Mr. ~~Pedder~~ PEP
16/12
(1) PM – No need to read it all!
(2) RG
(3) File

Secretary of State for Trade and Industry

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The Rt Hon Nigel Lawson MP
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11 December 1986

cc PS/MST
PS/SDH
Mr Gill
Mr Roberts
Mr MacDonald
Mr Titchener
Mr Everett
Mr Henley ECGD
Mr Michell Air
Miss Davis Air
Mr Twyford (o/o)

Dear Nigel,

£5BN DEFENCE DEAL WITH SAUDI ARABIA

I wrote to you on 25 March 1986 describing the problems that had then arisen over the financing of this deal and proposing a solution to these problems by using ECGD cover. I received a reply from John MacGregor broadly agreeing with the proposals.

It then became known that the Saudis were not prepared to act in a borrowing capacity, which had been the basis of the original proposal. As a result further proposals were put forward by George Younger to John MacGregor on 30 April with which I broadly agreed.

However once again these proposals proved unsatisfactory to the Saudis and the commercial parties and as a result another bank has appeared on the scene offering a fresh proposition. After considerable study and negotiation of this proposition by officials, I believe that ECGD should be authorised to provide the cover required, even though to do so would depart from its normal method of operation and would involve the department in accepting some risks relating to a barter deal.

I set out below details of these new proposals and would appreciate your agreement to the necessary ECGD cover. (These do not involve any change in the current oil netback arrangements which would, I know, concern Peter Walker.)

JG3AHV

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THE NEW PROPOSAL

The bank that has approached ECGD is the Banque Indosuez, a French bank with considerable business in the Gulf States and a branch in London. They are prepared to acknowledge the fact that payment for this project would be solely by means of oil and would be prepared to offer financing of $1.5bn provided that ECGD cover is given for $1bn against failure by the Saudis to deliver 300,000 barrels per day as the Saudis have agreed to do until all costs of the project, including the interim financing costs, have been met. The remaining $0.5bn will be provided unguaranteed by, I believe, a syndicate of Saudi banks.

This financing facility will be drawn by BAe on the authority of our MOD ("MODUK") in accordance with the contractual arrangements between BAe and MODUK which reflect the same arrangements between MODUK and MODA (the Saudi buyer). The principal of the facility and interest on it will be paid from the receipts from the oil supply contracts. The Saudi government has specifically agreed that interest (called "Finance Charges") will be paid in this way and this interest together with other banking charges, ECGD premium etc will form a first charge against the oil receipts. Thereafter a specified percentage (currently thought to be around 60%) of the balance of the monthly oil receipts will be used to repay the facility. The remaining balance will be paid to BAe to the extent that they are entitled to payment and any excess to BAe's entitlement will be held in suspense and added to the following month's oil receipts.

As the actual levels of monthly oil receipts will not be known and as the banks wish to ensure, as far as possible, that the whole facility will be repaid within a reasonable time-scale, a somewhat complex arrangement will be set up to ensure that if monthly oil receipts fall below certain levels then the percentage dedicated for repayment of the facility will be increased and payments to BAe will correspondingly be reduced.

Under such a facility there will be no explicit borrower of the money: that is to say that the Saudis will not enter into any separate agreement regarding repamynet. The security for repayment will rest solely on the obligation of the Saudis contained in the various letters exchanged between MODUK and MODA to provide oil at a certain level for as long as is necessary to repay the facility and to make payment to BAe (through MODUK) under the contracts. Obviously it is essential that ECGD should participate in discussions of any changes in these arrangements and I understand that this is acceptable to MODUK.

JG3AHV

ECGD COVER

The cover that the banks require from ECGD in respect of $1bn is against a Saudi failure to deliver oil at the agreed volumes, against Saudi interference in the transfer of the oil proceeds to the beneficiaries, against failure by the Saudis to pay by other means should the oil arrangements collapse and against war, civil disturbance etc which prevents the delivery and loading of the oil in Saudi Arabia.

The essential differences between this new arrangement and the previous one are:-

i that it acknowledges that all payments will be made through the sale of oil without any Saudi obligation to pay cash;

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

iii that the facility will be a single amount to be drawn down immediately rather than a revolving overdraft facility.

The support required from ECGD is also different in so far as previously the cover envisaged was against a cash payment obligation on the part of the Saudis, whereas now it is against their failure to provide the oil. It is because the quality of this cover is less than previously agreed that the banks consider that they can syndicate on a risk sharing basis only $1.5bn (compared with the £1.5bn previously thought available). In effect it will be the banks - not ECGD - that will carry the risks of a major fluctuation in the oil price over the next five years.

Similarly, because the new arrangements will mean that BAe will not receive payments as soon as they originally expected and therefore their exposure to loss for work done will be greater in the event of a collapse in the oil arrangements, BAe have asked for additional cover from ECGD against any losses they may incur in the events described in paragraph 9 above.

John MacGregor and others have been concerned about the legal position and it is true that as this facility is being set up after the original contractual negotiation, ECGD's rights will be less than usual. ECGD normally gives its guarantee against a legally enforceable obligation of an overseas party to make monetary payment for goods delivered or services rendered. Here ECGD is being asked to cover failure to deliver oil to meet the payments required. Furthermore the obligation in this respect as contained in the letters between MODUK and MODA would not, I am advised, be legally enforceable in a court of law, Nevertheless, although this would plainly weaken HMG's bargaining position if a dispute ever arose, in my view it is highly unlikely that HMG would ever in practice wish to take recourse to the courts for an agreement of this nature with the Saudi ruling family. Therefore if ECGD is to give this cover, it must be accepted that the arrangement with the Saudis could be enforceable only through diplomatic channels where the spirit of the agreement rather than its strict legal interpretation would prevail.

Subject to what is said above and despite the fact that this is a most unusual proposition, I do not consider the risks unacceptable and I am prepared to authorise ECGD to give cover against the risks I have described. The period of cover would be limited to 5 years and ECGD would have no liability if the receipts from oil proved insufficient to repay the facility in that period. The banks and BAe will be assuming all the risks of fluctuations in oil prices, exchange rates, interest rates etc and so long as the Saudis continue to offer for delivery the agreed amount of oil and do not interfere with the payment arrangements, then ECGD will have no liability. In the event of a collapse of the oil arrangements between Shell/BP and Aramco ECGD would only assume liability if within a reasonable period thereafter (say 3 months) the Saudi have failed to institute another method of payment. The agreed amount of oil on which ECGD's cover is based, is that contained in the letters between MODUK and MODA - currently 300,000 barrels per day. If this figure is formally altered at any time then cover will be based on the revised amount. ECGD's maximum liability would at the outset be set at $1.6bn (say £1.13bn).

Similarly I am prepared to authorise ECGD to give similar cover to BAe in respect of any losses they may sustain resulting from a Saudi failure to deliver oil, etc during the same 5 year period. The amount of ECGD's cover would be limited to £300m being the difference between that originally authorised at £1bn principal and the cover now required of $1bn. This would give total exposure on the deal of £1.43b compared to the £1.8b previously agreed.

Finally, I would confirm that ECGD's normal requirements about minimising losses in the event of default will be applied. These will include limitation on further deliveries, recovery by resale of undelivered goods etc.

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As the Saudis are getting impatient about the time taken to set up this facility early comments would be appreciated.

I am copying this letter to the Prime Minister, other members of OD, Peter Walker and Sir Robert Armstrong.

Yours,

Paul

PAUL CHANNON

JG3AHV