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27/10/86

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R E Adams Esq
HM Treasury
Parliament Street
LONDON SW1

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

Telephone 01 382 7000
Direct 01 382 7815
Fax 01 382 7649
Telex 883601

Your reference

Our reference

Date 23rd October 1986

Dear Bob,

SAUDI ARABIA - YAMAMAH PROJECT

1 In your reply dated 17 September you agreed that we should proceed to discuss with Banque Indosuez (BIS) and BAe the proposals contained in my letter to you of 29 August. We have now done so and although good progress has been made in our discussions, the banks have requested that we extend the scope of our cover in certain important respects without which, they allege, the facility will not be bankable. In addition BAe have requested cover for certain payments falling outside of the bank facility. I describe these various requests below.

Saudi interference in the transfer of oil proceeds

2 The basic concept of our proposal was that the cover would be limited to failure by the Saudis to deliver oil at the agreed rate. BIS argue that this does not go far enough. In so far as the latest formal exchange of letters between MODUK and MODA in July 1986 says that "the Project will be fully funded by means of revenue deriving from the sale of oil at a rate of at least 300,000 bpd for as long as is necessary to meet the payment obligations" and in so far as these payment obligations are expressed in the supply contracts (LOAs) to be cash obligations then there is a risk that between the date of delivery of the oil and the receipt by MODUK of the sale proceeds (when MODUK would be obliged to disburse to the UK parties) something may go wrong which would prevent those proceeds reaching the MODUK account. If such an event occurs BIS argue that the Saudi obligation to provide MODUK with the necessary revenue would still stand and in so far as BIS have no rights against the parties to the various agreements, they require cover against failure by the Saudis to make good the revenues which have failed for one reason or another to reach the MODUK account. The reasons for this failure can be various but fall into two broad categories:

i default by the Saudis - eg their failure to instruct the oil companies to pay the revenues into the agreed accounts or their revocation of standing instructions to MODUK as to the disposal of the proceeds etc;

ii default by the oil companies - eg. their failure to comply with the Saudi instructions or honour the oil-lifts agreements.

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In any of these events, proceedings against the defaulting party would have to be taken by another party over whom BIS have no control or against whom they have no rights and for these reasons cover is required.

3 The actual payment arrangements between date of oil lift and receipt of revenues by BIS are somewhat complex, in our view unnecessarily so. In the normal way we would have insisted that payments by Shell/BP went straight into the guaranteed loan without Saudi involvement therefore we asked MODUK to explore the possibility of simplification and of obtaining irrevocable Saudi commitments to ensure that the funds go direct to SIB. MODUK say however that they see no scope for further negotiations with the Saudis or for any change in the present agreed arrangements. We are left with no alternative therefore but to consider what cover we can give in these circumstances.

4 We have already told BIS that we are not prepared to entertain cover against any autonomous default by Shell/BP (or by any subsequent oil-lifters) in honouring the oil-lift agreements or in remitting the proceeds as instructed by the Saudis. In so far as Shell/BP entered into the Oil Agreement at the request of MODUK and BAe, Shell/BP can be said to be acting for the benefit of the latter and, in our view, any cover requirement by BIS in this particular respect should be addressed to them. On the other hand there is a strong case for ECGD covering the risk of direct Saudi interference in the transfer of the oil proceeds which results in payment not being made to BIS otherwise the cover we are offering against Saudi default would be incomplete. Similarly, although we are not prepared to give cover directly against the immediate results of a collapse of the oil-net back arrangements and/or non replacement by other oil arrangements we are prepared to countenance the Saudis underlying obligation (as expressed in the July exchange of letters) to pay by other means in such an event and to agree that failure by the Saudis in this respect would be insurable even though we are advised that the legal validity of that underlying obligation is questionable. For this purpose we would propose that our liability would be triggered if for a period of 3 months BIS receive nothing because the oil lift arrangements have broken down and the Saudis are not paying by other means. Our liability would commence at the end of that 3 months period and would continue in so far as the Saudis continue to be in default.

Extension of the repayment period

5 The second request from BIS is to increase the period of cover to 7 years. This derives from pressure from BAe to reduce the dedicated percentage of oil proceeds to be applied to repayment of the facility so that more funds are made available to BAe who are, it is said, suffering and are likely to continue to suffer from acute cash flow problems in this project. Although BIS are somewhat reluctant to agree to this possible stretching of the period over which the facility will be paid they would be prepared to concede if we also extend the period of cover. However we in ECGD consider that there are limits to the extent to which should be asked to come to BAe's rescue and

given the palpable defects in the legal and contractual arrangements the risks rise considerably the further the risk period is extended. Consequently we would be very reluctant to extend our horizon or risk any further than the agreed 5 years. On the basis of assurances we have received that the present Saudi Government is committed to the success of this project and fully intends to pay for it, then basically our cover is against a change in the present Saudi regime and the subsequent repudiation of the project. We recommend therefore that we confirm that the maximum period of risk will be 5 years from the date we issue cover.

Separate cover for BAe

6 I am afraid I must also revert to the question of additional cover that was mentioned briefly in paragraph 4.6 of my previous letter. We have now received a firm request from BAe to provide cover to them direct for the same causes of loss that will be the basis of our cover to BIS in respect of BAe's exposure (ie underpayment) during the course of the project. BAe expects that this exposure would reach a maximum of £500m in the second half of 1987 reducing to nil in the first half of 1989. As this is a relative short term risk we would be inclined to agree this request but we would wish to keep within the original maximum exposure figure of £1bn plus interest agreed by Ministers. Thus we would only be able to cover BAe for a maximum of £300m. If you are agreeable to such additional cover being given, we propose to limit liability to costs incurred only and in a disaster situation only ie. complete default by the Saudis on their undertakings in the July letter.

7 For completeness I would finally answer some of the queries raised by other Departments on my earlier letter. The Bank of England asked about the percentage of the oil revenues dedicated to the repayment of the facility as envisaged at present this will be 60% but there are certain additional provisions namely:

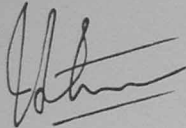
- a) if there is no agreement to extend the Oil Agreement beyond the present expiry date of February 1989, then the banks will require a minimum of US\$71m per month from the oil proceeds to ensure that the facility is repaid by February 1989.
- b) if a one year Oil Agreement extension is agreed at a rate of 400,000 bpd throughout then the minimum requirement will be \$44.45m to ensure repayment by February 1990.
- c) if b) applies and 60% dedicated percentage realises more than \$100m in any month the banks will be restricted to that amount and the balance will either go to BAe or to a reserve account.
- d) with regard to a) and b) above, the minimum amounts will always be exceeded unless the oil price falls below \$10pb. If that occurs the dedicated percentage will be increased so that these minimum amounts are achieved.

8 DTI also commented on the need for care in defining the causes of loss to be covered. I need hardly say that we fully appreciate that there will be problems in defining the risks involved in this complex and novel facility. However, we now

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have a clear idea of what these are and we are confident that our lawyers will be able to produce all the necessary documentation. We shall also ensure that the commercial banks confirm their willingness to lend a further \$400m on their own account.

9 We are being pressed to give a quick response to BIS's request and therefore your early reply is requested. I will of course report back after the next round of negotiations so that we can consider ~~whether~~ if a further EGC meeting is necessary before the final package is submitted for Ministerial approval.

Yours sincerely



P HENLEY

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