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FM FCO 151700Z AUG 84

TO PRIORITY DUBLIN

TELEGRAM NUMBER 162 OF 15 AUGUST

MY TELNO 160

KINSALE GAS

1. DR FITZGERALD'S MESSAGE TO THE PRIME MINISTER MEANS THAT THE KINSALE GAS PROJECT WILL NOW HAVE TO BE CANCELLED. THE PRIME MINISTER'S REPLY TO DR FITZGERALD, DRAWING THIS CONCLUSION, IS IN MY IMMEDIATELY PRECEDING TEL. 160.
2. THE DISCUSSION BETWEEN THE TWO GOVERNMENTS ON KINSALE GAS HAS BEEN COMPARATIVELY TERSE: WE ARE ACUTELY CONSCIOUS OF THE DANGER THAT THE IRISH GOVERNMENT WILL ALLOW THEMSELVES TO ASSUME THAT OUR UNWILLINGNESS TO GO AHEAD WITH THE GAS PROJECT SIGNALS SOME LESSENING OF OUR GENERAL INTEREST IN IMPROVING ANGLO-IRISH RELATIONS. IT IS IMPORTANT THAT THE IRISH SHOULD NOT BE ALLOWED TO DRAW THIS CONCLUSION, AND YOU SHOULD THEREFORE MAKE THE FOLLOWING POINTS TO THE IRISH AT A VERY SENIOR LEVEL:
  - A) WE ARE RELUCTANT AND UNHAPPY TO HAVE TO BRING THE KINSALE GAS PROJECT TO AN END. WE APPRECIATE THE STRENGTH OF THE POLITICAL CONSIDERATIONS POINTING IN FAVOUR OF CONTINUING WITH THE PROJECT IF AT ALL POSSIBLE - THOUGH THERE ARE ALSO CONTRARY POLITICAL ARGUMENTS:
  - B) WE HAVE BEEN FORCED TO CANCEL THE PROJECT SOLELY BECAUSE ECONOMIC CONSIDERATIONS NOW WEIGH SO STRONGLY AGAINST IT. THE 15P PER THERM PRICE GAP QUOTED IN THE PRIME MINISTER'S LETTER OF 31 JULY DEMONSTRATES JUST HOW LARGE THE GAP BETWEEN THIS PROJECT AND ECONOMIC VIABILITY HAS BECOME. IT IS AN ENORMOUS GAP, AND WE CAN UNDERSTAND WHY THE IRISH ARE UNABLE TO OFFER TO FILL IT. BUT PRECISELY BECAUSE IT IS SUCH AN ENORMOUS GAP IT IS UNREALISTIC FOR US ALONE TO FILL IT. THE OVERWHELMING ECONOMIC REALITY IS THAT THE PROJECT IS UNECONOMIC AND THAT NEITHER COUNTRY CAN AFFORD TO GIVE

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CONTEMPLATED LAST WINTER:

- IV) THE IRISH MAY ARGUE THAT WE HAVE ALWAYS SOUGHT AN ARTIFICIALLY HIGH RATE OF RETURN ON THE PROJECT. IN FACT THE REVERSE IS TRUE - IN CALCULATING OUR RATE OF RETURN WE TOOK ON TRUST THE AVAILABILITY OF GAS OVER THE LIFE OF THE FIXED ASSETS (32 YEARS) ALTHOUGH THE CONTRACT WOULD HAVE RUN FOR ONLY ABOUT 20 YEARS. IF WE HAD CONFINED OUR CALCULATIONS TO THE 20 YEAR PERIOD THERE WOULD NEVER HAVE BEEN ANY PROSPECT OF ECONOMIC VIABILITY.
- V) THE IRISH HAVE IN THE PAST ASSERTED THAT WE SHOULD COUNT AGAINST THE PROJECT THE PDS STG 140M OR SO THAT WOULD BE INVOLVED IF WE HAD TO WIND UP THE EXISTING TOWN GAS INDUSTRY IN NORTHERN IRELAND - ON THE GROUNDS THAT WE FACED EXPENDITURE ON THIS LEVEL ANYWAY AND SHOULD NOT THEREFORE ALLOW IT TO INFLUENCE OUR CALCULATION OF THE RATE OF RETURN. IF THIS IS RAISED AGAIN, YOU SHOULD POINT OUT THAT THE CALCULATION OF THE RATE OF RETURN MUST BY DEFINITION BE A RATE OF RETURN ON THE EXPENDITURE ACTUALLY INVOLVED: TO EXCLUDE PART OF THE EXPENDITURE FALSIFIES THE CALCULATION. THE SAVING OF EXPENDITURE ON CLOSING THE GAS INDUSTRY IS RELEVANT NOT TO THE CALCULATION OF THE RATE OF RETURN BUT TO THE CALCULATION OF HOW MUCH PUBLIC EXPENDITURE IS REQUIRED. OUR CALCULATIONS OF THE LATTER AT THE GAS PRICES NOW PROJECTED SHOW THAT AFTER DEDUCTING THE SAVING ON CLOSING THE EXISTING GAS INDUSTRY THE KINSALE GAS PROJECT WOULD HAVE CREATED AN ADDITIONAL BURDEN ON PUBLIC EXPENDITURE RUNNING INTO SEVERAL HUNDREDS OF MILLIONS OF POUNDS, INCLUDING THAT ARISING FROM ITS ADVERSE EFFECT ON THE ELECTRICITY INDUSTRY.
- VI) THE IRISH HAVE CHOSEN TO PRESENT THE PRIME MINISTER'S LETTER OF 31 JULY AS REQUIRING A PRICE CUT OF SOME 50 PERCENT, THAT LETTER WAS IN FACT VERY CAREFUL TO SAY THAT THIS SIZE OF PRICE CUT WAS THE SIZE OF THE GAP BETWEEN THE PROJECT AND ECONOMIC VIABILITY: THE PRIME MINISTER'S PENULTIMATE PARAGRAPH SPECIFICALLY RAISED THE POSSIBILITY OF THE IRISH GOING ONLY 'A VERY SUBSTANTIAL WAY TOWARDS BRIDGING THE

GAP'. WE CAN UNDERSTAND WHY THE IRISH FELT IT WAS TOO MUCH OF A BURDEN TO MAKE SUCH A 'VERY SUBSTANTIAL' RESPONSE, BUT THEY ARE MISREPRESENTING OUR POSITION IF THEY CONTINUE TO CLAIM THAT OUR POSITION WAS SIMPLY TO DEMAND A 50 PERCENT PRICE CUT: THIS MISREPRESENTATION IS UNDOUBTEDLY POLITICALLY HELPFUL TO IRISH MINISTERS, BUT IT DOES NOT HELP ANGLO-IRISH RELATIONS:

- VII) IN ANSWER TO THE COMMENT OF MR ALBERT REYNOLDS (FIANNA FAIL) THAT THE BRITISH GOVERNMENT HAS A PRACTICE OF BREAKING AGREEMENTS WITH THE IRISH: YOU SHOULD POINT OUT THAT THE PRESENT IRISH GOVERNMENT THEMSELVES SOUGHT RENEGOTIATION OF THE DEAL WHICH WE BELIEVED WE HAD AGREED WITH MR REYNOLDS IN MAY 1982. THE IRISH APPARENTLY FOUND THE DEAL ORIGINALLY AGREED TO BE ECONOMICALLY UNACCEPTABLE AND SUBSEQUENTLY SOUGHT MAJOR CHANGES IN THE WAY THE PRICE OF GAS IS CALCULATED:
- VIII) EARLIER IN THE SUMMER THE IRISH MADE SOMETHING OF THE ARGUMENT THAT WE WERE MORALLY BOUND BY THE MOU, THEY CLEARLY ACCEPT NOW THAT WE WERE NOT LEGALLY BOUND BY IT. WE DO, HOWEVER, ACCEPT THAT THE MEMORANDUM MARKED A REAL EXPECTATION BY BOTH GOVERNMENTS THAT A FIRM AGREEMENT WOULD BE SIGNED. WE ARE SORRY THAT CHANGES IN ECONOMIC CIRCUMSTANCES HAVE COMPELLED A DIFFERENT CONCLUSION:
- IX) DR FITZGERALD DREW ATTENTION TO POSSIBLE (NATIONALIST) DISMAY IN NORTHERN IRELAND IF THE PROJECT IS CANCELLED. BUT THERE WILL BE A MUCH STRONGER (UNIONIST) REACTION IF WE GO AHEAD WITH A PROJECT THAT IS PATENTLY UNECONOMIC. UNIONISTS WILL CLAIM THAT IF HMG PRESSES ON WITH A PROJECT THAT NO LONGER HAS ECONOMIC VALIDITY, THEN THE MOTIVE FOR PRESSING ON MUST BE POLITICAL: THE POLITICAL MOTIVE WOULD BE SEEN AS VERY STRONG (AND IN THEIR EYES VERY SINISTER) IF IT JUSTIFIED EXPENDITURE OF SEVERAL HUNDREDS OF PDS STG M.

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TO PRIORITY DUBLIN  
TELEGRAM NUMBER 163 OF 15 AUGUST  
MY TEL NO 161  
KINSALE GAS.

1. THE FINAL PARAGRAPH OF THE PRIME MINISTER'S MESSAGE TO THE TAOISEACH INDICATES THAT YOU WILL BE INSTRUCTED TO SEEK IMMEDIATE DISCUSSIONS WITH IRISH OFFICIALS AS TO THE BEST WAY OF ANNOUNCING THE END OF THE PROJECT.

2. HMG'S OVERALL OBJECTIVE IS TO MINIMISE ANY DAMAGE TO THE WIDER ANGLO/IRISH RELATIONSHIP BY DEMONSTRATING, BOTH TO THE IRISH AUTHORITIES AND TO THE PUBLIC, THAT THE DECISION HAS BEEN FORCED ON US BY ECONOMIC FACTORS ALONE, AND THAT IT DOES NOT IN ANY WAY DIMINISH OUR DESIRE FOR PROGRESS ON THE WIDE RANGE OF OTHER BUSINESS BETWEEN OUR TWO GOVERNMENTS.

3. IDEALLY WE WOULD LIKE THE IRISH TO JOIN US IN THE DECISION NOT TO PROCEED. BUT IT SEEMS VERY UNLIKELY THAT THEY WOULD BE WILLING PUBLICLY TO DO SO. WE EXPECT THEM TO INSIST THAT THE UK ALONE IS RESPONSIBLE FOR THE PROJECT'S COLLAPSE. APART FROM ANYTHING ELSE, IT HAS A BEARING ON THE CAPITAL CONTRIBUTION (SEE MY TEL NO 164). HOWEVER WE HOPE THAT THEY WOULD BE PREPARED TO SUBSCRIBE TO A JOINT STATEMENT, WHICH WOULD DEMONSTRATE PUBLICLY THE DESIRE OF BOTH GOVERNMENTS TO LIMIT THE IMPACT UPON ANGLO/IRISH RELATIONS OF OUR WITHDRAWAL FROM THE PROJECT. IT SHOULD NOT ONLY DRAW A LINE UNDER THE KINSALE PROJECT BUT RE-AFFIRM THE INTENTION TO PURSUE ECONOMIC CO-OPERATION.

4. IN SPEAKING TO DONLON OR LILLIS YOU SHOULD THEREFORE FIRST PROPOSE TO THEM THAT THE MOST SATISFACTORY WAY OF PUTTING AN END TO THE PRESENT UNCERTAINTY AND ACRIMONY WOULD BE A FORMAL JOINT ANNOUNCEMENT WHICH WOULD:-

(A) ACKNOWLEDGE THAT THE GAS PROJECT CANNOT PROCEED AND, AS FAR AS IT IS POSSIBLE TO DO SO, RECOGNISE THE REASONS WHY NOT: AND

IT THE LEVEL OF SUBSIDY THAT WOULD BE NEEDED:

- C) THESE ARE GENUINE ECONOMIC CONSIDERATIONS: AND THEY HAVE COME TO A HEAD ONLY AFTER THE MOU WAS SIGNED.
  - D) IN THE MATURING RELATIONSHIP BETWEEN THE TWO COUNTRIES, IT IS IMPORTANT THAT WE SHOULD BE WILLING TO FACE UP TO THESE ECONOMIC REALITIES. FOR THE TWO GOVERNMENTS TO HAVE PRETENDED THAT THE PROJECT WAS STILL VIABLE WHEN ALL OUR CALCUALTIONS SHOW THAT IT IS NOT SO WOULD ONLY HAVE STORED UP TROUBLE FOR BOTH GOVERNMENTS IN FUTURE. APART FROM ALL OTHER CONSIDERATIONS WE WOULD NOT WISH TO BURDEN FUTURE ANGLO-IRISH RELATIONS WITH A PROBLEM OF THIS SORT.
3. THE IRISH RESPONSE TO MANY OF THESE POINTS HAS BEEN MADE PLAIN IN DR FITZGERALD'S TWO MESSAGES: AND IN MR SPRING'S PRESS CONFERENCE ON 8 AUGUST. YOU MAY, IN RESPONSE TO IRISH COMMENT, NEED TO DRAW ON THE FOLLOWING POINTS:
- I) WHILST THE PROVISION IN THE MOU FOR OUR CALLING ON LOWER QUANTITIES OF GAS WOULD HAVE THE EFFECT OF REDUCING OUR LOSSES SLIGHTLY WERE THE PROJECT TO FAIL DISASTROUSLY AFTER THE SIGNING OF AN AGREEMENT, THERE WAS NEVER ANY SUGGESTION THAT A PROJECT HANDLING ONLY THESE VOLUMES OF GAS COULD BE FINANCIALLY VIABLE. IF THESE HAD BEEN THE PROJECTED SALES LEVELS WE WOULD NOT HAVE REACHED EVEN THE MOU STAGE:
  - II) WHIEE THE MOU PROVIDES FOR POSSIBLE RENEGOTIATION OF GAS PRICES, THE GAS PRICE FORMULA CAN ONLY BE CHANGED BY AGREEMENT BETWEEN BOTH GOVERNMENTS. IT WOULD BE UNREALISTIC TO EXPECT AGREEMENT TO A RENEGOTIATION ON THE SCALE THAT WE THINK WILL BE NEEDED IN 5 YEARS TIME IF THE IRISH ARE NOT WILLING TO CONTEMPLATE SUCH A RENEGOTIATION NOW:
  - III) THE IRISH HAVE ARGUED THAT THE ECONOMIC PROSPECTS OF THE PROJECT CANNOT POSSIBLY HAVE CHANGED SO SIGNIFICANTLY SINCE LAST AUTUMN: UNFORTUNATELY, THE IRISH ARE WRONG AND THE SHARP INCREASES IN HEAVY FUEL OIL PRICES IN THE LAST NINE MONTHS TOGETHER WITH THE LARGE DETERIORATION IN THE STERLING/DOLLAR EXCHANGE RATE HAVE ALREADY PRODUCED A GAS PRICE WHICH IS FAR IN EXCESS OF ANYTHING THAT WE

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(B) ISOLATE, AND LEAVE BEHIND, ANY DISAPPOINTMENT ABOUT CANCELLATION OF THE GAS PROJECT, MAKING CLEAR THAT THE FAILURE WILL NOT OBSTRUCT PROGRESS ON THE WIDE RANGE OF OTHER BUSINESS BETWEEN OUR TWO GOVERNMENTS.

5. IF THE IRISH ARE DISPOSED IN PRINCIPLE TO AGREE TO THIS YOU SHOULD SAY THAT WE SEE IT AS CONTAINING THE FOLLOWING POINTS:

(A) DISAPPOINTMENT THAT THE PROJECT COULD NOT PROCEED AFTER ALL THE EFFORT THAT WENT INTO IT FROM BOTH SIDES:

(B) RECOGNITION THAT BOTH SIDES HAVE ACTED REASONABLY AND IN GOOD FAITH: LEADING TO

(C) SOME DESCRIPTION OF THE FINAL POSITIONS OF BOTH SIDES TO THE DEAL. THE UK ENCOUNTERED ADVERSE FACTORS AS TO PRICE AND DEMAND WHICH IN ITS VIEW MADE THE PROJECT NON-VIABLE. THE REPUBLIC COULD NOT, AND DID NOT, DEPART FROM THE ECONOMIC CRITERION IT HAS SET ITSELF THAT THE PRICE OF THE GAS HAD TO RELATE TO THE PRICE OF REPLACEMENT FUEL TO THEM.

(D) AN AFFIRMATION THAT DISAPPOINTMENT OVER KINSALE WILL NOT HAVE ADVERSE REPERCUSSIONS ON OTHER MUTUALLY BENEFICIAL PROJECTS INCLUDING FUTURE COOPERATION IN ENERGY MATTERS.

6. A FULL DRAFT TEXT WILL BE TELEGRAPHED TO YOU SHORTLY. AS WE BELIEVE THAT AN EARLY PUBLIC ANNOUNCEMENT IS REQUIRED, WE HOPE IT WILL BE POSSIBLE TO AGREE A JOINT TEXT WITHOUT PROTRACTED DISCUSSIONS. YOU SHOULD MAKE IT PLAIN THAT IF THE IRISH DO NOT WISH TO SUBSCRIBE TO A JOINT STATEMENT WE SHALL MAKE A UNILATERAL ANNOUNCEMENT ON THE LINES OF PARA 5 ABOVE IN THE VERY NEAR FUTURE

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