



House of Commons  
Treasury Committee

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# **Transitional arrangements for exiting the European Union**

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**Fourth Report of Session 2017–19**





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# Transitional arrangements for exiting the European Union

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**Fourth Report of Session 2017–19**

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to the report*

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## The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury, HM Revenue and Customs and associated public bodies

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### Publication

Committee reports are published on the Committee's website at [www.parliament.uk/treascom](http://www.parliament.uk/treascom) and in print by Order of the House.

Evidence relating to this report is published on the [inquiry publications page](#) of the Committee's website.

### Committee staff

The current staff of the Committee are Sarah Rees (Clerk), Peter Stam (Second Clerk), Gavin Thompson, Marcus Wilton and Dan Lee (Senior Economists), Adam Wales (Chief Policy Adviser), George James (Senior Committee Assistant), Nick Berry (Committee Support Assistant), Matt Panteli (Senior Media and Policy Officer), Anne Stark (on secondment from HM Revenue & Customs), Tom Ludlow (on secondment from the Bank of England), Ruthanne Straughan (on secondment from the Financial Conduct Authority), Alexander Knight (on secondment from the National Audit Office) and Mei Jie Wang (on secondment from the Prudential Regulation Authority)

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# Contents

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<b>1. Introduction</b>	<b>3</b>
<b>2. Objectives</b>	<b>4</b>
The Government’s objectives: future partnership	4
The Government’s objectives: interim period	6
The EU’s objectives	7
Business views	8
Conclusions	10
<b>3. UK-EU trade in the absence of an agreement</b>	<b>12</b>
Overview	12
Sector-specific issues	14
Banking and insurance	14
Automotive	15
Chemicals	16
Air services	17
Accountancy	18
Cross-sectoral issues	19
Data transfer	19
Customs declarations	21
Border checks	22
Options to mitigate the impact of ‘no deal’	25
“Mini-deals”	25
Unilateral action	25
Government spending on Brexit preparations	27
Firms’ contingency plans	27
Conclusions	31
<b>4. Design and governance issues</b>	<b>33</b>
Transition and the Withdrawal Agreement	33
Transition and UK law	35
Scope and ambit	36
The role of the ECJ	36
Dealing with new law	37
EU agreements with third countries	37
Conclusions	38

<b>Conclusions and recommendations</b>	<b>40</b>
<b>Formal Minutes</b>	<b>45</b>
<b>Witnesses</b>	<b>46</b>
<b>Published written evidence</b>	<b>48</b>
<b>List of Reports from the Committee during the current Parliament</b>	<b>50</b>

# 1. Introduction

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1. Before the referendum on 23 June 2016, the Treasury Committee in the last Parliament ran a major inquiry into the economic impact of EU membership.<sup>1</sup> It continued its scrutiny of the UK's future relationship with the EU after the referendum.<sup>2</sup> This included a call for written evidence on the desirability and design of transitional arrangements.

2. The Committee in this Parliament has continued this work, launching on 20 October a wide-ranging inquiry covering four broad themes.<sup>3</sup>

- Transitional arrangements, including how these should be designed to minimise economic disruption, maximise certainty, and meet the UK's and EU's negotiating objectives.
- Preparedness for a scenario in which the UK's trade relationship with the EU abruptly reverts to one based on WTO commitments (so-called 'no deal').
- The long-term economic relationship, and the scope and parameters of a comprehensive free trade agreement that delivers the Government's "free and frictionless trade" objective.<sup>4</sup>
- The process of converting EU law, especially where new competences and powers are transferred to institutions falling within the Committee's remit.

3. This Report principally addresses the first two of these themes. It considers the importance of arrangements that take the UK from 'Brexit day' to its end-state relationship, and makes suggestions for how these should be designed. In order that these suggestions are as constructive as possible, it draws on both the evidence received in this Parliament and the last, and a close reading of Government and EU policies and negotiating priorities.

**4. The UK is leaving the EU. The Government has said that it intends to give effect to this by leaving the EU Customs Union and Single Market. But the means by which this is achieved, and the likely end-state relationship between the two parties, remains uncertain. This Report is the first in what is intended to be a series that seeks to make constructive recommendations in these areas. It deals primarily with a specific, albeit important and urgent, point of process: how can the UK move from its position within the EU to its end-state relationship in a smooth and orderly way, particularly when that final relationship might not be fully agreed on 30 March 2019?**

**5. Equally important questions about what the UK's long-term economic relationship with the EU might be, and the opportunities, risks and changes that will arise as a result of Brexit, will be addressed in future work.**

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1 Treasury Committee, First Report of Session 2016–17, [Economic and financial costs and benefits of the UK's EU membership](#), HC 122, 27 May 2016

2 Treasury Committee, [Press release](#), 12 December 2016

3 Treasury Committee, [Press release](#), 20 October 2017

4 HM Government, [The United Kingdom's exit from and new partnership with the European Union](#), February 2017, Cm 9417

## 2. Objectives

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### The Government's objectives: future partnership

6. The Government's negotiating objectives for leaving the EU have been described and refined in a series of policy papers and Prime Ministerial speeches. These envisage substantive change in the UK's eventual economic relationship with the EU. In particular, on leaving the EU, the UK will leave the EU Customs Union and cease to participate in the Common Commercial Policy, so that it can pursue an independent trade policy. It will also cease to be a member of the Single Market.<sup>5</sup>

7. In place of a trade relationship based on participation in the Single Market and EU Customs Union, the Government is seeking a "bold and ambitious free trade agreement" that achieves "the freest and most frictionless trade possible in goods and services".<sup>6</sup>

8. The Treasury Committee in the last Parliament concluded that:<sup>7</sup>

Even under a free trade agreement that eliminated all tariffs, the costs of trading with the EU would be likely to rise as a result of non-tariff barriers to trade, including rules of origin requirements and customs procedures.

Non-tariff barriers<sup>8</sup> affect all trade, but are particularly pertinent in services. Services account for 80 per cent of the UK's economic output,<sup>9</sup> and the UK ran a trade surplus in services with the EU of £14 billion in 2016.<sup>10</sup> The Government recognises that, to meet its objectives, the trade deal must be comprehensive;<sup>11</sup> as the Prime Minister put it in her letter to the President of the European Council, Donald Tusk, triggering Article 50, it should be "of greater scope and ambition than any such agreement before it".

9. Among the elements that the Government has acknowledged should form part of a future trade agreement are:

- Arrangements to minimise any costs and delays that might arise from complying with customs procedures together with "specific facilitations" for the Northern Ireland-Ireland border that "go beyond any previous precedents".<sup>12</sup>

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5 HM Government, [The United Kingdom's exit from and new partnership with the European Union](#), February 2017, Cm 9417

6 *Ibid*, Chapter 8

7 Treasury Committee, [Economic and financial costs and benefits of the UK's EU membership](#), First Report of Session 2016–17, HC 122, para 168

8 Non-tariff barriers are any obstacles to international trade that are not import or export duties. For goods trade, they can include import licensing, rules for valuation of goods at customs, pre-shipment inspections and rules of origin. For services, they can include restrictions on the ability of a service provider to establish itself or operate in a different country, and requirements for service providers to possess certain qualifications before being allowed to provide a service.

9 House of Commons Library, [Industries in the UK](#), Briefing Paper 06628, August 2016

10 House of Commons Library, [Statistics on UK-EU trade](#), Briefing paper 07851, November 2017

11 See, for instance, Secretary of State for Business, Energy and Industrial Strategy, HC Deb 7 November 2017, [col 1319](#): "It is essential for our trading relationship with the European Union not only to be tariff-free, but to allow the continuation of a means of production that involves multiple components going back and forth, often at very short notice."

12 HM Government, [Northern Ireland and Ireland: position paper](#), August 2017, para 45

- A new VAT regime for UK-EU trade, under which a new UK VAT policy will be required.<sup>13</sup>
- Rules of origin establishing, among other things, the proportion of local content and value that must be embodied in a traded good for it to qualify for zero or preferential tariff rates, together with procedures that minimise the administrative burden of proving the origin of exports.<sup>14</sup>
- For certain sectors, mutual recognition of regulatory standards,<sup>15</sup> and the associated inspection, certification, licensing, approval and surveillance regimes<sup>16</sup> that ensure conformity with those standards.<sup>17</sup>
- Arrangements for co-operation with and/or participation in EU regulatory agencies, including arrangements that allow for information sharing between regulators.<sup>18</sup> Regulatory co-operation forums are a common feature of many free trade agreements.
- The mutual recognition of professional qualifications.<sup>19</sup>
- Arrangements to permit and govern the flow of personal data between the UK and the EU.<sup>20</sup>
- Arrangements to monitor the functioning of the trade agreement, and ensure that its provisions are upheld, including a dispute settlement mechanism to which signatories, and possibly individuals and businesses, could bring cases.<sup>21</sup>

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- 13 See, for instance, the Financial Secretary to the Treasury (HC Deb 20 November 2017 col 759): “At the point at which we leave the European Union, we will gain further control over VAT, although that depends on the precise nature of the deal that is negotiated. It might be that we move from acquisition VAT to import VAT depending on where that negotiation lands, which remains to be seen. The general principle is that the Government are entirely committed to ensuring that burdens on businesses are kept to an absolute minimum and that trade flows are maintained”.
- 14 Secretary of State for Exiting the European Union (HC Deb 2 February 2017, [col 1230](#)): “We will have to have a good rules of origin scheme, just as any other free trade area has.”
- 15 HM Government, [Northern Ireland and Ireland: position paper](#), August 2017, para 57: “An agreement on regulatory equivalence for agri-food, including regulatory cooperation and dispute resolution mechanisms, would allow the UK and the EU to manage the process of ensuring ongoing equivalence in regulatory outcomes following the UK’s withdrawal from the EU.”
- 16 See, for instance, [evidence](#) from the Secretary of State for Health to the Health Committee, 31 October 2017: “we would be very willing to look at systems of mutual recognition so that we recognised EMA accreditation and they recognised ours and so on”.
- 17 See, for instance, the Secretary of State for Exiting the European Union (HC Deb 5 December 2017 [col 900](#)): “alignment isn’t harmonisation. It is not having exactly the same rules; it is sometimes having mutually recognised rules, mutually recognised inspection, and all that sort of thing. That is what we are aiming at”.
- 18 See, for instance, [speech by the Chancellor of the Exchequer at Mansion House](#), 20 June 2017: “cooperation arrangements must be reciprocal, reliable, and prioritise financial stability. Crucially they must enable timely and coordinated risk management on both sides”; and Margot James, [Oral evidence to the Lords Internal Market Sub-Committee](#) from Margot James (Minister for Small Business, Consumers and Corporate Responsibility), 2 November 2017: “We think it is important to establish [...] close co-operation with the EU post Brexit on competition enforcement [...] it would be mutually beneficial for the CMA and its European partners to be able to share confidential information for the purposes of competition enforcement”.
- 19 HM Government, [Collaboration on science and innovation: a future partnership paper](#), September 2017, para 16: “The UK is seeking to agree a continued system for the mutual recognition of professional qualifications”.
- 20 HM Government, [The exchange and protection of personal data: a future partnership paper](#), August 2017: “After the UK leaves the EU, new arrangements to govern the continued free flow of personal data between the EU and the UK will be needed, as part of the new, deep and special partnership.”
- 21 HM Government, [Enforcement and dispute resolution: a future partnership paper](#), August 2017, para 25: “Establishing a deep and special partnership with the EU will require a new dispute resolution mechanism to address any disagreements between the UK and the EU on interpretation or application.”

10. As the previous Treasury Committee concluded, it is likely that a comprehensive trade deal that included the elements described above would be classified in the EU as ‘mixed competence’.<sup>22</sup> This would require it to be separately ratified by the Council (generally acting by qualified majority), the European Parliament, the national parliaments of all 28 Member States, and a number of regional assemblies. The Secretary of State for Exiting the European Union, Rt Hon. David Davis MP, has said that he expects the trade agreement to be mixed competence.<sup>23</sup> The EU’s Chief Negotiator for Brexit, Michel Barnier, has also said that the future trade relationship will be a mixed agreement.<sup>24</sup>

### The Government’s objectives: interim period

11. Despite the limited time available under the Article 50 process to conclude a comprehensive trade agreement, the Secretary of State for Exiting the European Union has maintained that the Government “want[s] to conclude the overall negotiation—whatever the outcome may be—by the end of March 2019”.<sup>25</sup>

12. However, the Government has acknowledged the need for an “implementation period” after the end of the Article 50 process, but before the new trade relationship comes into effect. The Prime Minister said in her Florence Speech that, during this period, “access to one another’s markets should continue on current terms” so that “businesses and public services should only have to plan for one set of changes in the relationship between the UK and the EU”. She added that “the existing structure of EU rules and regulations” should apply, and emphasised that the period should be “strictly time-limited” and last for “around two years”.<sup>26</sup> The Secretary of State for Exiting the European Union has given three reasons for seeking an implementation period:<sup>27</sup>

- to give the Government more time to put in place arrangements for life outside the EU;
- to give other EU states time to make any consequential adjustments; and
- to give business clarity about what they might need to do to prepare for the UK’s withdrawal.

13. Consistent with the Government’s intention to conclude negotiations within the Article 50 window, the Secretary of State has made clear that transition is not intended to give more time for the conclusion of a trade agreement:<sup>28</sup>

if we were doing a negotiation during the period of transition, I suspect what we would get offered is a year extension and then another year extension—and each time we would be paying a fee. That would solve one of the European Union’s biggest problems with our departure: money.

22 Treasury Committee, [Economic and financial costs and benefits of the UK’s EU membership](#), First Report of Session 2016–17, HC 122, para 147

23 [Oral evidence taken before the Exiting the EU Committee](#), 25 October 2017, Q29

24 [Oral evidence taken before the Lords Select Committee on the European Union](#), 12 July 2017, Q1

25 See also the Prime Minister’s [letter](#) to Donald Tusk triggering Article 50, 29 March 2017 (“we believe it is necessary to agree the terms of our future partnership alongside those of our withdrawal from the EU”); and HC Deb 9 October 2017, cols 51–2, Statement by the Prime Minister on UK plans for Leaving the EU (“I expect, and we are working on, having that future arrangement negotiated by 29 March 2019”).

26 Prime Minister’s [Florence speech](#), 22 September 2017

27 [Oral evidence taken before the Exiting the EU Committee](#), 25 October 2017, Q22

28 *Ibid*, Q34

That would happen over and over again. It is not a good position to get into to be still negotiating during such an arrangement. That is why the sequencing as I have described it is the case.

14. The Prime Minister told the House on 11 December 2017 that negotiations on the implementation period would start “immediately” after the European Council summit of 14–15 December. She added that:<sup>29</sup>

There are some details to be sorted out, but the general agreement is that it will be agreed as early as possible in the new year. [...] Michel Barnier has indicated that it could be during the first quarter.

15. The Chancellor of the Exchequer, Rt Hon. Philip Hammond MP, said in evidence to the Committee:<sup>30</sup>

It is self-evident to me, and I think it will be to members of the Committee, that a transition arrangement<sup>31</sup> is a wasting asset. It has a value today; it will still have a very high value at Christmas and early in the New Year. But as we move through 2018, its value to everybody will diminish significantly.

## The EU’s objectives

16. The European Council’s negotiating guidelines indicate broad principles for any future UK-EU trade agreement, including that it should be “balanced, ambitious and wide-ranging”; that it must ensure a “level playing field” in terms of competition and state aid (with safeguards against unfair tax, social, environmental and regulatory measures); and that it should preserve the integrity of the Single Market and the indivisibility of its “four freedoms”.<sup>32</sup>

17. However, the guidelines do not envisage the conclusion of a trade agreement within the Article 50 period. In particular, they note that “an agreement on a future relationship between the Union and the United Kingdom as such can only be finalised and concluded once the United Kingdom has become a third country”, and refer only to “preliminary and preparatory discussions” on the future relationship taking place before March 2019. Michel Barnier told the Lords European Union Committee that “the scoping of the future relationship [...] will continue after 30 March 2019. We will need a few years, most likely, to continue with that negotiation on the free and fair trade agreement”.<sup>33</sup>

18. The preliminary and preparatory discussions referred to in the guidelines have not yet begun, but are likely to commence in the first quarter of 2018. As the Chancellor told the Committee, the long-term relationship “has not yet even begun to be discussed”.<sup>34</sup> A distinct mandate to discuss the framework for the future relationship will only be provided after the Council has judged that “sufficient progress” has been made on three

29 HC Deb 11 December 2017, [col 52](#) [Statement on Brexit Negotiations]

30 [Oral evidence taken on 11 October 2017](#), HC 424, Q19

31 The Chancellor referred in this session to “transition” and a “transition period”. The term “implementation” was not used. By contrast, the Secretary of State for Exiting the European Union told the Exiting the EU Committee that “transition period” was “their [the EU’s] phrase”, adding that “ours [the Government’s] is ‘implementation period’”.

32 [European Council \(Art. 50\) guidelines for Brexit negotiations](#), 29 April 2017

33 [Oral evidence taken before the Lords Select Committee on the European Union](#), 12 July 2017, Q1

34 [Oral evidence taken on 11 October 2017](#), HC 424, Q22

areas deemed to be “necessary to ensure an orderly withdrawal of the United Kingdom from the Union”: citizens’ rights, the Irish border and the UK’s financial obligations.<sup>35</sup> On 8 December 2017, the Commission recommended that the European Council conclude that sufficient progress has been made in the first phase. The European Council will make a decision on 15 December 2017, and if it agrees with the Commission’s recommendation, it is likely to adopt new negotiating guidelines at a subsequent meeting. This will include a distinct mandate for the second phase.

19. The Legatum Institute has noted that the structure of the negotiations “leave[s] a much shorter timeframe, which increases the likelihood that by March 2019, there will be no free trade agreement in place”, adding that “in this event, there will have to be some interim measures in place to make sure that trade is not disrupted upon leaving the Customs Union and the EU”.<sup>36</sup>

20. The negotiating guidelines also require that a “sufficient progress” determination is made before discussion of transitional arrangements. However, the guidelines envisage a particular form and design for the arrangements, stating that:<sup>37</sup>

Should a time-limited prolongation of Union *acquis* be considered, this would require existing Union regulatory, budgetary, supervisory, judiciary and enforcement instruments and structures to apply.

They also state that the arrangements must be “clearly defined, limited in time, and subject to effective enforcement mechanisms”, and that the same principles that apply to the future trade relationship must also apply to transition.

21. Asked by the Committee whether the EU side’s conception of transition was the same as the UK’s, the Chancellor said “they are broadly the same [...] the starting point has to be the existing structure”.<sup>38</sup> Sir Ivan Rogers, former UK Permanent Representative to the EU, said that there was “appreciation” in the rest of the EU for the fact that the Prime Minister had articulated in her Florence speech “a conception of transition that seemed to chime, at least in some respects—maybe in most respects—with the kind of thing that the 27 thought they had said on 29 April [the date that the guidelines were issued]”.<sup>39</sup>

## Business views

22. At the end of the last Parliament, the Treasury Committee took evidence on transitional arrangements, including through a call for evidence that asked specifically about the desirability of a time-limited ‘standstill’ arrangement, during which the same or similar rules of trade apply immediately after the UK leaves the EU. Much of the evidence received at that time reflected the more recent support given to a ‘standstill’ transition by five UK trade associations in an open letter to the Secretary of State for Business, Energy and Industrial Strategy, which called for an arrangement that “maintain[ed] the economic benefits of the Single Market and the Customs Union”.<sup>40</sup>

35 European Commission, [Directives for the negotiation of an agreement with the UK setting out the arrangements for its withdrawal from the European Union](#), 3 May 2017, para 10

36 Legatum Institute, [The Brexit Inflection Point: The Pathway to Prosperity](#), November 2017, p16

37 [European Council \(Art. 50\) guidelines for Brexit negotiations](#), 29 April 2017, para 6

38 [Oral evidence taken on 11 October 2017](#), HC 424, Q19

39 Q5

40 [Letter](#) from British Chambers of Commerce, the CBI, EEF, the Federation of Small Businesses and the Institute of Directors to Rt. Hon. Greg Clark MP, 22 June 2017

23. For instance, in oral evidence to the Committee, Xavier Rolet, then Chief Executive of London Stock Exchange Group called for “nothing less than a grandfathering<sup>41</sup> of the existing conditions of trade”.<sup>42</sup> Elizabeth Corley, Vice Chair of Allianz Global Investors, stated that “there will be some sort of agreement that you have to just grandfather the status quo”.<sup>43</sup> In written evidence, the International Underwriting Association stated that “the insurance industry fully supports ‘standstill’ arrangements in respect of financial services for a minimum of five years or until such time as the replacement arrangements have been clarified”.<sup>44</sup> The UK Trade Policy Observatory stated that “this approach [standstill] would allow management of negotiating resources while providing continuity and certainty in the early years of the UK’s withdrawal from the EU”.<sup>45</sup> The Futures Industry Association described standstill as “critical”.<sup>46</sup> The Society of Motor Manufacturers and Traders (SMMT) wrote that “should at the end of the negotiating period there not be an agreement on a future relationship, current arrangements should continue to apply to ensure continuity and certainty”.<sup>47</sup> The Airport Operators Association wrote that an agreement should be sought “to extend current arrangements until such time as a new agreement is concluded”.<sup>48</sup> In written evidence to the Committee’s current inquiry, Honda wrote that “a meaningful transition would see the UK remaining within the Customs Union and Single Market”.<sup>49</sup>

24. A number of respondents to the Committee’s call for evidence drew a distinction between a ‘bridging period’, during which a trade deal remained under negotiation, and a subsequent ‘adaptation period’ once the terms of the future trade relationship were unconditionally agreed, during which firms adjusted to the new relationship.<sup>50</sup> Many were also sceptical that details of the long-term relationship would be known with certainty by March 2019. Sir Ivan Rogers said “it takes years; I have always made that clear. I do not say this in order to be gloomy; I just say it as a pretty experienced person who has been around lots of trade negotiations”.<sup>51</sup> The UK Trade Policy Observatory stated that “deep trade negotiation will take longer than two years [...] it is more likely to take five years or more”.<sup>52</sup> The US-UK Business Council stated that “the complex approval process of the EU-Canada Comprehensive Economic and Trade Agreement should serve as a cautionary tale for those who believe it will be easy for Britain to negotiate a free trade agreement with the EU”, adding that securing ratification from “38 national and regional parliaments will be extremely difficult, especially in the face of increased trade skepticism in many Member States”.<sup>53</sup> The Association of Chartered Certified Accountants stated that “40 years of being a member of the EU cannot be undone in just two years”, and that “there is a strong risk of a period of several years after exit from the EU before any new agreement takes effect”.<sup>54</sup> The Personal Investment Management & Financial Advice Association

41 “Grandfathering” generally refers to provisions that allow actions taken before a certain date to be subject to a previous set of rules.

42 [Oral evidence taken on 10 January 2017, HC \(2016–17\) 483, Q253](#)

43 [Oral evidence taken on 10 January 2017, HC \(2016–17\) 483, Q289](#)

44 International Underwriters Association ([FCR0014](#)), para 2.3

45 UK Trade Policy Observatory ([FCR0040](#)), para 5.1

46 FIA ([FCR0012](#)), para 2.3.1

47 Society of Motor Manufacturers and Traders ([FCR0002](#)), p.1

48 Airport Operators Association ([FCR0019](#)), para 23

49 Honda Motor Europe ([EUN0011](#))

50 See, for instance, City of London Corporation ([EUN0008](#)), para 2

51 Q40

52 UK Trade Policy Observatory ([FCR0040](#)), para 1.3

53 U.S.-UK Business Council ([FCR0004](#)), para 5

54 ACCA ([FCR0034](#)), p.3

wrote that “the Government is currently at risk of greatly underestimating the time it will need to negotiate a final EU/UK Agreement or Treaty, and of failing to understand the complexity and expense of the issues that may arise for businesses in adapting to the new environment”.<sup>55</sup> Similar doubts have been expressed to other Parliamentary committees.<sup>56</sup>

25. The Committee will continue to take evidence on the UK’s future economic relationship with the EU, and will seek a diverse range of opinions to ensure all voices in this debate are heard.

## Conclusions

26. **The Committee supports the Government’s proposal for a time-limited arrangement after the Article 50 negotiations conclude, and welcomes the alignment between the UK and EU27 on the core objective of this arrangement; namely, that the same common rules of trade should continue to apply in the UK and the EU as existed at the point of the UK’s formal exit.**

27. **This ‘standstill’ transitional arrangement must be sufficiently simple to negotiate within a matter of weeks, to provide early certainty about the legal framework for trade from 30 March 2019, and maximise the time available for subsequent discussions on the future framework for trade.**

28. **There remain differences between the two sides as to the purpose of transitional arrangements. The EU27 use the term “transition” and envisage negotiations on a long-term trade deal continuing during the interim period, while the UK is a ‘third country’. The Government uses the term “implementation”, and maintains that the purpose of this period is to provide time to adapt to a trade relationship that will be known and agreed by the end of 2018, when the Article 50 talks are expected to conclude.**

29. **The Committee strongly supports the Government’s objective of maintaining, “the freest and most frictionless trade possible” through a “bold and ambitious” trade deal with the EU.<sup>57</sup> However, it considers it very challenging for the completed details of the ‘bespoke’ free trade agreement envisaged by the Government to be fully agreed within the Article 50 process, particularly when negotiations on the future framework for trade are not yet underway. More importantly, businesses do not have confidence that the future relationship will be known and agreed by March 2019. The Government should seek, by the end of the Article 50 process, an agreed framework for the future trade agreement and a clear direction of travel.**

30. **Taking this into account, it is highly likely that, for certain sectors, including financial services, the ‘standstill’ transition period will have to be followed by an adaptation period that provides time to adjust to changes to the legal and operational environment under the future trade relationship, once it is known with clarity. At this**

55 PIMFA ([EUN0009](#)), para 5

56 For instance, in [evidence](#) to the Lords EU Select Committee, Raoul Ruparel, then Director of Open Europe and now Special Adviser to the Secretary of State for Exiting the EU, said that “it will probably take more than two years”. Luiz Gonzalez Garcia of Matrix Chambers said that “it is highly unlikely that in two years you can negotiate it”. Dr Markus Gehring of Cambridge University said that “it is not very realistic [...] to hope to conclude those negotiations within the two years”.

57 HM Government, [The United Kingdom’s exit from and new partnership with the European Union](#), February 2017, Cm 9417

stage, the Committee makes no recommendations about the design or duration of this subsequent period, except that, unlike the ‘standstill’ period, it need not involve the UK applying the existing framework of EU rules across all sectors.

Taking into account the challenges of concluding a trade agreement during the Article 50 process, and the alignment between the two sides on the objectives for the interim period, there are in practice two broad categories of outcome for the UK’s economic relationship with the EU on 30 March 2019: a reversion to a trade relationship based on WTO commitments (sometimes called a ‘no-deal’ scenario), or the preservation, on a temporary basis, of the status quo. In terms of their economic impact on both the UK and the EU27, the difference between these two outcomes is dramatic. The next chapter considers the impact of an unplanned ‘no-deal’ scenario in more detail.

31. There is also scope for differences between the two sides on the governance of the interim period, and in particular how “the existing structure of EU rules and regulations” can be given effect in the UK after the EU Treaties have ceased to apply and the European Communities Act 1972 has been repealed. This is considered further in Chapter 4.

## 3. UK-EU trade in the absence of an agreement

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### Overview

32. Unless the Withdrawal Agreement specifies otherwise, or the parties unanimously agree to extend the two-year Article 50 window, the EU Treaties will cease to apply to the UK on 30 March 2019. Without an agreement providing an alternative basis for trade, the UK’s trade relationship with the EU will at that point then be determined by market access commitments made by the EU at the WTO. For brevity, this is referred to in the rest of this chapter as a ‘no-deal’ scenario.

33. In the last Parliament, the Committee concluded that relying on WTO commitments as a basis for trade would be “economically costly”,<sup>58</sup> and the evidence it has received since then—both general and sector-specific—supports this view. Shanker Singham, Chairman of the Legatum Institute Special Trade Commission told the Committee that while “the WTO deals very well with tariff barriers”, it “does not deal well with the issue of regulatory barriers or non-tariff barriers”. In relation to services trade in particular, Mr Singham said:<sup>59</sup>

If you look at the services schedules of most countries, including the EU services schedule, they are fairly weak. The UK’s major industry is services. It is very important for us to get this right.

34. Sir Ivan Rogers echoed Mr Singham’s evidence about the importance of non-tariff barriers:<sup>60</sup>

The whole point about a single market, which we are leaving, as I say, is the tackling, erosion of and, ultimately, elimination of non-tariff barriers. People keep on obsessing about the tariff barriers but, by and large, tariff barriers, with the exception of agriculture and one or two sectors like automotive, have largely been eliminated.

35. Hosuk Lee-Makiyama, Director of the European Centre for International Political Economy, described the WTO as: “more of a life insurance policy or worst-case scenario [...] you could say that the WTO commitments today function more as a least possible level of decency as to how two trading entities should behave with each other. If 50 per cent of the UK’s trade is with Europe, you cannot have those terms imposed upon it”.<sup>61</sup>

36. Were the UK to trade with the EU solely on the basis of WTO commitments, this would place it in an unusual position. Most advanced economies—even those without a preferential trade agreement covering tariffs—have arrangements with the EU that go some way to addressing the non-tariff barriers to trade that exist under WTO-only arrangements. For instance, the United States has agreements with the EU on (among other things) customs co-operation, and the mutual recognition of conformity assessment

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58 Treasury Committee, [Economic and financial costs and benefits of the UK’s EU membership](#), First Report of Session 2016–17, HC 122, para 166

59 [Oral evidence taken on 13 July 2016](#), HC (2016–17) 483 Q199

60 Q55

61 [Oral evidence taken on 13 July 2016](#), HC (2016–17) 483, Q175

procedures for certain goods. An equivalence determination by the European Commission made in February 2016 also allows central counterparties (CCPs)<sup>62</sup> based in the US to serve EU clients on the same basis as CCPs based in the EU. Sir Ivan Rogers said that, in such a scenario:<sup>63</sup>

We have no more rights than Venezuela or Yemen in the EU market. We have no more rights of access, because we have got no preferential agreement and we have got no legal agreement.

37. The economic forecasts of the Office for Budget Responsibility and the Bank of England assume a smooth adjustment to a new trade relationship with the EU. The OBR described the “policies and regimes [that] supersede those presently associated with EU membership” as one of the risks to its forecast.<sup>64</sup> Dr Mark Carney, Governor of the Bank of England, has said that there are “considerable risks” to the Bank’s outlook “which include the response of households, businesses and financial markets to developments related to the process of EU withdrawal”.<sup>65</sup>

38. The Committee received evidence that, for certain sectors, a ‘no-deal’ scenario will have an immediate impact on their ability to do business across borders, generally as a result of changes to the legal framework for trade. These sector-specific impacts, which are not exhaustive but instead reflect the evidence received by the Committee, are considered in the following section of the report. The Committee also heard that changes to data sharing arrangements, customs procedures and border formalities will have immediate consequences for the flow of cross-border trade more generally. These cross-cutting consequences are considered in the section entitled *Cross-sectoral issues*.

39. The consequences of a ‘no-deal’ scenario are examined against a counterfactual in which transitional arrangement is reached that preserves the ‘status quo’ on a temporary basis. Many of the changes, particularly with respect to customs procedures and border inspections, will eventually occur even under a comprehensive trade agreement, as a result of the Government’s decision to leave the Single Market and Customs Union. For many of those submitting evidence, the principal concern is the imminence of the changes in a ‘no-deal’ scenario, and the absence of time to prepare for them.

40. The medium-term risks, changes and opportunities that lie ahead will be considered in more detail in the Committee’s future work, as the terms of the long-term trade relationship between the UK and the EU become clearer.

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62 Central counterparties stand between the buyers and sellers of derivatives and equities, guaranteeing the terms of the trade even if one party defaults on the agreement. The CCP collects enough money from each buyer and seller for covering potential losses incurred by not following through on an agreement.

63 Q18

64 Office for Budget Responsibility, [Economic and Fiscal Outlook – November 2017](#), Cm 9530, para 3.150

65 Mark Carney, [\[De\]Globalisation and inflation](#), 2017 IMF Michael Camdessus Central Banking lecture, 18 September 2017

## Sector-specific issues

### *Banking and insurance*

41. In a ‘no-deal’ scenario, banks and insurers based in the UK<sup>66</sup> would lose the legal authorisation to serve clients in the rest of the EU,<sup>67</sup> either on a cross-border basis or through foreign branches. In written evidence, Lloyd’s of London described the impact on insurers that currently use these passporting rights:<sup>68</sup>

without either a new agreement in force or transitional arrangements, Brexit will mean that the activities in the EEA of UK passporting insurers will become unlawful. If they have branches in EEA Member States they must close them down and they will no longer be legally represented in those jurisdictions. They may not arrange new insurance contracts and may not renew existing contracts.

42. UK Finance (then the BBA) wrote of the impact on the provision of banking services in similar terms:<sup>69</sup>

EU27 businesses would suddenly be unable to receive services from UK-based banks, and vice versa, and existing legal agreements could suddenly become unenforceable. Without clarity and transitional arrangements, banks and their customers will be unable to continue, extend or begin contracts for these types of services, particularly for the many banking products that have a reasonably long duration.

43. Market infrastructure providers, such as the London Stock Exchange Group, would find themselves in a similar situation. In particular, without an equivalence determination by the European Commission, it would become uneconomic for EU27 banks to use central counterparties located in the UK.<sup>70</sup> JP Morgan wrote that such a situation would have “serious repercussions [...] any banks using their services would have to move entire pools of exposure [...] EU27 banks would find themselves in breach of regulations and would suffer punitive capital increases [...] there is a risk of market disruption and sharply increased costs of clearing, both of which would affect the non-financial end-users of markets”.<sup>71</sup>

44. A ‘no-deal’ scenario could also cause discontinuity in cross-border insurance and derivatives contracts that straddle ‘Brexit day’, since companies will no longer legally be able to collect premiums or pay claims (in the case of insurance contracts), or undertake life-cycle events (in the case of derivatives). The Bank of England has estimated that “six million UK policyholders, 30 million European Economic Area (EEA) policyholders, and

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66 Both UK-headquartered banks and foreign-owned UK subsidiaries.

67 Generally, references to the EU in rest of this Chapter also refer to the wider European Economic Area (i.e. Norway, Iceland and Liechtenstein).

68 Lloyd’s of London ([FCR0026](#)), para 2.4

69 BBA ([FCR0032](#)), para 4

70 UK CCPs would become “non-qualifying CCPs” under the Capital Requirements Regulation. EU banks seeking to clear on such CCPs would see the capital requirements attached to such activity increase by between 25 times (for non-direct clearing members) and 50 times (for direct clearing members). See, for instance, [FCR0012](#), Para 1.5.5

71 JPMorgan ([FCR0029](#)), para 14

around £26 trillion of outstanding uncleared derivatives contracts could [...] be affected”.<sup>72</sup> It added that “it will be difficult, ahead of March 2019, for financial companies on their own to mitigate fully the risks of disruption” and that both “UK and EU legislation would be required” to preserve the continuity of these contracts.<sup>73</sup> Andrew Bailey, Chief Executive of the Financial Conduct Authority, told the Committee that “if we woke up one morning and the passport was not there—those contracts could not be legally serviced. That is the guts of it”.<sup>74</sup>

45. As with other sectors, the potential disruption arising from a ‘no-deal’ scenario stands to affect both the UK and the EU. Dr Carney told the Committee that, given the dominance of the UK as a financial services provider to the rest of the EU, “these issues are bigger for Europe than they are for us, although they are material for us”.<sup>75</sup> He has also commented on the extent of reliance of the EU27 on UK financial services:<sup>76</sup>

Banks located in the UK supply over half of debt and equity issuance by continental firms, and account for over three quarters of foreign exchange and derivatives activity in the EU. If these UK-based firms have to adjust their activities in a short time frame, there could be a greater risk of disruption to services provided to the European real economy, some of which could spill back to the UK economy through trade and financial linkages.

46. The Bank has also noted that UK-incorporated companies provide around half of wholesale banking services used by EEA customers. And the ECB estimates that UK central counterparties (CCPs) clear approximately 90 per cent of euro-denominated interest rate swaps used by euro-area banks.<sup>77</sup>

## Automotive

47. In the automotive sector, compliance with EU standards is assessed by Notified Bodies in each Member State, which are responsible for certifying that vehicles, and their systems and components, meet relevant environmental, safety and security standards. In the UK, the Vehicle Certification Agency (VCA) is the body responsible for issuing the accreditation (known as “type approval”) that allows vehicles manufactured in the UK to be sold into the rest of the EU. Type approval typically takes between 6 and 18 months and costs £350,000 to £500,000.<sup>78</sup> The UK exports over half of the cars it manufactures to the rest of the EU.<sup>79</sup>

48. In a ‘no-deal’ scenario, the VCA would no longer be able to issue type approvals that allowed UK-manufactured vehicles to be sold into the rest of the EU. The validity of existing type approvals would also be uncertain. Mike Hawes, Chief Executive of the Society of Motor Manufacturers and Traders (SMMT), told the Committee in the last Parliament that WTO rules would be “the worst of all worlds” for the automotive sector.<sup>80</sup>

72 Bank of England, [Financial Stability Report – November 2017](#), p.8

73 *Ibid.*, p.8

74 [Oral evidence taken on 31 October 2017](#), HC475, Q84

75 [Oral evidence taken on 16 October 2017](#), HC474, Q25

76 Bank of England, [Opening remarks](#) by the Governor at the Financial Stability Report press conference, 30 November 2016

77 [Bank of England, Financial Stability Report – November 2017](#), p.11

78 SMMT [Issue paper on Type Approval](#), November 2016, p.1

79 SMMT, [Press Release](#), 26 January 2017

80 [Oral evidence taken by the Committee on 24 January 2017](#), HC (2016–17) 483, Q395

In written evidence, the SMMT stated that a “no deal scenario” could be “hugely damaging to the UK automotive industry”.<sup>81</sup> Ian Howells, Senior Vice President of Honda Motor Europe told the Committee that it “probably means that the product that we produce on 30 March, even though it is identical to that produced on the 29th, would not be allowed into the European marketplace”.<sup>82</sup>

49. In written evidence, Honda stated that:<sup>83</sup>

If EU and UK Type Approvals issued after Brexit are no longer mutually recognised, we would be unable to place products onto the market. Additionally, if approvals for parts and components are no longer recognised, we would face significant difficulties sourcing appropriately approved components from suppliers in the UK and EU. Both of these factors would have a very significant impact on our production activity.

## Chemicals

50. Most chemicals regulation in the UK is derived from the EU, the principal pieces of legislation being REACH, the CLP Regulation and the Biocidal Products Regulation. In particular, under REACH, EU companies are required to provide information to the European Chemicals Agency on the hazards, risk and safe use of chemical substances that they manufacture or import. These registrations are stored in a publicly accessible database. Exporters from outside the EU seeking to sell into EU markets are not bound by the obligations of REACH. That responsibility lies with either the importer of the chemical, or with a single representative (known as an ‘only representative’, or OR) appointed by the exporter. ORs must be established within the EU. Without a REACH-compliant importer or OR, chemicals exported to the EU cannot be released for free circulation.

51. UK companies have made more than 5,000 registrations under REACH, 40 per cent of which were made by UK-based ORs for non-EU manufacturers seeking to export to EU markets.

52. The Cosmetic, Toiletry and Perfumery Association explained the effect of a ‘no-deal’ scenario for the chemicals sector:<sup>84</sup>

Once the UK leaves the EU, UK manufacturers and importers would not be recognised as being established within the European Community and would each have to appoint an ‘Only Representative’ (OR) in an EU Member State in order to continue to sell chemicals on their own or in finished cosmetic products into the EU. On the same note, companies based in the UK currently acting as ORs for non-EU-based companies exporting into the EU would no longer be able to act in that role. Issues that would need to be addressed include the status of existing REACH registrations and of future registrations.

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81 SMMT ([FCR0048](#)), p.1

82 Q180

83 Honda Motor Europe ([EUN0011](#)), p.1

84 CTPA ([FCR0046](#)), p.2

53. BASF also highlighted the possibility that, in a ‘no-deal’ scenario, existing chemicals registrations made by UK firms would cease to be recognised. It wrote that, while “this extreme outcome we hope is implausible”, it would “effectively end trade in some chemicals between the UK and EU until such a time as the impasse was resolved”.<sup>85</sup>

54. In advice to companies, the European Chemicals Agency has stated that existing UK registrations will be regarded as “non-existent” after Brexit. It goes on:<sup>86</sup>

Consequently, your EU-EEA customers will need to register the respective substance themselves. Alternatively, in order to continue supplying your EU-27(or EEA)-based customers on the basis of your own registration, as a manufacturer you will need to either relocate to the EU-27/EEA or to appoint an Only Representative within the EU-27/EEA.

### **Air services**

55. The consequences for air services of a ‘no-deal’ scenario are potentially severe because, as the Airport Operators Association (AOA) stated in written evidence, aviation does “not form part of the WTO system. Instead, countries negotiate bilateral or multilateral air services agreements to provide airlines with the legal rights to fly certain places”.<sup>87</sup>

56. Within the EU, the Single Aviation Market was developed in the 1990s and there are now no commercial restrictions for airlines flying within the EU. Externally, the EU has negotiated a number of air services agreements, of which the most important is the EU-US Open Skies Agreement that enables any EU or US airline to fly any transatlantic route. A further 113 countries have a bilateral air services agreement with the UK. The movement of passengers and cargo within the EU is also facilitated by the European Aviation Safety Agency, which develops and monitors aviation safety legislation, and is responsible for the type certification of aircraft, engines and parts. The AOA described the consequences of a failure to reach a new EU-UK air services agreement, and new agreements to replace the EU’s external agreements:<sup>88</sup>

if there is no new agreement on air services once the UK leaves the EU, the legal framework for flights covered by the current EU-level arrangements disappears. While the UK has had bilateral air services agreements with most (but not all) EU27 countries prior to the Single Aviation Market coming into existence, these date from a different era and are no longer fit for purpose as a fall-back option. There is also a question over whether they are still legally valid since the Single Aviation Market superseded them. The same applies with the UK’s historical bilateral agreements with non-EU countries where there is now an EU-level air services agreement, like the US.

85 BASF ([FCR0047](#)), p.3

86 ECHA website, [Q&A on The UK’s withdrawal from the EU](#) [accessed 4 December 2017]

87 Airport Operators Association ([FCR0019](#)), para 6

88 *Ibid*, para 16

57. Sir Ivan Rogers said that, with no agreement in place:<sup>89</sup>

UK air carriers that had been operating within the Single Market pre-Brexit would lose their EU air traffic rights. To keep operating flights within the EU and continue to qualify as EU air carriers, which is the precondition to operate intra-EU air services, those companies would need to relocate their principal place of business into the EU27, i.e. where they oversee those air services' conduct, maintenance and repairs and maintain their principal financial functions.

58. In evidence to the Transport Committee, representatives from the air services industry considered that the consequences of a failure to reach an agreement on air services were so severe that it was, in practice, unlikely. John Holland-Kaye, Chief Executive of Heathrow Airport said:<sup>90</sup>

I share the Secretary of State's confidence that arrangements will be put in place to make that [a transitional arrangement] happen. [...] There will be pressure within the EU to make sure that a sensible, pragmatic deal is put together in the event that there is not an implementation period.

Willie Walsh, Chief Executive of International Airlines Group, said he was optimistic that an agreement would be reached that ensured "that the world will continue as it has".<sup>91</sup> Tim Hawkins, Corporate Affairs Director for Manchester Airports Group, said that "we recognise the theoretical risk at the end of a long process, but we are confident that there are a range of practical and pragmatic ways of addressing that risk, which mean that we do not end up there".<sup>92</sup>

59. The Chancellor told the Treasury Committee that while it was "theoretically conceivable that, in a no-deal scenario, no air traffic will move between the UK and the European Union on 29 March 2019 [...] "I don't think anybody seriously believes that that is where we will get to". He added that "even if talks break down and there is no deal, there will be a strong compulsion on both sides to reach agreement on an air traffic services arrangement".<sup>93</sup>

## Accountancy

60. As the UK's competent authority for statutory auditor regulation, the Financial Reporting Council (FRC) is recognised as an appropriate regulatory authority throughout the EU. This recognition allows auditors that it regulates some involvement in audits for overseas entities. In written evidence, the Association for Chartered Certified Accountants (ACCA) stated:<sup>94</sup>

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89 Q30

90 [Oral evidence taken before the Transport Committee](#), 30 October 2017, HC 531, Q2

91 *Ibid*

92 *Ibid*, Q8

93 [Oral evidence taken on 11 October 2017](#), HC 424, Q4

94 ACCA ([FCR0034](#)), p.3

It is not clear whether the UK regulators/competent authorities, such as the FRC, will continue to be recognised as such once the UK leaves the EU. This could significantly curtail the ability of UK professionals to provide services to EU clients.

[...]

Even if negotiations offer a favourable outcome in terms of mutual recognition of professional qualifications/competent authorities there is a strong risk of a period of several years after exit from the EU before any new agreement takes effect, during which UK businesses would be at risk of being excluded from the single market in services. Unlike the trading of goods, this would not simply entail a mere raising of barriers (e.g. tariffs), but in many instances effective exclusion from practice altogether.

## Cross-sectoral issues

### *Data transfer*

61. The ability to transfer data across borders is central to cross-border trade, particularly in services; it is estimated that about half of all trade in services is enabled by digital technologies and the related data flows, and three-quarters of the UK's cross-border data flows are with EU countries.<sup>95</sup>

62. The rules and principles governing the cross-border flow of data in the EU are being updated. At the point the UK leaves the EU, data protection rules will be set by the General Data Protection Regulation (GDPR) and a Police and Criminal Justice Directive (PCJ Directive), also known as the “Law Enforcement Directive”), both of which are set to take effect from May 2018. Also relevant are the EU-US Privacy Shield and the EU-US Umbrella Agreement, which provide frameworks for transfers of personal data between the EU and the US.

63. The Government intends to incorporate the provisions of the GDPR into UK law through the EU (Withdrawal) Bill. But outside the EU, UK data controllers that wish to continue receiving personal data transferred from the EU will have to demonstrate that they provide an adequate level of protection. The UK could seek an adequacy decision from the European Commission, involving a review of domestic data regime to determine how the UK's data protection landscape matches the requirements of EU law. Such a decision could only be reached after the UK had left the EU and become a “third country”. In written evidence, Eversheds LLP described how businesses might ensure the free flow of data in the absence of an adequacy decision:<sup>96</sup>

Lawful transfers may be achieved by use of European Model Clauses (EMCs) between exporters and importers. Businesses will need to identify all affected data flows and put in place the necessary EMCs and keep them up to date. Binding corporate rules (BCRs) can also make data transfers

95 Frontier Economics, [The UK digital sectors after Brexit](#), 24 January 2017

96 Eversheds LLP ([FCR0027](#)), para 5.10

lawful. However, UK businesses and organisations cannot make BCR applications from the UK and are unlikely to be able to maintain control of existing BCR arrangements from the UK post-Brexit.

64. The Chancellor said that “one of the scenarios we have to plan for is no data sharing [...] That could be because of a bad-tempered breakdown of negotiations or equally because, in the absence of a common framework of law, we may not have a legal framework for data sharing”.<sup>97</sup>

65. In its November 2017 Financial Stability Report, the Bank of England commented specifically on the implications of barriers to the flow of personal data for financial services:<sup>98</sup>

These barriers could, for example, impact firms’ ability to service EEA clients from their data centres, which are typically located in the United Kingdom, as they do now. This could in turn disrupt service provision to those customers.

### Box: the EU Customs Union and border checks

As a Member State of the EU, the UK is part of the EU Customs Union. The defining feature of the Customs Union is the common external tariff (CET). The CET means, first, that goods produced in the EU are not liable for further duties as they cross Member States’ borders; and second, that goods entering from outside the EU can, on payment of the relevant duties, move around within the Union without being liable for additional tariffs.

The Customs Union was envisaged in the 1957 Treaty of Rome, and was completed in 1968. But before the “creation” of the Single Market in 1993, Member States still inspected goods at borders to ensure that they met relevant domestic standards. The “regulatory union” created by the Single Market obviated the need for such inspections, and the right of free circulation of goods within the EU was fully established. Member States still retain the right to stop and inspect EU goods crossing borders for the purpose of combatting crime.

The EU provides the legislation and framework under which the UK operates its customs regime and manages the flow of international trade. In particular, the EU sets requirements for the declaration of goods entering or leaving the Union. These are contained in the Union Customs Code (UCC), a package of legislation that sets out the arrangements for managing the EU’s external borders.

The Code, which replaces previous 1992 Community Customs Code, took effect on 1 May 2016, although it contains transitional provisions that mean some elements do not enter force until 2020.

Like its predecessor, the UCC delegates extensive powers to the European Commission to specify the precise details of how Member States should operate their customs.

97 [Oral evidence taken on 11 October 2017](#), HC 424, Q54

98 [Bank of England, Financial Stability Report – November 2017](#), p.10

## Customs declarations

66. In the absence of an agreement, the UK would apply, from 30 March 2019, the same customs controls to imports from the EU as it does to those from the rest of the world. Likewise, EU Member States would apply customs controls to UK exports.

67. As part of these changes, businesses will be required to make customs declarations on trade between the UK and the EU. HMRC estimates that the total number of customs declarations in a ‘no-deal’ scenario would increase fivefold from its current level, and that the number of traders having to go through customs processes would rise from 170,000 to around 300,000.<sup>99</sup> Jim Harra, Tax Assurance Commissioner and Director General, Customer Strategy and Tax Design, HMRC, said that a ‘no-deal’ scenario presented a “significant challenge”, and that the Department’s existing IT system for making and processing declarations, known as CHIEF, was not capable of handling such an increase. CHIEF, which is 25 years old, is in the process of being replaced with a new system, known as the Customs Declaration Service (CDS).<sup>100</sup> This replacement was originally developed in order to accommodate changes to EU customs legislation, which take effect in 2020.

68. CDS is scheduled to enter service in January 2019, a timescale Jon Thompson, Chief Executive and Permanent Secretary of HMRC, told the Public Accounts Committee he was “reasonably confident” would be met.<sup>101</sup> Sir Amyas Morse, the Comptroller and Auditor General, told the Treasury Committee that he interpreted Mr Thompson’s remarks to mean that “there were still significant things that had to happen towards the end of the project that could disrupt its final delivery”. He added that “this is a substantial IT project and it is not unheard of for them to run over, let us say. We all know that, so why not say it?”

69. Before the referendum, HMRC described the CDS project as “business critical”.<sup>102</sup> In evidence to the Committee, Mr Harra said it was a “high-risk programme”.<sup>103</sup> Jon Thompson made the point that CDS was being implemented alongside other Brexit-related changes—to indirect taxation, data and information sharing, and welfare—and 250 existing projects. He said that “you cannot run an organisation at this scale with this level of transformational ambition and just subsume all this”.<sup>104</sup>

70. 130,000 firms conduct international trade only with the EU, and will, from 30 March 2019, be dealing with customs procedures for the first time in a ‘no-deal’ scenario. Mr Harra told the Committee that there was “a big challenge in reaching and supporting them and getting them able to comply with their obligations, certainly on a transitional basis, as well as an ongoing basis”.<sup>105</sup> Mr Thompson noted that customs declarations forms contained 55 data fields.<sup>106</sup>

99 [Oral evidence taken on 14 September 2017, HC 314, Q24](#)

100 [Oral evidence taken on 7 February 2017, HC \(2016–17\) 483, HC 483, Q537](#)

101 [Oral evidence taken before the Public Accounts Committee, 25 October 2017, HC 401, Q54](#)

102 HMRC, [Major Projects Portfolio data](#), September 2015

103 [Oral evidence taken on 7 February 2017, HC \(2016–17\) 483, Q545](#)

104 [Oral evidence taken on 14 September 2017, HC 314, Q26](#)

105 [Oral evidence taken on 14 September 2017, HC 314, Q23](#)

106 [Oral evidence taken on 14 September 2017, HC 314, Q88](#)

71. Ian Howells, Senior Vice President of Honda Motor Europe, told the Committee that the change in customs procedures was a “very definite cliff edge [...] on the 29th, you have one set of rules; on the 30th, you have another set of rules and you are not entirely sure how they are going to work”. He added that:<sup>107</sup>

we can take whatever HMRC might put into place for customs, for example, but then we have an internal processing time in which we need to change our own systems. It is not just our systems, but those of our supply chain, which is very extensive and includes a lot of very small and medium-sized entities.

72. Nana Evans, Fashion Designer and microbusiness owner, said:<sup>108</sup>

Even doing custom forms takes up time in your day [...] I do not have the time to put in a day to do extra paperwork. It is very different from when you could pass that on to another employee or even hire somebody else to do the extra paperwork that may come along.

73. By contrast, Will Butler-Adams, Managing Director of Brompton Bicycle Ltd. described new customs formalities as “not a big issue” and said that the “small problem” of delays in customs could be managed by pre-positioning stock in the EU: “we will stuff some stock into Europe if nobody has made their mind up, which is the most likely outcome”.<sup>109</sup>

### **Border checks**

74. To ensure the correct taxes and duties have been paid, and to ensure that goods comply with relevant standards, goods entering the UK from outside the EU are subject to checks at the border. The Committee took evidence on how these checks are conducted currently, which is considered below. It also took evidence on the scope for unilaterally relaxing or disapplying these checks, considered in the following section of the report.

75. The Committee in the last Parliament asked about checks made by HMRC to customs declarations at the border. Bill Williamson, Customs Director, HMRC, said that “96 per cent of customs declarations [made to HMRC] are cleared within seconds”.<sup>110</sup> Jim Harra clarified in correspondence that 99 per cent of export declarations were cleared within 20 seconds. 96 per cent of import declarations were cleared within the same timescale, although this figure includes up to 10 minutes “dwell time” for businesses to make amendments to submitted declarations. Three per cent of import declarations lead to documentary checks, 96 per cent of which are completed within two hours (or overnight in respect of maritime traffic after 3pm). Less than one per cent of imports are subject to physical checks as a result of HMRC’s processing of customs declarations.<sup>111</sup>

76. Asked about the number of extra staff required to deal with additional customs work after Brexit, Mr Harra gave an estimate of 3,000–5,000 officials, based on a “crude extrapolation” from the fivefold rise in the number of customs declarations. He said that

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107 Q185

108 Q268

109 Q257

110 [Oral evidence taken on 7 February 2017, HC \(2016–17\) 483, Q551](#)

111 [Letter from Jim Harra to Rt. Hon Andrew Tyrie MP, 21 February 2017](#)

he did not think so many would be required in practice because “even if the number of declarations grows, a large number of those will be made by existing international traders whose compliance we already manage”.<sup>112</sup>

77. Other agencies at the border also carry out checks to ensure compliance with EU rules. For instance, almost all commercial imports of animals and products of animal origin into the EU are subject to inspection at designated Border Inspection Posts.<sup>113</sup> In the UK, these checks are carried out by the Port Health Authorities (which are usually the local authority). In correspondence with the Committee in the last Parliament, Mr Harra listed 17 government agencies operating at the border.<sup>114</sup> In oral evidence, Mr Thompson emphasised most physical inspections were carried out not by HMRC, but by other agencies:<sup>115</sup>

if you go to many ports, the majority of interventions that happen at the local port are from the local district council or other local authority responsible for animal health. To be specific, I went to Felixstowe the other day. Approximately three quarters of the interventions on containers there are from Suffolk Coastal District Council, who are looking at it from an animal and plant health perspective. So we all think about it as Border Force and HMRC and Transport, but it is actually the local authority that is implementing some aspects of European Union legislation. They are the people who mostly open the containers.

78. The number of documentary and physical inspections is minimised by an intelligence-led approach that identifies higher-risk consignments, thereby balancing revenue compliance with the free flow of trade; as Mr Harra put it, “we use intelligence and other risk assessment to identify the ones we want to zero in on”.<sup>116</sup> Risk assessments rely in part on data sharing between the customs authorities of EU Member States. Mr Harra emphasised the importance of this arrangement:<sup>117</sup>

One of the ways that fluidity between the UK and the rest of the Member States works so well now is because we have very good systems that share information and intelligence. To manage the risks on day one without disrupting trade, it is important that we secure those for the future as well.

79. Concern has been expressed about the infrastructure and space available in ports dedicated to trade between the UK and continental Europe, where current inspection rates are very low. 99 per cent of freight arriving by ferry into Dover, or by shuttle through the Channel Tunnel, does not require customs clearance. Freight movement through the Eurotunnel accounts for 25 per cent of goods trade between the UK and the EU, and transit between the Port of Dover and the continent accounts for a further 31 per cent. Jon

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112 [Oral evidence taken on 14 September 2017](#), HC 314, Q23

113 100 per cent of live animals have physical, documentary, and identification checks. For products of animal origin and animal by-products not for human consumption, 100 per cent of imports have documentary and identity checks, and 1–50 per cent have physical checks

114 [Letter from Jim Harra to Rt. Hon Andrew Tyrie MP](#), 21 February 2017

115 [Oral evidence taken on 14 September 2017](#), HC 314, Q65

116 [Oral evidence taken on 14 September 2017](#), HC 314, Q92

117 [Oral evidence taken on 14 September 2017](#), HC 314, Q63

Thompson described the Dover-Calais loop as a “major concern”, adding that “we need to make sure that that system is balanced, because it only takes something like two hours to stop”.<sup>118</sup> Mr Harra said:<sup>119</sup>

The key challenge, for example, in ro-ro [roll-on, roll-off] ports, in contrast with container ports, is that in a lot of them there are no port inventory systems in place. Although someone can make a customs declaration to us under CHIEF or CDS, understanding which vehicle the goods are on that that declaration relates to is not possible without those port inventory systems. Therefore, you would rely on much less ideal, much more manual processes to try to manage the risks at the border.

80. The Road Haulage Association estimated that current customs systems applied at Dover and the Channel Tunnel would “slow the movement of vehicles by between 20 minutes and 4 hours”.<sup>120</sup> It also expressed concern that there was insufficient space to handle the volume of traffic requiring customs clearance.

81. The Rail Delivery Group made similar points in respect of delays and capacity.<sup>121</sup>

One of the primary concerns about potentially defaulting to a World Trade Organisation arrangement due to lack end-state agreement or without a transitional arrangement, would be the impact of additional customs controls on borders. Primarily this would have a significant negative impact on international passenger services and freight being transported through the Channel Tunnel. It could also increase delays at ports, having a knock on impact on capacity and planning of rail freight services across the network. Anecdotal evidence from discussions with colleagues in Switzerland suggest that imposing customs at rail borders can create delays of over an hour and depending on density this can create queues of 30km.

82. The CBI noted that border delays would be “extremely problematic for short life-span goods like food and plants”, and that “delays in the trade in goods also result in pressures on working capital for small businesses, who do not receive payments until goods are received”.<sup>122</sup> Allie Renison, Head of Europe and Trade Policy at the Institute of Directors, told the Committee:<sup>123</sup>

It has been estimated that, for every extra day that goods sit in customs, it is equivalent to a two per cent to six per cent tariff. It is the uncertainty around knowing how much longer things might have the potential to be held up in goods sectors that the question mark around planning comes from, not so much the idea that they cannot trade on those terms.

118 [Oral evidence taken on 14 September 2017](#), HC 314, Q58

119 [Oral evidence taken on 14 September 2017](#), HC 314, Q48

120 Road Haulage Association, Brexit Policy Paper – [Unimpeded access for international road haulage](#), February 2017, para 6

121 Rail Delivery Group ([FCR0005](#)), p.4

122 CBI ([FCR0041](#)), para 5.5

123 Q231

## Options to mitigate the impact of ‘no deal’

### “Mini-deals”

83. In evidence to the Exiting the EU Committee, the Secretary of State for Exiting the European Union said that the most disruptive consequences of a ‘no-deal’ scenario would be likely to be mitigated through a “bare-bones deal”, covering specific areas:<sup>124</sup>

There are various sorts of no deal. There is a no deal where we go to WTO arrangements but we have a bare-bones deal on other elements. I listed them to the Chairman: aviation, data and maybe nuclear—or not—and so on. Then of course there is a complete failure to agree and a hostile outcome. That is so incredible that it is off the probability scale. But in those circumstances, it is conceivable there will be no deal of any sort.

84. The Chancellor made a similar point in evidence to the Treasury Committee, stating that in respect of aviation:<sup>125</sup>

it is very clear that mutual self-interest means that, even if talks break down and there is no deal, there will be a strong compulsion on both sides to reach agreement on an air traffic services arrangement.

However, he did acknowledge the possibility “of a bad-tempered breakdown in negotiations”, in which “people are not necessarily acting in their own economic self-interest”.<sup>126</sup>

85. Sir Ivan Rogers was sceptical that economic self-interest would inevitably prevail, stating that in the event of a “breakdown of trust”,<sup>127</sup>

There is then not a guarantee that the two sides come together in some affable moment at the end of 2018 and say, “You know what? The world might end if we do not do a deal which is not really a no-deal”. It might be so bloody by then that both sides are looking to knock chunks out of each other and to start a trade war.

### Unilateral action

86. In a ‘no-deal’ scenario, the Government will have greater flexibility to decide the terms on which goods are shipped, and services provided, from the EU to the UK. The Committee heard that this flexibility could be used to mitigate some of the potential disruption to cross-border trade.

87. In relation to customs, Jim Harra told the Committee that the principal objectives of HMRC were to ensure security at the border, maintain the free flow of trade, and collect revenue. He said that there could be “flexibility” about how those three priorities were

124 [Oral evidence taken before the Exiting the EU Committee](#), 25 October 2017, HC 372, Q47

125 [Oral evidence taken on 11 October 2017](#), HC 424, Q4

126 *Ibid.*, Q52

127 Q34

balanced.<sup>128</sup> In particular, HMRC could increase its risk tolerance at the border, in order to facilitate trade (although its discretion to do so in respect of EU trade alone may be constrained by WTO rules).<sup>129</sup> Jon Thompson said that:<sup>130</sup>

One of the ultimate contingencies we could take [...] is to say: “Forget the revenue. Hypothetically speaking, we have three objectives. Forget the revenue; just let everything in.” Now, that is a theoretical position that we could take. There is £3bn on the line for that position, but it is theoretically possible.

88. The Chancellor ruled out such a radical approach, telling the Committee that “on day one, we will not accept trucks rolling through Dover packed with dangerous goods [...] we will have a system in place that protects our vital interests—our national security, our homeland security and our revenues”.<sup>131</sup>

89. Although on leaving the EU, HMRC would have the flexibility to alter its risk tolerance at the border in order to preserve the free flow of goods, UK exports to continental Europe will be subject to customs control and inspection processes at EU ports according to EU rules. This would include the requirement for live animals and animal products to pass through Veterinary Border Inspection Posts (there are none in Calais). Jon Thompson said that “it takes two parties to dance [...] We are not in control of what happens on the other side of the border, which is a significant element of the risk”.<sup>132</sup> Jim Harra said that there was as yet little understanding in Government about the preparations being made by other customs authorities for a ‘no-deal’ scenario.<sup>133</sup>

when it comes to post-Brexit arrangements, other Member States have been clear that that is a matter for the Commission and the Commission’s negotiating team to deal with. So we are not having significant discussions with other customs authorities in the EU about what their arrangements will be post-Brexit [...] More insight into their preparedness for that will be very useful to us, but we don’t currently have it.

90. Mr Harra added that “based on past experience, the European Commission will expect the customs authorities of France, and the authorities of other countries with UK-facing borders, to administer their controls and collect their revenues”.<sup>134</sup> Although the UK ranks highly on the World Bank’s international comparison of the efficiency of customs processes, along with some other EU countries (such as the Netherlands, which ranks third), the same cannot be said of Belgium, which ranks 13th, France, which ranks 17th, and Spain, which ranks 24th.<sup>135</sup>

128 [Oral evidence taken on 14 September 2017](#), HC 314, Q85

129 GATT Article I:1 – With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation [...] any advantage, favour, privilege or immunity granted by any Member to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other Members.

130 [Oral evidence taken on 14 September 2017](#), HC 314, Q93

131 [Oral evidence taken on 11 October 2017](#), HC 424, Q54

132 [Oral evidence taken on 14 September 2017](#), HC 314, Q93

133 [Oral evidence taken on 14 September 2017](#), HC 314, Q7

134 [Oral evidence taken on 14 September 2017](#), HC 314, Q96

135 World Bank, [Logistics Performance Index 2016](#)

91. Just as the authorities operating at the border could mitigate the disruption of a ‘no-deal’ scenario by relaxing the terms on which goods to enter the country, so the financial regulators could be flexible about the terms on which they allowed EU firms currently relying on inbound passports continue to do business. Talking about the options available to allow contracts to continue to be serviced in a ‘no-deal’ scenario, Andrew Bailey, Chief Executive of the Financial Conduct Authority (FCA) said that, with secondary legislation, the FCA could “create a regime that effectively preserved the authorisation, at least for the period in which the contracts are in some form—running to their end, as it were”.<sup>136</sup>

## Government spending on Brexit preparations

92. To date, the Government has committed to £3.7 billion in spending on Brexit preparations. Thus far, £412 million has been allocated, to the Department of International Trade, the Foreign and Commonwealth Office, and the Department for Exiting the European Union. £250 million will be allocated before the end of the 2017/18 financial year. It is intended that £1.5 billion will be allocated to Departments in 2018/19, and a further £1.5 billion in 2019/20.<sup>137</sup>

## Firms’ contingency plans

93. The Committee received evidence from firms (predominantly in the financial services sector) about their contingency plans in the event of ‘no deal’, and the timetable over which those plans would be put into effect. It also asked the financial regulators about the state of firms’ contingency planning.<sup>138</sup>

94. A recurring theme in respect of the contingency plans for UK banks and insurers is the creation of “optionality” that allows them to continue to operate in the EU27 on the conservative assumption that no deal is reached. Typically, this involves the establishment of a new subsidiary within the EU27 (or the expansion of an existing one), and the acquisition of relevant regulatory permissions currently provided by UK outbound passports.

95. In terms of the scale of activity that might be relocated, Douglas Flint, then Group Chairman of HSBC, told the Committee:<sup>139</sup>

in the first instance what people are thinking about is that you need to move your relationship managers into the European Union for the products that would need to be licensed within the European Union. The question that then follows is whether the middle and back offices need to be co-located with the front office, or whether you could continue to service the flows in an outsourcing arrangement, the way that many of us do to other parts of the country, not in the EU.

[...]

136 [Oral evidence taken on 31 October 2017](#), HC475, Q85

137 [PQ 115138](#) (answered 30 November 2017)

138 The Prudential Regulation Authority has conducted an exercise to analyse contingency plans of 401 banks, insurers and designated investment firms undertaking cross-border business between the EU and UK. This includes contingency planning for a scenario in which there is no agreement at the point of exit and no transitional period.

139 [Oral evidence taken on 10 January 2017](#), HC (2016–17) 483, Qq259, 277

The question would be whether the negotiation would allow the middle and back office the settlement, the risk management, the accounting and so on to be done outside EU27 and whether EU27 as part of the negotiation says, “No, if we are going to give you a licence, we want everything in our country.”

96. For firms in the rest of the EU using inbound passports to provide services into the UK, contingency planning is less advanced. Mark Carney, Governor of the Bank of England, told the Committee that “there has been a difference in terms of the depths, level of sophistication and advancement of contingency planning of outbound firms versus inbound firms”. By way of explanation, he added that “there has been some assumption by inbound firms that there would be some form of transition arrangement put in place and, therefore, the urgency of this type of planning was less important”. He also added that, in general, preparation for ‘no deal’ was less advanced in the rest of the EU than in the UK.<sup>140</sup>

97. The Association of British Insurers wrote that insurers’ contingency plans “usually involve the establishment of a subsidiary in an EU-27 jurisdiction”. The ABI described the implementation of such plans as “expensive, cumbersome and capital-inefficient”, but noted that, among most insurers, such plans were “well advanced”.<sup>141</sup> Lloyd’s of London wrote that the contingency plans entail “moving operational activity and therefore jobs from the UK to the EU-27, a process that will have its own momentum”.<sup>142</sup>

98. Asked when contingency plans would be put into effect, Andrew Bailey told the Committee:<sup>143</sup>

we tend to take the view that the end of this year/beginning of next year is the point at which these sorts of things will start happening. Each firm will no doubt give you a slightly different date if you push for precision, but that is the sort of date to have in mind when things start to happen that have much bigger consequences.

99. Sam Woods, Chief Executive of the Prudential Regulation Authority, said that:<sup>144</sup>

Contingency planning is a sliding scale of increased commitment, investment and momentum through time. It is much more prudent and prosaic than hovering over the relocate button or rushing to the exit door [...]

If we get to Christmas and the negotiations have not reached any agreement on this topic, diminishing marginal returns will kick in. Firms would start discounting the likelihood of a transition in the central case of their planning.

140 [Oral evidence taken on 17 October 2017](#), Q15

141 Association of British Insurers ([FCR0042](#))

142 Lloyd’s of London ([FCR0026](#)), para 3.10

143 [Oral evidence taken on 31 October 2017](#), HC 475, Q80

144 Sam Woods, [speech](#) at the Mansion House City Banquet, 4 October 2017

100. Katherine Braddick, Director General, Financial Services, HM Treasury, told the Committee:<sup>145</sup>

Those firms [in the financial services sector] have been planning for some time and have a timescale. They have had a number of decision points about progressing those plans, but they harden or become more certain at the point at which they start to alter contractual paperwork with clients. For most of the firms that we talk to, that will fall at some point in the first quarter of next year.

101. According to Mark Carney, financial services are the sector in which contingency planning “is the most advanced”, and in which decisions are likely to be taken earliest: “the first quarter starts to be quite crucial on transition. For other businesses, there is a bit of a lag”.<sup>146</sup>

102. Dr Carney’s evidence is borne out by survey data from the Institute of Directors (IoD), which found that a third of firms had not yet drawn up any contingency plans, 19 per cent had drawn them up but not yet implemented them; and 8 per cent had put them into effect. A further 37 per cent had no plans either to draw up or implement contingency plans.<sup>147</sup> Allie Renison of the IoD said:<sup>148</sup>

if we have to wait until March for phase two to be discussed, you will see people putting in place their contingency plans, because the financial year ends shortly thereafter. We have found that a good majority of businesses are still holding off both implementing and drawing them up, and you will see that accelerate in the first quarter.

103. Ms Renison added that financial services had more flexibility to move activity into the EU27 than capital-intensive manufacturing:<sup>149</sup>

For manufacturing, you are talking about disruption to supply chains, although not always, and the movement of production and operations outside of the UK, so they need a bit longer to plan. It is a much more substantial operation to move that kind of physical infrastructure outside of the UK.

104. Ian Howells echoed this point, stating that “we have a huge plant in Swindon; 4,500 people work there. It [moving jobs and activity] is certainly not something that is easily done in a very short space of time”.<sup>150</sup>

105. Ms Renison also noted that many firms’ contingency plans did not involve relocation (“only 25 per cent are either moving or looking at moving operation”), with others “looking at setting up shadow supply chains, sitting on cash flow or not holding on to as much stock”.<sup>151</sup> Mr Howells said that Honda’s ‘no-deal’ contingency involved “increas[ing] the amount of inventory that we hold on the UK mainland, as opposed to importing it on a

145 [Oral evidence taken on 14 September 2017, HC 314, Q19](#)

146 [Oral evidence taken on 17 October 2017, Q39](#)

147 Institute of Directors, [The business end of Brexit – IoD survey on planning & trade](#), November 2017

148 Q189

149 Q191

150 Q198

151 Q199

more regular basis” and seeking new type approvals to replace those issued by the VCA, which he expected would take 9 to 12 months. He stated that these plans would be put into effect by March 2018, in the absence of any agreement being reached on transition.<sup>152</sup>

106. Asked about the nature of the commitment required to avoid the activation of contingency plans, Mr Howells said that it would take an “assurance” from “both sides”.<sup>153</sup> Andrew Bailey said that the commitment to transition “has to be strong and it has to be strong on both sides” to avoid the activation of contingency plans.<sup>154</sup> The City of London Corporation acknowledged that a “detailed, legally binding agreement will not be in place until the Withdrawal Agreement is signed”, but called for a “strong political agreement at the December European Council or early in first quarter 2018”.<sup>155</sup>

107. Martin McTague, Policy Director, Federation of Small Businesses, expressed concern that smaller businesses were less likely to prepare for the changes that might occur in a ‘no-deal’ scenario:<sup>156</sup>

If the past is anything to go by, it will probably be the back end of 2018 before some people wake up to what is going to happen. If we are about to drop off a cliff in April 2019, they will be completely ill-prepared for that and it will almost certainly result in business failures.

108. Neil Warwick, Partner at Square One Chambers, a Newcastle-based law firm, agreed that “the vast majority of businesses are not making plans”.<sup>157</sup> Will Butler-Adams, Managing Director of Brompton Bicycle Ltd., was amongst them, telling the Committee that “I am just ignoring it all and I will find out what you all decide you are going to do in about two years’ time”.<sup>158</sup>

109. Mr Butler-Adams added that SMEs should not be should not be reliant on Government “which moves along at zero miles per hour and changes its ideas every five minutes”, and should not hold out hope for a deal: “in business, you prepare for the worst”. But even in a ‘no-deal’ scenario, he was confident that there would be no problem for his business in selling into the EU.

*Will Butler-Adams:* [...] Europe is no problem at all, because we are trading into Europe; therefore we need a European type approval. That is their type approval. As long as we pass it, we trade into Europe. [...]

*Chair:* [What if] the Europeans decide to play really rough?

*Will Butler-Adams:* They cannot, because we pass the European type approval along with any other country in the world with which we trade, just like we pass the American type approval, the Japanese type approval, the Argentine type approval. They cannot. That is their type approval. We already pass the type approval, so all our work is around the European type approval.

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152 Q193

153 Q195

154 [Oral evidence taken on 31 October 2017](#), HC 475, Q81

155 City of London Corporation ([EUN0008](#)), para 5

156 Q279

157 Q286

158 Q257

110. In contrast to motorised vehicles, there is no EU law that mandates specific standards for pedal bicycles, or requires that they be type approved by a notified body located within the EU before they can be sold.<sup>159</sup> The General Product Safety Directive places the onus on the manufacturer to demonstrate that their product is safe. However, pedal bicycles that comply with the appropriate construction and safety standards adopted by the European Committee of Standardisation (CEN) are presumed to be safe, and can be sold across the EU.

## Conclusions

111. **It is overwhelmingly in the economic interests of both the UK and the EU to reach an agreement on a ‘standstill’ transition. The alternative—a sudden reversion to a trade relationship based on WTO commitments—would be damaging for both sides. The basis for trade in a number of sectors—including financial services, chemicals, vehicles and air services—would abruptly become more restrictive. The Committee intends to continue its scrutiny of the Brexit preparations, including through an evidence session with the WTO Secretariat to consider their perspective.**

112. **More generally, goods and services trade would be affected by changes to data sharing arrangements and customs procedures. Many of these changes would occur anyway as a result of leaving the Single Market and Customs Union. But an unplanned ‘no-deal’ scenario leaves firms with insufficient time to adapt. This is particularly the case for the 130,000 firms—mostly SMEs—that trade only with the EU, and have no prior experience of dealing with customs formalities.**

113. **A ‘standstill’ transitional arrangement would also mitigate the major risk that HMRC’s Customs Declarations Service (CDS) is not ready in time for 30 March 2019. The Committee remains to be convinced that robust contingency plans exist to avoid the severe disruption to goods trade that would occur in an unplanned ‘no-deal’ scenario were this project to fail, or even be modestly delayed.**

114. **Irrespective of the delivery of CDS, the abruptness of the change to arrangements for cross-border trade in an unplanned ‘no-deal’ scenario will also have major consequences for the operation of borders and ports. The principal routes for UK-EU trade are not currently designed to cope with such arrangements. The decision to leave the EU Customs Union and the regulatory union of the Single Market will inevitably require large-scale investment in these ports. But the Committee remains to be convinced that the people, infrastructure and space required on both sides of the Channel to avoid major delays and disruption will be available by 30 March 2019.**

115. **CDS is just one example of the swift administrative preparation needed for an unplanned ‘no-deal’ scenario. To take another, functions currently performed by a number of EU regulatory agencies, including the European Supervisory Agencies, the European Aviation Safety Agency, the European Chemicals Agency, and the European Medicines Agency, will have to be repatriated and allocated to domestic regulators. Their resources would have to be expanded, and the legal framework amended, to reflect these new functions. It is a vast undertaking for Government and Parliament to complete in less than sixteen months.**

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159 In written evidence, Honda listed the EU regulatory acts that set requirements for 71 different aspects of a car’s construction. ([EUN0011](#)).

116. The Chancellor has allocated £3bn in the Autumn Budget for Brexit preparation measures. The Committee, like the Comptroller and Auditor General, is in favour of insurance. But there is not yet any clarity as to what those measures entail, nor how the money will be allocated between Departments. If it is to bolster the UK's negotiating position as the Government intends—by demonstrating to the EU27 that the UK is prepared for any eventuality—more detail will be required.

117. The Government and regulators can take other steps to mitigate some of the consequences of an unplanned 'no-deal' scenario. For instance, HMRC and other agencies operating at the border could radically scale back their inspection regime, and the financial regulators could allow firms currently passporting into the UK to carry on doing so, while they process applications for domestic authorisation. These actions have attendant risks—to revenue, to consumer safety, and to financial stability—that would grow over time. And they do not mitigate the risk of disruption on the other side of the border, which will remain subject to EU rules.

118. Mitigation of an unplanned 'no-deal' scenario may also be provided through agreements between the UK and the EU in specific sectors, such as aviation, where the potential for disruption is most severe. The Government appears to consider it inevitable that such arrangements would be reached in the dying days of the Article 50 process. But the history of international trade diplomacy is replete with examples of short-sighted political considerations prevailing over economic self-interest. And the conclusion of such agreements may come too late for firms that are intending to activate their contingency plans in the first quarter of 2018.

119. Some firms may be able to take action to adapt to the changes to the legal and operational environment arising from a sudden reversion to WTO rules. However, doing so will be costly. It may involve a relocation of jobs and economic activity from the UK to the remaining EU. And it may in the end be unnecessary if a trade agreement is eventually concluded that restores some of the rights and market access that existed while the UK was an EU Member State.

120. There is evidence, particularly in the financial services sector, that adaptation to a WTO rules environment is happening already. This process will gather momentum over time, and will only be stopped if sufficient certainty is provided by the negotiating parties that this outcome will be averted. It is not only the materialisation of a 'no-deal' scenario that has damaging economic consequences, but the anticipation of such a scenario. It is for this reason that the Committee agrees with the Chancellor that transitional arrangements are a "wasting asset", the value of which will diminish the longer they take to negotiate.

121. The commitment to preserve, through the EU (Withdrawal) Bill, the substance of EU law in the domestic legal system provides a sensible basis for the negotiation of a future UK-EU trade relationship that provides comprehensive market access. But it does not obviate the need for such access to be negotiated and agreed by both sides. In the absence of any agreement on these issues, the mere fact of regulatory alignment on the day after the UK leaves the EU will provide no mitigation to the consequences described above; the UK will have the status of a third country, and WTO commitments will form the basis for cross-border trade.

## 4. Design and governance issues

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122. The operation of Article 50 and the priorities of the negotiating parties have implications for the design and governance of a ‘standstill’ transition. Professor Catherine Barnard, Professor of EU law at the University of Cambridge, noted that reaching agreement on a ‘standstill’ transitional arrangement that was consistent with the Government’s objective of leaving the EU on 30 March 2019 gave rise to “really quite difficult terrain legally and structurally”.<sup>160</sup> Some of the design and governance issues on which the Committee received evidence are considered below.

### Transition and the Withdrawal Agreement

123. The Prime Minister’s Florence Speech envisages that transitional arrangements will be “agreed under Article 50”, meaning that they would form part of the Withdrawal Agreement, agreed by a qualified majority vote in the Council, and ratified by the European Parliament.<sup>161</sup> The Article 50 negotiating directives also imply that transitional arrangements will be agreed within the Article 50 process, and state that “article 50 [...] confers on the Union an exceptional horizontal competence to cover in this agreement all matters necessary to arrange the withdrawal”.<sup>162</sup>

124. Using Article 50 and the Withdrawal Agreement as the basis for transitional arrangements is important if it is to be negotiated quickly, since an agreement reached under a different legal basis could be classified as a mixed agreement, and require approval in the national legislatures of each EU Member State. However, some commentators have raised concerns that a ‘standstill’ transitional arrangement might exceed the EU’s competence under Article 50, such that it could not be negotiated as part of the Withdrawal Agreement.<sup>163</sup> Were the ECJ, on referral from a Member State, the Commission, the Council or the European Parliament, to find that the Agreement exceeded the EU’s competence, it “may not enter into force unless it is amended or the Treaties are revised”.<sup>164</sup>

125. Professor Kenneth Armstrong, Director of the Centre for European Legal Studies at the University of Cambridge, wrote that “the more substantive and forward-looking that an Article 50 transitional agreement becomes, the greater the legal risk that it could be considered to be outside the limits of the Union’s competence under Article 50”.<sup>165</sup>

126. Professor Barnard told the Committee that if transition is to be agreed under Article 50, “it is going to have to be short and sharp”,<sup>166</sup> but considered that it provided an adequate legal basis for ‘standstill’ transitional arrangements:<sup>167</sup>

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160 Q41

161 Prime Minister’s [Florence speech](#), 22 September 2017

162 European Commission, [Directives for the negotiation of an agreement with the UK setting out the arrangements for its withdrawal from the European Union](#), 3 May 2017, para 5

163 See, for instance, The Guardian, [European parliaments ‘could get vote on transitional Brexit deal’](#), 26 April 2017

164 [Treaty on the Functioning of the European Union](#), Article 218(11)

165 Professor Kenneth Armstrong ([EUN0006](#)), p.1

166 Q3

167 Q36

Even though Article 50 makes no reference to transition, Article 49 on accession makes no reference to transition and yet it is standard practice to have transitional arrangements there. If you have transition for a soft entry, surely you can have transition for a soft exit.

127. Professor Sir Alan Dashwood QC, a barrister at Henderson Chambers and former Director in the Legal Service of the Council of the European Union, agreed that Article 50 did not represent “any impediment to a transitional deal”.<sup>168</sup> He described two means by which ‘standstill’ transition could be incorporated into the Withdrawal Agreement:<sup>169</sup>

- *For the Withdrawal Agreement itself to provide that part of the existing Treaties (including any secondary acts) should temporarily continue to apply to the UK.* Professor Armstrong wrote that this option could involve having “a date for the entry into force of the agreement as a whole—on which date the UK would cease to be a Member State—but, as a derogation, specify a later date for the entry into force of the agreement when applied to certain provisions of EU law specified in the agreement or a specific Protocol on Transition”. He added that such an approach would be preferable for the EU side, in part because “the direct source of substantive obligations would not be the Article 50 agreement itself but would instead continue to be the EU treaties”.<sup>170</sup>
- *Writing the relevant provisions of the Treaties into the section of the Withdrawal Agreement relating to transition.* Professor Armstrong wrote that such an approach might be more desirable from the UK’s perspective “as it would be clear that the original EU treaties no longer applied to the UK”, and that, were the ECJ to be given jurisdiction over the agreement, the UK “could maintain that this was not the direct jurisdiction of the Court under the original treaties but an agreed and specific jurisdiction to which it had consented”.<sup>171</sup> Professor Armstrong added that this approach would be less acceptable to the EU because “it would not amount to a prolongation of the Union *acquis* [as envisaged in the negotiating guidelines] but rather its partial replication under a new legal instrument”, and that the creation of such an instrument may exceed the EU’s competence under Article 50.<sup>172</sup>

128. Professor Dashwood also noted the possibility of delaying the entry into force of the Withdrawal Agreement, meaning that the UK would “effectively continue to be a Member State of the Union” for the period of transition.<sup>173</sup> Professor Barnard added that “extension of the two-year period” was another means of achieving a ‘standstill’ transition, although she noted that this would be “the least politically palatable” option.<sup>174</sup>

129. In written evidence, the UK Trade Policy Observatory was sceptical about the possibility of negotiating any kind of arrangement, and wrote that “transition needs to involve extending Article 50”.<sup>175</sup> It added that:<sup>176</sup>

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168 Q36

169 Q36

170 Professor Kenneth Armstrong ([EUN0006](#)), para 18

171 Professor Kenneth Armstrong ([EUN0006](#)), para 23

172 Professor Kenneth Armstrong ([EUN0006](#)), para 24

173 Q36

174 Q36

175 UK Trade Policy Observatory ([EUN0004](#)), para 1.1

176 UK Trade Policy Observatory ([EUN0004](#)), para 1.2

negotiating a bespoke transition that replicates such access [to EU markets] will be nearly as complex as negotiating full Brexit. So complex, in fact, that it looks more or less impossible.

## Transition and UK law

130. Once it is agreed between the negotiating parties, the Withdrawal Agreement—including any transitional arrangements—must be given effect in UK law through the legislation. The Government has said that this will occur through Withdrawal Agreement and Implementation Bill, which will enshrine the Withdrawal Agreement in domestic primary legislation.<sup>177</sup>

131. It is not yet clear whether the Bill would make provision for the EU law that applies in the UK during transition to have direct effect and supremacy. Professor Barnard thought that:<sup>178</sup>

They [the EU27] will still require us to give effect to doctrines of direct effect and supremacy. That then raises interesting legal issues about how we deliver that because [...] there is a question about how we disinter the turning off of direct effect and supremacy. That is quite a lot of negatives but we will have turned off direct effect and supremacy by repealing the European Communities Act and then we will have to turn them back on in some way.

132. Professor Dashwood said that the transition arrangements would not “necessarily have to entail switching on direct effect and primacy again”, adding that:<sup>179</sup>

a solution that is satisfactory, perhaps not ideologically but substantively, would be to [...] apply the EFTA solution again here because the rules which the EFTA Surveillance Authority and the EFTA Court have to apply under the EEA agreement are the same ones as we would be seeking to extend the application of, at least so far as concerns the economic aspect of the package.<sup>180</sup>

133. Sir Ivan Rogers said that Professor Dashwood’s solution was “eminently rational”, but that it would lead to an “extremely complex negotiation inside the 27” that would not be conducive to a quick agreement on transition.<sup>181</sup>

134. In written evidence, Professor Armstrong set out two options for implementing transition in UK law, both of which would preserve the principles of direct effect and supremacy:

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177 HC Deb 21 November 2017 [col 977](#)

178 Q44

179 Q63

180 Professor Dashwood provided further detail of the “EFTA solution”, as a model for the UK’s long-term relationship with the EU, in written evidence to the Committee (EUN0003, Para 16), which involves the UK accepting “the jurisdiction of supranational (but not EU) institutions like the EFTA Surveillance Authority and the EFTA Court”. The EEA Agreement provides for an extension of the Single Market to the EFTA states of Iceland, Liechtenstein and Norway (the EEA EFTA states). The EFTA Surveillance Authority and EFTA Court perform analogous functions to the European Commission and ECJ: namely, they monitor compliance with, interpret and enforce the rules of the EEA Agreement in the EEA EFTA states. The concepts of direct effect and supremacy do not apply in the same way to EEA EFTA States as they do to EU Member States.

181 Q63

- for the relevant saved provisions of EU law [i.e. the EU law that falls within the scope of the transitional arrangements] to continue to have domestic effect via the European Communities Act 1972.<sup>182</sup>
- to replicate the approach of the 1972 Act in a new Bill and for saved provisions of EU law to have effect in a wholly analogous manner to how they had been given legal effect under the 1972 Act.<sup>183</sup>

He added that “replicating the known constitutional device of the 1972 Act would likely be acceptable to the EU”.<sup>184</sup>

### Scope and ambit

135. The reference in the negotiating guidelines to a prolongation of the *acquis* implies that transition will encompass not just EU law pertaining to the Single Market and Customs Union, but other areas, such as agriculture, fisheries, the environment, and justice and home affairs. Sir Ivan told the Committee that there could be “quite a difficult discussion inside the Government as to the scope and the ambit and the meaning of transition and what that does and does not permit you to do over the transitional period”.<sup>185</sup>

136. Discussing the scope of transition on 26 October 2017, the Secretary of State for Exiting the European Union told the Exiting the EU Committee that “I would expect all of the security and home affairs issues to continue [during transition]”.<sup>186</sup> On the question of fisheries, he said that this was “a negotiating issue [...] we have not come to a policy conclusion on that”.<sup>187</sup>

### The role of the ECJ

137. In her Lancaster House speech in January 2017, the Prime Minister said that, on leaving the EU, the jurisdiction of the ECJ in the UK will “end”, and that “our laws will be interpreted by judges not in Luxembourg but in courts across this country”.<sup>188</sup> The Government’s Future Partnership paper on enforcement and dispute resolution refers to “bring[ing] about an end to the direct jurisdiction of the Court of Justice of the European Union” (ECJ).<sup>189</sup>

138. However, the Government has indicated that it is prepared to be more flexible about the role of the ECJ during transition. Asked whether the UK “would accept the jurisdiction of the ECJ” during transition, the Secretary of State for Exiting the European Union told the Exiting the EU Committee on 25 October:<sup>190</sup>

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182 Professor Kenneth Armstrong ([EUN0006](#)), para 38

183 Professor Kenneth Armstrong ([EUN0006](#)), para 39

184 Professor Kenneth Armstrong ([EUN0006](#)), para 40

185 Q64

186 [Oral evidence taken before the Exiting the EU Committee](#), 25 October 2017, HC 372, Q16

187 [Oral evidence taken before the Exiting the EU Committee](#), 25 October 2017, HC 372, Q9

188 [The Government’s negotiating objectives for exiting the EU](#), speech by the Prime Minister at Lancaster House, 17 January 2017

189 HM Government, [Enforcement and dispute resolution: a future partnership paper](#), August 2017, para 1

190 [Oral evidence taken before the Exiting the EU Committee](#), 25 October 2017, HC 372, Q10

certainly initially, yes [...] by the end of it, we would want to be under alternative arrangements in terms of international arbitration, but that is something we would need to talk to the Commission about.

139. The Prime Minister told the House that during the implementation period:<sup>191</sup>

we [may] start off with the ECJ still governing the rules we are part of for that period, but we are also clear that we can bring forward discussions and agreements on issues such as a dispute resolution mechanism. If we can bring that forward at an earlier stage, we would wish to do so.

## Dealing with new law

140. Professor Barnard told the Committee that it was “very likely that they [the EU27] will insist [...] that we carry on accepting all of the EU rules that are adopted between 29 March 2019 and 2021”.<sup>192</sup>

141. The Government has not ruled out accepting new law during transition, on the grounds that it is unlikely that any EU legislation would enter force in the two-year period after March 2019 that the UK had not had the opportunity to influence as an EU Member State. The Prime Minister told the House that:<sup>193</sup>

Any new rules put on the table during the implementation period, given the way these things operate, are highly unlikely to be implemented during the implementation period.

## EU agreements with third countries

142. The EU has signed free trade agreements with over 60 countries, and several hundred further agreements covering external commercial relations.<sup>194</sup> On leaving the EU, in the absence of any negotiation, the UK will no longer be a party to these agreements. The Chancellor told the Committee that, in relation to the free trade agreements signed by the EU:

our planning expectation is that on day one after our exit from the European Union, we will have in place interim agreements with those third countries that the EU currently has trade agreements with that are effectively copy-outs of the EU-third country agreement, but as a UK-third country agreement.

He added that “this isn’t really a subject of negotiation, because we will simply take the EU agreement in its entirety, so that we have a patch, as it were, for day one”.<sup>195</sup>

143. Witnesses to the International Trade Committee agreed that extending the application of existing agreements for a transitional period, while freestanding trade agreements were negotiated, was a desirable approach, but noted potential difficulties, both practical and

191 HC Deb 9 October 2017 [col 53](#)

192 Q44

193 HC Deb 9 October 2017 [col 53](#)

194 See, for instance, the [Treaties Office Database](#) of the European External Action Service

195 [Oral evidence taken on 11 October 2017](#), HC 424, Q59

political, in doing so.<sup>196</sup> In written evidence to the Treasury Committee, the UK Trade Policy Observatory noted that preserving market access on existing terms would require an agreement on “diagonal cumulation”.<sup>197</sup> Their submission stated that “achieving such ‘diagonal cumulation’ is extremely unlikely”.<sup>198</sup>

## Conclusions

**144. An agreement between the UK and EU27 on transitional arrangements is now urgent. In his evidence to the Committee, the Chancellor argued that:**

**a transition arrangement is a wasting asset. It has a value today; it will still have a very high value at Christmas and early in the New Year. But as we move through 2018, its value to everybody will diminish significantly. Our European partners need to think very carefully about the need for speed in order to protect the potential value to all of us of having an interim period that protects our businesses and our citizens and allows investment and normal business activity.**

The Committee supports this view.

**145. In her Florence Speech on 22 September 2017, the Prime Minister outlined the Government’s objectives for a transitional deal, namely that: “people, businesses and public services should only have to plan for one set of changes in the relationship between the UK and the EU”; that “during the implementation period access to one another’s markets should continue on current terms”; that there should be a “strictly time-limited period” under “the existing structure of EU rules and regulations”; and that “how long the period is should be determined simply by how long it will take to prepare and implement the new processes and new systems that will underpin that future partnership”. If an agreement on these terms can be reached quickly, the Committee believes that such an arrangement will give people, businesses and public services the certainty they need to plan for the future and will also mitigate against the risk of a regulatory ‘cliff edge’ occurring during talks on the UK’s future relationship with the EU.**

**146. The operation of Article 50, the objectives of the negotiating parties, and the imperative for an early agreement, all constrain and condition the design and**

<sup>196</sup> [Oral evidence taken before the International Trade Committee](#), 15 November 2017, HC 520-ii: **Q14, Philippe De Baere**: [...] I am not saying that there would not be an interest in having a cut and paste, I am just saying that it is very difficult to do it in practice. You cannot just copy/paste the agreement. All the provisions will have to be gone through. For instance, in the agreement with Korea there is a reference to the protection of geographical indications of origin, which are identified by reference to the EU legislation on geographical indications of origin, which, after Brexit, will no longer apply. There has to be a substitute in the agreement for that. There are numerous examples of that.

**Q12, Andrew Hood**: In all of this there is some interest in countries on the other side who will want to have as much continuity in trade as possible, but the question is: what is their interest in doing so and where does the balance lie? In some cases, that may lie in agreeing to a rollover with all the technical changes that may have to come with that. In others they may say, “We would also quite like to just look at these one or two areas”. In others, it may be a more wholesale change they would like to see.

<sup>197</sup> Diagonal cumulation arrangements allow originating inputs from each country within the arrangement to ‘count’ as originating inputs in the other countries. For instance, if both the UK and EU have (separate) trade deals with South Korea, a UK producer could import a South Korean product, and export it to the EU (with or without changing or adding value to it), and it would be treated by the EU as if it were of UK origin (and thereby qualify for any preferential tariffs under a UK-EU trade agreement).

<sup>198</sup> UK Trade Policy Observatory ([EUN0004](#)), para 1.6

governance of transitional arrangements. In particular, the ‘standstill’ transition period must be sufficiently simple to negotiate within a matter of weeks. It must be consistent with the referendum result, in the sense that the UK should no longer be a Member State of the EU. It must also address concerns among the EU27 about preserving a balance of rights and obligations.

147. The Government has taken a pragmatic approach so far. It has accepted that the ECJ’s jurisdiction may continue; that the ambit of the arrangements may extend beyond EU law relating to the Single Market and Customs Union; and that the UK may follow new EU law implemented during transition.

148. The precise scope of transition, and whether the principles of direct effect and supremacy will continue to apply to the EU, are questions the Government has yet fully to address. The best outcome would be for transition to apply only to EU law pertaining to the Single Market and Customs Union, and for the transitional arrangements, along with the rest of the Withdrawal Agreement, to be implemented using domestic legal concepts, rather than in a way that retains the principles of direct effect and supremacy in the UK’s legal order.

149. But the best must not be the enemy of the good. The costs arising from the deferment, on a strictly temporary basis, of the repatriation of domestic powers to alter EU law, are outweighed by the economic benefits of avoiding a sudden reversion to WTO rules. The Government should not rule out a transition arrangement that encompasses EU rules beyond those pertaining to the Single Market and Customs Union, and retains, on a temporary basis, the principles of direct effect and supremacy, if that expedites the negotiations. Visible disagreement between the parties on points of principle would lead to a loss of confidence among businesses, and diminish the value of whatever is eventually negotiated. To prevent the arrangements becoming a ‘transition to nowhere’, and to address legitimate concerns over sovereignty, the Committee recommends that any transition should be capable of being unilaterally terminated by either side. Termination on the UK’s part should be subject to the approval of Parliament.

150. The two options presented by legal experts from whom the Committee heard—either to append relevant Treaty provisions to the Withdrawal Agreement, or for the Agreement to specify which provisions will continue to apply—are both reasonable ways of giving effect to ‘standstill’ transition. The other options available for the preservation of the ‘status quo’—the extension of the Article 50 period or the delaying of the entry into force of the Withdrawal Agreement—are not compatible with the Government’s objective of leaving the EU on 30 March 2019.

151. A core purpose of transitional arrangements is to allow planning for the UK’s future outside the EU to take place in an environment of stability and certainty. Given that the EU has exercised exclusive competence over trade policy for over 40 years, a key aspect of that planning is for the UK to establish independent trade relationships, both with countries which have an existing trade agreement with the EU and with those which do not. Notwithstanding that no trade agreements can enter force until the transition period has come to an end, nothing in the Withdrawal Agreement should prevent the UK from undertaking this work.

# Conclusions and recommendations

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## Introduction

1. The UK is leaving the EU. The Government has said that it intends to give effect to this by leaving the EU Customs Union and Single Market. But the means by which this is achieved, and the likely end-state relationship between the two parties, remains uncertain. This Report is the first in what is intended to be a series that seeks to make constructive recommendations in these areas. It deals primarily with a specific, albeit important and urgent, point of process: how can the UK move from its position within the EU to its end-state relationship in a smooth and orderly way, particularly when that final relationship might not be fully agreed on 30 March 2019? (Paragraph 4)
2. Equally important questions about what the UK's long-term economic relationship with the EU might be, and the opportunities, risks and changes that will arise as a result of Brexit, will be addressed in future work. (Paragraph 5)

## Objectives

3. The Committee supports the Government's proposal for a time-limited arrangement after the Article 50 negotiations conclude, and welcomes the alignment between the UK and EU27 on the core objective of this arrangement; namely, that the same common rules of trade should continue to apply in the UK and the EU as existed at the point of the UK's formal exit. (Paragraph 26)
4. This 'standstill' transitional arrangement must be sufficiently simple to negotiate within a matter of weeks, to provide early certainty about the legal framework for trade from 30 March 2019, and maximise the time available for subsequent discussions on the future framework for trade. (Paragraph 27)
5. There remain differences between the two sides as to the purpose of transitional arrangements. The EU27 use the term "transition" and envisage negotiations on a long-term trade deal continuing during the interim period, while the UK is a 'third country'. The Government uses the term "implementation", and maintains that the purpose of this period is to provide time to adapt to a trade relationship that will be known and agreed by the end of 2018, when the Article 50 talks are expected to conclude. (Paragraph 28)
6. The Committee strongly supports the Government's objective of maintaining, "the freest and most frictionless trade possible" through a "bold and ambitious" trade deal with the EU. However, it considers it very challenging for the completed details of the 'bespoke' free trade agreement envisaged by the Government to be fully agreed within the Article 50 process, particularly when negotiations on the future framework for trade are not yet underway. More importantly, businesses do not have confidence that the future relationship will be known and agreed by March 2019. The Government should seek, by the end of the Article 50 process, an agreed framework for the future trade agreement and a clear direction of travel. (Paragraph 29)

7. Taking this into account, it is highly likely that, for certain sectors, including financial services, the 'standstill' transition period will have to be followed by an adaptation period that provides time to adjust to changes to the legal and operational environment under the future trade relationship, once it is known with clarity. At this stage, the Committee makes no recommendations about the design or duration of this subsequent period, except that, unlike the 'standstill' period, it need not involve the UK applying the existing framework of EU rules across all sectors.

Taking into account the challenges of concluding a trade agreement during the Article 50 process, and the alignment between the two sides on the objectives for the interim period, there are in practice two broad categories of outcome for the UK's economic relationship with the EU on 30 March 2019: a reversion to a trade relationship based on WTO commitments (sometimes called a 'no-deal' scenario), or the preservation, on a temporary basis, of the status quo. In terms of their economic impact on both the UK and the EU27, the difference between these two outcomes is dramatic. (Paragraph 30)

8. There is also scope for differences between the two sides on the governance of the interim period, and in particular how "the existing structure of EU rules and regulations" can be given effect in the UK after the EU Treaties have ceased to apply and the European Communities Act 1972 has been repealed. (Paragraph 31)
9. It is overwhelmingly in the economic interests of both the UK and the EU to reach an agreement on a 'standstill' transition. The alternative—a sudden reversion to a trade relationship based on WTO commitments—would be damaging for both sides. The basis for trade in a number of sectors—including financial services, chemicals, vehicles and air services—would abruptly become more restrictive. The Committee intends to continue its scrutiny of the Brexit preparations, including through an evidence session with the WTO Secretariat to consider their perspective. (Paragraph 111)
10. More generally, goods and services trade would be affected by changes to data sharing arrangements and customs procedures. Many of these changes would occur anyway as a result of leaving the Single Market and Customs Union. But an unplanned 'no-deal' scenario leaves firms with insufficient time to adapt. This is particularly the case for the 130,000 firms—mostly SMEs—that trade only with the EU, and have no prior experience of dealing with customs formalities. (Paragraph 112)
11. A 'standstill' transitional arrangement would also mitigate the major risk that HMRC's Customs Declarations Service (CDS) is not ready in time for 30 March 2019. The Committee remains to be convinced that robust contingency plans exist to avoid the severe disruption to goods trade that would occur in an unplanned 'no-deal' scenario were this project to fail, or even be modestly delayed. (Paragraph 113)
12. Irrespective of the delivery of CDS, the abruptness of the change to arrangements for cross-border trade in an unplanned 'no-deal' scenario will also have major consequences for the operation of borders and ports. The principal routes for UK-EU trade are not currently designed to cope with such arrangements. The decision to leave the EU Customs Union and the regulatory union of the Single Market will inevitably require large-scale investment in these ports. But the Committee remains

to be convinced that the people, infrastructure and space required on both sides of the Channel to avoid major delays and disruption will be available by 30 March 2019. (Paragraph 114)

13. CDS is just one example of the swift administrative preparation needed for an unplanned ‘no-deal’ scenario. To take another, functions currently performed by a number of EU regulatory agencies, including the European Supervisory Agencies, the European Aviation Safety Agency, the European Chemicals Agency, and the European Medicines Agency, will have to be repatriated and allocated to domestic regulators. Their resources would have to be expanded, and the legal framework amended, to reflect these new functions. It is a vast undertaking for Government and Parliament to complete in less than sixteen months. (Paragraph 115)
14. The Chancellor has allocated £3bn in the Autumn Budget for Brexit preparation measures. The Committee, like the Comptroller and Auditor General, is in favour of insurance. But there is not yet any clarity as to what those measures entail, nor how the money will be allocated between Departments. If it is to bolster the UK’s negotiating position as the Government intends—by demonstrating to the EU27 that the UK is prepared for any eventuality—more detail will be required. (Paragraph 116)
15. The Government and regulators can take other steps to mitigate some of the consequences of an unplanned ‘no-deal’ scenario. For instance, HMRC and other agencies operating at the border could radically scale back their inspection regime, and the financial regulators could allow firms currently passporting into the UK to carry on doing so, while they process applications for domestic authorisation. These actions have attendant risks—to revenue, to consumer safety, and to financial stability—that would grow over time. And they do not mitigate the risk of disruption on the other side of the border, which will remain subject to EU rules. (Paragraph 117)
16. Mitigation of an unplanned ‘no-deal’ scenario may also be provided through agreements between the UK and the EU in specific sectors, such as aviation, where the potential for disruption is most severe. The Government appears to consider it inevitable that such arrangements would be reached in the dying days of the Article 50 process. But the history of international trade diplomacy is replete with examples of short-sighted political considerations prevailing over economic self-interest. And the conclusion of such agreements may come too late for firms that are intending to activate their contingency plans in the first quarter of 2018. (Paragraph 118)
17. Some firms may be able to take action to adapt to the changes to the legal and operational environment arising from a sudden reversion to WTO rules. However, doing so will be costly. It may involve a relocation of jobs and economic activity from the UK to the remaining EU. And it may in the end be unnecessary if a trade agreement is eventually concluded that restores some of the rights and market access that existed while the UK was an EU Member State. (Paragraph 119)
18. There is evidence, particularly in the financial services sector, that adaptation to a WTO rules environment is happening already. This process will gather momentum over time, and will only be stopped if sufficient certainty is provided by the negotiating parties that this outcome will be averted. It is not only the materialisation of a ‘no-

deal’ scenario that has damaging economic consequences, but the anticipation of such a scenario. It is for this reason that the Committee agrees with the Chancellor that transitional arrangements are a “wasting asset”, the value of which will diminish the longer they take to negotiate. (Paragraph 120)

19. The commitment to preserve, through the EU (Withdrawal) Bill, the substance of EU law in the domestic legal system provides a sensible basis for the negotiation of a future UK-EU trade relationship that provides comprehensive market access. But it does not obviate the need for such access to be negotiated and agreed by both sides. In the absence of any agreement on these issues, the mere fact of regulatory alignment on the day after the UK leaves the EU will provide no mitigation to the consequences described above: the UK will have the status of a third country, and WTO commitments will form the basis for cross-border trade. (Paragraph 121)

### Design and governance issues

20. An agreement between the UK and EU27 on transitional arrangements is now urgent. In his evidence to the Committee, the Chancellor argued that:

a transition arrangement is a wasting asset. It has a value today; it will still have a very high value at Christmas and early in the New Year. But as we move through 2018, its value to everybody will diminish significantly. Our European partners need to think very carefully about the need for speed in order to protect the potential value to all of us of having an interim period that protects our businesses and our citizens and allows investment and normal business activity.

The Committee supports this view. (Paragraph 144)

21. In her Florence Speech on 22 September 2017, the Prime Minister outlined the Government’s objectives for a transitional deal, namely that: “people, businesses and public services should only have to plan for one set of changes in the relationship between the UK and the EU”; that “during the implementation period access to one another’s markets should continue on current terms”; that there should be a “strictly time-limited period” under “the existing structure of EU rules and regulations”; and that “how long the period is should be determined simply by how long it will take to prepare and implement the new processes and new systems that will underpin that future partnership”. If an agreement on these terms can be reached quickly, the Committee believes that such an arrangement will give people, businesses and public services the certainty they need to plan for the future and will also mitigate against the risk of a regulatory ‘cliff edge’ occurring during talks on the UK’s future relationship with the EU. (Paragraph 145)
22. The operation of Article 50, the objectives of the negotiating parties, and the imperative for an early agreement, all constrain and condition the design and governance of transitional arrangements. In particular, the ‘standstill’ transition period must be sufficiently simple to negotiate within a matter of weeks. It must be consistent with the referendum result, in the sense that the UK should no longer be a Member State of the EU. It must also address concerns among the EU27 about preserving a balance of rights and obligations. (Paragraph 146)

23. The Government has taken a pragmatic approach so far. It has accepted that the ECJ's jurisdiction may continue; that the ambit of the arrangements may extend beyond EU law relating to the Single Market and Customs Union; and that the UK may follow new EU law implemented during transition. (Paragraph 147)
24. The precise scope of transition, and whether the principles of direct effect and supremacy will continue to apply to the EU, are questions the Government has yet fully to address. The best outcome would be for transition to apply only to EU law pertaining to the Single Market and Customs Union, and for the transitional arrangements, along with the rest of the Withdrawal Agreement, to be implemented using domestic legal concepts, rather than in a way that retains the principles of direct effect and supremacy in the UK's legal order. (Paragraph 148)
25. But the best must not be the enemy of the good. The costs arising from the deferment, on a strictly temporary basis, of the repatriation of domestic powers to alter EU law, are outweighed by the economic benefits of avoiding a sudden reversion to WTO rules. The Government should not rule out a transition arrangement that encompasses EU rules beyond those pertaining to the Single Market and Customs Union, and retains, on a temporary basis, the principles of direct effect and supremacy, if that expedites the negotiations. Visible disagreement between the parties on points of principle would lead to a loss of confidence among businesses, and diminish the value of whatever is eventually negotiated. To prevent the arrangements becoming a 'transition to nowhere', and to address legitimate concerns over sovereignty, the Committee recommends that any transition should be capable of being unilaterally terminated by either side. Termination on the UK's part should be subject to the approval of Parliament. (Paragraph 149)
26. The two options presented by legal experts from whom the Committee heard—either to append relevant Treaty provisions to the Withdrawal Agreement, or for the Agreement to specify which provisions will continue to apply—are both reasonable ways of giving effect to 'standstill' transition. The other options available for the preservation of the 'status quo'—the extension of the Article 50 period or the delaying of the entry into force of the Withdrawal Agreement—are not compatible with the Government's objective of leaving the EU on 30 March 2019. (Paragraph 150)
27. A core purpose of transitional arrangements is to allow planning for the UK's future outside the EU to take place in an environment of stability and certainty. Given that the EU has exercised exclusive competence over trade policy for over 40 years, a key aspect of that planning is for the UK to establish independent trade relationships, both with countries which have an existing trade agreement with the EU, and those which do not. Notwithstanding that no trade agreements can enter force until the transition period has come to an end, nothing in the Withdrawal Agreement should prevent the UK from undertaking this work. (Paragraph 151)

# Formal Minutes

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**Tuesday 12 December 2017**

Members present:

Nicky Morgan, in the Chair

Rushanara Ali	Alison McGovern
Charlie Elphicke	Catherine McKinnell
Stephen Hammond	Kit Malthouse
Stewart Hosie	John Mann
Mr Alister Jack	Wes Streeting

Draft Report (*Transitional arrangements for exiting the European Union*), proposed by the Chair, brought up and read.

*Ordered*, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 151 read and agreed to.

*Resolved*, That the Report be the Fourth Report of the Committee to the House.

*Ordered*, That the Chair make the Report to the House.

*Ordered*, That embargoed copies of the Report be made available (Standing Order No. 134).

[Adjourned till Wednesday 13 December at 2.00 p.m.]

## Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the [inquiry publications page](#) of the Committee's website.

### Wednesday 25 October 2017

*Question number*

**Sir Ivan Rogers**, former UK Permanent Representative to the EU, **Professor Catherine Barnard**, Professor of EU Law, University of Cambridge and **Professor Sir Alan Dashwood QC**, Barrister, Henderson Chambers, and former Director, Legal Service of the Council of the European Union [Q1–66](#)

### Wednesday 1 November 2017

**Sir Amyas Morse**, Comptroller and Auditor General, National Audit Office [Q67–174](#)

### Wednesday 15 November 2017

**Ian Howells**, Senior Vice President, Honda Motor Europe, and **Allie Renison**, Head of Europe and Trade Policy, Institute of Directors [Q175–247](#)

**Martin McTague**, Policy Director, Federation of Small Businesses, **Nana Evans**, Fashion Designer and Sole Trader, **Neil Warwick**, Partner, Square One Chambers, and **Will Butler-Adams**, Managing Director, Brompton Bicycle Ltd [Q248–295](#)

The following witnesses gave evidence to the Treasury Committee in the last Parliament on its inquiry [The UK's future economic relationship with the EU](#):

### Tuesday 28 June 2016

**Lord Turnbull**, former Permanent Secretary, HM Treasury, and former Cabinet Secretary, **Professor David Miles**, Imperial College London, and former member of the Monetary Policy Committee, and **Stephen King**, Senior Economic Adviser, HSBC [Q1–66](#)

### Tuesday 5 July 2016

**Professor Michael Dougan**, Professor of European Law, University of Liverpool, **Dr Robin Niblett CMG**, Director, Chatham House, **Sir Emyr Jones Parry GCMG**, former UK Permanent Representative to the United Nations and NATO, and **Raoul Ruparel**, Co-Director, Open Europe [Q67–161](#)

### Wednesday 13 July 2016

**Hosuk Lee-Makiyama**, **Shanker Singham** and **Dr Richard North** [Q162–246](#)

**Tuesday 10 January 2017**

**Douglas Flint CBE**, Group Chairman, HSBC, **Elizabeth Corley CBE**, Vice Chair, Allianz Global Investors, and **Xavier Rolet KBE**, Chief Executive, London Stock Exchange

[Q247–391](#)

**Tuesday 24 January 2017**

**Tom Williams**, Chief Operating Officer and President of Commercial Aircraft, Airbus, **Richard Carter**, Vice-President and Managing Director, BASF UK and Ireland, and **Mike Hawes**, Chief Executive, Society of Motor Manufacturers and Traders

[Q392–533](#)

**Tuesday 7 February 2017**

**Jim Harra**, Tax Assurance Commissioner and Director General, Customer Strategy and Tax Design, and **Bill Williamson**, Customs Director, HM Revenue & Customs

[Q534–631](#)

## Published written evidence

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The following written evidence was received and can be viewed on the [inquiry publications page](#) of the Committee's website.

EUN numbers are generated by the evidence processing system and so may not be complete.

- 1 Centre for European Legal Studies, University of Cambridge ([EUN0006](#))
- 2 City of London Corporation ([EUN0008](#))
- 3 EEF ([EUN0010](#))
- 4 Honda Motor Europe ([EUN0011](#))
- 5 National Farmers' Union ([EUN0002](#))
- 6 PIMFA ([EUN0009](#))
- 7 Sir Alan Dashwood QC ([EUN0003](#))
- 8 UK Finance ([EUN0005](#))
- 9 UK Trade Policy Observatory ([EUN0004](#))
- 10 Zurich Insurance ([EUN0007](#))

As part of the inquiry in the previous Parliament, the Treasury Committee issued a call for evidence on transitional arrangements. The following evidence was received:

- 1 ACCA ([FCR0034](#))
- 2 Airport Operators Association ([FCR0019](#))
- 3 Association of British Insurers ([FCR0042](#))
- 4 Association of Licensed Multiple Retailers ([FCR0016](#))
- 5 BASF plc ([FCR0047](#))
- 6 BBA ([FCR0032](#))
- 7 British Chambers of Commerce ([FCR0013](#))
- 8 British Hospitality Association ([FCR0020](#))
- 9 British Retail Consortium ([FCR0015](#))
- 10 Bupa ([FCR0037](#))
- 11 Confederation of British Industry ([FCR0041](#))
- 12 CTPA ([FCR0046](#))
- 13 Equity Release Council ([FCR0017](#))
- 14 Eversheds LLP ([FCR0027](#))
- 15 FIA ([FCR0012](#))
- 16 Finance Reporting Council ([FCR0001](#))
- 17 Financial Markets Law Committee ([FCR0031](#))
- 18 Gamma Communications plc ([FCR0007](#))
- 19 Hiscox ([FCR0030](#))
- 20 HSBC ([FCR0045](#))
- 21 ICAEW ([FCR0021](#))
- 22 International Underwriting Association ([FCR0014](#))

- 23 JPMorgan ([FCR0029](#))
- 24 Lancaster University ([FCR0009](#))
- 25 Lloyd's of London ([FCR0026](#))
- 26 Loan Market Association ([FCR0003](#))
- 27 London Market Group ([FCR0025](#))
- 28 MillionPlus ([FCR0011](#))
- 29 MSD ([FCR0024](#))
- 30 National Farmers Union ([FCR0018](#))
- 31 Rail Delivery Group ([FCR0005](#))
- 32 Russell Group ([FCR0038](#))
- 33 Society of Motor Manufacturers and Traders (SMMT) ([FCR0002](#))
- 34 Society of Motor Manufacturers and Traders (SMMT) ([FCR0043](#))
- 35 Society of Motor Manufacturers and Traders (SMMT) ([FCR0048](#))
- 36 The British Private Equity and Venture Capital Association ([FCR0033](#))
- 37 The Investment Association ([FCR0036](#))
- 38 The London Solicitors' Litigation Association ([FCR0006](#))
- 39 Tobacco Manufacturers Association (TMA) ([FCR0035](#))
- 40 U.S.-UK Business Council ([FCR0004](#))
- 41 UK Trade Policy Observatory ([FCR0040](#))
- 42 Universities UK ([FCR0022](#))
- 43 University of Birmingham ([FCR0008](#))
- 44 Which? ([FCR0039](#))
- 45 Zurich Insurance ([FCR0044](#))

## List of Reports from the Committee during the current Parliament

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All publications from the Committee are available on the [publications page](#) of the Committee's website.

### Session 2017–19

First Report	Appointment of Sir Dave Ramsden as Deputy Governor for Markets and Banking at the Bank of England	HC 472
Second Report	Appointment of Professor Silvana Tenreyro to the Bank of England Monetary Policy Committee	HC 471
Third Report	The Solvency II Directive and its impact on the UK Insurance Industry	HC 324