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A Strategic Phase-out of Colombia's Diesel Subsidy to Support the Energy Transition

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Summary

This policy brief addresses the critical issue of phasing out diesel subsidies in Colombia and underscores the urgent need for coordinated action and strategic planning. The Colombian government views the subsidy phase-out as part of its energy transition strategy, proposing investments in carbon-neutral technologies as a replacement. However, the transport sector – the main consumer of diesel – largely considers these plans inadequate and is sceptical about their feasibility.

Subsidies for diesel and gasoline, stemming from the Fuel Price Stabilisation Fund (FEPC), burden the Colombian budget with a significant deficit and threaten Colombia's fiscal sustainability. In 2022, subsides represented 2.5 per cent of the national gross domestic product (GDP). A failed subsidy phase-out could undermine the country's energy transition efforts, potentially leading to national strikes by the transport sector and eroding trust in the government's transformation plan.

The brief examines the hurdles for the diesel subsidy phase-out process, with a particular focus on the necessary reforms within the transport sector, scepticism about the government's energy transition plans and the potential negative effects for state-owned enterprise Ecopetrol. Drawing from these insights, the policy brief distils policy recommendations for the short and medium term. In the concluding remarks, it stresses that a failed subsidy phase-out could jeopardise broader energy transition efforts.

Recommendations for the national government (see p. 5 for more details):

Short term

1. Re-initiate stakeholder meetings on the phase-out promptly, with the Ministry of Transport taking the lead and involving additional key stakeholders such as clients of the transport sector, the Ministries of Social Prosperity, Environment, and Labour, as well as the National Planning Department.
2. Collaborate with these stakeholders to develop an action plan, incorporating support measures for the transport sector such as improving energy efficiency and coordination between the transport companies.
3. Create specific social programmes aimed at mitigating socioeconomic effects, using the General Participation System (SGP) and strengthening the System for the Identification of Potential Beneficiaries of Social Programmes (Sisbén).

Medium term

4. Review the objectives and strategies of national planning documents to accurately reflect the circumstances of self-employed truckers. These should consider reallocating funds from subsidies to supplement the existing Vehicle Fleet Replacement Fund (Fondo de Reposición del Parque Automotor).
5. Restructure the transport sector to enhance resilience and promote investment in sustainability. For instance, explore the model of cooperatives in the Colombian passenger transport sector, which enables truckers to maintain autonomy while mitigating investment risks.
6. Explore strategic partnerships between Colombian and foreign private-sector entities with experiences incorporating sustainable and responsible practices, academia and research institutions, and development agencies that have an interest in the Colombian energy transition process to expedite the transition to more sustainable technologies in the transport sector.

Introduction

The current Colombian government inherited serious economic challenges following the pandemic and global energy crisis. As part of a broader effort to address economic challenges, it increased gasoline prices in the country to improve its fiscal sustainability and reduce reliance on government subsidies (Neira, 2023). Its ambition to align fuel prices with global markets by phasing out subsidies presents an opportunity to transform the transport sector while supporting vulnerable households from the socioeconomic effects of the past years. This policy brief aims to pinpoint the challenges associated with the phase-out of subsidies for diesel – a heavily used fuel in the Colombian transport sector – and offers policy recommendations to address actors' interests and concerns.

The International Monetary Fund estimates that global fossil fuel subsidies for consumers cost governments USD 1.3 trillion in 2022, representing an increase of more than 400 per cent compared to 2015 (Black, Parry, & Vernon, 2023). From a fiscal perspective, the use of fossil fuel subsidies is extremely controversial, as they create deficits in government budgets, primarily benefit high-income households that consume more fuel, and disincentivise investment in cleaner and more sustainable technologies. In addition to the adverse fiscal and social effects, subsidies encourage the use of fossil fuels and contribute to greenhouse gas emissions.

Insights for this brief draw from interviews conducted for a research project at the German Institute of Development and Sustainability between 12 February and 24 March 2024 with 43 involved and affected stakeholders from the government, private sector and civil society as well as policy experts.

The Fuel Price Stabilisation Fund and its deficit

The current Colombian government, led by President Gustavo Petro, vowed to tackle the increasing deficit of its Fuel Price Stabilisation Fund (FEPC). Established in 2007, the FEPC aims to protect Colombian society from fuel price volatility and covers retail price disparities for gasoline and diesel compared to the international market (Ministerio de Hacienda y Crédito Público, 2022). The fund earns money when national prices exceed international prices and spends when they fall below, effectively subsidising fuel consumption during low-price periods.

Using an automatic pricing mechanism with price bands, the Ministry of Mines and Energy and the Ministry of Finance set monthly fuel prices. The system allows the government to avoid steep rises in fuel prices and suspend the automatic price increases (see Box 1).

Box 1: Automatic fuel pricing mechanisms

Automatic fuel pricing mechanisms use a pricing formula to calculate fuel prices to adjust them periodically to international market prices. The mechanism can include a price band to protect society and firms from price volatility on the international market. Price bands use price caps and floors to keep the price from rising above a fixed limit or more than a pre-set percentage. Many countries use independent institutions to set fuel prices so that they cannot be politicised, for instance, during election periods.

Figure 1 shows the balance of the FEPC for the past 16 years. It highlights the challenges that Colombia encountered after the pandemic and the global energy crisis, leading to a deficit equivalent to 2.5 per cent of GDP in 2022. As international market prices for petroleum fuels rose from 2021 onwards, the FEPC mitigated the effect by limiting price increases for consumers.

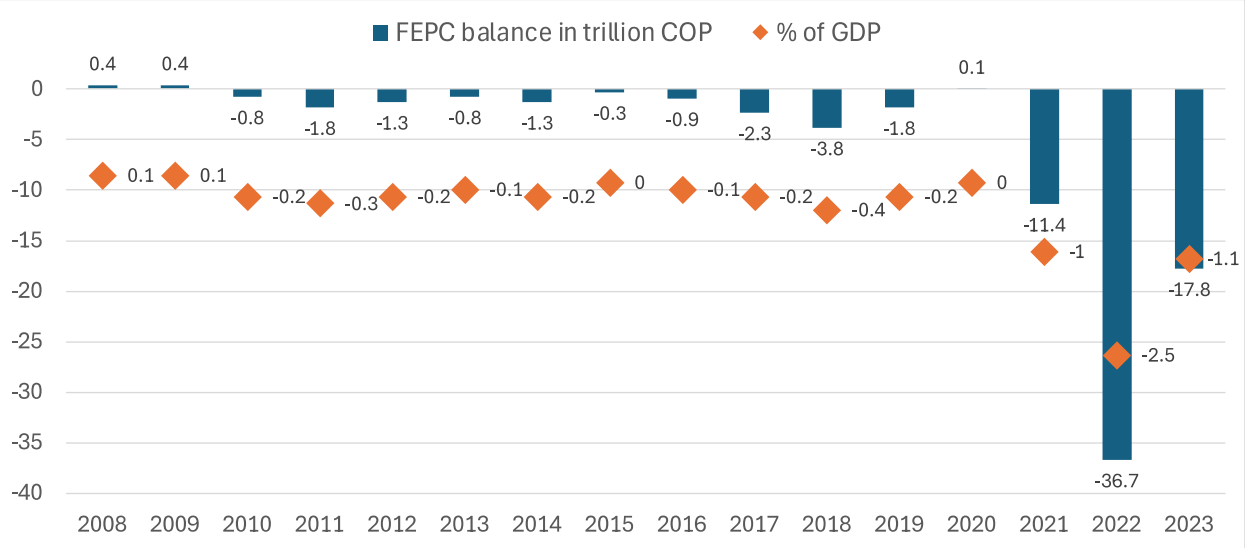
These circumstances led to a substantial burden on the government budget and contributed to the significant deficit, as illustrated in Figure 1. Experts highlighted that the deficit constituted an enormous threat to Colombia's debt sustainability and urged the government to act (Comité Autónomo de la Regla Fiscal [CARF], 2022). The FEPC accumulated a total deficit of COP (Colombian pesos) 100.3 trillion (ca. USD 26.2 billion), of which 73 per cent stems from the last

three years. Financial experts warned that international rating agencies might downgrade Colombia due to the high debt level.

To address part of the deficit, the Petro administration invested a lot of political capital to implement a subsidy phase-out for gasoline that was initiated in late 2022, with gasoline prices reaching world market prices at the start of 2024 (CARF, 2022; Presidencia Colombia, 2023; Rodríguez Rincón, 2023). The socioeconomic effects of the gasoline subsidy phase-out are still being debated. Some government officials underscored the regressivity of the subsidy, arguing that price increases would not severely affect low-income and vulnerable households (Morales Soler, 2022). Other stakeholders, including national and regional government officials, emphasised that even marginal cost increases have profound effects on low-income and vulnerable households (Casallas, 2023; Lopera, 2023).

In 2023, diesel subsidies became the greatest burden for the government, accounting for 77 per cent of the COP 17.8 trillion (USD 4.7 billion). Amidst the notable inflation and stagnating economic growth, the government now finds itself in a challenging position to tackle the fuel subsidy reform for diesel (Sánchez, 2024).

Figure 1: FEPC balance between 2008 and 2023* in trillion COP and as a share of GDP



Note: From 2008 to 2019, the FEPC balance fluctuated between COP -2 to +0.4 trillion, but starting in 2020, it experienced significant deficits, dropping to COP -36.7 trillion in 2022. As a share of GDP, the FEPC remained relatively stable until 2019, when it experienced a marked increase in the deficit from 2020 onwards, reaching -2.5 per cent in 2023.

*The results for 2023 are estimates.

Source: Ministry of Finance, using data from the Ministry of Mines and Energy

Negotiations with the transport sector: key for advancing diesel subsidy phase-out

The main consumer of diesel is the transport sector, including both cargo and passenger vehicles. Due to the absence of alternatives such as trains or massive inland waterway transport, diesel-powered vehicles move 96 per cent of goods in Colombia (Hernández & Cantillo-Cleves, 2024). Thus, the sector also represents a crucial challenge for the Colombian energy transition process (Departamento Nacional de Planeación [DNP], 2023).

Central to the current discussions between the government and the transport sector is the question of who should determine the allocation of the funds covering the diesel price disparities. For the government, the subsidies threaten the fiscal sustainability of the country, while redirecting the funds from subsidies offers potential resources for

the Colombian energy transition process. For example, funds currently covering diesel subsidies could be reoriented as investments to support the transport sector in adapting to the energy transition.

Transport sector representatives argue that the government lacks a clear implementation strategy for its transport energy transition plans and infrastructure investments. They view the energy transition plans as an inadequate replacement for diesel subsidies and warn that higher diesel prices could cause inflation, impacting essential goods such as food (Bancolombia, 2023; Fernández, 2024). For them, the diesel subsidy should stay in place, with minor changes.

Colombia's dependency on road transport gives the sector extraordinary bargaining power and the ability to resist policy implementation through strikes, as past experiences have demonstrated. In 2016, truckers' protests calling for improved labour conditions led to food shortages in some regions of Colombia (Santiago, Edgardo, Óscar, & Andrés, 2018). Thus, finding an acceptable pathway for the phase-out of the diesel subsidy is crucial for any policy initiative in this direction to be successful.

The Ministries of Finance, Mines and Energy, and Transport have had several technical meetings with the transport sector association, UNIDOS, which represents between 85 per cent and 90 per cent of workers in the sector. The aim is to find an effective way to gradually reduce diesel subsidies while implementing other measures to address the main concerns of the sector in relation to subsidies and other issues.

On 13 April 2024, the Ministry of Finance announced that diesel prices would increase gradually in the foreseeable future. However, by this date, the government had not yet reached an agreement with UNIDOS regarding diesel prices and other concerns raised by the transport sector during the technical meetings (Cárdenas, 2024). Three interconnected challenges, which are discussed in detail below, are complicating the discussions between the government and the transport sector.

Structural challenges in the freight transport sub-sector

The Colombian freight transport sub-sector suffers from a challenging economic situation as well as an oversupply of truckers, according to sector representatives and other experts. This problem is partially a result of the sub-sector's structures and modes of operation, which have led to an investment gap over time.

The sub-sector has three main actor groups: clients that commission the transport of goods, licensed transport companies that receive assignments and (largely) self-employed truckers who move the goods. Many trucks in Colombia are privately owned, and many families depend on the income that the truck drivers generate (Girozero, 2021). The share of self-employed people in the transport sector was 63 per cent according to data from the Organisation for Economic Co-operation and Development (Feria, 2021). Licensed transport companies own very few vehicles themselves and rely on the self-employed, who offer their services on a demand basis (Girozero, 2021).

This structure increases dependency on the diesel subsidy to decrease costs, and it creates severe inefficiencies, such as truckers having difficulties in finding work and inadequate investments in the maintenance, upkeep and renewal of trucks. Due to the predominant degree of self-employment among truckers, they continually need to find new assignments, which proves to be very hard due to the oversupply. As a result, truck owners rarely invest in new vehicles, which has led to an investment gap and the average age of a truck being 26 years (Ospina Henao, 2024).

Scepticism about the National Development Plan's visions for the transport sector

The National Development Plan highlights the transport sector as key for the country's energy

transition process (DNP, 2023). The plan includes potential solutions for the investment gap such as measures to improve energy efficiency and decarbonisation, which could support the subsidy phase-out. The government aims to assist with the transition to electric and hydrogen-powered vehicles by offering tax exemptions and low-interest loans as well as a fund for technological advancement in the transport sector. These ideas have been reinforced by the Just Energy Transition Roadmap documents, which include a set of strategies for the transport sector (Ministerio de Minas y Energía, 2023).

Sector representatives perceive the level of government incentives and support as inadequate to compensate for the loss of the diesel subsidy. They raise two main concerns about the government's plan to close the investment gap. First, the reliance on expensive technology with limited current availability and accessibility in Colombian markets makes the strategy seem unfeasible. Second, historical scepticism due to inadequate levels of support and unfulfilled promises heightens their concerns. They see the diesel subsidy as one of the few tangible benefits provided by the government.

Actors from the private sector and academia have reiterated the sector's scepticism and question the government's ability to implement the visions of the National Development Plan and other planning documents. High levels of turnover in key ministries and problems implementing other reforms have only strengthened this view, provoking fierce public debate. As of April 2024, nearly two years into the current administration, progress on developing new policies and actionable commitments has been limited, including the necessary coordination across and between ministries and levels of government.

Ecopetrol's role in providing fuel subsidies

The phase-out of fuel subsidies is closely linked to the energy transition process, as highlighted in the National Development Plan (DNP, 2023). A key player in the energy transition is state-owned enterprise Ecopetrol, which has the ambition to become carbon neutral by 2050 and has invested in the diversification of its portfolio for several years, though its core business remains heavily based in fossil fuels (Strambo & Arond, 2023). However, the surge in the FEPC's deficit since 2021 poses significant challenges for Ecopetrol, which temporarily has covered the costs of deflated gasoline and diesel prices, later settled by the government annually.

The government has a strong motivation to phase out the fuel subsidies to protect its debt sustainability and to support Ecopetrol as a key ally in the energy transition process. Changing the pricing formula to focus only on production costs for diesel, as suggested by UNIDOS, would force Ecopetrol to assume the loss that the subsidy currently creates. This is because setting diesel prices below global market levels with the new formula would require Ecopetrol to sell fuel at a reduced rate, thereby causing the company to incur substantial losses that the government previously covered.

Recommendations to phase out the diesel subsidy

Although it is key for reducing debt and making progress towards the energy transition, the phase-out of the diesel subsidy puts the government in a challenging and risky position. On the one hand, if the transport sector decides that the only option to have their needs heard is strike action, the country could face food shortages, protests and social unrest, as has happened in the past with attempts to regulate the sector (Ahumada Rojas, 2021; Santiago et al., 2018). On the other hand, a pass-through of the price increase without mitigation measures could fuel inflation and burden large segments of the population, also leading to social unrest.

A successful phase-out of the diesel subsidy is needed to strengthen confidence in the broader energy transition process and demonstrate the government's abilities to steer a complex reform

process. To mitigate the negative effects of the phase-out, the government urgently needs to act by creating more space for dialogue and debates that address the needs of the affected sectors; mitigating the adverse effects on vulnerable households; and avoiding negative impacts on its energy transition agenda. To steer the subsidy phase-out, the national government should consider the following recommendations.

Short-term actions to phase out the diesel subsidy

Resume technical meetings: The government should immediately resume hosting bi-weekly meetings to discuss the price reform until the end of its legislation period.

- To better address the transport sector's needs, the Ministry of Transport should take the lead and receive more autonomy for negotiations from the Ministry of Finance.
- The meetings should involve other actors from the government and private sector, including clients of the transport sector and the Ministries of Social Prosperity, Environment, and Labour, as well as the National Planning Department.

Establish an action plan: The government and key stakeholders should co-develop an action plan to phase out the diesel subsidy. The action plan needs to address the following key priorities:

- *Immediate support for the transport sector in their priority areas:* Together with the private sector, the government should identify opportunities for short-term cost reductions to increase the transport sector's trust in government actions and protect its profitability in the short term. For instance, trainings to reduce fuel usage and improve coordination between the transport companies and their clients through apps or other platforms could help truckers in the short term.
- *Social programmes to mitigate socioeconomic effects:* Government agencies such as the Ministry of Health and Social Prosperity as well as the National Planning Department should suggest mitigation measures that the subsidy phase-out could fund.
    - The government could invest in the General Participation System (*Sistema General de Participaciones*, SGP), which provides funds for social expenditures such as education and health (Ministerio de Vivienda, Ciudad y Territorio, 2021). Other countries have successfully implemented cash transfers that supported households with the price increases (Mukherjee et al., 2023).
    - The Identification of Potential Beneficiaries of Social Programmes database (*Sistema de Identificación de Potenciales Beneficiarios de Programas Sociales*, Sisbén) could benefit from the cash-transfer approach if potential beneficiaries register themselves and the database is expanded.
    - Parties should also assess the socio-economic pressures of the gasoline subsidy phase-out and other price increases from the past to get a comprehensive overview of the current vulnerabilities in society.
- *Pace of the price increase:* The government must prudently manage the pace of price increases and other transition elements to strategically coordinate adjustments with other policies and regulations, such as infrastructure development, the introduction of new technologies and workforce training.
    - Assessing market dynamics and societal preferences is imperative to ensure that the society and economy can adjust to changes (Rentschler & Bazilian, 2017).
    - A structured timeline would help all stakeholders as well as the public to prepare for the changes.
    - The timeline should include indicators that guide the price increases over time to protect workers in the transport sector and vulnerable households. Only when the indicators allow for a price increase should the government raise diesel prices.

Actions to be taken within the remaining legislation period

Revise the goals and strategies of national planning documents: Policy-makers must acknowledge that the diesel subsidy phase-out requires a broader reform in the transport sector than has been proposed so far. To reflect the realities of self-employed truckers, the government needs to redefine measures to close the existing investment gap, enabling the sector to participate in energy transition plans. The Just Energy Transition Roadmap, expected during 2024, provides an opportunity to outline this reform.

- The government should partially redirect funds from the diesel subsidy to the existing Vehicle Fleet Replacement Fund, while the terms and conditions of this fund should be pushed to help facilitate a transition to incorporate electric vehicles and a cleaner, more sustainable fleet generally.
- In the short term, analyse the evidence on the trade-offs between prioritising readily available technologies, such as more efficient diesel motors that reduce fuel usage, versus pushing for less accessible but cleaner (e.g. electric vehicle) technologies.
- In the long run, the government and transport sector should jointly explore new technologies such as electric vehicles or hydrogen power and define a strategy to set up a power infrastructure.
- Evidence on the co-benefits (health and climate impacts) of a diesel phase-out and improvements in the energy efficiency of the transport fleet should be part of public communications around these changes.

Restructure the transport sector: The transport sector requires reform to address the structural challenges that exacerbate its dependency on low diesel prices. The fragmentation and lack of economies of scale due to the small size of the average enterprise in the sector pose challenges to its potential for reform and development.

- The passenger transport sector has had successful experiences organising itself into cooperatives in the past, effectively addressing challenges that this sector has faced (see Box 2).
- Cooperatives could be an opportunity to re-structure the freight sub-sector, protecting the independence of the self-employed and encouraging greater formalisation. The government should offer clear incentives to cooperatives that facilitate a cleaner fleet, such as tax benefits and social security schemes.

Box 2: Cooperatives in Colombia

Cooperatives are employee-owned businesses in which all members equally benefit from profits and share investment risks. In many cases, they contribute to community development and are characterised by their democratic structures, which provide all members with a vote in business decisions. However, individual cooperatives may vary in their practices and priorities based on their specific goals and circumstances. Several cooperatives have been operating in the Colombian passenger transport sub-sector for many years. Cooperatives helped to settle the “penny war”, referring to the fierce competition between bus drivers for passengers that often led to harmful rivalries (Shaw & Alldred, 2015).

Engage with development and industry actors: Several development and industry actors are collaborating with the Colombian government on the energy transition, especially to explore the country’s potential to produce cleaner forms of energy. These actors should take the subsidy phase-out seriously, as strikes by the transport sector could affect their investment and development plans in Colombia.

- To accelerate the transition towards cleaner energy and technologies in the transport sector, the government should discuss with these actors the need to develop – and subsequently manufacture – sustainable transport technologies domestically in Colombia, building on existing capabilities in the pro-

ducing industries. For instance, Uruguay has a pilot project to test hydrogen trucks in the forestry sector, which could serve as a use case for Colombia (H2LAC, 2023). In addition, the envisioned strategic partnership for green hydrogen between Brazil and Colombia could foster more opportunities for economic development (Mejía, 2024).

- The government could pursue strategic partnerships between international private companies and the Colombian private sector to identify where they might provide mutual benefits. For instance, as industrialised countries seek to green their heavy industry with low-emission hydrogen, what opportunities exist for Colombia to develop a hydrogen industry, not only for export, but also to support (Aldana Rivera & León Peñuela, 2022, p. 122) and transform the Colombian transport sector, while ensuring local benefits and minimising negative impacts (Ministerio de Minas y Energía, 2022)?
- Establishing a hydrogen industry in Colombia faces its own challenges due to limited regulatory development, potential dependency on grey and brown hydrogen, risks around infrastructure development, agreements with affected communities and other problems.

Conclusions

The Colombian government and Congress should prioritise the subsidy phase-out in their remaining legislative period. The phase-out offers the opportunity to elevate the energy transition process from a temporary government policy to a State policy that is recognised by a broad coalition of political parties and societal actors. However, if the phase-out fails, the country could face strikes and protests, which would adversely affect the trust in – and support of – the government's energy transition plans.

Both international and domestic industry as well as international development cooperation actors with stakes in the Colombian energy transition should engage with the fuel subsidy phase-out, as it could affect their efforts in the energy transition process. Their support could accelerate the subsidy phase-out and increase confidence in the government's capabilities. For example, the German government hosts inter-ministerial consultations, and the subsidy phase-out process should become a core topic of the exchange. Germany has had its own negative experiences with a subsidy phase-out, and the two countries could learn from each other (Martinez, 2024).

At the moment, the government is losing political capital, as the phase-out of the fuel subsidies is affecting the trust of key stakeholders concerning the administration's capacity to implement complex reforms. The current course of the government to phase out the subsidy without having a final agreement with the transport sector reinforces the sector's suspicions that the negotiations lack sincerity. Other sectors are closely watching the negotiations between the government and the transport sector. The results could affect future negotiations between these sectors and the government on their contribution towards the energy transition. On the other hand, a successful phase-out could boost the government's political capital and society's trust in its ability to implement the energy transition. Time is of the essence, and confidence could deteriorate if negotiations continue to stall.

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