

CHEMICAL REACTIONS

Negotiating Brexit

Fujikawa Maru, Truk Lagoon – Photo Credit: Alasdair Nisbet

The negotiations for Britain’s departure from the European Union will begin in March with notification under Article 50 of the Lisbon Treaty. Along with death and taxes another certainty is that the UK will now leave the EU. The question is what will be the nature of the UK’s relationship with Europe. We consider the impending Brexit negotiations from the perspective of M&A bankers and give our analysis of the challenges. We see negotiation as a people’s business best conducted in a friendly manner where the parties are motivated to be fair but tough. No plan survives contact with the enemy, so both sides will need to be creative and flexible or enormous value for Europe as a whole will be destroyed.

THE MANDATE TO NEGOTIATE

Article 50 “2. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union ... It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.”

So the European Council will negotiate on behalf of the European Union but requires consent from the European Parliament. The Chief Negotiator on behalf of the European Council will be Michel Barnier, a French Republican politician. A final agreement, however, will need to be voted on by the EU Parliament and all the member states. The European Parliament has appointed Guy Verhofstadt, an ex-Prime Minister of Belgium, as its chief Brexit negotiator.

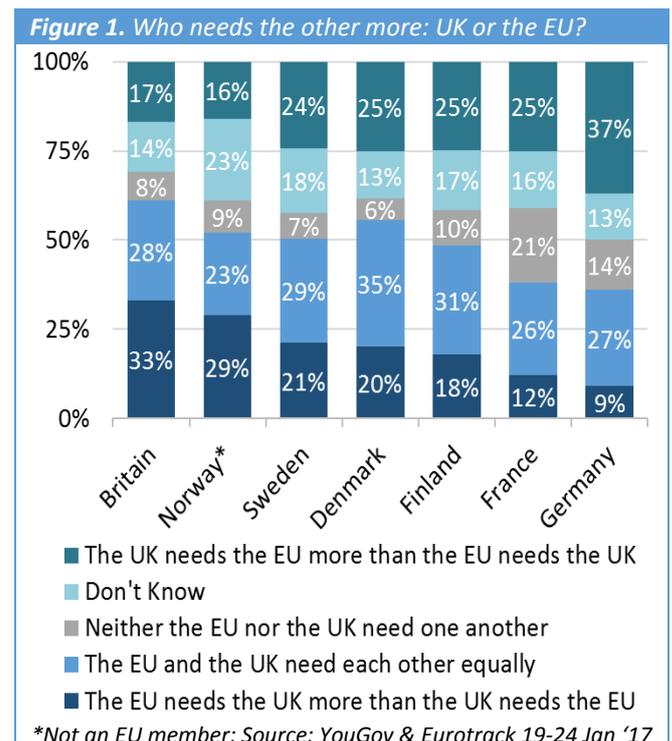
The UK has formed a Brexit Committee of Ministers led by Brexit Secretary David Davis.

ALIGNMENT OR COGNITIVE DISSONANCE

Both negotiating teams should have the same objective: **to negotiate a smooth and orderly exit that causes the least economic and social damage to both parties.** If not the risks are that both parties will suffer. Let's hope that they begin with an honest appraisal of their strengths

and weaknesses. Often, the party with the weaker negotiating hand is the one that is the more aggressive.

The narrative during the Referendum debate was that Europe needs the UK more than the UK needs Europe. It was justified by phrases like “Look at all the German cars that are sold here”. Therefore, there will be a strong desire to give Britain a “good” free market deal.



The reality may prove to be quite different. A recent YouGov poll suggested that the attitudes towards the UK and the resulting Brexit discussions varied considerably across Europe. For some in Europe, they are struggling to understand why Britain, that has been granted a number of exemptions, rebates and sweeteners, is leaving the European Union that they have struggled and aspired to join for so many years. The Latvian Foreign Minister Edgars Rinkevics recently quoted from *The House at Pooh Corner* by AA Milne in explaining Brexit to his parliament in January:

“Christopher Robin was going away. Nobody knew why he was going; nobody knew where he was going; indeed, nobody even knew why he knew that Christopher Robin was going away. But somehow or other everybody in the Forest felt that it was happening at last.”

In a number of countries, voters are angered by the comments by UK MPs, newspapers and pundits that risk encouraging the European negotiators to take a tough approach.

The first test will be to build a working relationship between the negotiating teams. Even when businesses are separating, defusing emotions and working towards a common goal of an amicable resolution is vital.

THE OPENING SALVOS

Theresa May has said that she does not want to declare her negotiating hand. Inevitably, however, in the early exchanges the UK will have to lay out at least a starting position. It is difficult to play football without your players on the pitch in certain positions. There are five key areas for agreement:

Divorce costs – The European commission has identified €60bn¹ of liabilities that the UK owes. These costs are mainly future liabilities for budget payments, unfunded pension liabilities, commitments already signed such as long term contracts including research funding. We expect the UK to attempt to do two things: challenge the valuation of liabilities and to broaden the discussion to other issues to be seen trading payments for benefits such as trade, financial regulation, etc.

People – for some in the UK, the Brexit decision was all about halting immigration but in reality there are a number of people issues:

- EU Citizens currently living in the UK
- UK Citizens living in the EU
- Future migration of UK and EU citizens
- Migration of refugees

We expect the people issues to be treated in two groups: initially the status of EU and UK nationals and later the question of immigration will be linked to trade representing two of the four pillars of the EU: the free movement of goods, services, labour and capital.

During the initial discussions about people there is likely to be agreement on a broad goal: **a reciprocal deal to guarantee the rights of 3 million EU citizens in Britain, and about 1 million British expats living in the EU.** But within the detail of that superficial agreement lie many politically sensitive choices: residence definitions, pension rights, unborn children, the ability to move, claim benefits, marry, divorce, even commit crime and avoid deportation — an entire cycle of modern life is potentially touched by the Brexit agreement.

“We can’t hide the fact that it is complex,” said Guy Verhofstadt, the European Parliament’s chief Brexit negotiator. *“But if we base ourselves on the principles of reciprocity and a uniform approach by the EU-27 then in my view there is no reason why we cannot find a lasting and equitable solution.”*

Legal – Theresa May has made her position clear *“So we will take back control of our laws and bring an end to the jurisdiction of the European Court of Justice in Britain. Leaving the European Union will mean that our laws will be made in Westminster, Edinburgh, Cardiff and Belfast. And those laws will be interpreted by judges not in Luxembourg but in courts across this country. Because we will not have truly left the European Union if we are not in control of our own laws.”* – Theresa May (17/01/17)

There are three key areas:

- **European laws** – the UK has unilaterally agreed to adopt all items of European Law that are incorporated in UK law which means that there is no debate.

*“As we repeal the European Communities Act, we will convert the ‘acquis’ – the body of existing EU law – into British law. This will give the country maximum certainty as we leave the EU. The same rules and laws will apply on the day after Brexit as they did before. And it will be for the British Parliament to decide on any changes to that law after full scrutiny and proper Parliamentary debate.”*²

- **European Court of Justice** – leaving the European Court of Justice is non-negotiable for the UK, the only question is when.

¹ Five years of normal funding of €12bn

² Prime Minister Theresa May set out the Plan for Britain, incl. the 12 priorities that the UK government will use to negotiate Brexit (17/01/17)

A likely requirement for a free trade deal with the EU is the retention of the influence of the European Court of Justice, failure to accept this will be a major impediment to granting free access for UK goods to the EU.

- **European Court of Human Rights** – this is not part of the EU and not covered under article 50. Britain played an active role in establishing it but it has become a cause célèbre for right wing commentators. It will be interesting to see what Britain's position will be after Brexit.

Trade – trade, law and immigration are linked. It will be challenging for the negotiators to bridge the gap between the parties on a combined solution.

There is much rhetoric in the UK that it can trade with the rest of the world and replace the sales to Europe with sales to other regions. The reality is that now almost half of the UK's exports are destined for the EU whilst under 10% of the EU's exports are to Britain. This is not surprising; the nearest trading nations are usually the best trading partners.³

Theresa May has made clear *“our objectives include a proposed free trade agreement between Britain and the European Union, and explicitly rule out membership of the EU's single market. Because when the EU's leaders say they believe the 4 freedoms of the single market are indivisible, we respect that position.”*

Some believe that the UK approach will be to show indifference to a “Hard Brexit” and then try to develop a piecemeal trade deal, seeking individual concessions for different industries. They may also try to link any payments associated with leaving the EU to the cost of securing a trade deal.

The biggest challenge for trade deals is time. They are notoriously complex and usually take many years to complete. Given that most trade deals take at least five years, it will be challenging for a trade deal to be agreed in the two-year window allowed. One advantage is that the UK and European product regulation is aligned.

The City – a key economic driver for the whole of the UK is the City of London. It has developed as one of the leading global financial centres and is the largest in Europe. Since Brexit was announced several countries, particularly Germany, France and Ireland, have been courting businesses to leave the UK. Several banks, Lloyds of London (Insurance) and other financial institutions are now considering this.

The UK has the most stringent Financial Regulation Regime in Europe. The EU has a “softer touch” regime

but has been adopting some of the UK rules. Banks have been able to operate in the EU by being regulated in one country (i.e. the UK) and “passported” into other countries. It seems unlikely that passporting rights will be granted to UK financial institutions and a lesser version known as “Equivalence” will be considered.

Europe will gain from the lingering uncertainty about Brexit and banks are already hedging their exposure to the UK by moving some activities to Europe.

Other – there are numerous other issues that are very important and need to be considered and may require separate negotiating teams. Examples are:

- Ireland – the status of Northern Ireland, the border with the Republic of Ireland and trade between Ireland and the UK, substantially its biggest trading partner
- Gibraltar – requires an open border with Spain
- European fisheries - many European fishing boats fish in UK waters, their status will change and needs to be agreed. Some see this as a key bargaining chip for the UK
- Defence – the UK, along with France, has nuclear weapons and one of the biggest armies in Europe. It is also plays a leading role in NATO. Britain's future commitment to the defence of Europe is seen as another important bargaining chip
- Airlines – UK access to the European Common Aviation Area and its agreement with US
- Various European bodies such as Euratom, for nuclear energy, need to respond to the UK's announced exit

EMPOWERING THE NEGOTIATING TEAMS

Theresa May has been determined to prevent Parliament having a final vote on the agreed treaty for the UK leaving the EU. She has now been forced to agree to regular updates and some form of Parliamentary vote at the end.

In contrast, the EU Commission needs approval from both the European Parliament and each member state (or Cantons in the case of Belgium). As the negotiations for the Canadian Free Trade deal have shown, it is a challenge to get all 27 countries to ratify the deal.

Potential risks for the whole Brexit process are the elections in several EU countries during the negotiating period that could change the political landscape of European government and could harden the European position and challenge the final ratification process.

³ To model trade Economists have used the “Gravity Model” using Newton's formula for gravity ($F=G(m_1 \times m_2)/r^2$), where F is the force, m_1 and m_2 are the masses of the objects interacting, r is the distance between the centres of the masses and G is the gravitational constant. In short, the further away you are, the fewer exports you will have.

THE TIMETABLE

Once notification under Article 50 has been made, the UK has two years to negotiate which includes time to get any treaties ratified unless there is a unanimous agreement to extend. If no agreement is reached, then the treaties cease to apply and the UK begins trading under WTO rules.

Article 50 “3. *The Treaties shall cease to apply to the State in question from ... two years after the notification ... unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.*”

The UK is vulnerable to delay. It is possible that the divorce is achieved, defining the status of UK and EU citizens abroad and the treatment of future liabilities, but the trade deal proves too complex in the time available.

With no deal, the UK would have to revert to WTO rules that means borders, tariffs and visas. This would be damaging to UK trade.

David Davis has already been urging his team to at least plan for the potential of no deal.

WHAT ABOUT THE CHEMICAL INDUSTRY?

The UK chemical industry is a major exporter of chemical intermediates and formulations whilst being an importer of petrochemicals and polymers.

Chemical companies are looking for tariff free trade, efficient border crossings, the free movement of labour and support for R&D.

The weaker pound has improved margins but many companies buy raw materials in US\$ and Euros which offsets the gain on exports.

Steve Elliott, CEO of the CIA said in January:

“[It is] in the UK and broader EU’s best interests to minimise disruption to trade and investment as we move out of the single market and towards a new Free Trade Agreement” – Steve Elliott, CEO of CIA (17/01/17)

We understand that the UK and European trade bodies (CIA and CEFIC) are giving this message.

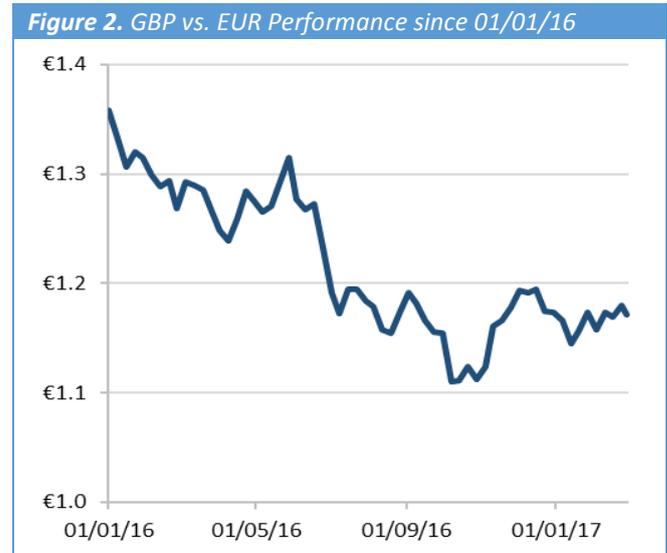
NO PLAN SURVIVES CONTACT WITH THE ENEMY

Helmut Von Moltke the Elder said *“no plan of operations extends with any certainty beyond the first contact with the main hostile force”*⁴. Or put more simply, no plan survives contact with the enemy.

Whilst both sides probably recognise the challenge of the task they will probably be underestimating the reaction of the other side to their proposals. They will need a flexible plan to accommodate the natural roadblocks in any negotiation.

WATCH THE POUND

In two years’ time there will be a forensic analysis of the success or failure of the negotiating teams. Until then, the pound will be a good barometer of the state of the Brexit negotiations. It fell after the referendum and as Theresa May and other Ministers have argued for a “Hard Brexit”, the pound has fallen further and conversely risen when they have made more conciliatory comments.



⁴ “On Strategy” (1871), as translated in *Moltke on the Art of War: Selected Writings* (1993) by Daniel J. Hughes and Harry Bell, p. 92

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