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MR TURNBULL 17 July 1984

KINSALE GAS

What has gone wrong

We are placed in an extremely difficult position over this contract. When E(A) gave the go-ahead last September, wider social and political considerations tilted the balance in favour of what was a very marginal economic project.

Since then market assessments have dropped by a third; the purchase price has risen by 17% (based on revised higher fuel oil prices which are the predominant element in the price formula); and the exchange rate has moved adversely. The result is a hopelessly uneconomic project.

It is reasonable to ask why the underlying assumptions of a project with a 32 year life should have changed so fundamentally in the course of 9 months. The answers are unconvincing.

The original market surveys were carried out in 1981. The desk revisions which took place in 1983 significantly underestimated the extent to which gas was losing the central heating market. This fact only emerged in market surveys carried out since. Similarly, recent sharp rises in fuel oil prices caused by the miners' strike do not fully explain why the underlying trend in fuel oil prices forecast for the next 30 years should have changed so significantly.

The simple answer is that we underestimated the degree of risk. It is not surprising that the Irish Government are now surprised that we wish to renegotiate the contract.

The Irish did in fact come very well out of the earlier negotiations. The price formula represented an extremely good deal for the seller but a very exposed position for the purchaser. The formula was based on 90% of the prevailing heavy fuel oil price and 10% of the gas oil price subject to 3 monthly adjustments. This was in line with the Irish Government's policy of selling the gas at a price which would enable them to replace it eventually with oil. The result however, as far as the purchaser is concerned, is that any rises in the fuel oil price which would normally improve the competitive position of gas will be nullified.

What to do now

Nevertheless, this is all water under the bridge. We now have no alternative but to renegotiate the terms of the contract or to withdraw.

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There is no chance of renegotiating a price cut of up to 15p per therm needed to restore the original marginal real rate of return. The best we can hope for is to reduce the price by about the 5p needed to ensure that revenues match operating costs. This assumes that we subsidise the £122 million capital costs of the project, on the basis that we would otherwise be liable for expenditure of the order of £140 million to secure the orderly closure of the existing gas industry. This latter figure includes conversion of appliances, and appropriate redundancies.

In the circumstances, this is probably the best we can hope to achieve. However, it is by no means certain that the Irish Government will accept and unless we can achieve this minimum position, we should withdraw. Even on this basis this remains an extremely risky project.

There is also the further point that the Kinsale project will increase electricity subsidies in Northern Ireland as gas sales reduce electricity revenues. These subsidies are currently running at £89 million per year. At the time of the original decision, E(A) commissioned an NIES generating strategy study with the aim of reducing electricity subsidies. This study is still outstanding and should be brought forward as soon as possible.

Conclusion

This project demonstrates once again the pitfalls when governments attempt to forecast supply and demand in the energy industries. It is difficult to place any credibility on the figures being put to E(A).

Given the special circumstances of Northern Ireland and the history of this project, we recommend that the terms of the contract should be renegotiated in order to ensure financial viability after capital costs of £122 million have been written off. If the Irish Government do not accept this position, which is a long way from a viable project in its own right, we recommend that the project should be cancelled.

DLP.

DAVID PASCALL

DAVABD