



PM/84/128

PRIME MINISTER

Renegotiation of the deal to supply Kinsale Gas from the
Republic of Ireland to Northern Ireland

1. I understand that the proposed sale of gas from the Kinsale field, which was discussed in E(A) on 18 July, is to be considered again at a meeting of E(A) on 24 July. As I may not be able to attend, I thought it would be useful if I were to put my views in writing.
2. We are all agreed that the project cannot go ahead on the basis of the existing Memorandum of Understanding. It must be seen to be commercially viable if it is to be regarded as a genuine example of North/South cooperation. It will be bitterly condemned by unionist opinion if it appears to be motivated by political rather than economic calculations.
3. But as I pointed out in my minute to you of 28 June, simple cancellation of the project without any attempt to improve the terms, would lay us open to serious charges of bad faith and would represent a set-back to Anglo-Irish relations at a particularly delicate time.
4. I therefore believe that if we can come up with a new financial formula which has a prospect of being accepted by the Irish and which would render the project commercially viable, we should press the Irish to renegotiate the deal. In doing so, we should be prepared to take into account the

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cost of closing down the existing Northern Ireland gas industry and should, if necessary, be prepared to make a contribution to the capital costs of the project.

5. The Irish probably see it as being in their interests to stall for as long as they can. They may even be prepared to dig in their heels and force us to cancel, in which case they would certainly try to put the blame on us. But there are domestic political factors which may encourage them to agree to renegotiate:

- (a) they cannot afford to abandon such an important project without making every effort to save it. They would stand to lose possibly Irish £500 million in foreign exchange over a period of 20 years;
- (b) cancellation would play into the hands of Mr Haughey and would tend to undermine the basis of Dr FitzGerald's conciliatory approach to Anglo-Irish relations;
- (c) Mr Spring's standing would be further damaged by the overthrow of a major project for which his Ministry is responsible.

6. Provided that we can devise a reasonable financial formula, I think that we should make it clear to the Irish that if they are not prepared to renegotiate, we will be forced, most reluctantly, to revoke the Memorandum of Understanding. In these circumstances, I believe that there is a chance that the Irish may be prepared to make concessions.

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7. I am sending copies of this minute to our E(A) colleagues, to James Prior and to Sir Robert Armstrong.

A handwritten signature in dark ink, appearing to be 'G. Howe', written in a cursive style.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
23 July 1984

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IRELAND: Supply of Natural Gas
May 79

23 JUL 1979

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10 DOWNING STREET

Prime Minister

Foreign Secretary has minuted supporting an attempt at renegotiating a cut in the price to cover operating costs only.

The Cabinet Office brief, however, challenges the argument that the capital cost of the new project is matched by the cost of closing the existing industry. The saving on keeping open the existing industry is more than swallowed up by higher electricity subsidies.

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PRIME MINISTER

Kinsale Gas:

E(A) (84) 46

Flag A

At their meeting last week the Sub-Committee agreed that they needed more information before they could take a decision on whether to proceed with negotiations for the supply to Northern Ireland of natural gas from the Kinsale field (E(A)(84)19th Meeting, Item 4). The memorandum by the Secretary of State for Northern Ireland (E(A)(84)46) sets out the information requested by the Sub-Committee.

Flag B

Proposed pricing formula

The pricing formula is set out in Annex A to the memorandum. It links the price of gas in each quarter to the average prices of heavy fuel oil and gas oil in the preceding quarter. It is forecast that the price in 1985-86 would be 28.5 pence a therm.

Required reduction in price

To return the project to the level of viability projected in the Autumn of 1983 would require a reduction in price of about 15 pence a therm. To cover the operating costs only would require a reduction of about 5 pence a therm.

Currency

Although payment is in sterling, pricing is effectively in US \$.

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Risk-sharing

Mr Prior implies that it may be possible to negotiate arrangements to share the risks arising from changes in the relative prices of heavy fuel oil and crude oil, but rules out any prospect of being able to negotiate sharing of the risks arising from movements in the exchange rate between the pound and the US dollar.

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2. The brief I submitted for the last meeting of the Sub-Committee remains valid: for convenience I attach a copy. The present minute comments briefly on how the information in E(A)(84)46 affects the issues.

Basis for re-negotiation

3. The only basis for negotiation which would restore the project genuinely to the level of viability assumed last autumn would be a reduction of 15 pence a therm, ie a reduction of more than half in the price of 28.5 pence a therm assumed for 1985-86. It seems inconceivable that the Irish would agree to this. Embarking on a renegotiation on this basis might indeed cause more ill-will than withdrawal from the project.

4. Mr Prior's preferred proposal is to seek a reduction of 5 pence a therm. This would enable the project to cover its operating costs. It would not however restore the project to the viability assumed last September. He justifies this proposal on the grounds that we need not look for a return on the capital costs of the investment since we should avoid the cost of closing down the Northern Ireland town gas industry. But the benefit of the latter was included in the economic assessment last autumn and has to be offset by the extra costs of subsidising the Northern Ireland electricity industry. We cannot count that benefit twice. A price reduction of 5 pence a therm therefore requires in practice a United Kingdom Government subsidy to this project.

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5. We cannot be sure that the Irish would accept even this proposal. They would argue that they were being expected to accept what is, internationally, a low price for their gas. Our reply would be that we were making a major concession in subsidising the capital costs of the project; they should be prepared to make a sacrifice also.

6. If Ministers think that a 5 pence reduction is worth pursuing, they will need to consider whether it is essential also to secure satisfactory risk-sharing arrangements. Trying to do so would no doubt increase the difficulty of negotiating a reduction in price.

Issues to be decided

7. The options are as follows:

- i. Renegotiation:
 - a. on a basis that would restore viability to the project ie a reduction of 15 pence a therm;
 - b. on a basis which would involve a UK subsidy but which might just be acceptable to the Irish, ie a reduction of 5 pence a therm.
- ii. Withdrawal.

8. If it is decided to withdraw, how should this be done? Should we, for example, suggest that there should be studies of possible ways of collaborating on other energy projects?

PLG

P L GREGSON

23 July 1984