

THE EURO-MEDITERRANEAN ENERGY RELATIONSHIP: A FRESH PERSPECTIVE

A NEW PARADIGM FOR EURO-MEDITERRANEAN ENERGY COOPERATION

and their great solar and wind potential, regional energy cooperation could also strongly foster large-scale deployment of renewable energy, which would allow southern Mediterranean countries to meet their increasing energy demand in a more sustainable way and would also have positive economic and political benefits for Europe.

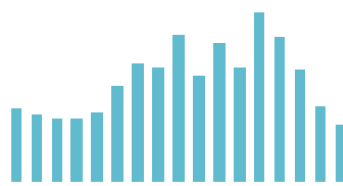
POLICY CHALLENGE

1 ENERGY: THE CORE OF THE EURO-MEDITERRANEAN ECONOMIC RELATIONSHIP

Energy is a fundamental component of the economic relationship between the European Union and the ‘southern neighbourhood’ Mediterranean countries¹. This dates back to the 1960s, when discussions started on the first large-scale energy infrastructure in the Mediterranean region – a gas pipeline connecting Algeria to Italy via Tunisia. Since then, more than 6,000 kilometres of gas pipelines have been laid across the Mediterranean, to connect Algeria with Spain and Italy, and Libya with Italy. Large-scale liquefied natural gas (LNG) and oil infrastructure has also been constructed all around the Mediterranean².

This infrastructure, built on the basis of bilateral state-to-state and company-to-company relationships between producers in the south and importers in the north, still channels a major part of Southern Mediterranean countries’ (SMCs) total exports to Europe (Figure 1).

Figure 1: SMC Exports to Europe: 2000-2014



Source: Bruegel based on Eurostat data.

In the early 2000s, the idea emerged of replicating the successful gas cooperation story in the Mediterranean region in the area of renewable energy. Taking a regionalist approach rather than a traditional bilateral approach to cooperation, two initiatives were launched with the objective of tapping into the vast solar and wind energy potential of SMCs: Desertec and the Mediterranean Solar Plan. These would supply clean energy to the SMCs and to Europe. Desertec was

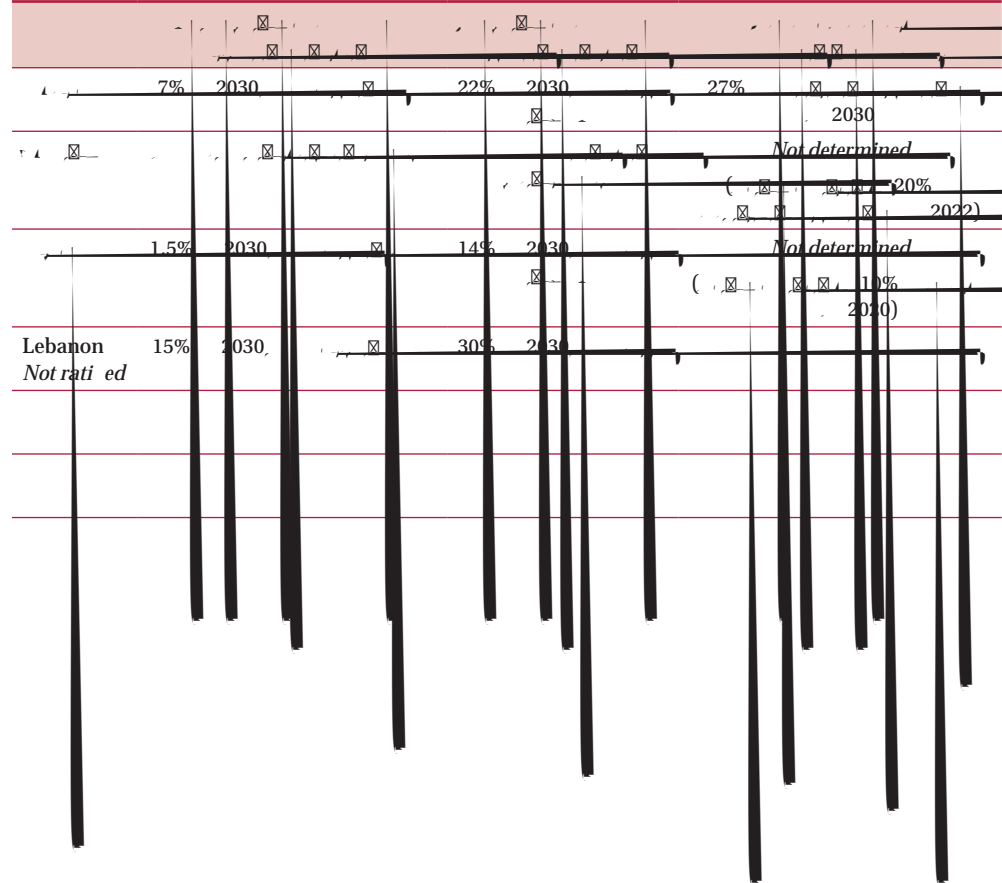
a German industrial initiative, and the Mediterranean Solar Plan was a Union for the Mediterranean flagship project. Both initiatives were supported by the European Union, which has always viewed energy cooperation as a special tool to promote political stability and economic prosperity in the region.

But these two initiatives failed in less than a decade, largely because of a lack of commercial and political realism. The initiatives’ business models were based on the export to the EU of solar and wind electricity produced in SMCs and were not commercially viable because of: i) high electricity generation costs; ii) lack of electricity interconnections between SMCs and between the northern and southern Mediterranean shores; and iii) the lack of a clear need on the EU side for additional renewable energy capacity. In political terms, the initiatives did not properly consider that the first priority for SMCs was meeting their own booming energy demand. Nor did they take sufficiently into account the overall lack of cooperation between SMCs, the group of countries with the lowest level of intra-regional trade in the world. In particular, both initiatives proved unrealistic because they sought to adopt a one-size-fits-all approach to a region that was – and continues to be – too complex and diverse for this to work (Tagliapietra and Zachmann, 2016).

This experience suggests that fostering renewable energy in the region cannot be done on the basis of a Eurocentric approach. In other words, instead of the traditional focus on exporting energy from SMCs to Europe, the priority should be supporting SMCs in meeting their booming energy demand in a sustainable way. Cooperation between the EU and SMCs in terms of renewable energy should be about developing projects for the SMCs’ consumption, not for Europe’s. Since 2000, energy demand, especially electricity demand, has boomed in SMCs (Figure 2). This trend is set to continue in the future, in response to expected population and GDP growth in SMCs.

From an energy cooperation perspective, the most sensible way for the EU to respond to this challenge is to foster

TABLE 1: SMCN, D, C, P, A



International private investment is essential to meet this large investment need. However, various barriers in SMCs continue to prevent international investors from becoming more engaged in SMC renewable energy sectors (RES4MED, 2017). Two key barriers stand out:

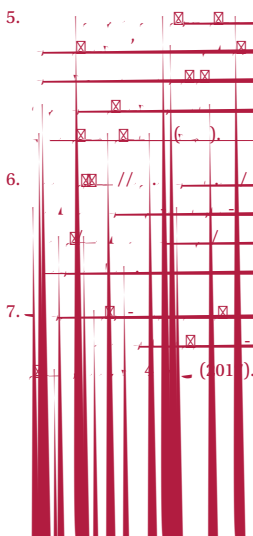
- **Legal and regulatory barriers:** All SMCs have renewable energy targets, but achieving them ultimately relies on the presence of sound and stable renewable energy regulatory frameworks. On this front, much remains to be done in the SMCs. Jordan is the only SMC with a well-established and reliable renewable energy regulatory framework, while in other countries the situation is more complex. For instance, frequent changes in feed-in-tariff schemes and fossil-fuel subsidies are a concern for investors in Egypt, while the lack of an independent regulatory authority is a key concern for investors in Morocco.
- **Financial barriers:** Currency convertibility, inflation and lack of foreign reserves are concerns for investors in almost all SMCs. The cost of financing and the limited availability of debt from commercial sources for renewable projects represent a general challenge in all SMCs, though to different degrees. These barriers are felt either through non-availability of finance or inflexible grace periods that are not adapted to the characteristics of such investments.

BOX 1: THE COST OF FINANCING INVESTMENTS IN SMCs

Over the last decade, wind and solar power have become mainstream technologies thanks to substantial declines in their costs. Since 2009, solar photovoltaic costs have dropped by 80 percent and this trend is continuing. Wind turbine costs have halved in the same period. In 2017, the cost of electricity generation from newly installed wind averaged \$0.06 per kilowatt-hour (kWh) worldwide.

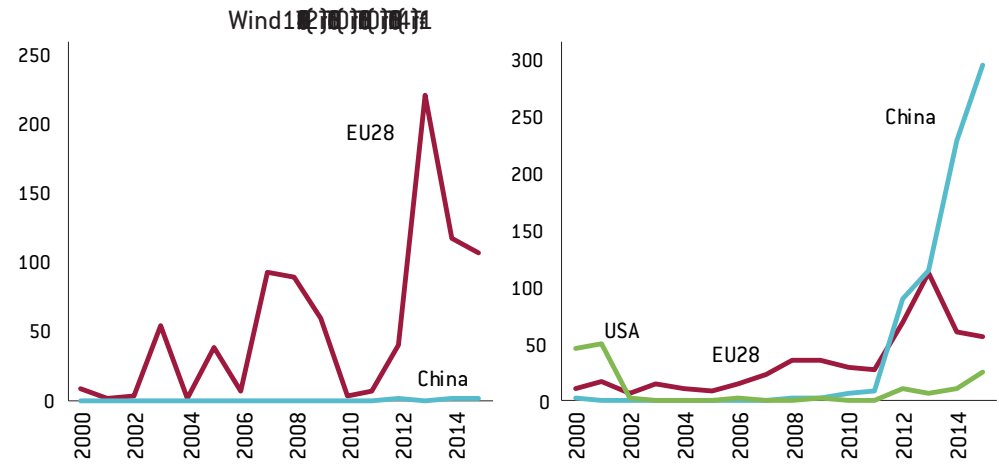
The cost structure of electricity generation from renewable energy technologies differs from thermal power generation since renewables do not use any fuels. Most of the generation cost relates to the capital cost of technologies. Financing costs, therefore, are key to ensuring cost-competitiveness. Capital costs include the costs of debt and equity, and are affected by country- and industry-specific risks. For instance, the cost of capital for renewable energy investments in Europe ranges from 3.5 percent in Germany to 12 percent in Greece for onshore wind (DiaCore, 2016). This wide range is a consequence of the different policy risks that investors face (for example, differences in the national regulatory frameworks that support the deployment of renewable energy sources).

An enabling investment environment boosted by low financing costs is fundamental to create markets for renewable energy technologies. This is where climate finance comes into play. In SMCs, renewable energy is financed from various sources. One form is funding made available by private investors, along with land ownership. This comes with minor risks as funds are readily available. Commonly, local banks and international finance institutions (IFIs) provide loans to investors in renewable energy. For these loans, the interest rate, which would determine to a great extent the cost of capital, could depend on factors including loan type, the currency of the loan and funding source. For instance, an issue for SMCs in particular is that interest rates for local currency are much higher than 10 percent currently. On the other hand, foreign exchange loans in euros or US dollars from IFIs such as the EBRD and the EIB could offer investors more favourable financing costs. Greater engagement of these institutions and other climate finance vehicles could leverage additional financing, in particular from the private sector, because the IFIs' risk-mitigation and credit-enhancement tools would reduce the risks for private investors.



SMCs must take action to overcome these barriers, in line with their respective national circumstances. That is, the governments of SMCs should act first and reform their energy sectors in order to

Figure 6: SMCs' wind power production in Europe (GWh)



Source: Bruegel based on Comtrade.

In order to have an impact, energy cooperation between the EU and SMCs should shift its focus from the export of energy from SMCs to Europe, to Europe supporting SMCs in meeting their booming energy demand in a sustainable way.

Europe could scale-up its climate financing activity in SMCs to support these countries in meeting their Paris Agreement pledges. But greater support should be linked to the implementation of energy reforms in SMCs, aimed at

removing the barriers to the private sector's engagement in their renewable energy sectors. This could be done by promoting pragmatic solutions to specific legal, regulatory and financial bottlenecks in individual SMCs. Higher levels of climate finance should be offered only to SMCs that actually implement such solutions. Supporting SMCs in meeting their energy needs in a sustainable way would also benefit Europe both in economic and political terms.