



The Economic Implications of the Colombian Government Policy Proposal on Infrastructure Investment

1. Introduction

In this edition of InfraEcon Insights, we discuss recent policy proposals; economic and regulatory repercussions in South America's infrastructure sector. Colombia is our case study, exemplifying the dichotomy between effective policies and less efficient, politically driven alternatives. Our analysis extends to energy sector reforms and shifts in transportation incentive mechanisms. Furthermore, we delve into the potential impact on private investment and the subsequent damages and remedies investors could encounter. Similar trends can be extrapolated to other Latin American jurisdictions like Mexico, Honduras, and Peru, where populist policies have often overshadowed economic efficiency.

2. Background: The Reform Era and Economic Principles

Like many Latin American jurisdictions, Colombia embarked on a transformative journey of restructuring its infrastructure sectors in the late 1990s. The era marked a pivotal shift towards market liberalization, institutional autonomy, and the pursuit of economic efficiency. At the heart of these reforms were Laws 142 and 143 of 1994, which laid the

foundation for Colombia's modern infrastructure landscape, setting it on a path of progress that continues to resonate today.

The backdrop for Colombia's infrastructure overhaul was recognizing the need to transcend traditional bureaucratic constraints and stimulate economic growth. By introducing market liberalization, the Colombian government acknowledged the critical role of private sector participation in fostering innovation, efficiency, and enhanced service delivery. The reforms sought to replace stagnant state monopolies with competitive environments that could propel sectors like energy, transportation, and telecommunications towards dynamic expansion.

Central to this paradigm shift was the establishment of independent regulatory bodies. These entities, such as the Energy and Gas Regulation Commission (CREG) established under Law 143, were designed to insulate decision-making from political influence. Colombia aimed to create a transparent and fair landscape by depoliticizing regulatory oversight, fostering investor confidence and long-term sustainability.

A resolute emphasis on economic efficiency was at the heart of Colombia's infrastructure reform. The lessons learned from years of inefficient public monopolies

galvanized a drive to streamline operations, reduce operational and economic inefficiencies and optimize resource allocation. The reforms signaled a departure from legacy practices and a march towards more agile, market-driven models.

Laws 142 and 143 represented not only legal amendments but also a philosophical shift towards a more competitive, private, investment-friendly environment. The architects of these reforms recognized that the country could only leverage cutting-edge technologies, management practices, and capital inflow that would revitalize its infrastructure backbone by incentivizing private participation.

Central to the reform's narrative was the uncompromising pursuit of economic efficiency. Policymakers recognized that infrastructure resources must be allocated optimally to drive economic growth. This principle underscored decisions to reduce vertical integration, introduce incentive-based regulations, and create subsidy mechanisms catering to diverse consumer segments' needs.

While the reform envisioned many benefits for the Colombian economy, a pivotal objective was attracting foreign investment. The global community's growing appetite for infrastructure investment dovetailed with the country's agenda to diversify funding sources. Colombia sought to position itself as a promising destination for capital, assuring investors of a robust regulatory framework and economic stability.

Over the past quarter-century, Colombia's infrastructure sector has evolved, adapting to changing economic dynamics and technological advancements. Lessons have been distilled from successes and challenges, leading to constantly refining policies and practices. As the country grapples with the complexities of the modern world, the bedrock of these reforms remains the cornerstone upon which future innovations are built.

Therefore, Colombia's infrastructure reform in the late 1990s was not merely a legislative overhaul but a declaration of intent to embrace modernization, efficiency, and progress. Laws 142 and 143 reshaped Colombia's infrastructure landscape, introducing market dynamics and regulatory autonomy that continue to resonate today. The lessons from this transformational period provide a compass for future policies, reiterating the importance of investment attraction and economic efficiency in propelling the nation's infrastructure towards new horizons.

3. Evolution of the Transportation Sector

Colombia's journey in the transportation sector stands as a testament to the transformative power of Public-Private Partnerships (PPPs). With international recognition for its institutional framework, risk management, and capacity structuring with the use of project financing since 2012, Colombia's commitment to PPPs has ushered in a new era of infrastructure development, as detailed below.

Central to Colombia's success in PPPs is attracting experienced investors equipped with advanced engineering designs and cutting-edge asset management technologies. The allure of profit and the prospect of contributing to national infrastructure growth have enticed seasoned investors. Their involvement has brought capital and innovation, propelling the sector towards efficiency and sustainability.

The application of stringent value-for-money¹ analyses to PPP projects has spotlighted their Effective, efficient, and economic use of resources, which requires the evaluation of relevant costs and benefits, along with an assessment of risks, and of non-price attributes and/or life cycle costs, as appropriate. "Value for superior worth compared to traditional public works. This assessment method scrutinizes the

¹ Effective, efficient, and economic use of resources, which requires the evaluation of relevant costs and benefits, along with an assessment of risks, and of non-price attributes and/or life cycle costs, as appropriate. "Value for Money: Achieving

VfM in Investment Projects Financed by the World Bank" The World Bank, procurement guidance, July 2016, first edition, page 1.

project's potential benefits and costs, validating the economic viability of PPPs. The result is a portfolio of projects that promise physical infrastructure and tangible economic advantages to the nation.

The advocacy for PPP projects has ushered in heightened competition among investors vying for infrastructure development contracts. This competition exerts downward pressure on costs while stimulating innovation in project proposals. The country's infrastructure landscape thus benefits from a pool of ideas that compete for efficiency and effectiveness.

Colombia's embrace of project financing has injected a dose of debt market discipline into the sector. This strategic structuring introduces the risk assessment and mitigation principles inherent in debt markets. As a result, project execution adheres to disciplined timelines and financial prudence, aligning the interests of investors and the state.

One hallmark of Colombia's PPPs is the risk mitigation approach by demanding substantial equity contributions from private investors. This requirement serves as a safeguard against abandonment risks and construction delays. The shared financial responsibility ensures that project execution remains on track, minimizing the chances of project disruptions and the subsequent economic implications.

In addition, incentive mechanisms have been thoughtfully integrated into PPPs, necessitating optimal project performance throughout the concession period. Private entities are held accountable for maintaining infrastructure quality and operational efficiency. This accountability structure benefits the state and establishes a foundation for long-term project sustainability.

Therefore, Colombia's transportation sector evolution through Public-Private Partnerships underscores the nation's commitment to modernization and economic growth. The partnership with seasoned investors, rigorous financial analysis, and performance incentives have positioned the sector for success. As Colombia continues to navigate its infrastructure

journey, the lessons learned from these PPP-driven advancements will undoubtedly shape the trajectory of sustainable, efficient, and economically effective infrastructure development. With the help of the PPP model, Colombia has built nearly 10,000 km of primary roads, which could not have been fully carried out through public works under the country's fiscal conditions. The jump in total private investment in infrastructure stands out: between 2002 and 2019, it grew 13.6 times in nominal terms. The total investments of COP\$ 12.4 trillion in 2019 represented 62% of the annual investment aspirations of COP\$ 20 trillion contemplated in the Plan Master of Intermodal Transportation 2015.

4. Evolution of the Energy Sector: A Market-Driven Transformation

The energy sector in Colombia has undergone a remarkable evolution, characterized by transformative legislative changes and the embrace of market principles. The turning point arrived with Laws 142 and 143 of 1994, which ushered in a new era of private involvement across the electricity value chain. These reforms were anchored in competitive market dynamics, creating a landscape where profit-oriented and economic efficiency principles were the basis for operation. Establishing the Energy and Gas Regulation Commission (CREG) was instrumental in ensuring equitable outcomes as a steward of fair play within the sector.

A significant outcome of these reforms was the promotion of competition in generation, which has facilitated the entry of new players. The introduction of incentive-based regulations was another pivotal aspect, fostering a culture of improved service quality. Simultaneously, cross-subsidies between end customers emerged as a pragmatic fiscal strategy, easing the financial burdens for the most vulnerable segments of the population.

Paralleling the success of electricity reforms, Colombia's approach to the natural gas sector took inspiration from the UK regulatory model. A landmark development was the establishment of the National

Hydrocarbons Agency, a move that recalibrated governance structures and jurisdiction over the sector's resources. The subsequent deregulation of wellhead prices breathed new life into the natural gas sector, creating a dynamic pricing environment that reflected market forces.

A cornerstone achievement of Colombia's energy sector evolution was the inauguration of the regasification plant in Cartagena. This strategic move linked the country to international markets, diversifying supply, and enhancing pricing efficiency. By aligning local prices with international benchmarks, this connection minimized supply costs, thus optimizing the nation's energy resource utilization.

The journey of Colombia's energy sector exemplifies the power of policy-driven reforms in creating dynamic, competitive markets. The laws of 1994 acted as a catalyst, inviting private sector participation and engendering a climate of accountability. The subsequent establishment of regulatory bodies ensured that market dynamics operated fairly and that service quality remained paramount. These reforms were replicated in the natural gas sector, where a regulatory structure akin to the UK's and measures to enhance price efficiency were embraced. Looking ahead, the evolution of Colombia's energy sector serves as a beacon for other nations, illustrating the importance of forward-thinking policies in fostering vibrant, sustainable energy landscapes. As technology advances and global markets shift, Colombia's example is a testament to the potency of well-structured reforms that harness market principles for the greater good.

5. Threats of Increased Uncertainty

The Colombian infrastructure sector, which has experienced positive momentum in recent years, is encountering uncertainty and unpredictability due to the current Colombian government's commitment to policy modifications. These initiatives, while aimed at reforming the sector, carry the potential to undermine

the gains achieved thus far, giving rise to serious concerns.

Transportation, a vital artery for economic growth, finds itself at a crossroads. The recent imposition of toll freezes, and a bias towards public works contracts strikes at the heart of the successful Public-Private Partnerships (PPP) model. This change threatens to erode the very essence of these partnerships, putting at stake the remarkable advancements that have been achieved. The PPP model, known for attracting private investments and ensuring infrastructure excellence as described previously, now faces the threat of being dismantled. This could compromise the quality of future infrastructure projects and erode investors' trust in these partnerships.

Meanwhile, the energy sector, a linchpin of national progress, is also entangled in a web of uncertainty. Proposals that tinker with the sector's governance and reshape remuneration frameworks cast doubt over the impartiality that has been the cornerstone of the sector's success.

These changes could undermine the transparent regulatory framework that has been pivotal in attracting private investments and fostering competitive dynamics. Furthermore, the specter of expanded state-controlled energy companies raises concerns about crowding out private investment and compromising the delicate balance between public and private interests.

The abrupt halt in hydrocarbon exploration is yet another puzzle piece in this complex narrative. The energy landscape, which has seen significant advancements in exploration and resource development, now confronts a sudden stoppage. This could undermine the potential for energy self-sufficiency and raise questions about the long-term strategic planning essential for a stable energy sector. Moreover, establishing 'energy communities', a government proposal that still lacks a precise meaning, but which leaves the door open for intrusive participation of loosely organized groups of rural settlers in the board of directors of established energy firms, raises alarm bells for the sector's sustainability

and societal stability. While community engagement is laudable, its implementation without proper equity contributions could lead to a chaotic power struggle for resources. This, in turn, threatens social harmony and could disrupt energy supply, further deepening the sector's vulnerability.

In the context of investment, these uncertainties can have far-reaching consequences. The sanctity of contracts², and the stability of regulatory frameworks are central to attracting foreign direct investment and fostering investor confidence. Alterations to established policies might be perceived by investors as creeping expropriation, deterring them from engaging in long-term ventures. This could lead to claims for damages in investor-state dispute resolution mechanisms.

From an economic perspective, it is imperative to understand and assess the multifaceted implications of these proposed policy changes. The potential consequences extend beyond immediate economic impacts to the very bedrock of investor confidence and long-term sector stability. The expertise of economic and damages professionals will be pivotal in assessing the validity of these policy shifts, their adherence to established agreements, and their potential to disrupt not just the sector but the broader economic fabric of Colombia.

As the Colombian infrastructure sector navigates through this period of policy uncertainty, stakeholders must tread cautiously, drawing from the lessons of the past and recognizing the pivotal role that policy stability plays in shaping a resilient, investor-friendly, and sustainable sector.

6. Impact on Investments

The recent policy shift in the Colombian infrastructure sector has raised critical concerns regarding its potential impact on investment and the subsequent likelihood of claims against Colombia. The overarching worry is the specter of creeping

expropriation, a phenomenon where incremental policy changes erode the value of infrastructure investments over time. Understanding the implications of this shift is pivotal in safeguarding the interests of investors and stakeholders.

One of the significant challenges presented by creeping expropriation is the gradual nature of its impact. Unlike overt expropriation, which involves direct seizure of assets, creeping expropriation operates subtly, often taking the form of regulatory changes, policy shifts, or biased contract preferences. This gradual erosion of value can profoundly affect infrastructure investments, sowing uncertainty and undermining investor confidence. As a result, infrastructure projects once deemed lucrative could languish due to dwindling profitability.

Stakeholders facing value erosion must consider strategic litigation as a potential avenue for remedy. While the path to legal recourse can be complex, the principles of international arbitration provide a platform for investors to seek compensation for the losses incurred due to policy-induced value depreciation. By demonstrating that the policy shift constitutes a breach of established agreements or international standards, stakeholders can pursue claims against the breaching party to mitigate their losses.

Economic analyses play a pivotal role in these claims. Robust assessment of damages requires a nuanced understanding of the intricate interplay between policy change, investment loss, and potential future earnings. Experts must meticulously evaluate the impact of policy shifts on cash flows, valuations, and return on investments. This assessment involves quantifying the financial repercussions of value erosion and projecting potential future losses. Moreover, the assessment must capture the broader economic context, including macroeconomic factors and market dynamics that could further exacerbate the damage.

² See "Legality and Market Reform in Soviet-Type Economies" John M. Litwack, *Journal of Economic Perspective*,

vol 5, Number 4 – Fall 1991 – pages 77-89.

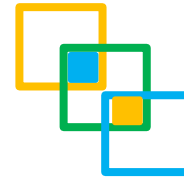
Policy shifts in the infrastructure sector could result in multiple layers of damages. Beyond direct financial losses, stakeholders could suffer reputational damage, loss of future business opportunities, and even regulatory risk. Economic experts must adopt a comprehensive approach that accounts for these multifaceted implications, offering a holistic view of the damages incurred.

Furthermore, the expertise of economic and damages experts is indispensable in establishing the nexus between policy change and its impact on investment. The challenge lies in quantifying damages and constructing a compelling narrative that links the policy shift to the resultant harm. This narrative is essential in convincing arbitration panels of the claim's validity and the extent of the damages suffered.

Conclusion

Colombia's infrastructure sector mirrors the delicate balance between policies that stimulate investment and those driven by political motives. The implications of these policy choices resonate beyond national borders. As policy currents change, investors and experts must stand at the helm, employing comprehensive strategies to safeguard investment interests, preserve economic efficiency, and pave the way for a thriving infrastructure landscape.

The current policy shift in the Colombian infrastructure sector underscores stakeholders' need for a proactive approach. The risk of creeping expropriation necessitates vigilance and preparedness to safeguard investments. The potential to bring claims against a State rests on demonstrating the breach of agreements or international agreements. Robust economic analyses, powered by the expertise of international arbitration professionals, are the cornerstone of these claims. As the sector navigates these uncertain waters, the role of economic experts and arbitration panels is critical in upholding the principles of fairness and protecting the interests of all stakeholders involved.



Infrastructure Economic Consulting and its group of Affiliates have the necessary experience and expertise to support investors in the infrastructure sector to analyze the specific circumstances of their investment in the context of the new proposed measures. In addition, we are experts in assessing from an economic and regulatory perspective the individual damages and remedies that such actions would have on their investments. There are numerous economic issues that the proposal on the energy and transportation sectors raises. They deserve a thorough analysis from an economic and regulatory perspective, and the potential harm to investments needs to be assessed.

Infrastructure Economic Consulting, LLC (InfraEcon) is an economic consulting boutique specializing in regulatory economics and quantum matters in International Arbitration for a variety of industries. Carlos Pabon-Agudelo is the Managing Director of InfraEcon. Juan Benavides and Gustavo Saguier are affiliates of InfraEcon. Details about our expertise can be found at www.infraconn.com.