



P.01345

PRIME MINISTERKinsale Gas

## BACKGROUND

In October 1983 a Memorandum of Understanding was signed with the Republic of Ireland for the supply of natural gas from the Kinsale field to Northern Ireland. Ministers approved the signing of the Memorandum on the basis that, although the appraisal had indicated that the project would show a rate of return only marginally above the minimum Required Rate of Return, there were wider social, economic and political advantages which outweighed the undoubted commercial risks (E(A)(83)4th meeting).

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2. A draft contract is now ready for signature. But the outlook on two of the key factors determining the project's rate of return has changed markedly since the Autumn. First the prospective market in Northern Ireland is now thought to be about one-third lower than estimated then. Secondly, the prospective price at which the Irish Government would sell the gas has risen, because of movements in the price of heavy fuel oil (to which the gas price is linked) and the exchange rate. Their combined impact is to make the projected rate of return on the project strongly negative: the net present value of the project has been revised downwards from £+4 million to £-107 million. To restore the marginal rate of return on the project expected when the Memorandum was signed, the price at which the gas is obtained from the Irish Government would have to be more than halved.

FLAG B

3. The Secretary of State for Northern Ireland reported the revised assessment to you in his minute of 22 June 1984. He argued that the Government should renegotiate the terms



and conditions of the contract; he proposed that the Government might pay the capital cost of the project (£140 million) on the grounds that if the project went ahead, it would avoid expenditure of the same order otherwise necessary to close the existing Northern Ireland gas industry. He suggested that the Irish Government would look to the United Kingdom (UK) Government to make a contribution of at least this size, in view of the political importance attached to the project. If the capital costs were met in this way, then providing a reduction of 4-5 pence per therm in the selling price of the gas could be negotiated with the Irish Government, the project would cover its operating costs.

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4. In his minute of 28 June the Secretary of State for Foreign and Commonwealth Affairs supported renegotiation.

FLAG D

The Chief Secretary, Treasury, however, in his minute of 29 June suggested that unless the 15 pence per therm reduction in the selling price necessary to restore commercial viability could be secured, the Government should withdraw from the project. Your Private Secretary's minute of 3 July agreed that an attempt should be made to renegotiate the terms of the contract; but you also pointed out that it might ultimately be necessary to withdraw from the project.

FLAG E

5. On 4 July the Minister of State, Northern Ireland Office (Mr Butler) discussed the contract with the Irish Minister of Energy, Mr Spring. Mr Butler indicated that renegotiation of the contract would be necessary if the UK were to go ahead; Mr Spring professed to be surprised and no real negotiations took place. On 10 July the Irish Prime Minister wrote to you and proposed that the project should proceed on the basis of the original Memorandum of Understanding.

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6. In his minute to you of 13 July Mr Prior sets out the options as follows:

- a. to accept the terms and conditions now on offer and sign the contract;
- b. to withdraw, without any attempt to negotiate concessions, on the grounds that the project is now too far from viability;
- c. to negotiate with a view to achieving a major concession on price.

He attaches a draft letter for you to send to Dr Fitzgerald on the basis of option c. He suggests however that it would not be desirable to float a compromise until Ministers have reached a clear view on the extent to which we are willing to renegotiate.

#### MAIN ISSUES

7. It is not disputed that the project is now totally uneconomic: no one favours accepting the contract on the basis of the original Memorandum of Understanding. The choice therefore lies between withdrawal and renegotiation.

#### The case for withdrawal

8. We understand that the Chief Secretary, Treasury will argue that, since there is now no realistic prospect of an economic rate of return (because the Irish Government will not bridge the price gap) the UK should withdraw. He will point out that Ministers have not previously agreed to overt subsidy for the project; that to offer subsidy on gas would be expensive in itself; and that it makes no sense to subsidise gas in Northern Ireland, when electricity is heavily subsidised. The subsidies necessary on electricity, because of a likely decline in demand once gas becomes available could indeed have to be increased.

The case for renegotiation

9. The case for renegotiation is primarily political. Abandonment of the project will undoubtedly have a bad effect on relations with Dr Fitzgerald's Government. On the other hand, as Mr Prior has pointed out, a joint project which was demonstrably uneconomic would attract political criticism and harm the cause of Anglo-Irish cooperation.

The basis of renegotiation

10. If it is agreed that renegotiation should be attempted, it should be borne in mind first that a reduction of 15 pence per therm in the price of gas would be necessary to restore the level of viability assumed in September 1983, and secondly that the Irish Government has so far shown no disposition to accept any reduction in price. The options are therefore:

- to seek a price reduction of 4 or 5 pence per therm and meet capital costs of around £140 million as Mr Prior envisaged in his minute of 22 June
- to seek a larger price reduction (say of 7 or 8 pence per therm) and make a smaller contribution to capital costs.

11. If however it is concluded that there is no basis for renegotiation which would be acceptable both to ourselves and to the Irish, withdrawal may be the more straightforward course. Ministers would then need to consider further how withdrawal might be handled in the way least likely to damage Anglo-Irish relations.

## HANDLING

12. You will wish to invite the Secretary of State for Northern Ireland to open the discussion. The Chief Secretary, Treasury will wish to argue the case for withdrawal and the Secretary of State for Foreign and Commonwealth Affairs the case for renegotiation. The Secretaries of State for Energy and Trade and Industry and the Chancellor of the Duchy of Lancaster will wish to contribute to the discussion.



CONCLUSIONS

13. You will wish the Sub-Committee to reach conclusions on the following:

- i. whether to seek an orderly withdrawal from the project; or
- ii. whether to seek renegotiation of the terms and conditions of the contract; and if so on what basis.

*PLG*

P L GREGSON

17 July 1984