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SAUDI ARABIA: DEFENCE DEAL (TORNADOS)
(now called the YAMAMAH PROJECT)

1 I last wrote to you and other recipients on the above topic on 18 March 1986 following which SOS(T&I) wrote to the Chancellor (copy PM and other members of OD) on 25 March. The Ministerial responses to this letter I am sure you have on file but, in summary, the Chief Secretary in his letter to SOS of 14 April, agreed that some cover might be given in order to alleviate the cash flow problems that emerged following the drop in oil prices since the original deal was negotiated between the respective Ministries of Defence. In essence the proposal involved ECGD guaranteeing a £1m overdraft facility to be provided by Lloyds to BAe which would be repaid from the proceeds of the sale of Saudi oil. UK banks would have also provided a further £500m without support on a risk sharing basis.

2 Subsequently SOS Defence wrote to the Chief Secretary on 20 April saying that the Saudis in effect refused to be sovereign borrowers under the proposed financing arrangements but proposing that, if the Saudis entered into firm obligations in the following respects, the cover should still be made:

2.1 commitment to generate sufficient oil revenue to meet all the project costs (including repayment of the finance facility and its associated costs);

2.2 commitment to pay cash if the oil lift arrangements fell through;

2.3 agreement to pay interest and other bank charges (including ECGD premium).

R E Adams Esq
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3 Following the above exchange Ramadan closed in and little progress was made with the Saudis. However, the next development as far as we in ECGD were concerned was an approach by Banque Indosuez (BI) who apparently had been requested by the Saudis to try to construct a financing facility which would be in competition with that proposed by Lloyds Bank (appointed previously by BAe to lead on the facility) and which would overcome the difficulties with the Lloyds proposals as perceived by the Saudis. BI is a French bank, established in Paris and very active in the Gulf States. It has a branch in London and is an authorised bank as far as we are concerned. It was apparently involved in financing along the lines described below the acquisition by Saudia of Boeing 747's.

4 The proposition from BI is somewhat complex in detail and had to be clarified with their representatives at a series of meetings. In essence however what they suggested was as follows:-

4.1 BI will head a syndicate of banks to provide a "facility" of $1.5 billion (note: not up to £1.5 billion as was previously suggested might be necessary) to enable sums to be paid to BAe in accordance with the contractual arrangements between BAe and MODUK and MODA (the Saudi government buyer). Drawings from the facility will be made by BAe on authorisation of MODUK.

4.2 This $1.5 billion facility would be in 2 parts: (in fact 2 separate syndicates) one for $1.1bn guaranteed by ECGD and the other for $0.4bn not guaranteed. All payments out of and into this facility would be on a pari passu basis between the 2 parts.

4.3 The principal of the facility would be repaid on a regular (eg monthly) basis as would be the interest and these payments would derive solely from receipts from the oil supply contracts. This would be achieved by dedicating a certain percentage (say 30% but precise figure yet to be agreed) of the monthly oil revenues to repay and service the facility.

4.4 BAe will receive the difference between this dedicated percentage and the total oil receipts to the extent that they are contractually entitled to payment. Any excess to BAe's entitlement would be held in suspense and added to the following month's oil receipts.

4.5 As the actual amount of money that is produced by the dedicated percentage is not known, there will be a somewhat complex arrangement whereby a minimum amount will be defined (being a small amount of principal plus all interest) and if the dedicated percentage does not reach this amount in any month, the balance will be made up by priority drawings on the oil revenues the following month.

4.6 ECGD has been asked to provide cover to BI against a default by the Saudi Government on its commitment under the terms of the exchange of letters dated 30 July 1986 between the Ministry of Defence (UK) and the Saudi Government to deliver oil to pay for the project. (Incidentally we also expect that some war risk cover against inability to load the oil onto the tankers may be sought and BAe have also hinted that they may be seeking further limited cover in respect of payment outside the BI facility).

5 The above is only a summary of the main features of the BI proposal: there are other aspects of a mechanical nature which if necessary are best explained orally. However the essential differences between this proposal and the previous one are:-

i that BI acknowledge that all payments will be made through sales of oil (for which purpose there would have to be such an obligation on the part of the Saudis);

ii that the facility will be repaid on a regular basis from a priority allocation from the oil revenues;

and

iii that a single loan to be drawn down immediately is being offered rather than a revolving overdraft facility.

6 Whilst we were studying the implications of the BI proposal, MoD officials heard that there was an opportunity to have a further exchange of letters between MODUK and MODA in order to resolve the problems about the interim financing arrangements. Some useful improvements were achieved as can be seen from the copy of Mr Chandler's letter of 30 July, countersigned by Prince Sultan, which is attached. Nevertheless the Saudis still refused to act as borrowers or to state explicitly that they have a cash payment obligation.

7 We have consulted our Solicitor and in his view this letters does not contain legally enforceable obligations on the part of the Saudis to continue to make oil available to meet all the costs of the Project (including the financing facility) or to pay cash in the event of the oil lift arrangements falling through. Thus as the earlier contractual documents are also imprecise the legal framework is imperfect and it is very doubtful if the Saudi commitment would be enforceable in the courts. Whilst this would weaken our bargaining position if a dispute arose at some future time, in our view it is highly unlikely that HMG would ever in practice wish to take recourse to the courts for an

R E Adams Esq
HM Treasury

agreement of this nature with the Saudi ruling family. Thus if Ministers wish ECGD to provide support for this loan they would have to accept that its terms could be enforceable only through diplomatic channels where the spirit of the agreement rather than its strict legal interpretation would prevail.

8 The MoD are convinced that this letter goes as far as the Saudis are prepared to go in giving the necessary commitments to service and repay the financing facility. We are prepared to accept that this is the most that can be squeezed out of the Saudis at this late stage and we believe that we have the ability to guarantee failure of the Saudi government to deliver oil in payment of the loan and the related costs in accordance with their implicit obligations to do so contained in this latest letter.

How do you know if/when they've defaulted?

9 Proposed ECGD support

Although this is a most unusual (and flawed) proposition we do not consider the risks unacceptable. We feel that ECGD could subscribe to a form of cover which would meet the lenders' requirements under paragraph 4.6 above and at the same time avoid all the pitfalls of a barter arrangement. It is proposed that any ECGD cover would have to be strictly limited in time (say 5 years). ECGD would only be liable for the stated cause of loss due to the failure to deliver oil as agreed. However ECGD would have no liability if the receipts from oil sales during the 5 year period proved insufficient to fully repay the loan to the banks by that time. Thus the Lenders and BAe will be assuming all the risks of fluctution in oil prices, exchange rates and interest rates. It is also proposed that ECGD's liability would be based on a maximum of an assumed profile of debt plus interest irrespective as to whether the oil arrangements would have yielded sufficient income to clear the debts by the time that ECGD's liability under its guarantee ran out. It is intended that any liability would be for the lessor of (a) amounts actually outstanding under the loan or (b) the amount specified in the assumed profile of debt for the relevant period. ECGD will also have no liability for any default by Shell/BP under the oil net-back arrangements or for the collapse of such arrangements.

10 As we see it ECGD premium will serve as a regulating mechanism for the amount and length of cover required. The larger the amount and the longer the period of cover the more costly it will be to the commercial parties. We expect, therefore, that the commercial parties would take into account certain assumptions of oil prices and exchange rates and the costs of ECGD cover before determining the length of cover required and the assumed profile of debt.

First loss on ECGD

11 Overall we believe that the carefully structured cover indicated

R E Adams Esq
HM Treasury

above would not leave us with unacceptable risks and if other Departments agree we would wish to discuss them with the commercial banks to see if they provide a basis for resolving the current problems relating to the implementation of this important contract. It should be noted that compared with the proposal earlier agreed with Ministers our potential exposure has been reduced and there has been no increase in the horizon of risk. It is also hoped that the risk-sharing basis with the commercial banks will be maintained. We do not consider that the limited cover proposed would conflict with our traditional policy of refusing cover for barter transactions as the commercial risks of a drop in oil prices will remain to be carried by BAe and the banks. We would propose to seek Ministerial approval for cover on these lines if the negotiations with the banks show that this basis is acceptable to them.

12 Early comments would be appreciated.

Yours sincerely

P HENLEY

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