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CONFIDENTIAL

Please follow up. Ck Mr Titchener OT4

Translation [illegible]

Reference:

1. Mr Twyford
2. PS/MfT
3. PS/SoS(T&I)

I hope you feel this adequately reflects the outcome of the last mtg you attended.

2 C.

cc PS/SoS(T&I)
Sir Robert Armstrong
Mr J Gill ECGD
Mr R T Kemp
Mr J Pinnell ECGD
Mr K Simpson ECGD
Mr M M Baker DTI
Mr J Bowder DTI (Air)
Mr W A Pedder DTI

£5BN DEFENCE DEAL WITH SAUDI ARABIA

Mr [illegible] 18/3

PROBLEM

1 ECGD has been asked to provide a somewhat novel facility to help finance the series of contracts involved in the Saudi deal. The facility is novel to the extent that it involves guaranteeing repayment by the Saudi Government of a bank overdraft to bridge the expected mis-match in timing between oil receipts and payments due to the UK contracting parties. The sums involved are large and the proposed Departmental liability has to be carefully considered againt the background of falling oil prices and the effect these will have on the Saudi economy. The case is one of the largest that ECGD has been called upon to consider.

RECOMMENDATION

2 Although in country risk terms the case for taking such a large liability on Saudi Arabia is not strong, nevertheless if the Secretary of State is prepared to recommend support to colleagues on national interest grounds then ECGD would not object to offering cover within a ceiling up to an overdraft limit of the dollar equivalent of £1 billion plus interest. For statutory returns a Departmental maximum of £1.8bn ($ equivalent) will be used but such an actual liability would only arise in extreme circumstances and then spread over a time. A draft letter for the Secretary of State to the Chancellor and other members of OD seeking their agreement is attached.

TIMING

3 As soon as possible as the overdraft needs to be in place very shortly to cater for deliveries due to start in March/ April.

BACKGROUND

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4 This deal involves the supply to Saudi Arabia of 132 military aircraft (of which 72 are Tornados) and related goods and services. It has been won against strong competition from the French. When the business was first being discussed, MoD assumed that payments

would be cash without the need for ECGD support and the earlier announcements of the deal implied that no governmental financing facility would be required. However, as negotiations progressed it became clear that the Saudis wanted to rely directly on income from oil on a barter basis. At first this was for a small amount of the cost but as time went on and the full scope of the deal became apparent the barter portion increased until towards the end of 1985 it became a Saudi requirement that, apart from some initial cash payments, all payments should derive from the proceeds of long-term oil lifting arrangements. Subsequently Shell and BP entered into 3 year contracts to lift 300,000 barrels per day on a net-back pricing basis and there are provisions for extending the period as necessary.

5 However, the proposed down payments and the oil deal do not solve all the funding problems. There will be some high valued deliveries of aircraft to the Saudis in 1986 when the funds from the oil sales will be far from adequate to meet all payments due. Similarly, in the present state of the world oil market, it is difficult to judge how much money the oil-lifting contracts will produce and at what particular points in time. To eliminate the discrepancies between the payments needed to be made and the oil revenue actually received at the times those payments are required, it is proposed that there shall be an overdraft facility in the name of the Saudis and with a UK clearing bank from which funds will be disbursed to meet these discrepancies and into which monies will be repaid as oil income is received. The bank making an overdraft facility of the size envisaged would require an ECGD guarantee to enable them to do so and thus, contrary to earlier expectations, ECGD has been asked for a substantial level of support in rather unusual circumstances to enable the deal to go through.

6 The arrangement proposed is that there shall be an account in a UK bank into which oil proceeds will flow and from which monies will be disbursed to pay for work done and goods delivered. This account will be allowed to go into debit (overdraft) up to pre-arranged half-yearly limits, substantial in the first 2/3 years but decreasing thereafter as oil receipts flow in greater amounts then payments out of the account. The overdraft will bear interest in the normal way and interest due will be a first charge on the oil revenues. If at any time oil revenues are inadequate to clear the overdraft as planned or pay the interest and if the oil lift arrangements cannot be increased accordingly, the Saudis will have an obligation to pay cash although in such circumstances this ability to meet this obligation will correspondingly be put under strain. ECGD's guarantee will come into effect if the oil arrangements fall through and if in that event interest is not paid or the overdraft reductions are not made in due time by the Saudi Government. The agreement setting up the overdraft facility will expressly provide for the payment of interest but there is nevertheless the risk that the Saudis may later argue that they are prevented from or choose not to pay the element that reflects interest as it is contrary to the Islamic Sharia law to which the Saudis are committed.

7 There has been much discussion amongst officials in the Export Guarantees Committee and with BAe as to what level of overdraft would be appropriate. On the one hand there are agreements between MoD and the Saudis setting out the delivery pattern and there are the needs of British Aerospace to obtain payment for goods delivered and work done: on the other hand there is the need for ECGD to act prudentially and not to allocate all or most available cover for Saudi Arabia to this one deal so precluding other business. Also it is ECGD's view that HMG should not bear all the risks of the collapse of the oil-lifting arrangements and of falling oil prices and that the commercial parties should accept some responsibility for this to ensure discipline on their part.

8 For the reasons described below and in order to go some way to help the satisfactory conclusion of this business, ECGD considers that cover for an overdraft limit of £1 billion ($ equivalent) plus interest would be the maximum it can take in the light of its assessment of the market and the need to keep cover available for other business. Such a limit will not be entirely adequate to cater for the supply and payment arrangements in all circumstances but in so far as there will be a shortfall MoD and BAe are investigating the possibility of arranging a further top-up overdraft unguaranteed by ECGD. On present estimates this could be up to £600 million.

9 One further aspect should be noted. Monies from the account will be disbursed against work done and goods delivered. However some of the aircraft will be diverted from those on order for the RAF for which payment has already been made by MoD. We understand that the funds so drawn will be used by BAe to replace the RAF aircraft at a later date. It could therefore be argued that BAe will be overfunded in relation to their strict cash flow requirements but in ECGD's view this does not concern ECGD and is a contractual matter between MoD and BAe.

ARGUMENT

EMPLOYMENT

10 This project provides some 6 million man hours of additional work within British Aerospace plc generating 1,500 jobs in the Warton Division and 750 jobs in other BAe factories by 1988. The overall benefit to UK aerospace industry is measured at between 8,000 and 9,000 jobs at the peak.

11 A major benefit from the order for Tornado aircraft for Saudi Arabia is the extension of the production programme at BAe Warton by some 2½ years, helping to bridge a serious gap in workload before the start up of EFA production.

COUNTRY ASSESSMENT

12 A major problem for ECGD support for this transaction has been the assessment of Saudi Arabia's current economic and financial position and its prospects which are set out more fully in the Annex. As a result of the falling demand for and declining price of oil, Saudi Arabia has run massive balance of payments deficits

in the last 3 years totalling an estimated $64bn: in 1985 the estimated deficit was US$24bn, despite a 30% cut in imports. These deficits have been financed largely by drawings on the Kingdom's liquid foreign assets of some $40bn and the accumulation of arrears. Since late-1985 Saudi Arabia has increased oil production substantially, though this has largely been offset by the halving of the oil price in early 1986 leaving revenues little increased.

13 It is far from clear where this process will lead and the possibility of a further sharp fall in oil prices cannot be ruled out. While Saudi Arabia is the best equipped oil exporter to cope with falling prices, because of its capacity to increase the volume of oil exports, it will have to continue a painful adjustment process if it is to move towards equilibrium in balance of payments. Failure to do so would result in its liquid foreign assets falling to zero by 1988. The adjustment process has already substantially reduced the level of economic activity and given rise to payment problems both by the Government and the public sector and the required adjustment will be correspondingly greater to cover new military contracts (like Tornado) which are expected to amount to well over $15bn.ECGD has not escaped the impact of this: as a result of payment defaults it has recently regraded Saudi Arabia from A (best risk) to B for premium charging purposes (on the other hand cover for this Defence deal at the level proposed would improve the Department's Section 2 portfolio from its current ratio of 36.6% A/B : 63.4% C/D to 42.16% A/B : 57.84% C/D).

14 Nevertheless, Saudi Arabia will continue to have a substantial income from oil, the defence package is clearly regarded by the Saudis as an important element in the Kingdom's defences, and it is reasonable therefore to expect that priority will be given to payment for it. In addition the FCO have advised that the Saudi Royal Family is heavily committed to the deal and that the risk of its being cancelled or substantially reduced by the present regime is very low. It is generally expected that the Kingdom's political structure will survive intact the difficult period which lies ahead, although the Royal Family in general will have to act with great sensitivity, and the King in particular has to ensure that consensus within the family is not jeopardised.

15 The sale is a very important one for the UK and officials are prepared to recommend that support be provided by ECGD for an overdraft facility up to a ceiling of £1,000m, which is essential if the tranaction is to proceed. Such and amount will still leave the commercial parties with a substantial risk for their own account and should also, subject to a further review which is now in hand, leave us with the capacity to take on other business in Saudi Arabia. It is not intended to seek support from Tornado partners for this UK commitment.

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