

**COLOMBIA**

**SECTOR PROGRAM FOR PUBLIC UTILITIES (PSSP)**

**(CO-0270)**

**LOAN PROPOSAL**

This document was prepared by the project team consisting of Roberto Manrique (RE3/FI3); Project Team Leader; Kevin McTigue (LEG/OPR); Henry Moreno (COF/CCO); Víctor Traverso (RE3/EN3); and Ignacio Coral (consultant). Jaime Millán and Juan Benavides (SDS/IFM) served as advisors. Laura Profeta and Gerónimo Frigerio (LEG/OPR) also advised the project team. Victoria Galeano (RE3/FI3) assisted with technical research.

**Project Summary**  
**Colombia**  
**SECTOR PROGRAM FOR PUBLIC UTILITIES (PSSP)**

Basic Data				
Date: 13 August 2004			Project number:	CO-0270
Project Team: Roberto Manrique (RE3/FI3), Project Team Leader; Kevin McTigue (LEG/OPR); Henry Moreno (COF/CCO); Victor Traverso (RE3/EN3); and Ignacio Coral (consultant). Jaime Millán and Juan Benavides (SDS/IFM) served as advisors.			Lending instrument:	PBL
			Sector(s):	Reform
			CESI Review:	17 June 2004
Financial Terms and Conditions <sup>1</sup>				
Borrower: Republic of Colombia			Amortization Period:	20 years
Guarantor: Republic of Colombia			Grace Period:	5 years
Executing Agency: Ministry of Finance (MHCP) through the Technical Vice Ministry			Disbursement Period:	Minimum 18 months, maximum 36 months
Source	Amount	%	Interest Rate:	Variable
IDB (Ordinary Capital)	US\$600 million	100	Inspection and supervision:	0%
Local	0	0		
Other/Cofinancing	0	0		
Total	US\$600 million		Currency:	US dollars from the Single Currency Facility
Project at a Glance				
<b>Project objective:</b>				
To support the Government of Colombia in implementation of a series of reforms to ensure that public electricity, telecommunications, water and sanitation services fulfill their objectives of equity, efficiency, quality and sustainability, and to promote a better climate for private investment.				
<b>Special contractual conditions:</b>				
Disbursements will be made in three tranches of US\$200 million, once the measures included in the Policy Matrix for each tranche have been fulfilled and verified to the Bank's satisfaction. These measures are grouped into five components: (i) macroeconomic stability; (ii) effectiveness of the regulatory, supervisory and control agencies; (iii) efficiency and financial sustainability; (iv) private sector participation; and (v) decentralized public utilities (see Policy Matrix).				
<b>Exceptions to Bank policies:</b>				
None.				
Project consistent with Country Strategy: Yes <input checked="" type="checkbox"/> No <input type="checkbox"/>				
Project qualifies as: SEQ <input checked="" type="checkbox"/> PTI <input type="checkbox"/> Sector <input type="checkbox"/> Geographic <input type="checkbox"/> % Beneficiaries <input type="checkbox"/>				
Procurement: Not applicable.				

<sup>1</sup> The interest rate, credit fee, and inspection and supervision fee mentioned in this document are established pursuant to document FN-568-3 Rev. and may be changed by the Board of Executive Directors, taking into account the available background information, as well as the respective Finance Department recommendations. In no case will the credit fee exceed 0.75%, or the inspection and supervision fee exceed 1% of the loan amount.\*

\* With regard to the inspection and supervision fee, in no case will the charge exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

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### Electronic Links and References

Abbreviations	<a href="http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=342983">http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=342983</a>
Basic Socioeconomic Data	<a href="http://www.iadb.org/RES/index.cfm?fuseaction=externallinks.countrydata">http://www.iadb.org/RES/index.cfm?fuseaction=externallinks.countrydata</a>
Active Portfolio	<a href="http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=360683">http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=360683</a>
Information available in the RE3/FI3 technical files	<a href="http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=358904">http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=358904</a>
Policy Letter	<a href="http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=357315">http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=357315</a>
Means of Verification	<a href="http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=358840">http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=358840</a>
Draft Outcomes Matrix; Indicator Quantification	<a href="http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=358891">http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=358891</a>
Methodology	<a href="http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=356282">http://opsws3.reg.iadb.org/idbdocswebservices/getDocument.aspx?DOCNUM=356282</a>

## I. FRAME OF REFERENCE

### A. Socioeconomic framework

- 1.1 Colombia's economy has slowed considerably since the second half of the 1990s. Following a brief burst of growth in 1998, the first quarter of 1999 saw the start of the worst economic recession in the last 70 years. Between 1999 and 2000 the country had to face simultaneously a decline in its gross domestic product (GDP), a crisis in the financial system and among mortgage borrowers, a fiscal crisis in local governments, looming contingent liabilities (pensions and infrastructure guarantees), and a growing imbalance in central government finances. All these problems emerged in a context of limited access to external financing and rising armed violence by domestic groups.
- 1.2 Over the last two years, the Colombian economy appears to have settled into a new period of growth. In 2003, the economy grew by 3.6% in real terms, a rate higher than projected (2%) and the highest in the last six years. The fastest growth was in the construction sector at 11.6%, followed by mining at 11%. Performance in 2004 has been encouraging. In the first quarter of the year, the economy posted an annualized growth rate of 3.8%. This trend is expected to continue for the rest of the year (projected growth of 4%). It is estimated that private investment will grow from the 8.5% of GDP recorded in 2003 to 10% of GDP in 2004. The unemployment rate continues to decline: between April 2003 and April 2004, the unemployment rate for the 13 major metropolitan areas dropped from 17.9% to 16.8%.
- 1.3 While the short-term economic outlook is positive, there is a pressing need to reduce the public debt as a proportion of output, and this will require greater efforts at fiscal adjustment. To this end, the government will seek congressional approval on three issues during the second half of this year: (i) pension reform for the special and exempt regimes; (ii) approval of the revised budget code; and (iii) rationalization of certain aspects of the taxation system.

### B. The program with the IMF

- 1.4 With respect to the standby arrangement (SBA) with the IMF, no difficulties are foreseen in complying with the structural benchmarks and performance criteria that have been set. From the third review of the program, conducted in April 2004, it emerges that: (i) economic performance has improved considerably, and projections for 2004 are favorable;<sup>1</sup> (ii) the government has satisfactorily complied with the agreements established in the SBA and is committed to continuing the reform

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<sup>1</sup> During the review, the IMF raised its economic growth projections for 2004 from 3.3% to 4%. The program continues with the 2004 objective of inflation at 5.5% and a fiscal deficit for the consolidated public sector at 2.5% of GDP. The external current account deficit for 2004 is projected at 2.2%.

process; and (iii) the risks to the program remain.<sup>2</sup> The fourth and final review of the program is scheduled for December 2004. The government has signaled its intent to continue within the framework of an arrangement.

### **C. Public utility issues<sup>3</sup>**

- 1.5 The public utility reform undertaken in Colombia during the 1990s was part of the State reforms facilitated by promulgation of the 1991 Constitution, which made the State responsible for the efficient delivery of public services and for the tasks of regulation, control and supervision. They also called on the State to serve the general welfare and to improve the quality of life of the population. These reforms seek to separate the roles of the State, limiting its involvement in running businesses in order to focus on policymaking and regulation. They also encourage the private sector to participate in various ways, either at its own initiative or under government contracts. In order to implement this principle, the Public Utilities Act (Law 142) and the Electricity Act (Law 143) were passed in 1994. These laws establish the regulatory and control systems for public utilities, the institutions of the electricity market, and the conditions to ensure competition in segments where it is possible and desirable. They also establish a procedure for granting subsidies to low-income users.
- 1.6 After significant progress in implementing these reforms in the 1990s, various difficulties emerged that have kept them from taking root and blocked further progress, thereby threatening the sustainability of the sector model and jeopardizing future service delivery. In terms of accomplishments, however, the reform has achieved many of the expectations created at the time of its adoption. Private investors have put more than US\$6 billion into the electricity sector and made substantial investments in natural gas and telecommunications, particularly in the mobile telephony area. The real cost of long-distance service has declined, and access to new and different communications services has improved, including the rapid penetration of mobile telephony. With respect to drinking water, the new legal framework has allowed for successful private involvement, substantially improving service efficiency in some cities<sup>4</sup> through concessions or management contracts. As well, small and medium-sized providers have moved into the drinking water sector in smaller localities.

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<sup>2</sup> These risks relate to: (i) the implications for the policy agenda of the presidential reelection process; (ii) the national security situation which, although improved, remains fragile; and (iii) the vulnerability of the medium-term fiscal position to a rapid rise in international interest rates.

<sup>3</sup> For purposes of this program, public utility services refer to residential electricity, telecommunications, and drinking water and sanitation services, as well as mobile telephony.

<sup>4</sup> The cities of Cartagena, Barranquilla, Santa Marta, Riohacha, Sincelejo, Tunja and Montería.

- 1.7 Despite this progress, development of this new framework over the last 10 years has not been without its difficulties. In the electricity sector, after a promising start with the sale of the national government's electricity generation assets, the privatization of distribution companies did not occur. At the subnational level, most municipal enterprises were unsuccessful in their attempts to operate on a sound business footing. The strategy of taking over insolvent companies proved ineffective. Ongoing disputes over electricity regulation have made the climate for private investment still more tenuous, and the regulatory process has become bogged down in the courts. The difficulties of distribution enterprises have forced the government to undertake costly capitalizations and to honor debt service and energy purchase contracts. An example of this is the bailout of Cali's municipal utilities, which involved heavy outlays of public funds. In the drinking water sector, the main problem lies in the structure of the industry with some 1,000 municipal utilities. This fragmented industry structure makes it impossible to achieve sector economies of scale or coverage and undermines the efficiency of the enterprises and the effectiveness of regulatory and policymaking institutions. Their dependence on the national budget, while it is less today than it was at the outset of the reform, has been growing because of rising contributions to the Solidarity Funds and the difficulties in using regional transfers to cover water subsidies. This is a heavy burden for the government, which is seeking to reduce its fiscal deficit.
- 1.8 In light of the foregoing, and with the gradual recovery of the economy, conflicts have sharpened, and a number of proposals have been submitted to Congress to amend Laws 142 and 143 in ways that would threaten the sustainability of the model. The government has resisted these initiatives in part, at the cost of significant growth in the volume of subsidies, through adoption of the National Development Plan 2003-2006, "Hacia un Estado Comunitario [Towards a Community-based State],"<sup>5</sup> which limits rate adjustments for zones 1 and 2 to the increase in the consumer price index (CPI) for four years.
- 1.9 While the critical economic situation that emerged in 1999 and the problem of maintaining law and order have inevitably affected the performance of the public utility sectors, it is also clear that many of the initial assumptions underlying the reform were out of line with Colombia's institutional reality. Thus, there is consensus that these problems are at the root of the current lack of effectiveness and credibility in the regulatory and control institutions, the poor performance of many State-controlled enterprises, the little incentive for private investment, and the growing weakness of the system for targeting subsidies at low-income users. There is also consensus on the urgent need to adjust the reforms to take account of existing conditions, while at the same time meeting the initial objectives of equity, efficiency, quality and sustainability. Nevertheless, even with a relative degree of consensus within the government and the utility enterprises on short and longer-

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<sup>5</sup> Law 812 of 26 June 2003.

term solutions for the sector, the highly charged atmosphere in Congress makes it difficult and even risky to try to resolve these issues through legislation. These substantial constraints condition the scope of the actions to be supported under this program.

#### **D. The country's strategy for public utilities**

- 1.10 In January 2004, the National Economic and Social Policy Council (CONPES) approved a policy paper with the general objective of enhancing the sustainability and facilitating the improvement of public utility services by strengthening the institutions and the general framework established by Laws 142 and 143. The policy paper also confirms the national government's authority to negotiate a loan with the Bank for this purpose. The following specific objectives are designed to achieve this general objective: (i) strengthen regulation by consolidating the established framework through new initiatives with meaningful participation by users and regulated entities in decision-making; (ii) supplement existing legislation by adopting tools that are up to the task of regulation, inspection and oversight, one of the focal points of the State reform program now underway; (iii) establish guidelines for the effective involvement of national government corporations in the delivery of utility services; and (iv) achieve the millennium development goals in the water and sewage sector.
- 1.11 In order to achieve the specific objectives, the Colombian government's public utilities agenda calls for defining and implementing a program of reforms to the sector's institutional and financial framework, so that those utilities can achieve their basic objectives of equity, efficiency, quality and sustainability, and to promote a better climate for private investment. The initiatives relating to review of the institutional framework for regulation and control of business activities is part of the general strategy for modernization of the State that is being supported by the public administration reform program, the principles of which are these: (i) private service providers must be subject to regulation and control; (ii) regulation and control must be of high quality as an incentive to private investment; (iii) the regulatory and control system must favor public participation, giving citizens an effective opportunity to demand intervention against market players whose behavior violates their rights, and in this way instilling community trust in the institutions; and (iv) mechanisms must be established for public disclosure and access to timely and reliable information for all users and consumers.

#### **E. The Bank's strategy**

- 1.12 The Bank's country strategy, approved by the Board of Executive Directors in September 2003, establishes three major areas of Bank activity in Colombia for the period 2003-2006: (i) laying the foundations for economic revival and jump-starting growth; (ii) fostering social progress and making sure that society's most vulnerable are protected; and (iii) strengthening governance and furthering the State

reform process. In addition, the country strategy identifies two important constraints: persistent fiscal shortfalls, and the escalating armed conflict. The gradual resolution of these two constraints constitutes a basic assumption for the success of the strategy.

- 1.13 In terms of these basic country strategy areas, the project will help to improve the efficiency and quality of public utility services and the climate for private investment. It thus includes measures designed to promote social development and protection for the most vulnerable groups, to improve governance in the country, and to support the State reform process. Social development and protecting society's most vulnerable are essential aspects of the efficiency and financial sustainability component that supports efforts to improve the targeting of subsidies for low-income users. They are also a focus of the decentralized utilities component that will lay the foundations for efficient and sustainable delivery of water and sanitation services.
- 1.14 The policy measures included in this program will also help to improve governance in the country and to support the State reform process. Measures under the component for enhancing the effectiveness of regulatory, supervisory and control agencies will lead to greater citizen participation in the regulatory process, and will reinforce public trust in this institutional structure. Policy measures under the efficiency and financial sustainability component will enable utility firms to operate better: otherwise, governance suffers. Establishing the basis for the efficient delivery and sustainable development of water and sanitation services is another important step in modernizing the decentralized utilities.
- 1.15 Finally, the program will contribute to the financial sustainability of public utilities and thereby help to reduce the fiscal imbalance. Consistent with the IMF standby arrangement, funds from this operation are included in the External Credit Disbursement Program for 2004-2006 that was recently approved by CONPES. As established in the central government's 2004 financial package, funding from the first tranche of the loan will represent a significant portion of external financing, together with other disbursements from the IBRD and the Andean Development Corporation.<sup>6</sup> Disbursements under the second and third tranches will support the public debt repayment profile, under which obligations of US\$4.87 billion are forecast in 2005, and US\$5.067 billion in 2006.

#### **F. The Bank's strategy for public utilities**

- 1.16 The Bank has a tradition of supporting the reform of public utility services. From the late 1980s onward, and particularly during the 1990s, its early analytical involvement was essential in developing the technical elements for developing such reforms. Its efforts produced concrete results in utility reorganization, particularly

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<sup>6</sup> Multilateral sources account for approximately 16% of financing in 2004.

in the energy sector, where the focus was on achieving economic efficiency by encouraging competition wherever possible, and ensuring transparent regulation in all other cases.

- 1.17 During the past decade, the Bank has supported structural change in Colombia through two sector programs<sup>7</sup> aimed specifically at modernizing the public sector and the financial system, promoting competition and private-sector participation in sectors in which the public sector traditionally held a monopoly or a dominant position. The IDB and the World Bank (IBRD) have also provided timely technical cooperation in support of these programs, to help in developing major structural reforms, building consensus, and implementing them.
- 1.18 The Bank's strategy in the utilities sector is intended to ensure long-run sustainability; to lay the foundations for attracting private investment; to make utility service delivery economically efficient; to extend such services to the entire population; to safeguard service quality; to foster environmental protection; and to encourage transparency and accountability in all sector activities by involving the public more actively in the regulatory process and sector development policy formulation.

#### **G. Program strategy**

- 1.19 Consistent with the country's and the Bank's strategy for public utilities, this program will support reforms to legislation, administrative procedures, policies and the regulatory and institutional framework governing residential utility services, in order to overcome weaknesses that have prevented them from operating effectively and that could jeopardize the sustainability of the model established in the existing legal framework. This operation, in turn, is part of the External Credit Disbursement Program for 2004-2006 that is necessary to cover projected public debt repayments. In light of all the reforms planned, and after assessing other possible instruments, it was concluded that the best available lending instrument would be a policy-based loan (PBL). The need and urgency of making these adjustments have been widely discussed in recent years and confirmed in evaluations conducted by the Bank in conjunction with the government and the IBRD. Since the basic guidelines of Laws 142 and 143 remain in effect (there is no need to enact new legislation in the short term), the program seeks: (i) to reestablish the credibility and improve the effectiveness of regulatory and control institutions; (ii) to enhance the efficiency and financial viability of public utility companies, including more effective targeting of subsidies for low-income users, ensuring that the subsidies are actually paid to the utility companies and improving the efficiency of service delivery by State-owned utilities; (iii) redefining the policy for private-

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<sup>7</sup> Public Sector Reform Program (615-OC/CO; PR-1752) cofinanced by the World Bank, Investment Sector Program (640-OC/CO; PR-1799); Electric Power Sector Program (1159-OC/CO; PR-2362); and the Financial Sector Reform Program (1231-OC/CO; PR-2461), prepared jointly with the World Bank.

sector participation; and (iv) seeking alternative solutions to the problems stemming from the decentralized nature of water and sanitation services.

- 1.20 It must be recognized that the problems involved in targeting subsidies in Colombia are very broad and extend to other sectors of the economy, and that to address them in a comprehensive manner is a task that exceeds the scope of this program. Nevertheless, this program seeks to identify and implement improvements in the targeting of utility subsidies, given the complexity and the urgency of the issue. Identification will be coordinated with other Bank programs also working to help the country improve the quality of targeting instruments and develop new supervisory tools.<sup>8</sup>
- 1.21 The program's design incorporates lessons learned from the Bank's experience with programs of this type, and draws upon best practices. The effort to assist Colombia in designing and implementing the proposed reforms and financing is being coordinated among the multilateral agencies and the government's own teams. During the preparation stage, the Bank's team sponsored a meeting in Colombia with the World Bank team and national authorities, at which all the issues on the utilities reform agenda were covered on the basis of a proposal from the national authorities with a view to making the two institutions' activities complementary. In addition, a group of representatives of the utilities and of the policymaking, regulatory, supervisory and control entities, businesspeople, academics, labor unions and civil society was invited to present views on public utilities issues at a special workshop. The results of that workshop and the analytical studies to date have provided valuable input in the preparation and analysis of this program.<sup>9</sup> The IBRD is also supporting a structural adjustment program for sustainable development with measures that complement the environmental and social strategy of this program.

## **H. Bank experience and lessons learned**

- 1.22 The Bank's broad and successful experience with PBLs in Colombia has revealed that: (i) policy measures must be associated with well-selected, high-impact reforms, and so their design and analysis will require a detailed assessment of the executing agency's operational and implementation capacity and ability to exert leadership and enlist support, as well as a realistic appraisal of their political feasibility; (ii) the financing has served as an effective countercyclical mechanism; (iii) the operations have advanced reforms, above all in the financial and local public sector, which were key factors in eliminating one of the major sources of

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<sup>8</sup> The parallel technical-cooperation loan for a social reform program (1382-OC/CO; PR-2639), currently in execution, includes identification of improved targeting mechanisms for social subsidies and their implementation at the municipal level.

<sup>9</sup> The annex contains an extensive, component-by-component list, of the technical documents used in program preparation and to be used during program execution.

- weakness in the private sector and of the nonfinancial public sector deficit; and (iv) PBLs have supported reforms that were necessary for eliminating fiscal imbalances. Moreover, sector reform programs must be accompanied by: (i) an economic and financial program tailored to the objectives; (ii) a sector development strategy that is consistent with program conditions; (iii) a legal, regulatory and institutional framework that will make government policy implementation feasible; and (iv) an express political will to carry out the planned reforms.
- 1.23 Among the lessons learned and applied in the design of this program are the following: (i) preparation and analysis of the sector program for public utilities was preceded by dialogue at the highest level, to set objectives, measures and strategies for sector development; (ii) the sector program has been carefully evaluated for suitability in support of specific policies, and to ensure that the objectives are consistent with the National Development Plan; (iii) the executing agency and the utility enterprises involved have been found to have the technical capacity needed to carry out the program effectively, and a fluid execution structure has been established, assigning top-level and technical responsibilities and those of the central government; and (iv) the activities needed to complete all the program policy measures on schedule have been scoped, and the government will be responsible for obtaining the necessary technical and financial resources for such purpose.
- 1.24 Among the useful lessons for the government are the following: (i) the selection of a PBL requires that there be consensus on the policies to be followed and the specific reforms to be implemented; (ii) sound management of a PBL requires timely decision-making on the policy measures that are part of the program; (iii) the government must carefully assess the potential implementation difficulties of a PBL, especially those factors over which the executing agency has little or no direct control.
- I. Coordination with other multilateral agencies**
- 1.25 With a view to developing a shared agenda of reforms that will contribute to the sustainability of public utilities, the Bank's technical team took the initiative and coordinated meetings at which the national authorities and technical staff of the IDB and the IBRD discussed the range of utility problems in Colombia and put all the issues on an agenda of actions to help solve them. The measures included in this PBL are part of that shared agenda.
- 1.26 On the environmental and social front, the Government of Colombia is negotiating a structural adjustment loan with the IBRD that is also an integral part of the External Credit Disbursement Program 2004-2006, and a supplemental technical assistance loan that includes reforms for sustainable development to achieve the millennium environmental goals. The PSSP will build on progress and work under these programs in the environmental and social areas of public utility services.

## **II. THE PROGRAM**

### **A. Objectives and description**

- 2.1 This program will support implementation of a series of reforms to ensure that public utility services fulfill their basic objectives of equity, efficiency, quality and sustainability, and to promote a better climate for private investment. Disbursements under the three program tranches will be made against fulfillment and maintenance of the measures in the Policy Matrix, which are grouped into five components: (i) fulfillment of the principal points of the Policy Letter and macroeconomic framework; (ii) effectiveness of regulatory, supervisory and control agencies; (iii) efficiency and financial sustainability; (iv) private sector participation; and (v) decentralized public utilities. The Means of Verification matrix specifies the approach of the policy measures and the evidence of compliance with each of them.

### **B. Program structure**

#### **1. Component 1. Macroeconomic stability**

- 2.2 Colombia has succeeded over the last few decades in maintaining a significantly more stable macroeconomic framework than other countries in the region. The outlook for the Colombian economy is considered bright by domestic and foreign investors alike. In the context of the government's proposed fiscal measures, there is a high probability that this stability will be maintained in the near future, something that will not only permit but indeed facilitate achievement of the goals under each component of this program. On this point, maintenance of a responsible fiscal policy is of particular importance for gradually reducing the level of public indebtedness as a proportion of GDP.
- 2.3 Assessments and studies have also shown clearly that a stable macroeconomic framework can help to bolster confidence in government policy, something that is essential for the success of this program. The design of the PBL takes account of the inherent risk that unforeseen domestic or external shocks might interfere with achievement of the objectives. To minimize this risk, the components of the program, while they exhibit synergies, are relatively independent of each other, so that if progress towards one of them is slow this will not jeopardize the others. The attached Policy Letter describes how the sector program for public utilities fits into the broader framework of the Government of Columbia's economic and social strategy.
- 2.4 Compliance with the Policy Letter will be verified for each program tranche, as will the macroeconomic framework's consistency with program objectives (conditions 1, 2 and 3).

## **2. Component 2. Effectiveness of regulatory, supervisory and control agencies**

### **a. Background**

- 2.5 The 1991 Constitution established the Superintendency of Residential Utilities (SSPD). Law 142 of 1994 instituted enabling regulations for its operation and set up the Regulatory Commissions.<sup>10</sup> These divergent legal origins meant that the Regulatory Commissions' functions of regulation were separated from those of supervision and control, which were in the hands of the SSPD. Although the separation of functions demands a great deal of coordination, the problems that have arisen for this reason are considered minor and surmountable. More serious have been the problems encountered by the SSPD and the regulatory commissions in utilizing to their full extent the contributions collected from the regulated entities to cover the commissions' expenses, and in the restrictions that prevent them from selecting the most suitable candidates for the positions of commissioned experts (*expertos comisionados*) and Superintendent.
- 2.6 The performance of the regulatory commissions has been highly controversial, with the possible exception of the CRT. In particular, the CREG has been caught up in ongoing disputes with the utilities and with the government. In the opinion of the experts, its procedures are largely nontransparent, highly complex and erratic, and lend themselves to manipulation. There is no formal provision for accountability, and this has created a climate of confrontation marked by numerous lawsuits against the commission's decisions. The national government established a dialogue with investors to seek a solution to the situation, as a result of which a working group was set up to propose reform of the CREG. That working group submitted proposals for rules under Laws 142 and 143 in the areas of procedural transparency and accountability, and these have served as important inputs for the government's reform agenda. The CRA has sparked less controversy than the CREG, although there is consensus that regulatory development is behind in addressing pressing sector problems.
- 2.7 For constitutional reasons, formal budgetary autonomy for the SSPD and the commissions is not possible, and their budgetary performance has been affected by the government's fiscal austerity measures, even though their revenues are specifically earmarked. This rigidity has had a particular impact on the SSPD by limiting its program of inspection visits and preventive supervision, and on the CREG in its activities relating to highly specialized technical studies and advisory services that are needed to fulfill its regulatory function in a timely and effective manner. While the CRA and the CRT have an annual cash plan that facilitates their budgetary management by identifying funds actually available for use during the

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<sup>10</sup> Energy and Gas Regulatory Commission (CREG), Telecommunications Regulatory Commission (CRT) and Water and Sanitation Regulatory Commission (CRA).

respective period, the CREG has no such plan. These technical limitations are compounded by the difficulties experienced in contracting experts with the experience and capacities necessary to do the job: pay levels are low, eligibility rules are inadequate, and the selection process is largely nontransparent. The regulatory agencies' ineffectiveness exacerbates the obstacles to private company participation in the regulatory process. This in turn results in more expensive services, or in new burdens on the State which, with the absence or withdrawal of private investors, is obliged to provide services.

- 2.8 Competition in electricity and telecommunications is a recent phenomenon, and the institutional structure originally adopted for oversight and control has not kept pace with subsequent developments. As a result, there is little interagency coordination in prevention and enforcement activities, and there are procedural overlaps and gaps and duplication of effort among ministries, regulators, the SSPD and the Superintendency of Industry and Commerce (SIC). The various telecommunications markets are supervised and controlled by different entities, with differing approaches that depend on an artificial distinction between residential and nonresidential services. In the wholesale electricity market, the SSPD has failed to punish anticompetitive behavior, and the lack of institutional coordination has impeded the establishment of market oversight mechanisms. The commissions define what constitutes anticompetitive behavior and how the industry should be structured, while the SSPD is responsible for protecting consumer interests and for antitrust enforcement and controlling unfair competition. The SIC has responsibility for controlling restrictive business practices and unfair competition for the remaining nonresidential operators, and for consumer protection in utility networks not classified as residential (such as mobile telephony).

#### **b. Objectives and proposed reforms**

- 2.9 This component seeks to reform regulatory, supervisory and control agencies so that, within the framework of existing legislation, they can address the problems that have compromised their performance and undermined their effectiveness and credibility.
- 2.10 To address the problem of transparency in regulatory actions, the proposed reform calls for meaningful stakeholder participation in regulatory processes and for making public the actions of the regulatory commissions, which are to be made accountable by establishing an indicative regulatory agenda and by conducting periodic assessments of regulatory management with public discussion of the findings. Consultation procedures are established for resolutions of general scope, and public hearings are to be held on rate-setting resolutions, allowing for broad discussion and requiring the commissioned experts to respond explicitly to public comments. To broaden the field of suitable candidates for the positions of commissioned experts, the program will establish transparent candidacy and selection procedures, and will ensure that pay levels are objective and competitive

in conformance with the range of discretion allowed by law. To ensure that funding is steadily available to the commissions and the SSPD, the budget system is to be made less rigid by exempting regulatory and control agencies from future fiscal austerity measures upon the expiration of Law 617 (which imposes budgetary cutbacks on public entities) in October 2005, among other measures to allow greater flexibility in their budgetary management. To solve the problem of interagency coordination so that prevention and enforcement functions can be fulfilled without procedural duplication, overlap and gaps among ministries, regulators, SSPD and SIC, the reform will make the SIC the sole authority responsible for investigating and punishing anticompetitive behavior by the utilities.

- 2.11 The foregoing proposals should significantly improve the effectiveness of regulatory, supervisory and control agencies, and will be supplemented by other measures that the government is pursuing, as described in its Policy Letter. These include: development and implementation of management and results-based audits so as to increase the transparency of public utilities; and establishment of a single information system to give stakeholders greater access to information held by public utilities.

### **c. Conditions**

- 2.12 For the first tranche, rules must be in place to guarantee transparency, stakeholder participation, and accountability in the actions of the regulatory commissions (condition 4); and an action plan must have been approved to: (i) establish transparent candidacy and selection procedures for commissioned experts; (ii) establish a specific career structure for entry, tenure, advancement and retirement of personnel of the Superintendency of Residential Utilities; (iii) establish objective criteria for determining the remuneration of commissioned experts; (iv) exempt the regulatory commissions and the SSPD from budget cutbacks (condition 7).
- 2.13 For the second tranche: the regulatory commissions must first deliver: (i) their management and earnings report for the previous period and (ii) their report on enforcement of the new rules on transparency and stakeholder participation, and (iii) publish their annual indicative regulatory agenda (condition 5); (iv) a specific career structure for SSPD personnel must be in place; (v) advisory and consulting services and investigation by the regulatory commissions must be recognized as investment outlays, and the commissions must have prepared their annual cash plan (condition 8); (vi) the SIC's authority to investigate and punish anticompetitive behavior in public utility services must be strengthened (condition 10).
- 2.14 For the third tranche: (i) the findings of an external evaluation of the regulatory commissions' accomplishment of the objectives of these rules, including process quality and effectiveness, must be published (condition 6); the new procedures for candidacy, selection and remuneration of new commissioned experts must have

been implemented; and the regulatory commissions and SSPD must have been made exempt from budget cutbacks (condition 9).

### **3. Component 3. Efficiency and financial sustainability**

#### **a. Background**

- 2.15 Law 142 requires the utility rate system to be governed by criteria of economic efficiency, financial self-sufficiency, solidarity and redistribution. It establishes a system of subsidies for users that reduces the amounts billed to residential customers of zones 1 and 2<sup>11</sup> and pays for this out of the contributions of residential customers in zones 5 and 6, commercial and industrial customers and funding from the national budget. The subsidies go only to residential customers in rate zones 1 and 2, and cover only basic or subsistence levels of consumption, i.e. the minimum quantity of service necessary to meet basic monthly needs for a typical residential user in those zones. Subsistence consumption is calculated at 250 time-pulses per month for basic switched telephone service; 200 kWh of electricity per month; 20 m<sup>3</sup> of power gas per month; and 20 m<sup>3</sup> of drinking water per month. The maximum subsidies<sup>12</sup> set in Law 142 were lower than those prevailing at the time the law was issued. This meant that subsidies had to be gradually reduced,<sup>13</sup> resulting in higher billing in some cases. In addition, to offset the impact on low-income users of rate hikes in basic subsistence consumption of residential utilities, the National Development Plan 2003-2006 limited increases for zones 1 and 2 to the rate of inflation over this period.
- 2.16 The annual estimated cost to the national budget of utility subsidies for 2006 is US\$450 million. In the electric power sector, contributions from residential, commercial and industrial users were US\$176 million in 2002, while subsidies to users in zones 1, 2 and 3 totaled US\$226 million. The difference was covered from the national budget and from the Solidarity Fund<sup>14</sup> of the Ministry of Mines and Energy. Given the expected trends in electricity demand and costs and the effects of the National Development Plan, however, it is estimated that the national budget contribution in 2006 will be close to US\$200 million for the electric power sector

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<sup>11</sup> In contrast to social programs where subsidies are awarded on the basis of the “standard beneficiary identification system,” which includes income, household and personal characteristics as variables, public utility subsidies are awarded on the basis of a zoning stratification of housing.

<sup>12</sup> 50%, 40% and 15% of the average service delivery cost.

<sup>13</sup> The reduction process was completed in 2000 for most of the electric utilities, but it has been delayed in the drinking water sector.

<sup>14</sup> The Solidarity Fund administers user contributions and the subsidies granted to end users by the various electricity and gas companies. It is regulated by Decree 847 of 2001, whereby utility firms that are in surplus after netting contributions received and subsidies granted must deposit those surpluses to the fund within a certain time limit.

- alone. For basic switched telephone service, the contributions would be around US\$45 million, without including the impact of the National Development Plan. In the case of water service, contributions would be slightly higher than for electricity.
- 2.17 Reimbursements from the national budget and the municipal governments to enterprises running at a deficit are sometimes late because of budget appropriation problems. Moreover, those utility companies that receive more contributions than the subsidies they grant, given the structure of their customer base, are often slow to return the surplus, because there are no collection mechanisms for allocating resources to meet public utility subsidy needs. The delay in transfers from both of these sources can result in cyclical cash flow difficulties for the companies running at a deficit, which in turn means that they will be late in paying their obligations. This raises their finance costs and the prices they must pay for the goods and services necessary to operate effectively.
- 2.18 The subsidy targeting system is based on a stratification of dwellings by physical characteristics, prepared by the municipal governments using the national government methodology. While that methodology has been considered effective for minimizing errors of exclusion (denying subsidies to eligible low-income consumers), it is limited to households that have service. The incentives to the municipal governments are such that errors of inclusion (paying subsidies to those who do not deserve them) and of exclusion are very frequent. The situation is made worse by the high levels set for basic subsistence consumption. Given the situation, the targeting rules for the subsidies will have to be revised in order to benefit those who really need them.
- 2.19 The State is heavily involved as a utility provider,<sup>15</sup> and it has been very difficult to separate the government's roles as regulator, policymaker, and service provider, even though more than 10 years have elapsed since the reform was adopted. In those utilities where the national government is the majority shareholder, the existing government line varies. Policies and directives come from the President of the Republic, who is represented in these firms by the managers. The sector Minister serves as the authority for the sector, chairs the regulatory commission, and is a member (and frequently the chair) of the firm's Board of Directors. The Minister of Finance serves as the fiscal authority and represents the national government in some firms. The municipal utilities that opted to organize themselves as State-owned commercial and industrial enterprises are controlled directly by the mayor. The weakness of corporate and political governance means that the utilities are subject in their management to outside pressures through

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<sup>15</sup> The State controls more than 60% of electricity generation, 100% of transmission, and 60% of distribution in national and municipal enterprises; it has a major presence in the municipal telecommunications enterprises, some of which have expanded into long-distance and new generation PCS services, and its involvement in the water sector is even greater, since efforts to enlist the private sector have not made much progress.

intervention by local or regional politicians. A number of State-owned enterprises are still saddled with recurrent losses and decapitalization, excessive operating expenses, high and inflexible labor costs, elevated contingencies (lawsuits, court proceedings), growing and unfunded actuarial liabilities, and a fiscalist approach to dividends and investments. What is needed, then, is a framework for effective corporate governance in State-owned public utilities.

### **b. Objectives and proposed reforms**

- 2.20 The objective of this component is to enhance the efficiency and financial sustainability of public utility firms while meeting the service needs and the payment capacity of low-income groups.
- 2.21 The program will support: (i) the design and promotion of a voluntary mechanism that will allow the municipios some autonomy in using national and municipal government funds to cover utility subsidy requirements; (ii) reducing the basic subsistence consumption levels for conventional telephone and electricity services in order to reduce the shortfall between contributions and subsidies, which has a significant fiscal impact; (iii) improvements in subsidy targeting that will benefit the lower-income population without increasing the fiscal impact over that of the current targeting system, and thus help to make the subsidy system sustainable;<sup>16</sup> (iv) greater efficiency, transparency and accountability for State-owned utilities.

### **c. Conditions**

- 2.22 For the first tranche, a mechanism consistent with municipal autonomy will be identified for using national and municipal government funds to cover utility subsidy needs (condition 11); the subsistence consumption level for basic switched telephone service will be reduced from 250 to 200 time-pulses per month per subscriber (condition 14); and the subsistence consumption level for electricity will be reduced from 200 kWh per month for the whole country to 193 kWh per month for users at altitudes below 1,000 m, and 182 kWh per month for users at higher altitudes<sup>17</sup> (condition 15).
- 2.23 Prior to the second tranche: a consensus-building and publicity campaign will be undertaken for the mechanism for using national and municipal government funds to cover utility subsidy needs, as well as a program of incentives to the municipios

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<sup>16</sup> The work of identifying subsidy targeting alternatives is still under way, and political decisions will be required before the alternatives can be evaluated. It has been agreed therefore with the government to introduce some flexibility to the definition process that is to be completed for the second tranche.

<sup>17</sup> The subsistence consumption level depends essentially on available energy substitutes and on the climate. In the equatorial zone where Colombia is located, the climate depends on altitude above sea level.

to adopt it<sup>18</sup> (condition 12); the subsistence consumption level for electricity will be reduced to 186 kWh per month for users at altitudes below 1,000 m and to 165 kWh per month for users at higher altitudes (condition 16); agreement must be reached on a proposal and action plan to improve utility subsidy targeting so as to benefit the lower-income population without increasing the fiscal impact over that of the current targeting system, and to help make the subsidy system sustainable (condition 18); and a corporate governance policy will be implemented to: (i) improve the professional qualifications of government representatives on the boards of directors and managers of utility companies; (ii) establish a strategic plan with financial and efficiency indicators; and (iii) establish mechanisms to ensure transparency and accountability in their management (condition 20).

- 2.24 The third tranche will require: maintaining the consensus-building and publicity campaign for the mechanism for using national and municipal government funds to cover utility subsidy needs, as well as a program of incentives to the municipios to adopt that mechanism (condition 13); the subsistence consumption level for electricity will be reduced to 179 kWh per month for users at altitudes below 1,000 m and to 147 kWh per month for users at higher altitudes (condition 17); implementation of the agreed measures to improve the subsidy targeting system (condition 19); and the corporate governance plan will be in effect for at least three utilities in which the State has a majority shareholding (condition 21).

#### **4. Component 4. Private sector participation**

##### **a. Background**

- 2.25 The Colombian government has been relatively successful in attracting private investment in utilities. As in most countries of the region,<sup>19</sup> such investment has involved primarily the privatization of State enterprises, and concessions. The private sector today plays an important role in most sectors. Between 1994 and 2003, private investment in electricity amounted to US\$7.3 billion, in telecommunications US\$3.102 billion, and in water and sanitation US\$330 million. Colombia ranked fifth in Latin America and the Caribbean in terms of private investment in infrastructure during the period 1990-2002.
- 2.26 The ambitious plan for private participation that was pursued during the past decade succeeded in reducing substantially the dependence of public utilities on increasingly scarce government funds, and in laying the basis for the continued expansion of investment in these sectors. Private sector involvement has improved the efficiency, coverage and quality of utility services. Yet despite this progress,

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<sup>18</sup> These incentives would involve the central government in cofinancing infrastructure projects and upgrading utility management at the municipal level, for municipios that adopt this voluntary mechanism.

<sup>19</sup> "Private Participation in Infrastructure: Trends in Developing Countries, 1990-2001", World Bank, 2003.

private investment in utilities has declined because of a combination of factors: falling demand (down 10% between 1997 and 2001), low rates of return, problems with public security, country risk, rising poverty indices, and the ineffectiveness of regulatory, supervisory and control bodies. While private investment in the electricity sector was very significant in 1997-1998 (US\$3.4 billion), it fell sharply in the two subsequent years (US\$279 million in 1999 and US\$70 million in 2000). The situation would be even more critical if it were impossible to cover the subsidies from the national budget. Worse still, without a sufficient transfer from the government, the utilities would not be able to afford the minimum maintenance and investment that is considered necessary to guarantee continuous and efficient provision of service, to support higher levels of growth, to facilitate access for low-income groups, and to cover the investment gap left by the government's fiscal constraints. To address the situation, the government is committed to designing a policy for private participation for the modernization and sustainable development of public utility services, and to take steps to eliminate the institutional and regulatory barriers that still cloud the investment climate.

- 2.27 In the electricity sector, public installed capacity rose between 1998 and 2003 by 853 megawatts, representing annual growth of 3%, while private installed capacity grew during the same period by only 162 megawatts, representing annual growth of 0.5%. Thus, the public sector's installed capacity has grown further and faster than the private sector's. Considering moreover that most of the increased public capacity is in hydropower, which is more costly than the thermal power that accounts for the totality of private capacity, it may be concluded that public investment has risen much further and much faster during the last 10 years.
- 2.28 On the regulatory front, one of the most controversial issues has had to do with the so-called "capacity charge" for electricity generation. This capacity charge is in effect a premium over the spot market price that is paid to generators for contributing energy to the system in critical availability situations. These charges were established in an effort to strengthen the weak price signal provided by the short-term wholesale energy market, so as to encourage private investors to help expand generating capacity. Application of this incentive in Colombia has left much discretion with the regulator in terms of setting the parameters, and this could have significant financial implications for private investors. Public and private investors alike have expressed concern that the amount of the charge has been insufficient to achieve the desired degree of private participation, thereby jeopardizing the future security of supply. If the situation is not corrected, it could further undermine the transparency of the electricity market and reduce the incentives for private investment.

#### **b. Objectives and proposed reforms**

- 2.29 The objective of this component is to help improve the investment climate and thereby increase the efficiency, quality and coverage of utility services.

2.30 To achieve this objective, the program will help define a policy to improve the climate for private participation in the development and financing of utility services, following consultations between the government and interested parties.<sup>20</sup> In order to address over the longer term the problem of inadequate regulatory signals for attracting private investment in expanding electricity generation, the program will support the introduction of new incentives that will be defined in accordance with the criteria of stakeholder participation and public disclosure of regulatory commission activities, supported by the component that deals with the effectiveness of regulatory, supervisory and control bodies (condition 4). In July 2004 CREG opened a public hearing on a proposed methodology for a mechanism to replace the current capacity-based charges in effect until 2006. CREG also plans to set up an electronic market for contracts in the coming months. The two measures are closely interrelated and create incentives for investment in new generating plant, enhance the investment climate and provide clarity on leveling the playing field between public and private investors. Given the repercussions of this decision on the sector model's sustainability, potential proposed methodologies will be discussed at the highest level with participation of recognized international experts, market participants and other stakeholders.

### **c. Conditions**

- 2.31 For the first tranche, the principal points of a policy on private participation in utility development and financing will be approved, including a strategy of dialogue with stakeholders (condition 22).
- 2.32 For the second tranche, the policy for private participation in the development and financing of public utilities will be in place (condition 23).
- 2.33 For the third tranche, incentives will have been established for the expansion of electric generating capacity over the longer term (condition 24).

## **5. Component 5. Decentralized public utilities**

### **a. Background**

2.34 Although the reforms of the past decade had a generally favorable impact on their development, the decentralized water and sanitation utilities still suffer structural and economic problems. The fragmented business structure of the sector, together with the recent economic crisis and the country's high poverty indices, have a direct impact on the sector's long-term viability, on the capacity of the CRA and the SSPD to play their role respectively, and on the possibility of involving the private

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<sup>20</sup> A document has been prepared with policy guidelines that will serve as input for the dialogue process once the final policy has been defined. This document covers issues relating to the general investment climate and that of the sector, innovative mechanisms for project financing, contracts, regulation, project management and the defense of State interests, among other things.

sector more closely in this industry. As a group, the major utility enterprises (ESP), numbering around 10 and serving markets with more than 500,000 inhabitants, are financially viable over the longer term, while the sustainability of the remaining enterprises, serving markets of 20,000 customers or less, must be regarded as low or nil. In this latter group, where market capacity to pay for services falls short of the cost of providing those services, steps must be taken to make the industry viable: the most important will be to reorganize the business structure of the industry so as to achieve economies of scale, and to reformulate sector and regulatory policies

- 2.35 In 2003 the Ministry of Environment, Housing and Territorial Development (MAVDT) was given the responsibility for formulating a sector policy, following the merger of the Environment Ministry with the Development Ministry, which previously had the lead. Because this change (which was inspired by budgetary considerations) was made only recently, the government has yet to formulate a comprehensive development plan for the sector, with a long-term vision for resolving the sustainability problem and achieving the millennium goals for water, sanitation and the environment.
- 2.36 The government plans to achieve the millennium goals by expanding water service coverage to 90%, and sewage service to 80%, through investments estimated at US\$3.5 billion. Between 1990 and 2003, water supply coverage rose from 66% to 82%, and sewerage from 56% to 60%. The SSPD estimates that there has been a narrowing, from 25% at the beginning of the model to 15% today, in the gap by which utility rates fall short of covering the cost of providing service; while there are still some weaknesses, the regulatory and control system has been strengthened; and blueprints for promoting private participation have been developed and published. On the other hand, public financial transfers to the sector have risen from US\$28 million in 1995 to US\$240 million in 2003. The major issues and question marks in the sector may be summarized as these: low levels of coverage; fragmentation of the industry, which cannot capture economies of scale; insufficient financing; a still-new institutional framework; high levels of subsidies with targeting problems; and problems of political stability and diseconomies of scale that discourage private participation. These are the areas that must command priority attention in the context of a sector development plan.

#### **b. Objectives and proposed reforms**

- 2.37 The objective of this component is to lay the foundations for the efficient and sustainable delivery of water and sanitation services.
- 2.38 The program seeks to support institutional and financial reforms and to assist agencies at the national level to develop national plans and the policies and strategies needed so that at the subnational level actions can be taken and adequate signals and incentives can be provided to improve the sustainability and efficiency

of the utility companies, and the structure of the sector can be consolidated to achieve economies of scale. The component will also support the design of a development plan for the sector that will improve governance, establish a sound business structure, and guarantee financial sustainability for the provision of service over the long run. Specifically, the development plan will include actions to: (a) expand coverage; (b) improve the efficiency of the utility companies; (c) enhance the corporate governance and autonomy of the utility companies; (d) improve water and service quality; (e) establish a financing structure for the sector; and (f) help consolidate the industry within an appropriate institutional framework.

### **c. Conditions**

- 2.39 For the first tranche, the following must have been approved: (i) a strategy for a new business structure and sound corporate governance; (ii) the outline of a sector development plan that includes institutional aspects, industry structure, and a financing strategy for meeting the millennium goals (condition 25).
- 2.40 For the second tranche, the strategy must be implemented through tendering for advisory services to design at least two pilot projects, each with at least 10,000 connections and covering at least three municipal enterprises located in multiple municipios; an action plan will be approved for establishing the new business structure and corporate governance practices; and the sector development plan must be in effect (condition 26).
- 2.41 For the third tranche, the action plan for the new industry structure and corporate governance must be implemented by contracting advisers to structure at least two additional projects, each with 10,000 connections and covering at least three municipal utilities located in multiple municipios; and the short-term measures established in the sector development plan must have been implemented (condition 27).

### **C. Cost and financing**

- 2.42 The total program cost is US\$600 million, to be provided from the Bank's Ordinary Capital. Funds will be disbursed in three tranches of US\$200 million each. Each tranche will be disbursed once the measures included in the attached Policy Matrix have been fulfilled to the Bank's satisfaction.

**D. The Bank's financing conditions**

**Table II-1  
Loan terms and conditions\***

Source of funds:	Ordinary Capital
Amount:	US\$600 million
Terms:	
Amortization period:	20 years
Grace period:	5 years
Disbursement period:	minimum 18, maximum 36 months
Interest rate:	Variable
Inspection and supervision fee:	0%
Credit fee:	0.25% on undisbursed amounts
Currency:	U.S. dollars from the Single Currency Facility

\* With regard to the inspection and supervision fee, in no case will the charge exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount, divided by the number of six-month periods included in the original disbursement period.

### **III. PROGRAM EXECUTION**

#### **A. Borrower, guarantor and executing agency**

- 3.1 The borrower and guarantor is the Republic of Colombia. The Ministry of Finance (MHCP) will be the executing agency, acting through the Technical Vice Ministry. In light of the program's characteristics, the MHCP will coordinate execution with the National Planning Department (DNP).

#### **B. Program execution and management**

- 3.2 As the executing agency, the MHCP will be responsible for overall supervision, overseeing the timely fulfillment of objectives, policy measures and results. This supervision will be conducted in coordination with the DNP. Given the multi-sector nature of the measures proposed, and in light of recent experience and lessons learned with programs of this kind, a working group will be established with representation from the entities involved, chaired by the executing agency. The general coordinator of the program at the MHCP will have the following duties: (i) to serve as the national government's liaison to the Bank, responsible for collecting, assessing and submitting the technical, legal and administrative information and documentation necessary for smooth program execution; (ii) to coordinate the program of activities needed to implement the policy measures, with professional staff assigned for this purpose in the respective sector entities; (iii) to provide the necessary technical and financial resources for preparing and establishing consensus on the policy measures and ensuring their timely implementation; and (iv) to coordinate the collection, analysis and submission to the Bank of supporting information on compliance with the policy measures.
- 3.3 To facilitate execution, the MHCP, as executing agency, will work with the DNP to present a project execution plan that identifies the authority responsible for implementing the policy measures, and the operational coordinators in each of those entities, their mechanisms for interaction with the authorities and coordinators appointed for this purpose in the MHCP and the DNP; identifies financial and technical support requirements, including communication and dialogue; and establishes an execution timetable for timely implementation of the policy measures. The program execution plan will be prepared in coordination with the sector entities responsible for instituting the program policy measures.
- 3.4 During the preparation stage, the Bank team helped to define the objectives, scope and magnitude of the activities necessary to execute the program. These include activities under the program for communication and dialogue with stakeholders and

with civil society.<sup>21</sup> Given its fiscal constraints, the government has requested the Bank to allow some flexibility in financing these activities. Nevertheless, the government will be responsible for obtaining the necessary technical and financial resources to meet all these needs in a timely and sufficient manner. An IDB technical-cooperation loan is currently being negotiated with a component for developing and strengthening the regulation, supervision and control of infrastructure services.<sup>22</sup> A portion of the funds under that component could be used to support execution of this PBL.

- 3.5 Previous experience with operations of this kind, together with the MHCP's and DNP's operational and implementation capacity and their ability to exert leadership and enlist support, as well as their active participation in formulating the program, and the consensus achieved with the ministries and sector entities for defining the policies to be followed and the specific reforms to be implemented with each of the policy measures will ensure the feasibility of those measures and fulfillment of commitments by all the entities involved in the program.
- 3.6 The Bank has planned a kickoff workshop with the executing agency and the respective sector authorities, to review and agree the program execution plan, including the role of each entity in that plan, and a schedule of activities for each entity, so as to ensure timely fulfillment of program measures.

**C. Execution and disbursement periods**

- 3.7 The execution period will be between 18 and 36 months. The loan is designed to be disbursed in three tranches of US\$200 million each. Disbursements under the three tranches have been scaled against the scope of the policy measures and to supplement the other resources that the government possesses for meeting its financial obligations in 2004-2006.

**D. Monitoring and evaluation**

- 3.8 The Bank will monitor the program through loan administration missions and through active participation by the Country Office. Based on the agreed means of verification, the MHCP and the DNP will continually evaluate progress and fulfillment of the policy measures and provide the Bank with semiannual reports on progress and problems, on the content and outcomes of the reforms, and progress in terms of the program execution plan. This monitoring will enhance the effectiveness and coordination of the respective actions.

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<sup>21</sup> The program includes measures relating to communication and dialogue for formulation of the policy on private participation; incentives for the expansion of electricity generating capacity; the national development plan for the water and sanitation sectors; and consensus-building and outreach activities concerning the voluntary municipal mechanism.

<sup>22</sup> Colombia: Program in Support of Privatization and Concessions in Infrastructure. Stage Two (CO-0263).

- 3.9 The outcomes matrix establishes the expected effects and the indicators, identifying the indicator, baseline and monitoring methodology for each program component. This matrix will be used to measure the impact of the program as a whole.
- 3.10 The executing agency will compile, store and maintain at its own premises all the information, indicators and parameters, including the semiannual reports, technical reviews during the implementation stage and the final evaluation, as necessary to help the Bank prepare the project completion report.

**E. Other execution issues**

**1. External audit**

- 3.11 The Bank reserves the right to request financial reports from the borrower on the use of loan proceeds that have been audited by independent auditors previously accepted by the Bank. As such, the borrower undertakes: (i) to maintain separate accounting records and supporting documentation for external audits or verifications that may be requested on the use of the funds; (ii) to maintain a separate Bank account in which the loan proceeds will be deposited; (iii) to prepare and submit disbursement requests to the Bank; and (iv) not to use the funds to purchase items on the negative list or for procurement in countries that are not members of the Bank.

**2. Inspection and supervision**

- 3.12 The Bank will establish such inspection and supervision procedures as it deems necessary for satisfactory execution of this program. The borrower will cooperate with the Bank in such regard by providing all necessary assistance and information.

## **IV. FEASIBILITY AND RISKS**

### **A. Institutional feasibility**

- 4.1 The Ministry of Finance (MHCP) will serve as program executing agency, working in close coordination with the National Planning Department (DNP) and, through it, with other institutions including the Ministry of Environment, Housing and Territorial Development (MAVDT), the Superintendency of Residential Utilities (SSPD), the Superintendency of Industry and Commerce (SIC), and the regulatory commissions.
- 4.2 The Bank has had broad and very successful experience with the MHCP and the DNP in programs of this kind. The two entities have been involved in all the structural adjustment programs entailing reforms in Colombia. Historically, the DNP has been the entity responsible for coordinating preparation of the National Development Plan, which develops the government's comprehensive reform agenda in close cooperation with the respective sector agencies. This responsibility and its own internal structure have allowed the DNP to develop and consolidate the technical capacity and the leadership necessary to help prepare complex policy measures and coordinate their implementation. More recently, the DNP has been building its capacity to evaluate government programs under the National Development Plan, stressing program evaluability and mechanisms for disseminating outcomes. The MHCP has had the lead in programs of this type with the Bank for more than a decade, and has demonstrated its ability to enlist support and develop consensus on the government actions necessary to carry out the reform agenda in light of fiscal targets. The sector agencies involved also have proven execution capacity, which has been carefully assessed during preparation of this program and confirmed through their active participation in designing the program measures and in the workshops where the proposed reforms were discussed and approved.
- 4.3 This past performance attests to the capacity of the executing agency, the DNP, and the sector agencies to participate in this type of program. The program is designed to be implemented via administrative measures within the government's existing sphere of action, and are not subject to legislative changes that would have to go through Congress. This strengthens its institutional feasibility, because execution depends in practice on the commitment and motivation of the participating entities. Analysis shows that interest and motivation levels are adequate and sufficient: there is consensus on the policy measures, which were proposed by the government and have been discussed and agreed at the highest level among participating organizations, and on the need for the funds from this program, in light of the government's forecasted financial obligations.

## **B. Expected outcomes of reforms**

- 4.4 The measures under the component on the effectiveness of regulatory, supervisory and control agencies will produce greater confidence in this class of institutions, which is key to the sustainability of the sector model. In the electricity sector, it is expected that this greater confidence, together with adequate incentives, will encourage private-sector participation in expanding electricity generation capacity. This will yield further results, such as greater efficiency in generation, driven by more competition, less sector demand for budgetary support, and fewer conflicts of interest between the State's regulatory and business functions. Greater confidence in the supervisory and control agencies will provide a boost to various economic activities, and in particular will improve the climate for investing in the development of these services.
- 4.5 Improved targeting of subsidies, supported by the component on efficiency and financial sustainability, will enhance the efficiency of public expenditure for the most vulnerable groups, while at the same time alleviating fiscal pressure. Reducing the basic subsistence consumption levels for telecommunications and electricity will increase the efficiency of those services by sending a better price signal and, from the fiscal viewpoint, will reduce the transfers needed to cover the subsidies, thereby freeing up public funds for use in activities with greater social benefits. In addition, State-owned utilities that implement corporate governance policies will become more efficient.
- 4.6 Endowing the water and sanitation sector with effective business structures and new financing strategies should promote the development of this sector, which has suffered from a lack of a strategy or development plan. These conditions are necessary, if the government's collateral efforts to increase the coverage of these decentralized public utilities are to succeed.

## **C. Net fiscal impact of reforms**

- 4.7 The measures to be taken under this program will have a significant net fiscal impact. The greatest impact will come from gradually reducing the subsistence consumption level for electricity between 2004 and 2007. Simulations by the DNP and the UPME show a subsidy reduction of US\$8 million during 2004, US\$19 million during 2005, US\$32 million during 2006, and US\$57 million during 2007. Savings will continue to grow beyond that year, at least apace with population growth. These data mean that the present value of the fiscal impact of that measure, discounted at 12%, is US\$350 million. Another quantifiable net fiscal impact comes from the reduction of the basic subsistence level of consumption of basic switched telephone service, estimated at US\$8 million a year, with a present value of US\$67 million.

- 4.8 In addition to these quantifiable impacts, there is a significant but not readily quantifiable impact associated with the participation of private investors in the program for expanding electricity generation capacity, which will be encouraged by the incentives offered in this PBL. There is no doubt that, without private investment, the government would have to fill the gap, because it cannot allow a regulatory failing it is capable of correcting to result in power shortages. This is already happening: no major privately owned power plants appear in the generating capacity expansion plan.
- 4.9 There are other impacts that are difficult to quantify as well. These include the improved targeting of subsidies, which currently amount to some US\$450 million a year, with the elimination of costly transfers to those who, through errors of inclusion, really do not deserve them. There should also be a net fiscal impact, in the form of costs avoided through better corporate governance practices at utility companies.

**D. Environmental and social impact**

- 4.10 **SEQ/PTI classification.** In terms of social impact, the program is expected to contribute to enhanced equity, quality, coverage and efficiency in public utilities. Because its efficiency and financial sustainability component supports better targeting of subsidies so as to effectively benefit low-income customers, this operation qualifies as a social equity enhancing project (SEQ) as described in the indicative targets mandated by the Bank's Eighth Replenishment (document AB-1704) and includes indicators to measure social equity enhancement. Under the guidelines for PBL formulation, this operation does not qualify as a poverty targeted investment (PTI).
- 4.11 **Environmental and social impact.** The program does not call for physical or other investments, and therefore will have no direct environmental or social impact. Nevertheless, the measures to support the effectiveness of the regulatory, supervisory and control agencies, especially those for involving stakeholders in the regulatory process and for bringing transparency and accountability to the actions of the regulatory commissions, are positive social features of this program. As part of the policy measures for decentralized public utilities, it is important to note the commitment of the authorities to achieving the millennium goals. The program is supporting a water and sewage development plan that will help increase the coverage of these services from their current levels of 82% and 60% to 90% and 80%, respectively, by 2015.
- 4.12 In addition to the measures under this program, the Government of Colombia is committed to taking concrete steps for the country's sustainable development. The national authorities are negotiating a programmatic sustainable development structural adjustment loan (SUSDEVSA) with the World Bank as part of the External Credit Disbursement Program 2004-2006, as well as a supplemental

technical assistance loan. The central objective of the SUSDEVSAL is to support government efforts to meet the millennium development goals, in particular those relating to environmental sustainability and the reduction of poverty and infant mortality. This program will mean a series of structural adjustments, backed by new laws, decrees and policies, designed to: (i) strengthen the country's environmental policy, and (ii) accelerate the mainstreaming of environmental considerations in policies for priority sectors (water, energy, transport, housing and regional development), so as to address environmental problems that affect the poorest segments of the population.

- 4.13 The SUSDEVSAL measures relating to the environmental and social aspects of public utilities will include: (i) adjustments to the environmental licensing system to make the environmental impact assessment (EIA) a more efficient and effective tool; (ii) preparation of the three-year action plans by the autonomous regional corporations, to enhance the instruments that will allow the MAVDT, the communities and the corporations to monitor management on the basis of socioeconomic and environmental impact indicators; and (iii) reforming the rules governing the use and exploitation of water resources, in light of environmental sustainability principles.

#### **E. Risks**

- 4.14 The principal risks relate to coordination and the execution of policy measures that will involve a great many policymaking, regulatory, supervisory and control entities as well as State and municipal utility companies; the ownership and motivation of the sector entities responsible for implementing the set of reforms under the program; and the availability and timing of the funds needed to carry out the policy measures, including those relating to communication and dialogue. To mitigate these risks, a working group is being established, headed by the MHCP and consisting of representatives of the major sector entities responsible for implementing the policy measures; and the executing agency will present a program execution plan identifying for each entity the responsible authorities, the line coordinators, technical and financial assistance needs, and an execution timetable. Preparation of this plan will be coordinated with the respective sector entities. As well, all activities have been planned with a view to ensuring that program measures will be completed on time and on budget. In light of the government's fiscal management problems, the executing agency wants to retain the necessary flexibility for obtaining these resources. Nevertheless, it will be responsible for obtaining resources to support and develop timely consensus on the planned reforms and the additional activities that may arise during execution.
- 4.15 There is likely to be opposition from those affected by the improved targeting of subsidies, recognizing that the reforms will eliminate some of the benefits that now flow to some customers not eligible for them. There may also be opposition to cuts in the basic subsistence consumption levels, since this will result in higher utility

- bills. Colombia's experience with subsidy lifting, which has included changes in targeting to exclude certain zones and, of course, reduction in subsistence consumption levels, shows that opposition to better subsidy targeting is likely to be greater than to lower subsistence consumption levels. To minimize the risk of opposition to these measures, the government will have to undertake and finance the necessary communication and dialogue efforts to communicate the rationale for its measures, to publicize their actual impact, and to help the users affected by them to offset that impact.
- 4.16 There is a political risk that Congress may not accept, in the form envisioned, the government's proposal to exempt the regulatory commissions and the SSPD from budgetary cutbacks. In such case, arrangements would be made for the commissions' costs of advisory and consulting services and investigations to be covered through their capital budgets, and to have them prepare an annual cash plan that would lend a degree of flexibility to their budget management.
- 4.17 For the decentralized utilities, there is a risk that introduction of a new business structure could be held up by opposition from mayors who would see their influence in the municipal utility companies diminished as a result of their consolidation with the utilities of other municipios. The government, and specifically the MAVDT, is addressing this risk through outreach efforts to convince the mayors, the municipal councils and, of course, the citizens, of the benefits of these measures.
- 4.18 Finally, there is a risk that the policy for encouraging private participation will be inadequate to attract private investors into the development and financing of public utilities. This risk is being considerably mitigated through the dialogue that will precede formulation of this policy, during which its contents will be widely disseminated and stakeholders can provide their input and perspectives.

## V. POLICY MATRIX

COMPONENT	FIRST TRANCHE	SECOND TRANCHE	THIRD TRANCHE
<b>1. Macroeconomic stability:</b> <i>Objective: To maintain a stable macroeconomic framework</i>	(1) The principal points of the Policy Letter have been fulfilled, and the borrower's macroeconomic framework is consistent with program objectives.	(2) The principal points of the Policy Letter have been fulfilled, and the borrower's macroeconomic framework is consistent with program objectives.	(3) The principal points of the Policy Letter have been fulfilled, and the borrower's macroeconomic framework is consistent with program objectives.
<b>2. Effectiveness of regulatory, supervisory and control agencies:</b> <i>Objective: To reform the regulatory, supervisory and control agencies so as to guarantee the efficient provision of utility services to the entire population</i>	(4) Rules are in place to guarantee transparency, stakeholder participation, and accountability in the actions of the regulatory commissions.	(5) The regulatory commissions have delivered their management and earnings report for the previous year; and a report on enforcement of the new rules on transparency and stakeholder participation; and have published their annual indicative regulatory agenda.	(6) The findings of an external evaluation of the regulatory commissions' fulfillment of the objectives of these rules, including process quality and effectiveness, have been published.
	(7) An action plan has been approved to: (i) establish transparent candidacy and selection procedures for commissioned experts; (ii) establish a specific career structure for entry, tenure, advancement and retirement of personnel of the Superintendency of Residential Utilities (SSPD); (iii) establish objective criteria for determining the remuneration of the commissioned experts; (iv) exempt the regulatory commissions and the SSPD from budget cutbacks.	(8) A specific career structure for SSPD personnel is in place, covering entry, tenure, advancement and retirement; advisory and consulting services and investigation by the regulatory commissions are recognized as investment outlays; and the commissions have prepared their annual cash plan.	(9) New procedures have been approved for candidacy, selection and remuneration of the new commissioned experts; and the regulatory commissions and the SSPD have been exempted from budget cutbacks.
		(10) The SIC's authority to investigate and punish anticompetitive behavior in public utility services has been strengthened.	
<b>3. Efficiency and financial sustainability:</b> <i>Objective: To enhance the efficiency and financial sustainability of public utility firms while meeting the service needs and the payment capacity of low-income groups</i>	(11) A mechanism consistent with municipal autonomy has been identified for using national and municipal government funds to cover utility subsidy needs.	(12) A consensus-building and publicity campaign has been undertaken for this mechanism, as well as a program of incentives to the municipios to adopt it.	(13) These programs remain in execution.
	(14) The subsistence consumption level for basic switched telephone service has been reduced from 250 to 200 time-pulses per month per subscriber.		

COMPONENT	FIRST TRANCHE	SECOND TRANCHE	THIRD TRANCHE
	(15) The subsistence consumption level for electricity has been reduced from 200 kWh per month for the whole country to 193 kWh per month for users at altitudes below 1000 m, and to 182 kWh per month for users at higher altitudes.	(16) The subsistence consumption level for electricity has been reduced to 186 kWh per month for users at altitudes below 1000 m, and to 165 kWh per month for users at higher altitudes.	(17) The subsistence consumption level for electricity has been reduced to 179 kWh per month for users at altitudes below 1000 m, and to 147 kWh per month for users at higher altitudes.
		(18) Agreement has been reached on a proposal and action plan to improve utility subsidy targeting so as to benefit the lower-income population without increasing the fiscal impact over that of the current targeting system, and to help make the subsidy system sustainable.	(19) The proposal is in effect and the measures agreed in the action plan to improve the subsidy targeting system have been implemented.
		(20) A corporate governance policy has been implemented to: (i) improve the professional qualifications of government representatives on the boards of directors and managers of utility companies; (ii) establish a strategic plan with financial and efficiency indicators; and (iii) establish mechanisms to ensure transparency and accountability in their management.	(21) The sound corporate governance plan is in effect for at least three utilities in which the government is a majority shareholder.
<b>4. Private sector participation: Objective:</b> <i>To improve the investment climate and thereby increase the efficiency, quality and coverage of utility services</i>	(22) The principal points have been approved for a policy on private participation in utility development and financing, including a strategy of dialogue with stakeholders.	(23) The policy for private participation in the development and financing of public utilities has been implemented.	(24) Incentives have been established for the long-term expansion of electric generating capacity.
<b>5. Decentralized public utilities: Objective:</b> <i>To lay the foundations for the efficient and sustainable delivery of water and sanitation services</i>	(25) For the water and sanitation sector, the following have been approved: (i) a strategy for a new business structure and sound corporate governance; (ii) the outline of a sector development plan that includes institutional aspects, industry structure, and a financing strategy for meeting the millennium goals.	(26) The strategy has been implemented through tendering for advisory services to design at least two pilot projects, each with at least 10,000 connections and covering at least three municipal enterprises located in multiple municipalities; an action plan has been approved for establishing the new business structure and sound corporate governance practices; and the sector development plan is in effect.	(27) The action plan for the new business structure and sound corporate governance practices has been implemented by contracting advisers to structure at least two additional projects, each with 10,000 connections and covering at least three municipal utilities located in multiple municipalities; and the short-term measures established in the sector development plan have been implemented.