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EA(83) 4th Meeting

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CABINET

MINISTERIAL STEERING COMMITTEE ON ECONOMIC STRATEGY

SUB-COMMITTEE ON ECONOMIC AFFAIRS

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MINUTES of a Meeting held in Conference Room A, Cabinet Office on WEDNESDAY 14 SEPTEMBER 1983 at 4.00 pm

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PRESENT

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
(In the Chair)

The Rt Hon James Prior MP
Secretary of State for
Northern Ireland

The Rt Hon Peter Walker MP
Secretary of State for Energy

The Rt Hon John Biffen MP
Lord Privy Seal

The Rt Hon Norman Tebbit MP
Secretary of State for Employment

The Rt Hon Lord Cockfield
Chancellor of the Duchy of Lancaster

The Rt Hon Tom King MP
Secretary of State for Transport

The Rt Hon Peter Rees QC MP
Chief Secretary, Treasury

THE FOLLOWING WERE ALSO PRESENT

The Rt Hon Baroness Young
Minister of State, Foreign and
Commonwealth Office

The Hon Adam Butler MP
Minister of State
Northern Ireland Office

Lord Bellwin
Minister of State, Department of
the Environment (Minister for
Local Government)

Mr Wyn Roberts MP
Parliamentary Under-Secretary of
State, Welsh Office

Mr Alexander Fletcher MP
Parliamentary Under-Secretary
of State, Department of Trade and Industry

SECRETARIAT

Mr P L Gregson
Mr J F Stoker

SUBJECT

KINSALE GAS

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KINSALE GAS

The Sub-Committee discussed a memorandum by the Secretary of State for Northern Ireland (E(A)(83)9).

THE SECRETARY OF STATE FOR NORTHERN IRELAND said that in November 1982 he had recommended agreement with the Republic of Ireland (ROI) for the supply of natural gas to Northern Ireland from the Kinsale field. Colleagues accepted the strong financial, economic and political arguments for that proposal. Subsequent discussions revealed differences in understanding of the original terms, and changes since then had had a significant impact on the calculations. The ROI had put fresh price proposals which he believed met UK requirements in many respects. The overall case remained for the Kinsale project as the only realistic alternative to costly and contentious closure of town gas undertakings in Northern Ireland. It was a significantly more cost-effective way of meeting projected energy demand than closure combined with alternative sources of energy. It offered continuing employment in an industry now employing 1000 and would generate additional construction jobs. It would allow Northern Ireland to offer the same fuel range as competitors for new investment. Consumers would benefit from wider choice, additional competition and lower gas prices. Some of the terms, however, were less satisfactory than the 1982 terms. Risks associated with a single source of supply and the security implications remained but he was convinced that the balance of advantage lay firmly with concluding the deal. The new Irish formula would produce a price of 27 pence per therm if applied in April 1983, compared with 24 pence under the original proposals. This compared very well with current international prices; the future price would depend on oil prices and the sterling/dollar exchange rate. Evaluation over 32 years indicated a likely internal rate of return of 5.2 per cent, and possibly 5.4 per cent given some further marginal concessions by ROI. These rates were lower than the 6.9 per cent predicted in 1982 not only because of the new terms but also because of substantially revised economic assumptions. 1983 assumptions applied to the original terms would produce a rate of 5.9 per cent. Assessment was based on marketing consultants' projections of likely growth in sales of natural gas and on consultants' estimates of capital costs. The rate of return was particularly sensitive to changes in sales volume. Investment appraisal showed that importing natural gas continued to be substantially more cost effective than closing the gas undertakings and





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increasing supplies of other sources of energy. The present analysis indica a cumulative saving over the evaluation period of £316 million compared with alternative energy sources. The new terms proposed by ROI did not include risk sharing of sterling/dollar currency movements, as had the original term to the extent that the pound depreciated against the dollar there would now a faster escalation of gas prices. Currency risk sharing was not a common feature of international contracts, however, and ROI would not move on this point. The UK would stand to gain the full benefit of any appreciation by sterling. Reassessment of the Public Sector Borrowing Requirement (PSBR) effect showed an increase of £244 million in place of the savings indicated the 1982 evaluation. This change stemmed essentially from revised assessmen of the impact of gas competition on the Northern Ireland Electricity Service (NIES), showing an adverse effect on potential surpluses which NIES was projected to earn (mostly in the next century). In addition, the cumulative surplus for gas was now expected to be lower than in the 1982 calculation. Viewed on its own, the Kinsale project would lead to a reduction in PSBR compared to the costs of closing the Northern Ireland gas industry. Projecte surpluses for NIES were based on the Department of Energy's Common Economic Assumption for England and Wales that electricity tariffs would increase by a average of almost 2 per cent per year. This was not assumed in the NIES Corporate Plan, however, and the 1982 appraisal assumed that NIES tariffs wou remain constant in real terms. In addition, input prices of coal and oil wer now projected to rise more slowly than foreseen in 1982. If surpluses of the order now predicted were achieved by the NIES, it would remain to be decided whether some of the benefits should not be passed to consumers by tariff increases below those in England and Wales, provided that an acceptable rate return was achieved by NIES. This would reduce the apparent impact on the PSBR. It remained his intention that the public expenditure implications of project would be contained within the totality of the existing allocation to the Northern Ireland programme. A new natural gas industry in Northern Irela must be firmly based on a major marketing effort, efficient management and technical competence. Radical changes in the present industry would be necessary. It had been a prime objective to involve the private sector as fa as possible. Private sector interests in the project had been pursued and maintained. The real extent of private sector commitment, however, could be tested only after a firm agreement on price. If, in the event, the project was entirely or mainly handled through a public sector organisation, his planning

assumption was that short and medium term financial performance objectives, incorporating annual deficit targets for initial years and leading to eventual profitability, would be set for the industry. The extent of any initial subsidy would depend on the clarification of the private sector contribution. He intended that the industry should not be subsidised once profitability had been achieved. The project stood a reasonable chance of attracting non-quota assistance from the European Regional Development Fund and would certainly be eligible for quota-section grants towards major items of capital expenditure. Failure to accept the ROI proposals would lead to pressure to maintain a gas industry in Northern Ireland by other means. The alternatives would entail capital expenditure significantly higher than for Kinsale. A coal gasification/ smokeless fuel plant for Belfast only would be uneconomic for the foreseeable future. Closure of the existing town gas industry, as well as provoking considerable consumer opposition, would also mean that no means would be available to distribute economically viable supplies which became available in the future. The capital cost of the project would be only £27 million more than closure. The collapse of negotiations with ROI would have important political repercussions. Those in Northern Ireland who would welcome cross-border co-operation would be disappointed as would opinion, for example, in the US. The ROI would regard failure as a serious blow to economic co-operation. Failure to agree would expose Dr Fitzgerald to regrettable criticism from Mr Haughey's party. In conclusion, he believed that uncertainty for the gas industry must end. The risks of the project were acceptable when weighed against the social, economic and political advantages. He sought colleagues' agreement to concluding an agreement with ROI on the basis of the latest proposals, subject to any marginal enhancement.

In discussion, it was argued that the financial terms negotiated with the ROI had deteriorated since 1982 to such an extent that the project should not be approved. In 1982, the projected effect on the PSBR over 32 years had been a reduction of £287 million: now the agreed projection was of an increase of £244 million. The projected internal rate of return was 5.2 per cent, compared with 6.9 per cent projected in 1982, and depended on assumptions that gas would continue to be supplied on similar terms beyond the 20-year life of the contract with the ROI which was proposed. On the other hand, it was suggested that most of this deterioration, particularly in relation to PSBR effects, could be ascribed, not to changes in the terms negotiated with the ROI, but to changes



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in the economic assumptions provided by the Department of Energy on which th analysis had been based. In particular, assumptions now included an average increase of almost 2 per cent a year in electricity tariffs, whereas the analysis in 1982 had assumed that NIES tariffs would remain constant in real terms. Even on this assumption, however, the bulk of the PSBR increases fro the project were forecast to take place in the third decade of its operation in the shorter term, effects on the PSBR would be beneficial. In terms of capital costs, the cost of proceeding with Kinsale gas were only £27 million greater than the costs of closure of the town gas industry in Northern Irela the true rate of return would therefore be greater than calculations based o the full capital cost would suggest. The investment appraisal suggested tha in spite of PSBR effects, Kinsale gas was, in resource cost terms, a cheaper means of meeting the energy requirements of Northern Ireland than the alternatives. The price at which the gas was being offered was comparable wi current prices for gas being traded internationally elsewhere.

The following main points were also made in discussion.

a. The proposals which had been put forward in 1982 had envisaged that the natural gas industry in Northern Ireland should eventually be a candidate for privatisation. In this respect, the likelihood on current assumptions that the project would make no annual profit before its eleventh year and no cumulative profit before its twenty-third (by which time the terms of the contract might have been renegotiated) was not encouraging. On the other hand, the interest of a major private firm in the retailing of the gas had been maintained and could provide a welcome commercial input into that part of the industry.

b. The key to the basic problems affecting energy supply in Northern Ireland could be argued to lie in the subsidies currently paid there to limit the cost of electricity to consumers. Limitation of these subsidies would both have a directly beneficial effect on public expenditure and create market conditions in which Kinsale gas could be sold at tariffs which would be profitable while remaining competitive with electricity prices. On the other hand, it was poin out that energy costs in Northern Ireland were already significantly

higher than in Great Britain: subsidies paid at present were explicitly intended to prevent tariffs in Northern Ireland from rising above the highest elsewhere in the United Kingdom. Moreover, the Prime Minister had given a clear commitment to this policy in March 1981 and made it clear that the undertaking on electricity prices in Northern Ireland was a major decision of principle, and was unaffected by the prospect of natural gas supplies from Kinsale.

c. Financial and economic considerations apart, there were compelling social and political arguments for proceeding with the project. There was pressure from consumers for a gas supply as a generally more economical alternative to electricity: if the gas industry in Northern Ireland closed, it would be one of the few areas in western Europe where no supply was available. The project would be welcomed by those in Northern Ireland, in the Republic and in the United States who were in favour of cross-border co-operation. Failure to go ahead with it would be unhelpful to relations between the United Kingdom and the ROI at a time when those relations were recovering from a period during which they had reached a low ebb and when an Anglo-Irish summit meeting was in prospect.

THE CHANCELLOR OF THE EXCHEQUER, summing up the discussion, said that the Sub-Committee accepted that the economic and financial viability of the Kinsale gas purchase could not be clearly established. Despite the deterioration in the terms renegotiated with the ROI since 1982, however, and despite the fact that the economic basis of the energy supply industry as a whole in Northern Ireland was in some significant respects less than satisfactory, the Sub-Committee accepted that the project should go ahead on the terms proposed, subject to any further marginal improvements which might prove negotiable with the Republic. The terms of the agreement should remain confidential for as long as seemed desirable from the point of view of other current negotiations for international purchases of energy. The Secretary of State for Northern Ireland should consult the Secretary of State for Energy on this point. The Sub-Committee accepted that the terms of the Government's commitment on electricity prices in Northern Ireland precluded the removal of the subsidies, but agreed that, within the terms of the commitment, it would be desirable to explore the scope for reducing the cost of the subsidies. They had noted



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that an efficiency audit had been carried out of the Northern Ireland Electricity Service and that scope existed for reviewing strategy for electricity generation in Northern Ireland with a view to greater reliance i the long term on more economical sources of fuel than at present. The Secretary of State for Northern Ireland should seek to establish, in consultation with the Chief Secretary and the Secretary of State for Energy, what economies were capable of achievement by these means; and how they coul be applied to reduce the cost of electricity subsidies in Northern Ireland a part of arrangements to ensure the best and most efficient arrangements possible for the supply of energy generally in the Province. He would repor the Sub-Committee's conclusions to the Prime Minister.

The Sub-Committee -

1. Took note, with approval, of the Chancellor of the Exchequer's summing up of their discussion; and invited the Secretary of State Northern Ireland, the Chief Secretary and the Secretary of State fo Energy to be guided accordingly.

2. Approved the proposals in E(A)(83)9 subject to the points made in the summing up of the discussion.

3. Took note that the Chancellor of the Exchequer would report their conclusions to the Prime Minister.

Cabinet Office
15 September 1983