawing from coal power generation by 2025. How the government will make the traditional policy consistent with new developments may attract attention.

While the U.K. has tried to implement energy subsidies including the FIT-CfD (Feed-in Tariff with Contracts for Difference) system to pave the way for investment in low-carbon electricity sources, the EU has been screening these subsidies from the viewpoint of competition law. If the withdrawal is realized, the U.K. may not have to receive the screening but may be able to implement them more easily. As represented by the 2008 Climate Change Act, the U.K. has set climate change,

renewable energy and energy conservation policy targets that are as tough as or tougher than EU targets. Irrespective of whether the U.K. would actually leave from the EU, no major changes may be made to these targets.

In electricity trading, the EU has built an international wholesale electricity trading framework through the ENTSO-E (the European Network of Transmission System Operators), allowing non-EU European countries such as Switzerland and Norway to participate in the market and benefit from the enhancement of the international transmission network on the same conditions as EU member countries. The U.K. now participates in the framework as an EU member. Even if the U.K. leaves the EU, no major change may come as far as the U.K. continues to participate in the framework as a non-EU country.

Since before the national referendum, Amber Rudd, Secretary of State for Energy and Climate Change, emphasized the advantages of the U.K.'s stay in the EU in terms of energy security, electricity rates and investment. In this respect, National Grid released a report on impacts of Brexit on the U.K. energy sector. The report cited two scenarios of Britain's exit from the EU -- the Norwegian scenario in which Norway stays in the IEM (Internal Energy Market) and the Swiss scenario in which Switzerland stays outside the IEM -- and concluded that the U.K.'s leave from the EU would have great impacts particularly on energy infrastructure investment in both patterns. It also noted that the U.K.'s secession from the IEM would cost consumers an additional 500 million pounds annually by the early 2020s.

The first challenge the EU would face on the U.K.'s leave would be how to secure its budget. EU revenues include customs duties on imports from non-EU countries, sugar levies, a portion of value added tax revenues in the EU members and contributions from the members. Germany, France and the U.K. shoulder some 50% of the total contributions to the EU budget, indicating that it would be difficult for the EU to maintain the present budget size after the U.K. leaves the union. In such case, the EU may have to shrink internal energy infrastructure expansion projects and programs for non-EU neighboring countries under its Energy Union strategy, on which the EU has focused in recent years.

If the U.K.'s leave from the EU is fixed, the EU may have to revise its energy and climate change policy targets for 2020 and 2030, including country-by-country targets. In international relations, the leave by the U.K. known for its hardline policy against Russia may variously affect the other EU members' attitudes on the "reduction of dependence on Russia" underlying the Energy Union strategy.

Afterword

In response to the national referendum results, Scotland that has supported the U.K.'s stay in the EU is expected to push another referendum on its independence from the U.K. Scotland's Prime Minister Nicola Sturgeon has vowed to make preparations for a referendum. The U.K. for its part cannot ignore Remain campaign supporters who suffered a thin defeat. A campaign for collecting signatures for the second national referendum has gained strength on the Internet, collecting 3 million signatures by June 26. Furthermore, calls for national referendums on the leave from the EU have emerged in the Netherlands and Sweden. The U.K. vote could stimulate other EU member countries' moves to secede from the EU, causing a domino effect. The shock of the U.K.'s decision to leave the EU will not fade away soon. Its fate and aftereffects will continue to attract global attention.

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