



## The Political Economy of Governance in the Euro-Mediterranean Partnership

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New Challenges: Regional Integration

### **The Role of Energy for Regional Integration in the EMP: Strengthening Institutions**

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# 1. Introduction

Regional integration is an important long-term requirement to ensure sustainable economic growth and prosperity for the Mediterranean Partner Countries (MPCs). The first paper of this working package (CSS-Jordan) draws conclusions on the failure of the existing trade-based mechanisms within the Euro-Mediterranean Partnership (EMP) for fostering regional integration in both directions north-south (vertical) and south-south (horizontal) in the Mediterranean basin. However, the EU and the MPCs are moving towards stronger cooperation in other economic sectors, like environmental issues, infrastructure and especially in energy. This third working paper of Working Package 8 looks to evaluate the potential of energy cooperation for fostering regional integration in the Euro-Mediterranean Partnership. Do we have governance institutions for managing EuroMed energy cooperation? Do actors want and need these? This working paper identifies the regional energy dependencies, the key actors in both sides of the Mediterranean, their preferences, the existing institutional cooperation framework and the restrictions.

We assume that energy integration leads to a wider economic integration. The paper's core hypothesis is that energy producers and consumers on both sides of the Mediterranean basin have similar preferences and that there should therefore be a strong likelihood for integration. Here we assume that the stronger the energy interdependence between EU-MPCs the higher potential for institutional cooperation. Based on the Barcelona Declaration and in the progress of EuroMed energy cooperation since its promulgation we will assess some of the major goals and identify some obstacles. For this purpose we will apply the Markets & Institutions (M&I) approach from the Clingeandel International Energy Programme (CIEP) and will make some policy recommendations, especially with regard to the reform of the existing institutional framework in order to facilitate overall regional energy integration.

This paper is organised as follows: the second section outlines the theoretical links between energy and regional integration. After a literature review on regional integration theory, Section 3 presents the political economy approach, including core assumptions and hypothesis. Chapter 4 identifies the existing regional cooperation ties in EuroMed energy integration. Section 5 describes bilateral energy dependencies, assessing both the role of governments and private companies in integrating energy markets. Section 6 assesses the EuroMed regional integration efforts, identifying institutional, political and economic constraints. Section 7 draws the core conclusions, outlining the key role of energy for regional integration within the Euro-Mediterranean Partnership.

## 2. Linking energy integration with economic and regional integration

As already mentioned, this paper seeks to draw attention to the role that cross-national common economic infrastructure<sup>1</sup> projects can play in fostering MENA and EMP economic integration. Cross-national common economic infrastructure projects in these regions currently span various sectors including transport, water supply and energy. The link between economic infrastructure, integration and economic growth has been analysed by economists for decades (Hirschmann 1958, Moreno et al 1997, Canning 1999). As Fouire notes (2006:3), there are three means by which economic infrastructure integration have positive impacts on economic growth: first, offering better services; second, raising the productivity of workers; and third, benefiting the construction sector. Infrastructure integration creates also positive spill-overs to trade, competitiveness and other sectors (Fouire 2006:3). Integrating energy markets also helps ensure energy supplies, increase economic efficiency and macro-economic productivity (WEC 2007:82). For Nicoletti et al. (2003:29-47), *“Trade and FDI may also be affected by factors that are, or have been, closely-related to government policies regarding transportation, communications and energy supply”*. Eastery/Rebelo (1994:13) notes that *“investment in transport and communication is consistently correlated with growth”*. In general, the benefits of regional integration in the area of public goods have been shown by several papers (Schiff/Winters 2002, Mattli 1999). Whereas progress in MENA’s network of transportation infrastructure and services has only recently been strengthened, integration in the MENA’s energy sector has a long history(see chapters 4 and 5). However, several factors have had a negative impact in the sector, including: government interventionism; poor technical, managerial, and financial performance; high system losses in transmission and distribution; unsustainable tariffs; and environmental factors (WEC 2007:82).

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<sup>1</sup> According to Hirschmann (1958) we distinguish between economic infrastructure for promoting economic activity (roads, electricity, water) and social infrastructure for promoting health and education (schools, hospitals, etc).

### 3. The political economy approach

Which actors are behind regional energy integration? Although the reasons and motives of international cooperation have been a core research issue of international relations theory, regional integration theory has mainly concentrated on the way regional cooperation works (decision making, institutions), its elements (supranational, intergovernmental, regime-specific), and the reasons for integration. For studying regional integration there are several mid-level approaches which emphasise actors, interests, preferences, institutions, political structures and policy outcomes.

In order to explain the reasons for regional integration, most of studies in political science focus on institutions and processes. A first set of studies subsumed under the label of *supranational governance* started explaining regional integration as the result of spill-over-effects after the integration of one policy and creation of the consequent institutional framework (Miltrany 1943, Haas 1958, Sewell 1966). A complex policy environment, variable interests and actors, and limited information about the long term implications of short term decisions lead to a lost of control by national governments and to an unexpected institutional and policy outcome (Pierson 1996, Hix 2002). Yet critics argue that bargaining among countries may produce treaties, without necessarily producing integration. Supranational institutions are indeed important for the analysis of the EU, but not for most regions in the world. *Liberal-intergovernmental* approaches (Taylor 1982, Moravcsik 1991, Meunier/Nicolaidis 1999) identify certain national *demands* of economic and social actors for regional integration, as well as *supply* of treaties by governments. The primary actors of regional integration are states, whose preferences are driven by economic rather than geopolitical interests at the domestic level. Regional integration is the result of hard-won bargains and trade-offs between the states. However, critics argue that this approach does not explain the creation of supranational institutions (Hix 2004:14). Finally, the *rational choice institutionalist* perspective of integration (Tsebelis/Garrett 2001, Schneider/Bailer 2005) uses formal (usually mathematical) models of a particular bargaining situation in order to predict the policy equilibrium which leads to a certain degree of regional integration<sup>2</sup>.

*Political Economy* restates the core implications of these three approaches from the political sciences and puts special emphasis on the regional and national conditions that drive the *demand* for integration. Some scholars argue that such a demand is due to *external influences*

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<sup>2</sup> However, the differences between these approaches should not be over-emphasised (Hix 2004:17). Indeed, the power of every approach can be only judged as it helps to understand the past and to reduce the uncertainty about the future.

on the national economy. As small economies have a strong dependency on trade because of the lack of local resources, they tend to be highly vulnerable to any external economic shock and require highly adaptive decision-making systems (Katzenstein 1985). Depending on the impacts of external economic effects, the national demand for integration changes: if there is a negative effect of economic openness, then the demand for integration from the political elite's coalition increases because the costs of interdependence outweigh the costs of integration (Milner 1997). For these researchers, the external impacts of globalisation on domestic politics lead to crisis management, becoming the central ingredient in the demand for integration. Other political economy researchers concentrate on the *internal influences* on the national economy for explaining regional integration. As Milner notes, the demand for regional and cross-regional integration depends on the degree of home benefits (Milner 1997). Different domestic groups such as private investors or trade unions demand stronger regional integration as a way to increase their own benefits. In general, given the neo-classical economic argument that individual countries will achieve higher long-term growth by adopting free trade policies, there is an incentive to pursue integration (Krugman/Obstfeld 1997, Alesina et al 1995 & 1997). Finally, several studies note that nations sharing a common past of economic crises will tend to be more likely to participate in regional integration than those who have had minor crises. This explains the higher degree of development of regional integration in Latin America in the 90s and in East Asia since the Asian crisis of the late 90s.

However, it is not possible to explain regional integration only as a result of domestic and international economic conditions. First, the domestic gains of one potential member may not be sufficient to explain its participation in regional integration if the probability of other potential members adapting domestic institutions is low (Feng 2003:283). Second, if adaptation among member countries is not present the international economic conditions may still offer uneven effects. Therefore recent studies (Feng 2003, Dorrucchi et al 2004) emphasise the relationship between *economic conditions for integration* and the *economic institutional environment* at the domestic level. First, economic institutional homogeneity among countries should reinforce the integration processes as it reduces uncertainty and transaction costs (*the institutional effect*)<sup>3</sup>. The study of Dorrucchi et al (2002) presents a set of economic variables<sup>4</sup> based on the optimum currency area (OCA) theory which lead to stronger or weaker economic integration. Second, regional integration results in the modification of domestic

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<sup>3</sup> Institutions are defined as economic institutions characterized by monetary policy, fiscal policy, government regulation and economic openness.

<sup>4</sup> These include measures of the synchronisation of the business cycle, convergence of inflation rates, exchange rate variability, trade openness and integration, convergence of interest rates, and income convergence.

institutions, making them compatible across members (*the integration effect*). Depending on the degree of both effects in regional blocks this approach makes predictions about the likelihood of further integration. Above all, the quality of institutions seems to be the outstanding factor for fostering economic development and has a positive effect on regional integration (Rodrik et al, 2004:135).

Based on this political economy approach, we will assess the state preferences shaping EuroMed energy integration by applying the CIEP spatial model (CIEP 2005:19-20), which positions states according to their behaviour on an axis ranging from a political state-driven extreme (“*regions and empires*”) to an economic, market-driven extreme (“*markets and institutions*”). According to this model, we assume first that state behaviour in the international energy arena is influenced by lobbies at the domestic level. We further assume that energy companies do not always follow politics, being able to develop their own interaction ties. We hypothesise that: a) Euro-Mediterranean states whose energy sector is primarily state dominated are pushing for energy cooperation in the Euro-Mediterranean Partnership, and b) due to current political and economic conditions, there is a window of opportunity for the European Commission to exploit agency slippage and foster regional energy integration. However, the Commission’s chosen “*market & institutions*” approach might not address the demands of both European member states and Mediterranean Partner Countries, causing bilateral actions of both sides which undermine the coherence and efficiency of EuroMed energy integration.

#### **4. The genesis of EuroMed energy integration**

The pivotal role of energy for fostering regional cooperation and integration in the Euro-Mediterranean Partnership was addressed already in the Barcelona declaration of 1995. In contrast to trading sectors like agriculture, where both sides of the Mediterranean compete, the energy matrix of the Euro-Mediterranean space is - in net terms - complementary. Today the European Union’s member states import - as a group - 13% of their oil and 20% of their gas consumption from the MPCs (Annex 1). Some MPCs play a major role as transit countries for energy coming from the gulf and Caspian region<sup>5</sup>. Particularly Algeria, Libya and Egypt have the potential to become major suppliers of both gas and oil to Europe, based on their transport advantage (CEIP 2004:94). In sum, geographical proximity for energy production and transit, as well as the significant oil and reserves of the MPCs and their

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<sup>5</sup> MPC’s have also a high potential in renewable energy (see chapter XX).

potential in renewable energies, makes cooperation a crucial step for guaranteeing energy supply to the European Union. These conditions lead EuroMed states to specify in the Barcelona Declaration “*creating the appropriate framework conditions for investments and the activities of energy companies, cooperating in creating the conditions enabling such companies to extend energy networks and promoting link-ups*”. The signatory states agreed to cooperate in several areas such as implementing the European Energy Charter Treaty<sup>6</sup>, encouraging producer-consumer dialogue, fostering oil and gas upstream, and fostering regional energy trade (both south-south and north-south) through interconnections<sup>7</sup>. Although since the establishment of the EMP in 1995 several EuroMed ministerial meetings took place aiming to create a Euro-Mediterranean energy partnership<sup>8</sup>. The EuroMed Energy Ministers Conference in Athens in May 2003 was the first concrete step towards identifying priority areas in energy cooperation like integrating the Maghreb electricity market and its future harmonisation with the EU market, cooperating for the safety, security and continuity of energy supply, the gradual achievement of the new south north and south-south infrastructures for completing the Mediterranean electricity and gas rings. Taken together these strategic energy goals and the concrete measures listed in the EMP and ENP action plans<sup>9</sup> would represent a Euro-Mediterranean Energy policy. The institutionalisation of energy cooperation by creating the Rome Euro-Mediterranean Energy Platform (REMPEP) in December 2003 can be seen as a first step in implementing this policy<sup>10</sup>. According to the overall European energy policy objectives, EuroMed energy cooperation has to cope with three major goals: security of supply (availability), competitiveness (price) and environmental sustainability (CO2 emissions). The European Commission is putting special emphasis on the first of these objectives by cooperating in a) the development of compatible interconnections, b) the integration of the oil and a gas market framework, and c) in the use of renewable energy. We will now present the current state of cooperation in these fields.

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<sup>6</sup> The Treaty (signed in 1994) is a legally-binding multilateral instrument “*to strengthen the rule of law on energy issues, by creating a level playing field of rules to be observed by all participating governments, thereby mitigating risks associated with energy-related investments and trade*” (Energy Charter 1994).

<sup>7</sup> For a detailed list of all cooperation measures see Barcelona Declaration.

<sup>8</sup> Trieste (1996), Brussels (1998), Grenada (2000) and Valencia (2002).

<sup>9</sup> The ENP Action Plans replaced since 2007 the former National Indicative Programmes (NIP) under the EMP.

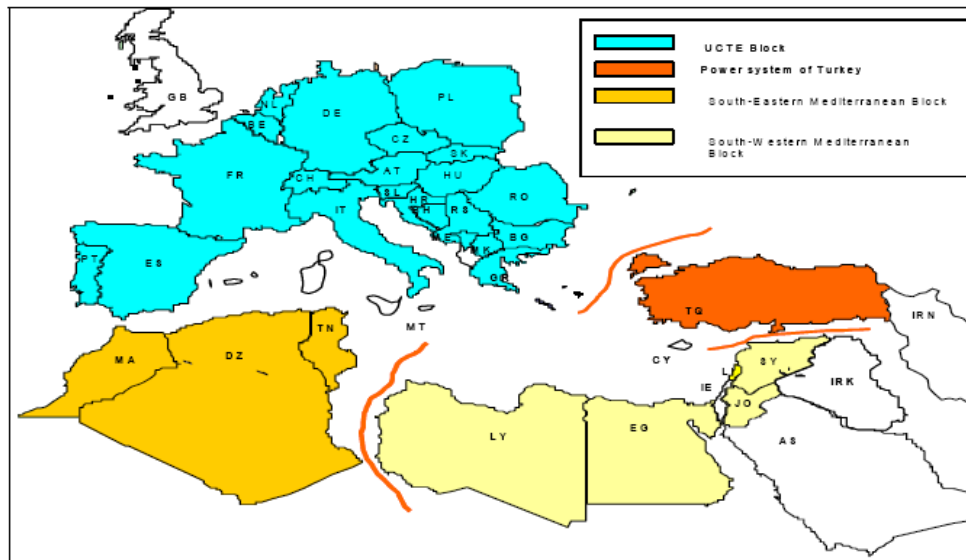
<sup>10</sup> The long term goal of REMPEP is the creation of an integrated Euro-Mediterranean energy market (EC 2007:29).



## 5. Electricity integration in EuroMed

Since 2004, the European Union member states are interconnected through the UCTE<sup>11</sup>. As EuroLectric notes (2007:9), this system lead to the “creation of one of the biggest synchronous systems in the world with a high level of security and reliability”. Chart 1 shows the existing electric interconnections in the EuroMed region.

**Chart 1: The EuroMed Electricity Ring**

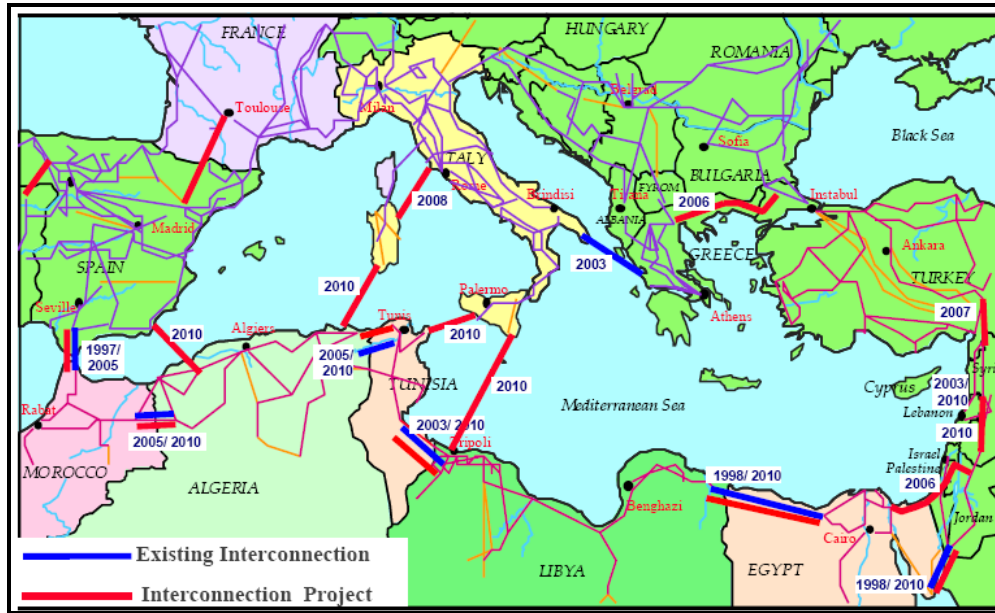


Source: EuroLectric, 2007

In the Southern and Eastern Mediterranean basin there exist four different power systems: the Turkish Block (entailing connections to the Caucasus countries), the South Eastern Mediterranean Block (SEMB - covering Libya, Egypt, Jordan, Syria and Lebanon that are synchronously interconnected), the South Western Mediterranean Block (SWMB- covering Morocco, Algeria and Tunisia) and the isolated systems of Malta, Cyprus and Israel (with several projects for interconnectivity with the EU or with the Mediterranean ring). It should be underlined that the SWMB is already connected to the UCTE grid (undersea Morocco-Spain synchronous interconnection since 1997). The SEMB is indirectly linked with the European block through the existing interconnections between with the SWMB. However, installed capacity of power interconnections in the MPCs is very limited (EuroLectric 2007:36).

<sup>11</sup> However, this doesn't count for Ireland, Sweden and the UK. For a brief history on the development of interconnected electric systems in Europe see Eurolectric (2007:7-9).

**Chart 2: Electricity interconnections in EuroMed**



Source: OME, 2005

The possibility of exporting electric power to the EU is a major incentive for MPCs to integrate. For this objective, new undersea transmission technologies based on the direct current system (DC) are being analysed (EuroLectric 2007:9). As already mentioned, today the electric systems of Maghreb countries (Algeria, Morocco and Tunisia) are interconnected with six lines (EuroLectric 2007:29). However, of the overall electricity trade in the Mediterranean basin (including EU Mediterranean countries), only 5% was accounted for by energy trade both among MPCs themselves as well as between MPCs and the EU (OME 2005:4). In 2003, regional electricity trade took place “*mainly between Morocco and Spain, Morocco-Algeria-Tunisia as well as Libya-Egypt-Jordan- Syria-Lebanon, and a part between Balkans and Greece*” (ibid). In 2006, the EU decided to increase interconnection capacities between France – Spain – Morocco – Algeria – Tunisia – Libya – Egypt – Middle Eastern countries – Turkey – Greece and Italy by establishing a fully integrated EuroMed electricity grid (the Mediterranean Electricity Ring project). Particularly interesting is the project to build an additional interconnection of *European interest* between Italy and Tunisia (EuroLectric 2007:37). Prospects for both south-south and north-south electricity integration in the Euro-Mediterranean region are optimistic, as by 2030 the south is expected to increase its current electricity exports to the EU by more than ten times (ENCOURAGED 2007:31). However, this depends on overcoming existing economic regulatory and political barriers for developing electricity interconnection infrastructure among MPCs themselves and between them and EU countries (OME 2007c:36).

## 6. Gas production and transit integration in EuroMed

According to the European Commission (2007b:7), the EU's gas import requirements will more than double by 2030 as compared to 2000. Until 2007 the only MPC exporting gas EU was Algeria (Annex 1). However, due to high export potential of Egypt, Libya and Syria, this situation might change in near future (OME 2005:6).

As the EC states, "Algeria is a strategic country for the European Union's energy supply (hydrocarbons), particularly gas (almost 25% of gas imports). This proportion will rise over the next two years with the completion of work on the undersea gas pipeline linking Algeria directly to Spain. Algeria's energy potential is enormous and should play a key role in the EU's energy security" (EC 2007a). The largest operating gas pipelines in the EuroMed region are TRANSMED (Algeria-Tunisia-Italy)<sup>12</sup> and Maghreb-Europe Gas –MEG– (Algeria-Morocco-Spain-Portugal-

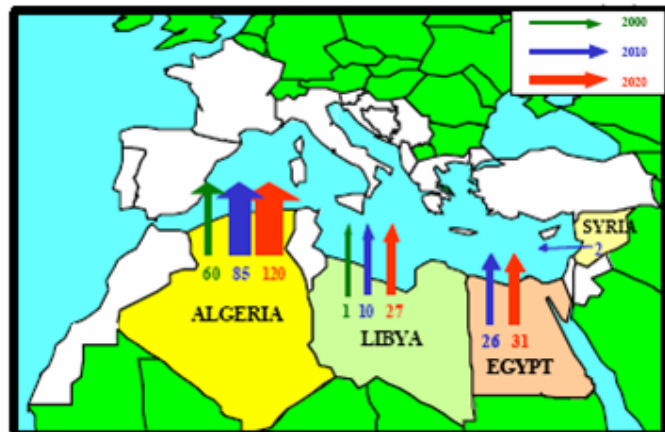
France). Both traditional gas pipelines connections and the growing role of liquid gas (LNG) will make huge investments necessary.

However, although markets have been continuously liberalised since the early 1990s, barriers to investment in gas infrastructure and cross-

border gas trade remain high, because of market risk (long payback periods of up to 20 years, uncertainty on price and volume), regulatory risk (impact of market rules and regulation) and political risk (uncertainty relating to political tensions and wars). Particularly the absence of proper multilateral cooperative institutions seems to be "both the symptom and cause of the inability to secure investments in regional infrastructures" (WEC 2005:80).

Among the biggest investment projects are two pipelines: the MEDGAZ project (Algeria-Spain) and the GALSI project (Algeria-Italy). Both projects are developed under a Production Sharing Agreement (PSA) model, i.e. private-public-partnerships between state owned and

Chart 3: MPCs gas export potential to the EU



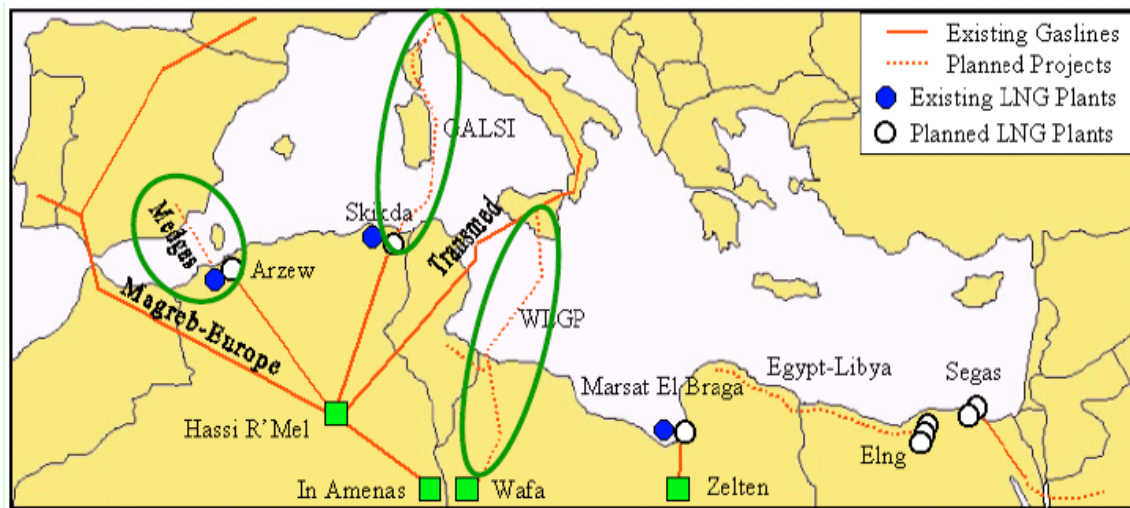
Source: OME, 2005

<sup>12</sup> The Transmed pipeline was initiated already in the 1970s and has an overall length of 2,580 km, of which 550 in Algeria (in 2000 the Algerian section was named "Enrico Mattei"), 370 in Tunisia, 160 in the Mediterranean and around 1,500 in Italy. For further details, please check WEC 2007.

private companies. These and further regional cooperation projects are subsumed under the umbrella of the Euro-Mediterranean gas ring (Martínez 2006:11).

Within EuroMed, institutional regional cooperation in the gas field exists only in the form of investment loans for energy companies. As the OME notes, there has been a “*sort of spontaneous co-operation between the two groups of countries, based on a businesslike approach*” (OME 2003:14). Yet at the bilateral level the EU has recently signed strategic energy partnership agreements with Algeria, Morocco, Jordan and Egypt, while dialogue with other EMP countries is being enhanced (EC 2007d).

**Chart 4: MPCs gas interconnections and projects**



Source: Cova 2004

The question of whether gas can become a key element of regional energy integration in the EuroMed partnership has been assessed by Estrada (2006), who points out that North African gas resources are primarily focused towards the European Union member states, with Spain, Italy and France being the main importers. The large interdependency among producing, transit and consuming EuroMed countries is an important prerequisite for developing regional governance institutions. To what extent this has been achieved will be analysed in chapter 5.

## 7. Oil production and transit integration in EuroMed

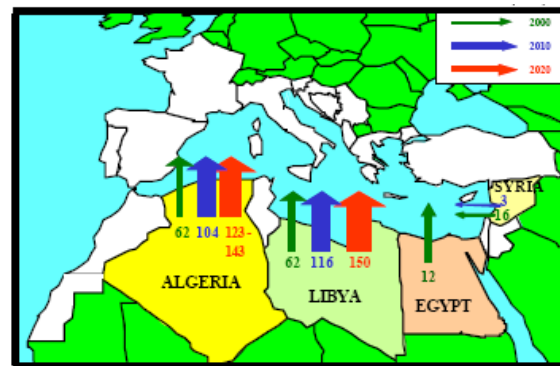
As already mentioned, MPCs' importance to the EU for oil production and transit is large. MPCs' oil reserves account for more than 6150 Mtoe, most of which is located in Libya (63%), followed by Algeria (23%), Egypt (7%) and Syria (7%).

Some MPCs like Libya are expected to more than double their oil exports by 2020 (OME 2003:4). MPCs are not only producers but also transit countries for exports from the Caspian and Gulf region. Due to varied

supply routes, some studies see the creation of an Eastern Mediterranean oil market (OME 2003:5). As oil prices are set on the international market, regional cooperation exists in developing prevention measures in case of oil spills and accidents. Here, the European Commission, the relevant Governments, interested

international bodies, as well as energy companies already cooperating (OME 2003:5).

**Chart 5: MPCs oil export potential**



Source: OME, 2005

## 8. Renewable energy integration in EuroMed

Morocco and Algeria have especially high potential and interest in developing wind, solar (thermo and PV) and hydro energy power generation capacity. According to the European Commission, a small area of the Sahara's desert surface, if used for solar thermal energy production, would provide enough electricity to supply the whole European Union<sup>13</sup>. Therefore, most European Union member states are supporting the use of renewable energy by regulating its entrance into the electrical grid<sup>14</sup>. This has been a prerequisite for large investments by European companies in the region, especially from German and Spanish companies in Morocco and Algeria. In the Mashreq, countries are also interested in developing renewables. In fact, by October 2007 Algeria, Tunisia and Turkey had already passed specific renewable energy legislation, whereas Egypt and Morocco were still developing legal framework (OME 2007c:51). As the OME notes, renewable energy in the

<sup>13</sup> EC European Research on Concentrated Solar Thermal Energy (2004).

<sup>14</sup> By September 2007, most EU states had implemented several instruments promoting the use of renewables.

EuroMed region can enhance security of energy supply by allowing energy source diversification, mitigate risks in the current energy portfolio, creating a framework for investment enhancing industrial competitiveness, and creating new jobs promoting economic development (OME 2007c:46). However, there are two major constraints for the development of renewable energies in the Mediterranean: first, institutional and legal barriers as the institutional and regulatory framework is rather declaratory than mandatory; and second, renewables compete with relatively abundant conventional energies, widely deployed and subsidised in several countries of the region for decades.

## **9. The region: energy dependencies and state actors' interests**

As mentioned above, the Mediterranean region presents unique conditions for economic benefits due to the proximity between energy producers and energy consumers. However, producing (exporting), consuming (importing) and transit countries might have different interests. As the IEA notes (2005:51), "*Mainly, concerns among consuming countries about security of supply are matched by those among producing countries about security of demand. Together, consumer and producer governments can improve the mechanisms by which they seek to reconcile their interests and achieve mutually beneficial outcomes*". Against this backdrop, the Energy Charter Treaty was developed as an international instrument for better coordination of energy policies, but until October 2007 Turkey was the only MPC which had signed it. In this section we will show energy interdependencies in the Euro-Mediterranean region. We will then explain different preferences of producer, transit and consumer countries, as well as the potential for stronger cooperation. Based on recent energy statistics (EC 2006, EIA 2007), we cluster the countries into three categories:

### **Exporter countries**

This group consists of Algeria, Libya, Egypt and Syria. Even though some producing countries have tried to cooperate in developing joint production activities (Algeria-Libya), today they are competing with each other to supply the European Union, especially with gas. The reason for this competition is – unlike in the oil sector - there is no global gas market, but only single gas contracts in which both consumers and producers compete with each other. In the Mediterranean region, Algeria has by far the most advanced gas exploitation sector, but Libya, Egypt and Syria are attracting foreign investors for further developing their own gas

industries (Martínez 2006:10). As gas infrastructure is particularly expensive and (as mentioned before) due to several risks investments hard to construct, Libya is, looking in the short term, for a connection to the Algerian gas pipelines going to Spain and France.

## Algeria

Algeria - OPEC member since 1969 - has by far the largest energy resources and production capacities in MENA. Supplying about 3% of world gas, the country was the eight-largest gas producer in the world in 2006 (IEA 2007:13). Algeria exports over 80% of its gas to the European Union,<sup>15</sup> the main markets being Italy, Spain and France.<sup>16</sup> The EU covers more than 20% of its gas consumption with Algerian gas (EC 2006). In the oil sector, although Algeria has been producing oil since 1956, the country is considered under-explored, with potential for future hydrocarbon discoveries (EIA 2007). In the oil sector, Algeria is also a major oil exporter to the European Union, the main consumers being France (8%), Italy (7%), Spain (6%) and Germany (EIA 2007).<sup>17</sup> Algeria signed an Association Agreement with the EU in 2002, which addressed “*the development of energy resources (through partnership with oil companies) and energy supply (by a majority gas use, energy saving and a tariff policy aiming to reflect costs)*” (Kagianas et al 2003:2670).

Algeria’s energy sector has traditionally been dominated by the state companies Sonatrach (oil) and Sonagas (gas), building production sharing agreements (PSAs) with several European and international companies operating in the country<sup>18</sup>. Both state companies are ranked among the largest oil and gas companies (natural gas and LNG) in the world (WEC 2005:77). However, since 2001 the Algerian gas and oil sectors have been the subject of deep reforms implemented by the Algerian government. Estrada states (2006:169) that according to new hydrocarbons law dispatched in April 2005, the Algerian state is no longer formally a *producing state* as Sonatrach and Sonagas have been separated from the Ministry of Energy and Mines, which was one of the key challenges of the EuroMed FTA for the Algerian government. Today, both companies have become primarily *commercial companies*, having several gas development projects, particularly with the European Union (GALSI, MEDGAZ),

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<sup>15</sup> Interview with Algerian Minister of Energy and Mines in OME 2007c.

<sup>16</sup> Some of these countries re-export gas to other EU member states like Portugal, which covers 100% of its gas imports with Algerian gas (CIEP 2004:200).

<sup>17</sup> Buying around 35% of Algerian oil exports, the USA is Algeria’s largest consumer (EIA 2007).

<sup>18</sup> For instance ABB, Amerada Hess, Anadarko, Burlington Resources, BHP Billiton, BP, Cepsa, CNODC, CNPC, Enagas, Endesa, Enel, ENI, Gaz de France, Maersk, Petrobras, Petrofac, Repsol-YPF, Statoil, Talisman, Total, Wintershall, Woodside, YPF. Source: EIA 2007.

which are again supported by European Institutions (EC, EIB) and by European member states. Sonatrach and Sonagas are also present in the European market by selling directly in European markets like the United Kingdom, Spain and Italy. However, both companies complain about unequal conditions for market access into the European Union (OME 2007). Above all, despite national protectionist tendencies in EU member states with regard to foreign access to the internal market (see chapter 4.2.3), Algerian energy supplies have become an integral element of European Union's energy strategy.

## **Libya**

Due to its major oil and gas reserves, Libya is expected to more than double its oil exports by 2020 as compared to 2000 (OME 2003:4). Similar to Algeria, economic growth in Libya is highly dependent on the hydrocarbon industry, accounting for 60% of the country's GDP (EIA 2007). Due to the impact of economic sanctions and to Libya's stringent fiscal terms on foreign oil companies, the country remained highly unexplored for a long time. However, since international sanctions have been lifted in 2004, and as the country's oil and gas internal investment constraints for foreign companies have been reformed, FDI in the sector has grown significantly (US\$ 500 mill. 2007, EIA 2007). The country's oil industry is controlled by the state-owned National Oil Corporation (NOC), which has several subsidiaries with foreign capital on a joint-venture basis (NOC 2007). According to the EIA, in 2006 the main consumers of Libyan oil were Italy (38%), Germany (19%), Spain (8%), United States (7%), France (6%) and China (5%). Due to the recent development of undersea pipelines, Libyan gas exports are mostly going to Spain and Italy (Sicily) – and from there to the rest of the EU (EIA 2007). Libya's leading foreign energy operator is Italy.<sup>19</sup> Integrating regional markets plays a major role for Libya: the country signed 1997 an agreement with Tunisia for the construction of a pipeline for exporting up to 70 Bcf of natural gas per year from 2010 on (EIA 2007). Major agreements have also been signed with Algeria for the common exploration of oil and gas fields in southern border region (Martínez 2006:10). Since 1997 Libya also has agreements with Egypt for the import, export and transit of gas and oil (EIA 2006).

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<sup>19</sup> ENI Press release 16<sup>th</sup> October 2007.



## Egypt

Due to its major gas reserves, Egypt (also an OPEC member) is becoming one of the world's largest gas exporters, increasing its production volume over 300 percent between 1999 and 2005 (EIA 2006:4). Overall gas and oil contribution to Egypt's GDP is about 10%. For the EuroMed Partnership, Egypt plays a leading role by exporting its gas to both European Union countries and MPCs. Exporting natural gas started recently: since 2003 a gas pipeline between Egypt and Jordan across the Sinai and under the Gulf of Aqaba to Amman, has bypassed Israeli waters (WEC 2005:76). Further south-south integration is intended through the Arab Gas Pipeline. This project aims to export Egyptian natural gas to the Middle East with eventual further exports to the European Union (via the Nabucco pipeline). The countries involved are Egypt, Jordan, Syria, Lebanon, Turkey and Romania. Since 2004 there is also a gas export pipeline project from Iraq to the EU through Egypt, Jordan, Syria and Lebanon to be ready for use from 2010 on (EIA 2007). But Israel is also intended to be connected with the Arab gas pipeline through a submarine pipeline from Al-Arish (Egypt) to Ashkelon (Israel) from 2008 on.<sup>20</sup> However, due to recent regional security disputes (Israeli-Lebanon war) the Egyptian government has stopped the progress of this project, emphasising instead the pipeline project from Egypt through Jordan (Aqaba) and Syria to Lebanon (Tripoli), which - as already mentioned - bypasses Israeli waters. Expected gas export revenues will be *"particularly important to Egypt's future international balance of payments due to the decline in oil exports"* (EIA 2006:5). AGIP, the Italian oil and gas company, has become the largest foreign developer of Egypt's gas fields<sup>21</sup>.

Egypt's oil reserves are estimated at 0.3% of world reserves. Today, the country covers its own domestic demand with high subsidies (more than US\$ 2 bio in 2006),<sup>22</sup> putting huge pressure on public finances. However, as the EIA states *"though the government hopes to reduce demand by gradually lifting subsidized prices and targeting subsidies more effectively, this is a politically sensitive issue that will take time to fully implement"* (2007:5). Egypt's oil industry has undergone major reforms since World Bank adjustment programs went into effect during 1991, privatising and restructuring state owned enterprises. The key operator in the oil field is GUPCO (The Gulf of Suez Petroleum Company) - a joint venture owned in equal shares by US/British BP Amoco and EGPC (The Egyptian General Petroleum

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<sup>20</sup> United States Securities and Exchange Commission (USSEC) – Report on Ampal-American Israel Corporation. June 8<sup>th</sup> 2007.

<sup>21</sup> NY Times, 23- December 1999.

<sup>22</sup> Data from EIA (2007) based on official figures from the Egyptian government.

Company). Other international companies like Italy's state owned ENI-Agip, Apache, British Gas, Deminex, TotalFina-Elf, Exxon-Mobil, Marathon, Norsk Hydro, Novus, Repsol, Royal Dutch Shell, Samsung and Texaco have been operating in the country's oil sector since the mid-1950s (EIA 2006).

Egypt also has a strategic means for transporting energy in the Euro-Mediterranean region. The Suez Canal and Sumed (Suez-Mediterranean) Pipelines are the two main routes for the export of Persian Gulf oil. Also in gas transit Egypt is looking for a more active transit role, attracting liquefied natural gas (LNG) tankers through major discounts (EIA 2007).

## **Syria**

Syria is the only significant oil and gas producer in the Eastern Mediterranean, although some studies have noted the need for new discoveries to ensure Syria's export capacities (OME 2003, EIA 2006). Despite the weight of some EU member states (Cyprus, Czech Republic, Germany and Italy), particularly China is becoming increasingly important for oil exports. China has also become Syria's key partner in developing its oil and gas industry (Al Kabalan 2006). Foreign participation in the Syrian oil and gas industry has long tradition. In fact, since 2001 several American and European companies have been involved in shared production agreements in Syria.<sup>23</sup> Today, Syria's largest foreign oil producer (AFPC) is a joint venture between the Syrian state oil company (SPC), Shell (majority stake holder), the India-based Oil and Natural Gas Corporation (ONGC) and the China National Petroleum Company (CNPC). However, basically due to the Syrian role in the assassination of former Lebanese Prime Minister Rafik Hariri in February 2005 and in the Israeli-Lebanese war 2006, the EU has not ratified the EMP's association agreement with Syria accomplished in October 2004. In the energy field this has led to reluctant participation of European companies in Syria's vital oil sector (Al Kabalan 2006). However, Syria hopes to become a key transit country for the resources of the Middle East and North Africa to the EU. As the IAE states, Syria "*is already on track with the construction of its section of the Arab gas pipeline running from Egypt to Turkey*" (IAE 2007).

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<sup>23</sup> Even though the United States imposed economic sanctions against Syria in May 2004, US energy companies operating in Syria were not forced to divest their investments in Syria (EIA 2006).

## 10. Transit countries

As recent disputes between Russia on the one hand and Ukraine and Belarus on the other show, transport of energy from producer to exporter countries is a strategic political issue. Especially in the transport of natural gas, mostly by pipeline, different national borders need to be crossed. As bilateral conflicts in these matters might have international effects for gas supply, international conventions like the Energy Charter Treaty of 1991 or the European Energy Charter of 1994 are intended as instruments to ensure cross-border energy flows in times of crisis. The European Energy Charter's key provisions concern the protection of investment, trade in energy materials and products, transit and dispute settlement issues. However, as Estrada notes, European demand for implementation of the Charter provisions in neighbouring countries is putting big pressure on EU's security of supply, as it doesn't consider interests of the energy partners like Algeria (Estrada 2006).

In the Mediterranean region, Morocco, Tunisia and Turkey are transit countries. However, some producing countries are also here, for example Algeria in the framework of the July 2007 *Trans-Saharan Gas Pipeline Project* for supplying gas from Nigeria to Europe through Niger and Algeria (EC 2007c). By charging tariffs for the transport of natural gas, transit countries have the power to influence both the security of supply and the negotiations of gas prices. Therefore investments in gas always involve the possibility of re-routing a cross-border pipeline to minimise transit risks (WEC 2005:81). However, this power is not bounded or coordinated and therefore tariffs differ widely across the countries of EuroMed countries. We will now profile the major players of the region in detail.

### **Morocco**

Although Morocco has large proven oil and natural gas reserves, due to a lack of investment the country is today essentially a major transit country for gas coming from Algeria through the Maghreb-Europe Gas (MEG) pipeline. Morocco is the largest energy importer in northern Africa, importing an overall value of above US\$2 bill. in 2005 (EIA 2007). The entire energy sector is due to be liberalised by 2007. This means that in Morocco there is no national champion in energy production as there is in Algeria or Egypt. Today, more than twenty foreign companies from the EU, USA, Norway and Asia (Malaysia, China) are operating in the country.

Morocco plays a major role in regional energy integration. Together with Tunisia and Algeria, the country is willing to integrate its energy market with that of the European Union and

create a Maghreb regional electricity market (three countries are connected but remain with separate electricity policies).

## **Tunisia**

Tunisia has very low oil reserves and its domestic production capacity doesn't meet the country's consumption demand. However, the country looks to foster oil exploration by attracting foreign companies<sup>24</sup>. Tunisia plays a major role in transiting Algerian gas to Sicily through Trans-Mediterranean (TransMed) pipeline; receiving receives taxes (royalties) from the pipeline as payment for access through its territory. The country also plays a key role in the context of the Trans-Maghreb Electricity Integration, a regional integration initiative to connect its domestic power grid to the Spanish one (and to the UCTE). As the EIA (2006:9) notes, "*when the two networks are connected, an integrated North African power grid will stretch from Morocco to Egypt*". Tunisia's oil and natural gas exploration and production activities are dominated by the state company *Enterprises Tunisiennes d'Activités Pétrolières (ETAP)*. Most activities are based on a PSA model, and attracted more than 40 foreign companies by 2006. Swedish and German companies have particularly strong activities in the country (EIA 2006).

## **Turkey**

Turkey lacks significant domestic energy resources. However, its location makes the country a key energy transit country, with the Bosphorus Straits, through which Caspian oil passes en route to European markets; the Baku-Tbilisi-Ceyhan (BTC) Pipeline, the first transnational pipeline that transports Caspian oil without crossing Russian soil; and Turkey's port of Ceyhan, which is the primary terminal through which Iraq's northern oil exports pass (EIA 2006). As Kilic (2006:1931) notes, "*Turkey is a pivotal bridge between energy-rich regions and Europe which spends approximately 300 billion USD per year for imported energy sources*". Summing up, due to its strategic geographic situation, Turkey is becoming a major hub for energy in the region.

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<sup>24</sup> Tunisia reformed its hydrocarbons laws in August 2000, granting tax reductions up to 40% (EIA 2007).

## **Israel**

Since the creation of the Israeli state, the country has been wholly dependent on imported fuel, buying oil from Norway, Mexico and other distant non-OPEC suppliers, and bringing in coal for power plants from South Africa, Australia and Colombia. For most of its independent life, Israel was prevented by boycotts from buying oil or gas from its Arab neighbours. Although a net gas and oil importer, Israel is becoming a key player in re-exporting Caspian oil to Asia, including India, China and South Korea. In May 2006, Turkey and Israel announced a joint project for transferring water, electricity, natural gas and oil to Israel via four underwater pipelines<sup>25</sup>. The project foresees the connection of the Ceyhan-Tblisi-Baku (BTC) - which links the Caspian sea to the Eastern Mediterranean – to the Israeli port of Ashkelon in the Red Sea.

## **11. Importer countries**

Importer countries include the EU member states and the MPCs Jordan, Lebanon, Israel and Morocco; the latter being also a transit country. Consumer countries have to achieve security of their supplies. Therefore, most of them diversify their import matrix in both origin country and fuel. Consumer countries have an inherent interest in achieving low prices for energy goods. Here we will present the major players of the region and their ties with energy producing MPCs.

### **Jordan**

Although Jordan is foreseen as a transit country for future Egyptian gas exports to Turkey and the European Union, both countries are primarily net oil and gas importers. Before the Iraq war started in 2003, all of Jordan's oil needs were covered by Iraqi supply, receiving a portion for free and the rest at about one-third of the world market price<sup>26</sup>. Due to production disruptions in the aftermath of the war, Saudi Arabia, Kuwait and the United Arab Emirates provided Jordan with oil at prices believed to have been below market levels (ibda). Iraqi oil supply to Jordan was re-established by September 2007.

As the USDA (2005) states, “Jordan is moving toward a pool model for the electricity market and the country is considered a main crossing point for a number of electrical

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<sup>25</sup> The Jerusalem Post, May 11<sup>th</sup> 2006.

<sup>26</sup> International Herald Tribune, August 23<sup>rd</sup> 2007.

interconnections in the future, including: the seven member electric interconnection project (EIJLLST), which aims to connect the electrical networks of Egypt, Iraq, Jordan, Lebanon, Libya, Syria and Turkey; the electrical Interconnection project of the Mediterranean countries (MEDRING); the project of the Pan Arab Electrical Interconnection; and the Regional Interconnection project (EIJP)". Electricity and energy consumption in Jordan is expected to increase dramatically over the next years (EIA 2007). Since the late 1990s the government has pushed a sectoral liberalisation policy, giving up distribution by state-owned monopolist National Electric Power Company (NEPCO) and opening the market for several electricity generation and distribution companies. However, NEPCO maintain ownership of transmission lines. Electricity is mainly generated in Zarqa and Aqaba. Jordan plays an important role in the regional electricity market.

## **Lebanon**

Lebanon imports all of the oil it consumes, Kuwait and Qatar being its key suppliers. The Lebanese cities of Zahrani (south) and Tripoli (north) were the location of important coastal refineries for crude oil from Iraq and Saudi Arabia. However, since the beginning of Lebanese civil war (1975-1990) production has not been operational. In April 2006, Lebanon and Qatar signed an MOU to study the feasibility of building a refinery (EIA 2006). In renewable energy there are some projects focused either on the use of solar thermal collectors for water heating or on the use of hydropower, although the latter's share has been decreasing in recent years (Houry 2005). The overall performance of the Lebanese energy sector has been very poor, suffering major technical, administrative and financial problems. Although the government ratified 2002 a reform law for the electric sector in Lebanon, the implementation of measures to unbundle, regulate and restructure the sector and activate the participation of the private sector remain critical (Abi Said 2005:4)

## **France**

According to the European Commission (EC 2006a), France is a large consumer of MPCs' oil and gas, importing 12% of its gas from Algeria and 12% of its oil from Algeria (7%) and Libya (5%). The country is looking to enhance Algerian gas supply by implementing the Medgaz natural gas *pipeline* which links both countries through Spain<sup>27</sup>. Therefore, French

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<sup>27</sup> The pipeline will be 210 km long and connect the western Algerian coast with Almería. Production is scheduled to start in mid-2009 (Economist Intelligence Unit 2007).

state-owned company Gaz de France (GdF) has built a consortium of which it holds 12% plus Algeria's Sonatrach (36%), Spain's Cepsa and Iberdrola (20% each), and Spain's Endesa (12%). Supplying 25% of France's *liquid natural gas* (LNG) consumption, Algeria is its most important strategic LNG partner. In the oil sector, France's Total (the former TotalFinaElf) has substantial production operations in Algeria (Timimoun Basin – see Spain), and retailing and refining capacities in Morocco. The country is also engaged in several projects in Tunisia and Egypt. Especially since the mid 2007, France has been looking for a stronger role in shaping EuroMed energy integration by strengthening its ties particularly with Algeria, Morocco and Libya. These has been underlined by the visits of President Sarkozy to Libya, Algeria and Morocco just after taking office in June 2007, signing cooperation agreements on the development of nuclear energy and a gas-solar power plant among others<sup>28</sup>. President Sarkozy announced that energy supply will be a key issue during the French-Algerian meeting in November 2007. France's gas sector is basically dominated by Gas de France, which until recent reforms had a legal monopoly on the production, distribution, transportation, and import of natural gas in the country. According to the EIA (2007), GdF has made good use of the EU directive on opening their natural gas sectors to foreign investors to enter the domestic natural gas markets of other EU countries: "*As a result, almost one-third of GdF's 15 million customers are outside France*" (EAI 2007).

## **Spain**

Spain's energy enterprises were privatised in the early 1990s and there is no direct state participation in energy production and transport. Spanish companies' oil and gas activities are basically limited to the exploitation of foreign resources. Unlike France, the Spanish energy sector is not concentrated in one company for generation, transport and distribution of both gas and oil. Repsol/YPF, Spain's largest oil company and one of the world biggest oil companies, has no oil activities in the Mediterranean. But Cepsa, the second largest Spanish oil operator, has important gas operations in Algeria in Rhoudé el Krouf (RKF) and Ourhoud (ORD), both in the Saharan region of Algeria.

In the gas sector, Cepsa also has production activities in the Timimoun Basin, a gas-rich south western part of the country. Cepsa is also shareholder in the Medgaz pipeline project (Algeria-Spain). Gas Natural, Spain's largest natural gas company, is involved in major

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<sup>28</sup> See EuroActiv 27.07.2007 and International Herald Tribune 23.10.07.

exploration projects for LNG in four regions. In Morocco, Gas Natural is a shareholder in the consortium holding the Maghreb-Europe Gas (MEG) pipeline.

## **Italy**

The Italian gas sector is dominated by state-owned ENI. Since 1992 ENI is not a wholly state-owned enterprise but a joint-stock company, with the Italian government holding more than 60% of the outstanding shares.<sup>29</sup> Through several subsidiary companies ENI controls not only natural gas production, but also its transport and retail (EIA 2007). Government intervention in the energy sector has been particularly important for developing EuroMed gas pipelines, so in the 1970 when building the Transmed pipeline (WEC 2005:80) and today when developing the Galsi pipeline. However, Italy has been implementing EU liberalisation requirements the late 1990s, opening the sector to new national and foreign companies by unbundling production, distribution, and transmission activities (EIA 2007).

Most of Italy's oil imports (27%) are from Libya (EIA 2007). Italy's presence in Libya goes back to 1959, with major oil production capacities in onshore and offshore areas. The exploitation of the Elephant oil field, in the south west of the country, began in 2004. Italy also imports natural gas from Libya via the Greenstream pipeline (from Mellitah in Libya to Gela in Sicily). In October 2007, state-owned ENI signed a cooperation agreement with Libya's NOC on gas and oil exploitation involving Italian investments of 20 billion Euros by 2017. In Algeria, Italian state company ENI is a shareholder in Transmed, the largest existing gas pipeline in EuroMed connecting Algeria with Italy through Tunisia. The growing gas importance of Algeria for Italy made state-owned company Enel create - together with Algeria's Sonatrach and Germany's Wintershal l - the Galsi consortium in 2002, for building a natural gas pipeline from Algeria to Italy (Sardinia). In Tunisia, Italy has had oil and gas production capacities since 1961 and is shareholder in Transmed. In Egypt, Italian oil production began 1955 in the Gulf of Suez (Belaym Marine). Italian gas activities in Egypt have been pursued since 1967, when Abu Madi was discovered; Egypt's richest and most productive oil field to this day.

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<sup>29</sup> As of 13<sup>th</sup> September 2007 (see ENI Shareholders structure at [www.eni.it](http://www.eni.it)).



## Germany

Germany's interests and links to the Mediterranean are based in its oil imports from Libya (12% of total consumption) and gas imports from the latter and Algeria. In the oil sector, the country is indirectly connected with Libya through the *Transalpine Oelleitung* (TAL) between southern Germany and Trieste in Italy<sup>30</sup>, re-exporting Libyan oil. German private company Wintershall has been involved in oil exploration and production in Libya since 1958, producing oil from five onshore fields. In the gas sector, several German companies (RWE, Wintershall) in upstream gas fields liquefy recovered gas and export it from Algeria, Egypt and Libya. There are projects for transporting Algerian or Libyan natural gas from Italy to Germany through the Trans-European Natural Gas Pipeline (TENP), a private Italian-German joint venture.

Germany's energy market was liberalised in the mid 90s, causing strong competition in the generation and distribution sector, but not in transport capacity.<sup>31</sup>

## 12. Non-regional actors

### United States

The United States is a large importer of Algeria's LNG. Until 2004, American companies were not allowed to invest more than US\$20 million annually in the Libyan oil and natural gas sectors<sup>32</sup>. The removal of the sanctions has attracted several energy projects into the country. But Syria has also been the target of US American energy investments from companies like ChevronTexaco, ConocoPhillips, U.S. Occidental and Veritas. Although evidence shows a strong link between US energy interests and government's foreign policy, the US energy sector is fully privatised, with no direct government involvement in production or import activities (EIA 2007).

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<sup>30</sup> Germany and Italy were also connected through the Central European Line (CEL) which was closed in 1997 due to rising costs, environmental issues, and competition from the TAL (EIA 2007). Later on the line was converted to transporting gas between both countries.

<sup>31</sup> Four companies (E-On, RWE, EnBW and Vattenfall) control 100% of the network capacities in Germany.

<sup>32</sup> Iran-Libyan Sanctions Act (ILSA). In April 2004, the United States removed Libya from the sanctions.

## Russia

Accounting for 33% of its oil and 46% of its gas imports, Russia is a key energy supplier for the EU (EC 2006). The country has major interests in the Mediterranean, with Turkey playing a leading role as a transit country for Russian oil and gas exports through both the Bosphorus Straits and the *Bluestream* gas pipeline. The country is also involved in several international energy exploitation activities in the Mediterranean.

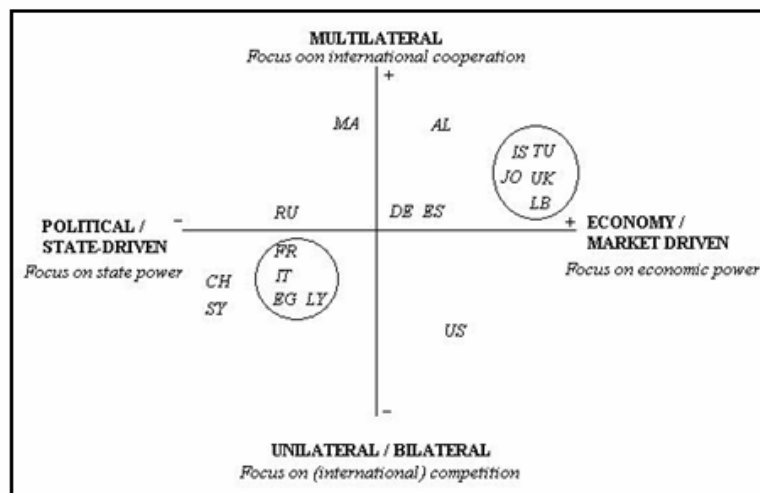
## China

Although the MPCs do not directly export oil and gas products to China, the region has a core importance in the transit of oil and gas exports to China. China has cooperated in the civil use of nuclear energy with Egypt since December 2006<sup>33</sup>. China has also made significant investments in the Suez Special Economic Zone, a cooperation framework established in 1999 during a visit of Egyptian President Mubarak to China.

## 12. Markets or Politics: clustering interests and preferences

What drives energy politics on both sides of the Mediterranean? Is it possible to reach further regional integration through energy cooperation? As we have seen, due to complementary preferences, energy is a

Chart 5: Clustering EuroMed Energy interests



Source: own elaboration

major issue for EuroMed integration. Whereas most MPCs are either energy producer or energy transit countries, EU member states are consumer countries interested in long term security of energy supply. However, both the EU and MPCs pursue a mixed strategy in their energy policies, combining private sector activity with state action. Energy issues are always embedded in a permanent tension field between trade, foreign and security policy. As we have

<sup>33</sup> In December 2006 Egypt's President Mubarak visited China and signed an agreement on nuclear cooperation.

seen, both European and Mediterranean countries have different institutional frameworks shaping their national energy policy. Whereas in France, Italy, Egypt and Libya energy sectors are dominated by states interventionism, other countries like Israel Tunisia, Jordan, Lebanon Algeria and the United Kingdom show a strong private sector. State control is not formally present in countries like Germany, Spain and Algeria, however the full implementation of market laws remains subject to political pressures.<sup>34</sup> These political factors nevertheless have the potential to artificially violate the proper functioning of markets. If political preferences which are not related to energy issues overpower common economic interests, an important precondition, namely trust, might be eroded.

The political significance of hydrocarbon revenues is large, as political leaders often use them to maintain their political status. In this sense, owning, controlling and managing the sector guarantees political stability. However, as we have seen in the country analysis, particularly Algeria has liberalised the oil and gas sector, as its political elites seem to have realised that the *capitalist ownership* of a national energy champion is far more lucrative than its *political ownership* (Estrada 2002).

The Role of Governments in EuroMed energy goes far beyond production, licensing and market regulation, including environmental standards, taxation policy and the harmonisation of setups for cross-border regional trade (WEC 2007:81). Particularly important is the government's role in backing and guaranteeing long term contracts and projects. Companies receive a key role in shaping EuroMed energy integration. Yet as the last chapter showed, private energy firms acting in the EuroMed region are often dominated by state-owned companies which follow political rather than market rationales.

### **13. Assessing EuroMed energy integration**

Compared with the ambitious goals of the Barcelona Declaration and of the following Energy Ministers declarations, progress in achieving EuroMed energy market integration remains limited. As we have seen, interests and preferences within the EU and the MPCs are diverse. Therefore some countries have a stronger incentive to engage in bilateral negotiations on energy despite the EuroMed framework. As the OME notes, "*this unsatisfactory performance of the Barcelona Process in the energy sector may be traced back to two main reasons: the insufficient involvement and commitment in the Process of the most important "players" (viz.*

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<sup>34</sup> See the intervention of the Spanish government during EON tak-over attempt of Endesa in 2007 and the German's government pressure on the European Commission after the proposal of a 3<sup>rd</sup> energy package in September 2007.

*policy makers, energy companies and financial institutions) and the poor implementation of the decisions taken at the political level”* (OME 2006:5). Taking a closer look, we can identify three main obstacles which hinder integration: the heterogeneous preferences within the European Union itself; the insufficient institutional framework; and the negative investment environment in the Mediterranean Partner Countries.

### **Heterogeneous preferences and multi-level governance in the EU**

It seems evident that the European Union considers energy matters to be something that goes beyond mere national boundaries. Due to the strong dependency on external energy sources, energy integration seems not only to ensure security of supply, but also to increase economic gains, by producing and distributing energy more efficiently and competitively (Hira et al 2003:193). Therefore the European Union launched two core directives for energy integration in 1997 by opening markets to competition: the *electricity directive* and the *gas directive*. Although both directives didn't lead to intended energy market integration, they notably increased pressure for liberalisation and deregulation within the EU. However, as the OME notes, “*in the 1990s, priority was given to competition development in a context of abundant and cheap energy. The focus turned on security of supply following the unexpected magnitude of oil price increase starting in 1998*” (OME 2007:6). Against this backdrop the European Union published in November 2000 a green paper on a strategy for ensuring energy supply. After years of discussion and lobbying in the European institutions, but particularly due to the energy conflict between Ukraine and Russia in 2004 which caused a disruption in energy supply to the European Union, a strong dynamic appeared in favour of developing a European energy policy in 2006. With the publication of the green paper “*A European Strategy for Sustainable, Competitive and Secure Energy*” in March 2006, the EC tried to harmonise external policies for serving Europe's energy interests. In March 2007 the European Council agreed to develop an Energy Policy for Europe (EPE), establishing the main long term goals as: 1) increasing security of supply, 2) ensuring the competitiveness of European economies and the availability of affordable energy, and 3) promoting environmental sustainability and combating climate change (EC 2007f:11). In September 2007 the European Commission made a new proposal for energy market integration, including cross-border trade facilitation and increased solidarity among EU member states<sup>35</sup>. However, implementing a common European energy policy remains a Sisyphus task as due to *national self interests* member

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<sup>35</sup> EC Communication IP/07/1361, 19<sup>th</sup> September 2007.

states remain reluctant to give up their sovereignty in this policy field. Against this backdrop the proposal of the Commission has caused strong opposition from several EU member states, especially from Germany and France. These countries indirectly accuse the Commission of going far beyond the Council's mandate<sup>36</sup>. As we analysed in the country profiles, France is pursuing a more independent energy policy agenda towards the Mediterranean as compared to other EU member states.

Despite the European efforts towards integrating energy policy, the approach chosen by the Commission is based on what academia calls the “*market & institutions*” approach (CIEP 2005:17). Particularly problematic is the implementation of the European Energy Charter Treaty by the Mediterranean states,<sup>37</sup> which covers sensitive issues like the protection and promotion of foreign investment in the energy sector, free trade in energy goods and services, energy transit, and multilateral dispute settlement mechanisms. This has pushed an academic-technical debate “*in which the issues of European energy security are analysed from a geopolitical point of view instead of that from supply and demand, which bears an economic slant*” (Estrada 2006:2774). Regional energy integration efforts of the European Commission might have to take into considerations of both member states and MPCs which do not agree with the market and institutions approach.

### **The institutional framework: fostering trust?**

Although preferences on both sides of the Mediterranean basin seem to be homogeneous, for the EuroMed energy cooperation there is no supranational institution which can enforce rules.<sup>38</sup> However, as the EU integration process shows, institutions are key vehicles for building trust and confidence among policy actors. EuroMed energy policy has instead been mainly dealt with within intergovernmental structures. The workload remained within the EuroMed Energy Forum, which doesn't have an institutionalised structure.<sup>39</sup> Therefore, cooperation remained on an ad-hoc, project based basis within the framework of the EMP's National Indicative Programmes (NIPs) under the MEDA programme<sup>40</sup>. In order to ensure long term coherence and consistency, EuroMed energy ministers launched in October 2004

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<sup>36</sup> Press release by the German Ministry of Economics, 19.09.2007.

<sup>37</sup> Until October 2007, despite of Turkey no Mediterranean Partner Country had signed the Energy Charter.

<sup>38</sup> This non cooperative game can be modelled in a prisoners' dilemma.

<sup>39</sup> This forum consists of the General Directors for Energy from Euro-Mediterranean partner countries and of the General Director for Energy and Transport from the Commission.

<sup>40</sup> The MEDA Program was replaced 2004 by the ENP Action Plans.

the Rome Energy Platform (REMEP). This institution was not supposed to have binding competencies, but promoting energy cooperation and delivering recommendations for the yearly meetings of the EuroMed energy ministers and for the Euro-Med Energy Forum (OME 2007). However, In October of 2007, three years after its creation, REMEP had still not started operating, causing consequent delays in cross-cutting actions like cooperation on safety, security and continuity of energy supplies as well as on the harmonization and approximation of laws in the framework of reforms, although the EuroMed Meeting of Foreign Ministers announced in November 2007 the operational take-off of REMEP by December 2007.

On the financial side, The European Neighbourhood Partnership Instrument (ENPI) replaced in January 2007 the MEDA Program which had ruled EuroMed multilateral financial aid since 1995<sup>41</sup>. The ENPI Regional Strategy Paper issued in June 2007 particularly promotes the Trans-European Transport and Energy Networks for both South-South and North-North connections (EU 2007a:11). On the other hand, EC bilateral aid concentrates on energy efficiency and technical assistance. As the EC states (2007a:11), EU member states concentrate their donation mainly in country-specific programmes and activities. The European Investment Bank (EIB) created the Facility for Euro-Mediterranean Investment and Partnership (FEMIP) in 2002 for promoting infrastructure investment in the MPCs. Since then, the bank has supported energy infrastructure in the Mediterranean with more than 2.5 Billion Euro, Egypt receiving around 40 Percent of it (see Annex 3). At both bilateral and multilateral levels energy plays a key role in overall funding.

### **The negative investment field in the MPCs**

The institutional, legal and regulatory framework has a direct impact on the energy investment climate. As the World Energy council notes, *“The “rule of law” in the upstream, downstream and transit countries (where relevant) is vital. This includes factors such as commercial laws and level of enforcement, historical track record on upholding contractual agreements, the role and independence of the judiciary system in resolving disputes and the abilities of governments to implement long-term strategies, are important, because costly infrastructure such as cross-border gas pipelines have high “sunk cost.”* (WEC 2005:81). International investors in the energy field seek to share risks by developing common joint ventures with national energy companies, like the Transmed consortium between Sonatrach

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<sup>41</sup> Regulation (EC) No 1638/2006.

and ENI. But market regulation also plays an important role, as many former monopolies in both European and Mediterranean countries are confronted with liberalisation requirements within the EuroMed Energy Charter.

On the other hand, the traditional problem of Dutch Disease seems to affect some MPCs. As many developing countries in other regions, richness in natural resources has led energy producing MPCs to avoid painful economic reforms like cutting energy and other subsidies. As in the CIEP study noted (2005:111), “*finding oil in a poor country is similar to winning the lottery. Just as a lottery winner might abandon his job, the government makes so much money exporting petroleum that it doesn’t develop other industries*”. In the country analysis of section 4 we noted the high dependency of producing MPCs upon oil and/or gas revenues. Therefore, diversifying revenue sources by developing other sectors is a key long term target of these countries. Foreign direct investments can play a key role here, but unfortunately, as GO-EuroMed Stage I research noted, these figures have been particularly low in the MPCs, although there has been a positive trend since 2004.<sup>42</sup>

## 14. Outlook

Energy plays a key role in regional integration under the Barcelona process. However, there seems to be an unbalanced outcome of the EMP in the energy area. Whereas some Mediterranean countries have implemented EU regulations by liberalising for instance their gas or electricity sector, European states have not truly opened up their markets for Mediterranean companies. However, as Schiff/Winters states “*unbalanced costs and benefits (...) makes it difficult to reach cooperative agreements*” (2002:4). Although EU energy cooperation instruments have contributed to creating energy infrastructure, a long term institutional commitment is needed, especially for managing major continuous, cross-cutting actions with no time limit. With regard to the European efforts towards integrating energy policy, the approach chosen by the European Commission is based on what academia calls the “*market & institutions*” approach (CIEP 2005:17). Yet this economic approach does not take into account the strong state interventionism in most MPCs as well as within some EU member states, in which market-based supply and demand mechanisms do not seem to work any longer. Market dynamics in the European Union herself have a decisive influence on the harmonization of energy preferences in EuroMed. An institutional reform of EU’s Energy Policy is therefore urgent. One interesting instrument for ensuring energy supply would be to

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<sup>42</sup> See GO-EuroMed Summary of Key Findings 2006.

build an EU demand monopoly for overcoming bilateral short-term benefits and disadvantages. MPCs could enhance South-South coordination by building a supply cartel in the form of a EuroMed Energy Institution. In any case, coordination and consistency remain the biggest challenge for achieving the regional integration potential of energy in the EuroMed Partnership.



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