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Observations from CRE regarding the evaluation of the STEP project

Summary

On the 26th of September, the cost and benefit analysis of the STEP project (report prepared by Pöyry), was discussed within the high level group on interconnections in the South West of the European Union (HLG). New questions were asked to the Consultant and additional elements of valorisation were mentioned by TIGF. Such elements were presented at two technical meetings, on the 8th and 16th of November. At the 16th of November meeting, it was suggested that the elements provided by TIGF could be regarded as part of the overall evaluation of the project.

In this note, the Commission de Régulation de l'Énergie develops its analysis of the information and methodologies used to evaluate the STEP project, summarizing positions already expressed during HLG meetings. In particular, CRE advocates for relying on solid CBAs based on well known methodologies and subject to open discussions, in particular regarding assumptions and modelling. CRE's ambition is that the reflection on the relevance of moving ahead with a project like STEP is fed by objective parameters, actually defending the interests of European citizens. In a context of energy transition including a probable decline of gas demand, new investments in gas infrastructures must be based on a rationale which promotes an access to cheaper energy and secured supplies while contributing to mitigating CO_2 emissions.

Based on the elements developed below, CRE considers that Pöyry's study well covers the legitimate expectations of the HLG and should constitute the basis of decisions regarding the future of the STEP project. In particular, it appears after several discussions with the consultant that its approach captures most of the benefits of new interconnection projects. Therefore, CRE considers that references to other uncaptured benefits should be considered carefully to avoid double counting of benefits already accounted for in Poÿry's study. In any case, additional elements should only be considered if they derive from unbiased methodologies and if they are supported by substantiated assumptions based on observable effects of new interconnections. CRE concludes from the analysis below that this is not the case for the additional analysis carried out by the consultant Frontier Economics at the request of TIGF, and it is therefore strongly opposed to including its results in the HLG evaluation.

A. CRE views on the Pöyry's study

CRE acknowledges the quality of the work performed by Pöyry to evaluate the costs and benefits of the STEP project. This study, commissioned by the HLG, is based on agreed Terms of Reference and follows a methodology coherent with ENTSOG's standards. CRE is of the view that this study meets the initial expectations of the HLG, namely to have an independent, robust and credible analysis of the STEP project as a basis for agreeing upon potential further developments.

Even though the original intention of circulating an intermediate report among the HLG was not fulfilled, CRE positively notes that the feedback from HLG members expressed in the September meeting was taken into account by Pöyry and that various demands were integrated in the final version of the report.

This study evaluates the interest of the STEP project, based on an economic modelling of the European gas market, under various scenarios of demand and supply. It concludes that the project is beneficial, in the sense that it brings economic benefits higher than its costs, only in specific circumstances, with very limited availability of gas from Algeria and of tight LNG market with high prices. Such scenarios cannot be expected to occur repeatedly over the lifetime of the project. CRE notes that the project is also not beneficial under the conditions of the additional scenario requested by HLG members (namely a scenario of high demand for gas in Europe correlated with abundant LNG at a very competitive price). In any case, the results of the study show that the benefits of the project are entirely located in the Iberian Peninsula.

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In addition to that, the study concludes from the evaluation of additional quantitative criteria used by ENTSOG that the project does not improve other dimensions such as security of supply. Similarly, the STEP project brings very limited value to the resiliency of the European gas system in various cases of stress tests. The probabilistic study requested by HLG members concludes that in almost all cases, the additional benefits from STEP are still lower than its costs.

An important feature of the STEP project, which is however not fully captured by Pöyry, is the fact that it does not create firm capacity, as was demonstrated by the joint technical study performed by French and Spanish TSOs in 2015. The interruptible nature of the capacity created by the STEP project is not completely reflected by the consultant when estimating level of booked capacity – which would be much lower than what is supposed in the study – or when assuming the tariff level – the tariff for an interruptible capacity being lower than the tariff for firm capacity. This situation leads to overestimating the benefits of the project, in particular when performing the financial analysis, which is based on revenues from capacity bookings[1].

Based on these elements, CRE considers that Pöyry's study gives a clear indication on the lack of interest for European consumers of the STEP project.

B. CRE analysis on the study carried out by Frontier Economics

It does not seem adequate to place on an equal footing Pöyry's study and Frontier Economics' document. Whereas Pöyry worked at the request of the Commission, TIGF launched and funded Frontier Economics' study to identify hypothetical additional benefits that would be neglected by the ENTSOG CBA methodology used by Pöyry. In this matter, there is a risk that TIGF's judgment is biased since it is directly interested in promoting STEP, as it would increase its revenue. As a matter of fact, TIGF openly supports the STEP project.

Frontier Economics and TIGF eventually identified three kinds of benefits allegedly missed by Pöyry. CRE strongly questions these results for the following reasons:

1. Liquidity

   Frontier assumes that the new capacity would increase the market liquidity. Consequently, the transaction costs would decrease of the order of 5% in both France and Spain (which would correspond to benefits during the project lifetime ranging between 145 million €$_{2017}$ and 493 million €$_{2017}$ across scenarios, with the average at 290 million €$_{2017}$).

   CRE considers that this result arises from a set of unsubstantiated assumptions, mostly a reduction of bid-ask spreads in both markets (between 2,5 to 5 bps in France and between 5 to 10 bps in Spain). These figures can hardly have the necessary credibility to rely upon.

   STEP would only create interruptible capacities (and a relatively small amount in comparison with the markets sizes and the existing capacities). It seems impossible to justify such impacts on the spreads, in particular since the STEP capacity would frequently be unused or interrupted. Frontier Economics could at least improve the accuracy of its calculation by limiting hypothetical impacts on the spreads when gas would actually flow through the STEP pipeline.

   A sounder method would be to study existing Interconnection Points with interruptible capacities and to assess potential correlations between the adjacent markets liquidity and the availability of the interruptible capacities. For instance, CRE investigated a potential correlation between traded gas quantities at PEG Nord and the interruptible capacity at the IP between the North and South French zones since June 2013. We could not observ any meaningful link between those data (the correlation coefficient is only 0,12) which contradicts Frontier Economics' theory.

   Moreover, Frontier Economics does not provide any detail regarding the distribution of these theoretical benefits across the different categories of stakeholders. In our perspective, only final consumers' interests could justify an investment and TSOs or shippers' benefits should not be considered.

   In summary, CRE does not deny that STEP might contribute to improve the integration of the French and Spanish markets in some specific circumstances but does not see the measurement provided by Frontier as a credible economic estimation of this outcome. Lower bid-ask spreads are seen, in general, as an indicator of improved liquidity but are not seen as a benefit per se. Without an increased competition, this condition is not sufficient to deliver lower prices for consumers. The paradox is even that the increase of the churn rate degrades the benefit of liquidity.

[1] Even though these shortcomings have to be underlined, CRE is of the view that it is not a critical point since (i) improving the methodology on this aspect would only degrade further the benefits of the project and (ii) the financial analysis is only a supportive element in ENTSOG methodology used to complete the economic cost-benefit analysis.

2. Competition

   According to Frontier Economics, STEP could contribute to enhancing competition and reduce the margins of the retailers to the benefit of the end consumers. This expectation is based on the following rationale: "*Qualitatively, we note that there are currently 21 active retailers in France, and 9 in Spain. Amongst these retailers, 5 are active in both France and Spain. This suggests that STEP could contribute to 4 additional Spanish active retailers entering the French market, and 16 additional French active retailers entering the Spanish market*".Consequently, Frontier Economics assumes, without any justification, that the retailers' EBIT margin would drop by at least 0,375% and up to 0,5% both in France and in Spain (which would correspond to benefits during the project lifetime ranging between 100 million $€_{2017}$ and 134 million $€_{2017}$ across scenarios, with the average at 127 million $€_{2017}$).

   CRE strongly questions the underlying reasoning adopted by Frontier Economics, namely that additional cross-border capacity would necessary lead to increased retail competition. In a country with large import capacities from diverse gas sources, such as France, it can't be asserted that the level of these capacities is the restricting factor for competition on retail markets, which is primarily driven by price dynamics and regulatory framework.

   Furthermore, recalling that STEP would only create interruptible capacities, CRE considers that is it even more unlikely that its commissioning would be the basis for the decision of a shipper to enter a new market, since such interruptible capacities could only act as a short-term optimisation tool.

   It is even more surprising that Frontier Economics considers the majority of the benefits of increased competition accrue to France (73% in France / 23% in Spain). This result is driven by "*the larger number of residential customers in France and the higher level of consumption by customer in France, driving higher margins in absolute terms*" but it fully disregards two hard facts:

   - The level of competition in France is stronger than in Spain. Frontier Economics acknowledges that France might expect only 4 additional retailers (compared to 21 currently) whereas Spain might expect 16 additional retailers (compared to 9 currently).
   - The reality of the flow patterns is clearly from France to Spain. Pöyry's study clearly established that in most cases, STEP would allow to flow gas from France to Spain and relatively seldom from Spain to France. It does not seem realistic to assume that a significant share of the French retail market could be supplied from Spain.

   In the unlikely case of improved competition, it would then make much more sense to expect more benefits in Spain.

   In summary, the characteristics of the STEP project cannot alleviate potential obstacles to the entry of new retailers on the French and Spanish markets. Thus these figures cannot be seriously considered as a benefit of the project.

3. Avoided investments

   According to TIGF, STEP would allow to avoid regional network reinforcements in Narbonne and Perpignan areas, amounting to 60 million €. TIGF claims that these reinforcements are foreseen in its Long Term Development Plan. However, TIGF never submitted such reinforcement projects for approval by CRE. There was notably no mention of such projects in its latest Ten Years Development Plan, which TIGF published last October.

   Therefore, this alleged benefit of 60 million € cannot be considered in CRE perspective.

To conclude, CRE considers that the results of the Frontier Economics' study are not reliable enough to be seen as receivable in the cost and benefit analysis of the STEP project. They are mostly based on unsubstantiated assumptions. The High Level Group mandated Pöyry to carry out a Cost Benefit Analysis according to a well-established methodology. Only the results of this analysis should be considered. Carrying out the STEP project would indeed be a very important decision in terms of costs and influence on flow management in both gas systems. In a context of decreasing gas consumption, such a project should only be decided if providing undiscussable benefits.

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