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~~Re~~ NO

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Prime Minister:

Mr Prior proposes renegotiating the Kinsale gas contract. This may have to go to E(A) but, in any event, await Treasury response?

22/6

I agree with the conclusion that we pursue option (c) not

Prime Minister

KINSALE GAS

Following my minute of 7 June (not copied to all), I am writing to seek colleagues' agreement to modifying our approach to the Kinsale Gas project and to pursuing further negotiations with the Republic of Ireland.

Colleagues will recall that, with their agreement, a Memorandum of Understanding was signed in October 1983 for a supply of natural gas from Kinsale in the Republic of Ireland to Northern Ireland; it was expected that over a 32 year life the project would show a rate of return marginally above the 5 per cent minimum. We accepted at that time that the wider social economic and political advantages outweighed the undoubted risks of the project.

The Northern Ireland Gas Company Limited has been negotiating with its Irish opposite number about the detailed terms of the contract; a draft contract is now ready for signature. Since October, however, the prospects for the project have deteriorated significantly. Recent market surveys have shown a decrease in the potential sales of one-third (reflecting, inter alia, the rapid recent penetration of the domestic central heating market in Northern Ireland by solid fuel); the price of heavy fuel oil - which is the predominant element in the price formula - has risen substantially in relation to crude oil and is expected to remain at a higher level; and the exchange rate has moved adversely.

We have reassessed the project on the basis of this latest information; this reassessment demonstrates that there is now a real possibility of an outcome which would leave us with a substantial deficit at the end of 32 years as against the positive rate of return which we

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accepted last year. Indeed, on the new market and price assumptions the project would not meet its operating costs even if we were to contribute, without expectation of return, the total capital cost.

Adam Butler has outlined these developments to Mr Spring, the Irish Minister of Energy, who expressed surprise and shock. Officials have had further discussions with the Irish, who have responded that we should not take a short term view of a long term project, having regard in particular to the notorious unreliability of energy forecasts. Their clear view is that we should put our current doubts to one side and proceed. Irish officials have also taken the firm line that there can be no question of any re-negotiation of price. The Memorandum of Understanding was of course neither an international Treaty nor a legal contract. Nevertheless, it is already clear from their public and private reactions that the Irish regard us as being strongly morally and politically bound by the terms ofthe Understanding, agreed as it was by both Governments.

Options

There is no realistic prospect that the Irish would make concessions of the magnitude required to restore the project to the degree of viability expected last year. This being so, the following options appear to be open to us:-

a. Decide that we cannot proceed with the project because the forecast economic results are unacceptable.

b. Conclude that the moral commitment is so great and that the political cost of failure to implement the project on the basis of the Memorandum of Understanding would be so high that we must proceed to sign the contract in spite of the adverse economics.

c. Set out to close the gap in the viability of the

 /.... project as we

project as we now see it by attempting to renegotiate improved price terms from the Irish as well as displaying on our side a readiness to accept substantial costs as a direct charge on public funds.

Option (a) Cancel

There are strong reasons for not going ahead with the project. The latest assessment shows that the project does not meet the criteria for viability on which we based our decision last year and on which we have set such public store. If the projections now made prove to be an accurate forecast of the development of demand and the movement of oil prices over the next three decades, then the project would, at a 5% discount rate, have a net present value of - £107m. The project would not run into annual surplus for the first time until 1999/2000, after reaching a peak funding requirement of £170m in the previous year. On the other hand, if we decide to withdraw from the deal on the basis of these results we will be exposed to charges of extreme bad faith. We have of course been careful to avoid any legal obligation. If we did cancel the project we should seek ways of easing the resentment on the Irish side by offering wide-ranging discussion on energy issues.

Option (b) Proceed

The case for proceeding has to be based on an acceptance that we have some moral obligation to follow on from the Memorandum of Understanding. Additionally, this course has the advantage that some jobs in the gas industry will be secured and consumers will retain an additional fuel option. On the other hand, we have always stated that this project was going forward on the basis that it was viable and in the genuine interests of both parties. The latest assessment shows we can no longer be confident that this is the case for Northern Ireland.

/.... Option (c)

Option (c) - Re-negotiate

There is of course a possibility that the Irish might agree to abate the purchase price of the gas. If we made an irrecoverable contribution of £152m (or £122m - net of assumed EC aid) which would be equivalent to the capital costs of the project we would require an abatement of 4.5p per therm from the Irish to cover operating costs. If the UK Government were willing to make a contribution to the project equivalent to the amount (£141m) which we would have to pay to secure the orderly closure of the existing gas industry, a 4p abatement from the Irish would be needed.

There is no indication yet that the Irish would be willing to make such concessions - but I believe we wuld be wrong not to approach them. If they refuse, it is difficult to see any rational basis upon which we could continue with the project - but we would have made a major effort to preserve it and this would help us in handling the strong criticism we will face (in the Republic, from the Nationalist community in Northern Ireland and from the Opposition) if the project is cancelled.

It is of course arguable whether we should even be willing to meet capital costs in this way. It conflicts with our normal approach to investment analysis. On the other hand, it is widely known that the Government estimates the costs of closing the existing industry at around £140m and most observers, as well as those in Northern Ireland and the Republic who have an interest, take it for granted that in our assessment of the project we will disregard this £140m which we would have to spend in any case. To our critics, and I think to our supporters, it will seem better to spend the £140m to assure the establishment of a new energy industry with the social, economic and political benefits accruing from that decision, and in the process to maintain the goodwill of the Irish at a sensitive and difficult time, rather than to spend such a sum for the negative purpose of closure. It is on this basis that we would publicly defend a decision to meet the capital costs.

/.... Conclusion

Conclusion

Time is against us. There is predictable pressure from the Irish to sign the supply contract; but more important, there is a tight timetable within Northern Ireland for bringing the first gas deliveries to the Province by end 1985, and if this work is delayed, the first deliveries will slip badly, further affecting the economics of the project if we do not take a firm decision soon. There is therefore no time for lengthy renegotiations.

There are major political sensitivities whatever decision we take; but on balance I believe our best course is on the lines of option (c). If colleagues agree with this, Adam Butler will seek an immediate meeting with Mr Spring in order to:-

a. Explain to him the unexpected nature of our new market and oil price forecasts and the implications of these on our project evaluation.

b. Confirm that we continue to attach importance to the project but that it must, at the minimum, meet its operating costs. In order to achieve this objective we are willing to meet its capital cost but we still need a price reduction equivalent to 4 to 5 pence per therm (at 1984 prices).

I am copying this minute to our E(A) colleagues, to Geoffrey Howe, and to Sir Robert Armstrong.

J. P.

22 June 1984

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Ireland 5/79
econ Co-opn

22 JUN 1984

FILE ✓

PRIME MINISTER

Andrew.

Kinsale Gas.

NIO phoned following amendments:-

Line 3: should read "If we made an irrecoverable contribution of £152m (or £122 m net of assumed EC aid)...."

Line 9: "The £141m would also be net of EC aid..." onwards to end of the paragraph should be ~~deleted~~ deleted.

Sue
22/6.