CIDOB • Barcelona Centre for International Affairs

ISSN: 2013-4428

notes internacionals CIDOB

32 MAY 2011

AHEAD OF SPRING IN ALGERIA: Tough Energy and Economic Challenges Await

Francis Ghilès Senior Research Fellow, CIDOB

Algeria has remained uncharacteristically calm since the winds of change started sweeping across the Arab lands five months ago. But the country will not stay for ever immune from the clamour for change voiced by millions of younger people who cannot find employment and want a say in the running of countries characterised by ageing oligarchies. How the economy evolves and which policies will or will not be implemented in the coming months and years is critical to their future and to the survival of the ruling elite. This piece will focus on energy and economic challenges in a country which remains as totally dependant on the export of hydrocarbons as it did forty years ago.

On a superficial reading, the first ten years of the new millennium brought plenty of good news for the Algerian economy. Between 2000 and 2009 real Gross Domestic Product (GDP) increased at an annual average of 3.7% and real GDP per head by 22%. Unemployment declined by more than half to 10%. The economy was buoyed by a favourable macroeconomic environment marked by high oil and gas prices and very conservative macro economic policies whose consequences were wholly predictable: large fiscal surpluses and ever larger foreign exchange reserves which have reached an estimated $170bn today. The country's foreign debt of $25bn was paid off. Agriculture for its part has seen production rise, helped by the virtual disappearance of terrorism and the long term leases available far more readily today than yesteryear. Towns and villages across Africa's second largest country bear witness to a huge building boom

Economic progress is however proving to be far bumpier than these rather bland statistics suggest. Recent developments in gas markets worldwide and depressed European gas demand leading to the sharpest contraction since 1970 have thrown up new challenges for the country's policy makers. Algeria has failed to diversify its exports away from oil and gas: their value accounts for 98% of all foreign income and two thirds of tax receipts, figures which are unchanged from 1971. Meanwhile, the new foreign investment rules introduced in the 2009 Supplementary Budget Law and the 2010 addendum to this budget are having a negative effect on Foreign Direct Investment (FDI) and on the private sector. The bureaucracy seems intent on waging permanent guerrilla warfare on *bona fide* private producers of goods and services, thus depriving many young Algerians of a job they need: the unemployment rate among those who are under 30 years of age is estimated to be 21% according the International Monetary Fund (IMF).

Restoring order in the hydrocarbons sector

The malaise in the oil ad gas sector was thrown into sharp focus early last year when an investigation of corruption targeting the national oil and gas company resulted in the suspension and arrest of a number of senior executives including the CEO of Sonatrach and three of its four executive vice presidents. The policy making style of the very powerful minister since 1999, Chakib Khelil was openly questioned as

were a number of his decisions. The minister's dismissal in May 2009 did considerable damage to Sonatrach's reputation and paralysed decision making for months. The appointment of Youssef Yousfi, a safe pair of hands and a man of integrity helped steady the ship but many policy targets and decisions have been affected as a result.

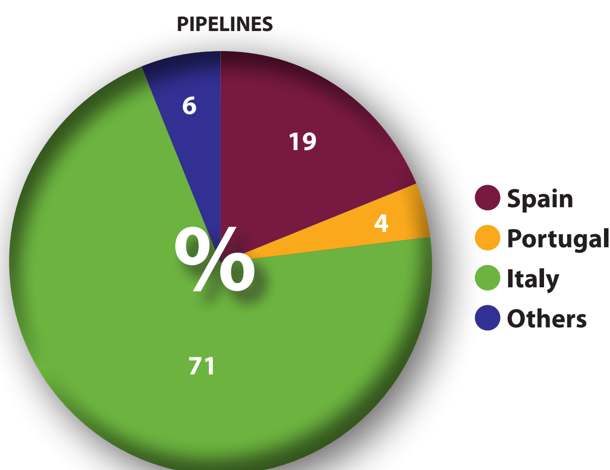
Last year's traumatic experience at Sonatrach was a far cry from the early 2000s when Chakib Khelil insisted that Algeria would be in a position to export 85Bcm/year (billion cubic metres) of gas by 2010/2013 and 100Bcm by 2020 to - it must be said, a sometimes sceptical world of senior western gas executives. By 2007 such targets looked out of reach as the major Gassi Touil Liquefied Natural Gas (LNG) project with Repsol and Gas Natural began to unwind, compounding an earlier loss of gas export capacity at the Skikda LNG plant when a deadly explosion destroyed three of six gas trains and 4Bcm/yr of LNG production capacity. In 2010, total gas exports reached 55Bcm, way below such ambitions.

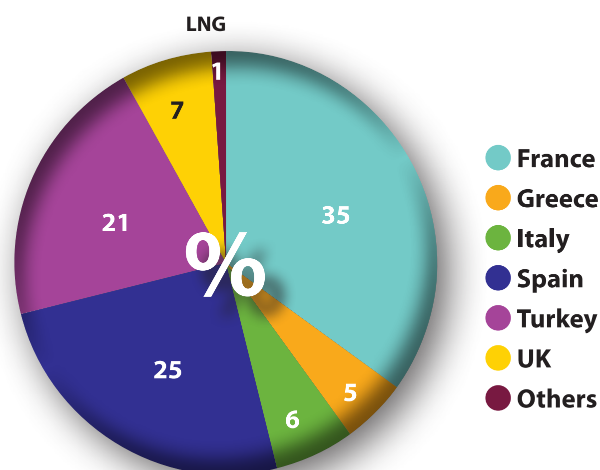
Another factor fed the scepticism of a growing number of observers of Algeria: no important new gas reserves had been discovered and developed in Algeria since 1990s and by 2007-8 it was obvious that the terms offered by Sonatrach to foreign companies were attracting ever less interest from major international oil companies: between 2001 and 2010 Sonatrach held nine exploration bid rounds, the last three of which registered a very low success rate. Upstream constraints on production were weighing ever more heavily on the company's capacity to honour, by 2013, the export contracts it had entered into.

but not least, great care should be made to avoid damaging existing wells by aggressive depletion policies: the long term productive capacity of the wells was considered to be of paramount importance. Two years later they were discarded by Chakib Khelil who went on to propose introducing very liberal amendments to the Hydrocarbons Law which would have given foreign companies unprecedented access to explore and develop Algeria's oil and gas fields.

One reason caution was thrown to the wind may be traced to the presence, in the Pentagon, on September 11th 2001, of the head of Algeria's *Direction du Renseignement, General* General Tewfik Medième. Algerian leaders felt they had been shunned by the major western powers during the brutal assault on the state led by radical Islamic forces in the 1990s and often complained they could not purchase much needed weapons because they were accused of leading a dirty war against such forces. General Medième was quick to grasp that the state of shock his hosts were in offered him a unique opportunity to turn Algeria's "black sheep" status to advantage: he offered the know-how the forces he commanded and the Algerian army had acquired over the previous decade in fighting terrorism to the US. This gave Chakib Khelil, whose close business links with Halliburton, whose former CEO was none other that the then vice president Dick Cheney, *carte blanche* to ramp up the country's export projections. Hubris probably played a part too as Chakib Khelil was happy to be centre stage, often quoting broad conclusions from reports from his staff he had not even bothered to read.

Algeria's gas exports by destination in 2010





Source: OME and Cedigaz

Before Chakib Khelil was appointed in 1999 two broad rules guided long term policy planning in hydrocarbons. Algeria would not enter into any new export commitment where oil and gas were concerned without an equivalent volume of proven reserves being found. Furthermore when projections of future exports and domestic consumption were made, its authors had to ensure that 35 years worth of domestic consumption were built into the model. Last

The minister also changed the rules of engagement for foreign companies bidding to explore and develop new gas fields in Algeria, to the dismay of his senior advisors. Hence, when Repsol and Gas Natural won major contracts to develop the Gassi Touil integrated LNG project, other major international oil and gas multinationals and some senior Algerian energy officials were aghast: they understood only too well that there was not the slightest chance

that the two Spanish companies could complete the job at the price they had bid. In other words, it was only a matter of time before the wheels came off the train.

By then, the attempts by Chakib Khelil to "liberalise" foreign investment rules in the hydrocarbons sector to enhance the exploration, production and export capacities of Sonatrach had come up against a barrage of criticism within the Algerian establishment. Aggressive depletion policies were considered anathema and the suggestion, in particular, that Sonatrach might be part privatised eventually provoked fury across the top political and military class. Such fury was reminiscent of 1991 when the then prime minister and former CEO of Sonatrach, Ahmed Ghozali had spoken of "selling Hassi Messaoud", the country's largest oil field, the reason put forward being that the servicing of Algeria's foreign debt was absorbing virtually all of its annual foreign income from oil and gas sales.

It also reminded long standing observers of Algeria of the opposition, back in 1976 to the Hydrocarbons Development Plan of Algeria, known as the *Valhyd* Report, written the US company Bechtel and consultants DeGolyer and McNauton: the policy promoted in this document was "geared to the rapid exploitation of Algeria's oil and gas reserves and to their early conversion into productive assets for the long term economic benefit of the country's citizens." Criticism of Chakib Khelil's ambitions was not limited to Algeria, powerful voices from abroad were equally vocal: the King of Saudi Arabia protested to President Bouteflika that Algeria was "selling" its oil and gas fields cheaply; President Vladimir Putin flew to Algiers on a state visit, never left the airport and confronted the Algerian head of state and his minister with harsh words: if the proposed amendments were passed Russia would ask for a 17% stake in Sonatrach; Hugo Chavez joined in the argument. President Abdelaziz Bouteflika took note and Chakib Khelil's was forced to backtrack: he dropped his proposed amendment but was mauled in the process.

In the three years which followed and despite well publicised concern among European Union states about future security of supply, worries which were fanned by disputes between Russia and Ukraine and high oil and gas prices, the number of multinational companies willing to sign new contracts to explore and develop new gas fields with Sonatrach fell sharply. Official Algerian export projections of gas made at the turn of the century, began to look unreal. The recession in Europe from 2008 got Sonatrach off the hook: European gas demand in 2008/9 came back to the level of 2004: in 2010 Sonatrach exported 57Bcm worth of gas, around two thirds by pipeline and the balance by LNG. The number of markets in which Algeria was selling gas was also declining as LNG was no longer shipped to Belgium and the US, in the case of the latter because of the fast growth in nonconventional gas production. That same year also failed to see the completion of the Medgaz pipeline being built between Algeria and Spain; of the expansion of the capacity of the TransMed pipeline, which carries Algerian gas to Italy via Tunisia, to 32.5Bcm/year and of the Gassi Touil integrated LNG project. More broadly, Sonatrach's aggressive depletion policies were being questioned while speculation in the media about technical problems at the Hassi R'Mel gas field were denied. By 2009, the Algerian press was openly questioning Chakib Khelil's policies, something it would have never dared do a few years earlier when complete *omertà* ruled on all matters gassy and oily – bar the words of the minister. The mismatch between the amounts of gas Algeria could offer and how much Europe would need had in the words of one recent report "led to a conspicuous disconnect between the upstream and the downstream gas business segments"[1].

Gas exports represent today 49% of Algerian exports with oil and other hydrocarbon products a further 49% and non hydrocarbons less than 2%. The contribution of hydrocarbons exports to the overall value of exports stands exactly where it was 40 years ago, an indictment of the country's incapacity to diversify its economy. Over the past quarter of a century, Algeria's hydrocarbon potential has progressively become more 'gassy' than 'oily'; today natural gas represents two thirds of the country's hydrocarbon reserve base. Exports of gas are thus not only of greater importance every year but they are increasingly "a key variable in Algeria's macro-economic balance, in addition to bearing added geostrategic significance for the country's international relations."

When Repsol and Gas Natural won major contracts to develop the Gassi Touil integrated LNG project, other major international oil and gas multinationals and some senior Algerian energy officials were aghast: they understood only too well that there was not the slightest chance that the two Spanish companies could complete the job at the price they had bid

Devising a coherent gas marketing strategy is thus essential for Algeria, all the more if one considers the important structural changes which are underway in global international gas markets. Over the last two decades, production of unconventional gas in the US has more than quadrupled; trade in LNG has been expanding; market liberalisation in

1. Hakim Darbouche, *Algeria's shifting gas export strategy: Between policy and market constraints*. The Oxford Institute for Energy Studies, March 2011.

several countries and falling transportation costs have broken down barriers between regionally segmented markets among the largest groups of gas consumers (Europe, America and Asia). In select markets, spot gas price indexation has become an alternative to traditional pricing based on long-term and oil-price indexed contracts. New emerging markets have increased global supply thus reducing the market share of traditional gas producers. Although Algeria's gas production has remained stable, its share in global gas production has been on a downward trend since the early 2000s. The country remains however the world's 8th largest producer and a key suppliers for European gas markets – the third most important outside EU supplier after Russia and Norway.

Increasing domestic requirements and an ever growing list of upstream setbacks as a result of the failure to attract large foreign investment in exploration and development suggests new rules for bidding will be enacted sooner than later. The sooner the better because, having extracted more than 55% of its known oil reserves, Algeria is now in the second half of its oil production life cycle. "This would not necessarily be bad news if encouraging new oil discoveries were coming along. The bad news is that over the past five years, Algeria's oil reserves have remained flat and production started to decline after reaching its peak, while domestic consumption has increased by more than 30%" points out Sohbet Karbuz, Director of Hydrocarbons at the *Observatoire Méditerranéen de l'Energie* in Paris. Oils exports thus declined a situation which can only get worse unless strong action is taken now. High oil and gas prices are here to stay which allows Sonatrach some time but beyond oil and gas lies the question of solar power which Algeria claims it wishes to develop. To meet such a challenge however means revising the huge energy waste which results from artificially low prices (3.5 cEuros/kWh). Diversifying the energy mix would also help boost hydrocarbons exports and contribute to water desalination, a vital necessity in the years ahead. The regulatory framework and demand management policies need to be overhauled. It is also not clear how much the recent attention paid to unconventional oil and gas – in particular the recent cooperation agreement between Sonatrach and the Italian company ENI to develop such resources, will become a game changer in Algeria's upstream industry. Beyond restoring order in the hydrocarbon sector, the consequences of postponing a sound energy strategy will become ever more painful.

Building a coherent economic policy: an urgent matter

Despite the launch of a $200bn public investment programme to build new infrastructure in 2004 and a string of new laws and rules ostensibly aimed at trade liberalisation, public enterprise restructuring and support for private entrepreneurs, private sector investment remains very hesitant. New dams and desalination plants have it is true been built which have allowed millions of Algerians to have regular access to water; new motorways have eased the flow of traffic between Algiers and major cities yet the massive importing of new cars. But the ample credit facilities granted to buyers of new cars have led to a ballooning of consumer debt and traffic gridlock, not least in the capital, Algiers. Shoddy building – of roads, of apartment buildings etc are a reflection of the state's inability to implement the rules it dictates and pervasive corruption. Algeria ranks poorly in the World Bank's 2011 Doing Business overall index (136th out of 183 countries).

Reforms in banking and finance are essential to make Algeria "more attractive for private investment" (2) Yet, despite the presence of a few foreign banks, practices in this sector are best described as "Jurassic park": more than a third of all public bank loans are non performing according to the IMF and it is simply impossible for a young entrepreneur who is not well connected to get a bank loan. Despite relatively large public investment ratios, the quality and efficiency of public expenditure lag behind most of Algeria's partners and competitors - the efficiency of public investment has in the eyes of many Algerian state managers declined over the past decade. To be blunt, the Algerian government does not seem to have an industrial and economic policy worthy of the name.

Despite the presence of a few foreign banks, practices in this sector are best described as "Jurassic park": more than a third of all public bank loans are non performing according to the IMF and it is simply impossible for a young entrepreneur who is not well connected to get a bank loan

The country has witnessed a huge building boom since 1999 but large swathes of land around the major cities and along the beautiful coast line, notably around Algiers and west of Oran at Ain Turk and Bou Sfer, have been irretrievable destroyed by buildings which spring up in quite chaotic fashion years before the local authorities are able to provide properly paved roads, water, electricity and drainage, let alone such amenities as schools, post offices and hospitals. Some cities are well run such as the old royal city of Tlemcen in the west and Setif and Bejaia in the east. The capital of western Algeria, Oran retains its raffish charm and strong Spanish influence but rush hour here is akin to a city three times its size. The new Sonatrach tower, the extravagant conference centre built for a major international gas conference last year, some of whose promoters have ended up in jail for corruption, mosques built in a style which is an insult to anybody who appreciates local architecture, ritzy apartment blocs on the sea front which belong to Miami but not to a city where garbage collection is a major problem, all this speaks of a lack of basic rules of town planning and a total disregard for aes-

thetics, which is a misfortune considering the city's site on the Mediterranean, shadowed by the cliffs of the Santa Cruz mountain.

Large industrial or transport projects are akin to the Loch Ness monster in Algeria. In the capital, a light metro systems will start operating soon, thirty years before it was first mooted. The government says that it is in talks with Renault to build a plant which may produce 10,000 cars in the town of Mostaganem but its forebear was already discussing such a project in 1981 except that Fiat was then the favoured partner and the site was the town of Tiaret. Many of the grandiose projects hark back to the dreams of central state planning of the 1970s but such thinking is still "normal" for some ministers.

The reasons for turning economic logic on its ahead are sometimes pretty obvious: the government opened the floodgates for new cars before it had time to properly improve the road infrastructure – imports being a sector where powerful entrenched interests are more likely to gain licences than serious entrepreneurs. Even when motorways are finally built, they are unlike those in other countries: the Algiers Oran motorway for instance boasts not a single petrol station, restaurant or resting area over its 450m kilometres – built by the Chinese, its costs soared way above initial estimates and also the price other foreign bidders had offered. The motorway's at times bumpy surface bears testimony to worst practice rather than best. The quality of public policy in Algeria has declined dramatically over the past decade.

It is easy to forecast that Algeria, which has received FDI flows well below Middle East and North Africa averages, will continue to put off many foreign investors. Improving domestic productivity and offering more job opportunities in the immediate future is destined to remain a pipedream in the immediate future

Few young Algerians remember that before foreign trade was nationalised in 1971 and a radical policy of *Révolution Agraire* adopted, Algeria's non oil and gas products represented 40% of the total value of exports. Despite all the difficulties they confront, a growing number of Algerian entrepreneurs refuse to despair of the future. With more than half their fellow countrymen under the age of 30 years, they argue, the winds of change are bound to blow. Here as elsewhere in the Arab world, the voice of younger people will become louder – but the lack of work incentives, the growing black market in goods and drugs, sheer bloody mindedness have become characteristic features of a growing number of young Algerians: changing attitudes will not be easy. Meanwhile tens of thousands of Chinese workers slave away in conditions and for wages no Algerian would accept.

Despite these confused conditions, many Algerian entrepreneurs are fighting to produce goods and services, increase the capacity of their firms or farms, build hotels worthy of the name and promote tourism. Development of the tourist sector is hampered by the refusal of the authorities to allow low cost flights to Algeria and the behaviour of the state carrier Air Algérie which regularly cancels domestic flights without the slightest concern for passengers. More and more young Algerians are learning French, Spanish and English, are surfing the web and looking at the world, ever more indifferent to the proclaimed outdated Arabism of state TV broadcasts.

Private investment in unexpected sectors such as olive oil production and wine making is running at an all time high and the production of olive oil sometimes exported as far as the US. This is a sector attracting interest from some important western investors, keen on investing in a sector where export markets, at least until the recent crash in prices, appeared to be guaranteed if quality was high. Others entrepreneurs have set up factories to make pharmaceutical and cosmetic products under licence; joint ventures in new clinics where the laws do not penalise FDI to harshly are moving ahead: a new dental clinic, a joint Algerian German initiative opened last year in Algiers, others are being planned. In Oran, one meets a growing number of Spanish entrepreneurs – the crisis in Spain has forced many to look towards a country they had until recently disdained or simply never heard but which offers real business opportunities for those who have strong nerves and a long term view. However difficult the market is, it remains solvent on account of the high price of oil.

The International Monetary Fund is starting the obvious when, in a recent report[2] it spoke of the "likely negative effects of the new FDI rules" on export diversification and the importance of export diversification for commodity exporters. The most important aspect of the legislation introduced by the government in 2009 is a 49% ceiling on the stake any foreign investor can hold in a new FDI project - the financial sector was included in this rule last year. It is easy to forecast that Algeria, which has received FDI flows well below Middle East and North Africa averages, will continue to put off many foreign investors. Improving domestic productivity and offering more job opportunities in the immediate future is destined to remain a pipedream in the immediate future. For some foreign investors, matters have taken a turn for the worse over the past three years. When *Orascom* sold its GSM mobile business to the Russian Vimplecom, the Algerian state tried to pre-empt the buyer, arguing it had a right to buy be-

2. Reinout de Bock & José Gijón, *Selected Issues*: Algeria, International Monetary Fund, December 27, 2010

cause the value of that part of Orascom's business had been undervalued. Beyond the question of who is right or wrong on this point, Algeria Telecom, the state operator does not have the management capacity to run itself, let alone another company. No one needs to feel sorry for *Orascom* however considering the unorthodox manner in which it obtained its first business contracts in Algeria. All large FDI contracts are political but this is not true for a myriad of smaller ones, especially when the local Algerian partner is private.

Equally absurd is the encouragement given by the government for state companies to trade and conclude service and management contracts among themselves in order to bypass the private sector: state companies then subcontract part of the contract to private ones. Purchasing orders which in many countries take one month can take up to two years. This is a truly Orwellian state of affairs and could lead to a paralysis of economic activity. The truth of the matter is that the Algerian government has long since given up any pretence of an industrial policy worthy of the name. This does not stop business thriving – some large contracts with foreign companies like that of the Aguas de Barcelona-Suez to improve water distribution in Oran is working smoothly, to the satisfaction of all parties and the population of Oran; many other smaller and medium size partnerships are also moving ahead.

Until the Algerian government offers a more realistic economic and industrial policy and reaches some kind of serious accommodation with the private sector, until it appreciates that legal rules cannot be changed at the whim of a minister and that overall predictability is a key to encouraging FDI and subsequent export diversification, the number of unemployed will swell. Whatever reform drive might have existed a few years ago has been blunted by the high price of oil, which has flooded the state coffers and bought the government time to delay hard questions – these questions like the reform of the banking sector have been put off for so long that younger Algerians cannot even remember the bold reforms attempted twenty two years ago. But a growing cushion of hard currency reserves (estimated at $170bn) is doing little to ease social tensions, joblessness and growing poverty. What it does is offer a guarantee of creditworthiness to foreign investors who are able to find a reliable public or private partner in Algeria.