

ECGD

COVERING CONFIDENTIAL

Export Credits Guarantee Department
PO Box No 272
Aldermanbury House
Aldermanbury
London EC2P 2EL

Telephone 01 382 7000
Direct 01 382 7815
GTN 2890
Telex 883601

Your reference
Our reference
Date 10th March 1986

R E Adams Esq
HM Treasury
Treasury Chambers
Parliament Street
LONDON SW1

DEFENCE DEAL WITH SAUDI ARABIA

At the last EGC meeting on this subject it was agreed that we should draw up a draft submission to SoS(T&I) incorporating a fresh market assessment and recommending that SoS should write to Cabinet Colleagues seeking agreement to the proposal that ECGD should limit its cover to an overdraft facility up to the equivalent in dollars of flbn.

I now attach such a draft and all its Appendices. They are, I think, self-explanatory except possibly in respect of the figures quoted in paragraph 2 of the submission. A Departmental Maximum Liability of fl.8bn may seem large in relation to a guaranteed overdraft of flbn repayable over a short period of time but in fact it is calculated on the basis of worst possible case and is very unlikely to occur in practice. Interest rates would have to rise substantially from the current levels of around 9%(\$) to about 15% for the whole period; the Saudis would have to default when the overdraft was at its maximum and to continue to default; the oil revenues would have to fall away entirely and the supply contracts would have to be substantially completed without any prospect of cancellation or rephasing. Although in fact our total liability is not likely to reach such an amount, nevertheless this is the figure we propose to put under the statutory limit and to form the basis of our premium charge.

I should be grateful if Departments would let me have their agreement to the terms of this submission and their confirmation that they would not oppose their own Ministerial agreement.

P HENLEY

COVERING CONFIDENTIAL

Copies to:-

- | | |
|-------------------|-------------------------|
| T J H Downing Esq | BoE |
| M M Baker Esq | DTI |
| J Bowder Esq | DTI (Air) |
| P Sullivan Esq | FCO |
| R A Ludford Esq | ODA |
| L J Davidson Esq | MoD (DS13) |
| A D Harris Esq | MoD (DESO Stuart House) |
| D Jones Esq | MoD (Sentinel House) |
| W A Pedder Esq | DTI |
| J Hibberd Esq | CO |
| W Ricketts Esq | Dept of Energy |
| P Kitcatt Esq | HM Tsy |
| Ms D Seamman | HM Tsy |
| S Robson Esq | HM Tsy |
| P Mountfield Esq | HM Tsy |
| Mrs A Case | HM Tsy |
| J Gill Esq | ECGD |
| R T Kemp Esq | ECGD |
| D H Twyford Esq | ECGD |

CONFIDENTIAL

Draft submission to SoS(T&I)

£5bn Defence Deal with Saudi Arabia

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 against 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

CONFIDENTIAL

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 time. A draft letter for the Secretary of State seeking colleagues' 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

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 international competition particularly 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

CONFIDENTIAL

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 for this purpose 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 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

CONFIDENTIAL

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 rapidly decreasing thereafter as oil receipts flow in greater amounts than 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. 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.

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 Saudis Arabia to this one deal so precluding other business. Also

CONFIDENTIAL

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 purpose and 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.

Argument

Employment

9 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

CONFIDENTIAL

aerospace industry is measured at between 8,000 and 9,000 jobs at the peak.

10 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

11 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 price of oil, Saudi Arabia has run massive balance of payments deficits in the last 3 years: in 1985 the estimated deficit was US\$24bn, despite a 30% cut in ^{imports} exports. These deficits have been financed by drawings on the Kingdom's liquid foreign assets. Since late-1985 Saudi Arabia has increased production substantially, and this has largely been responsible for the halving of the oil price in 1986.

12 It is far from clear where this process will lead, but the possibility of a further sharp fall is not ruled out. While Saudi Arabia is the best equipped oil exporter to cope with falling prices, because of

CONFIDENTIAL

its capacity to increase the volume of 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. 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.

13 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.

14 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. 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 transaction is to proceed.

Draft Ministerial Letter to Cabinet Colleagues

£5 bn. Defence Deal with Saudi Arabia

I am sure you are well aware of the considerable coup that the winning of the Saudi deal has meant for this country particularly against strong foreign competition mainly from the French. The orders for 132 military aircraft (of which 72 are tornados) and related goods and services will involve some 6 million man hours of additional work within British Aerospace, will save between 8,000 and 9,000 jobs at the peak to UK aerospace industry and will extend the production programme at BAe Warton by some 2½ years, thus helping to bridge a serious gap in workload before the start up of EFA production.

MoD led the negotiations with the Saudis and until fairly late in the day had been under the impression that all payments would be cash and that no financing would be involved. However, towards the end, the Saudis made it clear that they expected all payments to be made from oil lift arrangements and for this purpose Shell and BP entered into contracts with the Saudis to lift 300,000 barrels per day on a net-back pricing basis. Unfortunately these oil lift arrangements, because of uncertainties over price and thus the yield and also because large payments are due to BAe in the earlier stages of the deal when revenues will be relatively small, will not be adequate to meet all payments and to overcome this problem it has been proposed that an overdraft facility with a UK bank be set up to bridge the expected mis-match in timing between oil receipts and payments due.

The size of the necessary overdraft is difficult to judge in advance because the actual oil revenues under the net-back arrangement are impossible to forecast but in the light of informed guesses of future movements in oil prices and exchange rates it has been estimated that an overdraft of between £1bn and £1.6bn may be required in the early years.

To enable the UK bank to arrange such an overdraft facility an ECGd guarantee will be required to cover at least the bulk of the risk of Saudi default. 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. As a result of the falling demand for and price of oil, Saudi Arabia has run massive balance of payments deficits in the last 3 years: in 1985 the estimated deficit was US\$24bn, despite a 30% cut in exports. These deficits have been financed by drawings on the Kingdom's liquid foreign assets. Since late-1985 Saudi Arabia has increased production substantially, and this has largely been responsible for the halving of the oil price in 1986.

It is far from clear where this process will lead, but the possibility of a further sharp fall is not 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 exports, under any circumstances 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. However, 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. 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.

Because of the present uncertainties, this is not, in many senses, an ideal time to be considering such a massive liability for ECGD but the deal is important to the UK, the need for an ECGD guaranteed facility to help its successful conclusion has been demonstrated and, come what may, it is thought that Saudi Arabia will see its way through the current difficulties in the world oil markets and remain relatively strong. In addition I believe that the Saudi Royal Family is heavily committed to the deal and will not allow it to fail. In all the circumstances I am therefore prepared to authorise ECGD to give cover within a ceiling up to an overdraft of the dollar equivalent of £1 billion plus interest. To the extent that this proves inadequate by reason of low oil receipts, then any excess will have to be provided from unguaranteed sources.

I would appreciate your agreement to what I propose.

The Committee for the Study of the Economy and Finance of the Province has been a major factor in the development of the Province's economic policy. It has provided for the Province a wide and coordinated view to be reached. The Cabinet Committee on Economic Management Group produced a paper for the Joint Intelligence Committee in 1967, "Economic Policy: The Balance of Payments 1967-1970", the main recommendations of which are summarized below.

In the early 1960's, Canada's balance of payments showed a major surplus. This was the result of the high level of demand for and price of our exports. In 1967, all major countries showed a surplus and the balance of payments surplus was estimated to be \$1.5 billion. The surplus was due to the high level of demand for our exports and the high price of our exports. The surplus was also due to the high level of demand for our exports and the high price of our exports. The surplus was also due to the high level of demand for our exports and the high price of our exports.

The surplus was due to the high level of demand for our exports and the high price of our exports. The surplus was also due to the high level of demand for our exports and the high price of our exports. The surplus was also due to the high level of demand for our exports and the high price of our exports. The surplus was also due to the high level of demand for our exports and the high price of our exports.

ANNEX

SAUDI ARABIA: MARKET APPRAISAL

The prospects for the Saudi economy and balance of payments have been a major issue in official's consideration of whether ECGD support should be provided for the Tornado deal. To enable a co-ordinated view to be reached, the Cabinet Office's Economic Assessments Group produced a paper for the Joint Intelligence Committee (JIC): "Saudi Arabia: the Balance of Payments Outlook to 1990", the main conclusions of which are summarised below.

BACKGROUND

2 In the early 1980's Saudi Arabia achieved massive balance of payments surpluses as a result of the high level of demand for and price of its oil. In 1981 oil export revenues reached US\$111bn and the balance of payments surplus was US\$44bn. Thereafter oil revenues fell sharply reflecting Saudi Arabia's adherence to its role as the OPEC "swing producer", bearing the brunt of the falling demand for OPEC oil, to an estimated US\$27bn in 1985. Although imports have also been reduced sharply (by an estimated 30% between 1984 and 1985) there have been balance of payments deficits totalling an estimated US\$64 billion in 1983-85 (1985 deficit US\$24bn). These deficits were financed by drawings on Saudi Arabia's liquid foreign assets which are now estimated to have fallen to an estimated US\$50 bn - less than half their level of a few years ago.

3 Faced with these problems, in late 1985 Saudi Arabia abandoned its role of swing producer, by increasing production, and its commitment to official OPEC prices by concluding sales of oil on a netback basis, by which the selling price of crude is related to the value of the refined products. This was followed by an attempt by OPEC to regain its share of the world oil market. In the first 2 months of 1986 oil prices have fallen sharply; Brent blend which was trading on the spot market at around US\$27 per barrel in November 1985 had fallen to US\$15.50 on 5 March.

CONFIDENTIAL

SAUDI PROSPECTS

4 The JIC paper considers Saudi Arabia's prospects against 3 scenarios: a recovery to an average price of US\$20pb in 1986, in line with the latest World Economic Prospects (WEP); a price of US\$5 pb lower than that assumed in WEP; and a precipitous fall to below US\$10 pb.

5 The WEP assumptions depend very much on OPEC members restraining production in 1986 with a gradual increase in output and price thereafter. On this basis, even if the balance of payments deficit is to be held to US\$20 billion in 1986 the Saudis will have to cut back visible imports by 20% - following a 30% cut in 1985 - and the services deficit by 20%, with smaller cuts followed by some increase in later years, if the balance of payments deficit is to be reduced to below US\$5 bn pa by 1990. This is clearly a very rigorous and painful adjustment programme and there are obvious doubts about the Saudis' will and ability to restrain imports to this extent. However failure to do so will have damaging implications, including a further heavy rundown of the Kingdom's external financial assets. Even if this adjustment is achieved the cumulative balance of payments deficit is likely to reach US\$60 bn over the period 1986-90 - more than the estimate of current external financial assets. Whilst it may be possible to finance half the deficit by means such as a measure of foreign borrowing (via parastatal organisations) and repatriation of private foreign assets the best prospect is that the Kingdom's external financial assets will stand at US\$20 bn by 1990 - a substantial sum perhaps but only a fifth of their level a few years ago.

6 If oil prices are lower by around US\$5pb then the WEP assumptions (ie at US\$15.7pb in 1986, with a gradual increase from 1988), low cost OPEC producers and in particular Saudi Arabia should see increased demand. In 1986 and 1987 however Saudi Arabia's oil export revenues are projected to be US\$4 bn lower than under WEP assumptions, although this is offset by higher revenues (US\$7 bn) in 1988-1990. The overall impact for the period 1986-90 is therefore similar to that in paragraph 5.

7 Both the above scenarios assume a maintenance of discipline on production levels by OPEC. If this is not maintained and a massive oil glut results, the

CONFIDENTIAL

assumption is that oil prices would fall precipitously to below US\$10pb. This is very much uncharted territory where relevant projections are hard to construct. However it is probable that even Saudi Arabia would experience a loss on export earnings under this scenario, compared to those set out in paragraphs 5 and 6, and would therefore still need to cut its imports and draw upon financial assets.

IMPLICATIONS

8 The 1970's and early 1980's saw rapid economic growth fuelled by high oil revenues. Imports rose accordingly, and failed until 1984 to adjust to the sharp fall in oil revenues which began in 1982. The adjustment process has already proved painful. Government expenditure - traditionally the locomotive of the economy - has been cut back. The private sector is contracting, and a number of important firms have collapsed or rescheduled debts. The banking sector faces increasing problems as a result of non-performing loans.

UNCERTAINTIES

9 The scenarios assume that the Saudi authorities perceive the prospects for the oil market and their balance of payments as presented above, and that they will act systematically and promptly to make the necessary adjustments. It is by no means clear that they will do so. If they do not, the balance of payments deficit will be worse than projected: with the result that the reserve of financial assets could be exhausted within 2-3 years. There are a number of other assumptions which may not be fulfilled: eg that the Saudis will restrain oil production to hold up prices to a certain level or that they will be able to mitigate their drawings on their financial assets by some borrowing and through the repatriation of private assets.

10 POLITICAL

The changing economic climate and falling living standards create obvious risks for the government. The view is that the prospects of violent revolt are small; although discontent with the Royal Family will increase, this will be containable. However the traditional Saudi consensus will be subject to growing tension.

CONFIDENTIAL

ECGD EXPERIENCE

11 Current ECGD exposure on Saudi Arabia stands at £241m, with potential commitments of £143m. ECGD has long been concerned at the level of claims paid in respect of Saudi business in both the public and private sectors. Even before the downturn in the economy these were significant. Over the period 1980-1985, total claims paid were almost £37m, against recoveries of £9m and premium income of £18m. This experience, and the increasingly pessimistic outlook for the Saudi economy, have led to a more cautious underwriting approach particularly for transactions involving the private sector; and to the regrading for ECGD premium purposes of Saudi Arabia from A to B. The regrading was originally proposed last year but delayed because of the possible implications for the defence package. It will now be implemented with effect from 1 April 1986.

12 If support is given for the defence package, the £1 bn liability will form a very significant element against the Section 2 account. Continuing support for other underwritable business up to a certain size (say, a contract value of £50m) on cash terms could be provided under the Section 1 account. There could however be implications for ECGD's ability to consider support for major projects or business on unusual - eg credit-terms. No such business is currently under consideration but the Post in Riyadh advise that the possibility should not be ruled out. If such cases do arise they would have to be considered ad-hoc on their merits at the appropriate time.

CONCLUSIONS

13 Very clearly Saudi Arabia faces an uncertain but difficult future. Much depends on developments in the oil market which dominates the Saudi economy, and which Saudi Arabia influences by virtue of its massive production capacity, and much on the ability to continue adjustment particularly in the import of goods and services. Cutbacks in imports last year and reduced government expenditure are suggestive of a greater degree of realism. It is not clear however how far this extends, nor indeed whether the Saudis appreciate that the downward pressure on oil prices remains a long term phenomenon.

CPD12/20/2/86/2