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Secretary of State for Trade and Industry

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215) 5422
GTN 215)
(Switchboard) 01-215 7877

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cc PS/MFT
PS/GP
PS/Sir P. Middleton
Mr Kemp
Mr Pinnell
Mr Simpson
Mr Baker
Mr Bowden
Mr Peddar
Mr Gill

25 March 1986

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The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

Dear Nigel,

EXPORT CREDITS GUARANTEE DEPARTMENT : £5bn 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 competition 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 peak to UK aerospace industry and will extend the production programme at BAe Wharton 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 in 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, because large payments are due to BAe in the earlier stages of the deal when revenues will be relatively small, these oil lift arrangements will not be adequate to meet all payments. To overcome this problem it has been proposed that an overdraft facility with a UK clearing 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

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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. Repayment of the overdraft will not be dependent solely on the availability of oil revenues under the net back arrangements: there will also be an obligation on the Saudis to pay cash (however difficult this may be) if these revenues are inadequate.

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. Monies from the overdraft 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 and I 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 my view this does not concern ECGD and is a contractual matter between MoD and BAe.

The overdraft facility will bear interest in the normal way. Although the agreement setting up the facility will expressly provide for the payment of interest there is nevertheless the risk that the Saudis may later argue that they are prevented from or chose not to pay the element that reflects interest because it is contrary to the Islamic Sharia law to which the Saudis are committed.

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 declining price of oil, Saudi Arabia has run massive balance of payments deficits in the last 3 years totalling an estimated US$24bn, despite a 30 per cent cut in imports. These deficits have been financed largely by drawings of some $40bn on the Kingdom's liquid foreign assets 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.

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, under any circumstances it will have to continue a painful adjustment process if it is to move toward equilibrium in balance of payments - failure to do so wuld result in its liquid foreign assets falling to zero by 1988. The adjustment process has

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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.

Because of the present uncertainties, this is not, in many senses, an ideal time to be considering such a massive commitment either for Saudi Arabia or for ECGD but the deal is important to the UK, an ECGD guaranteed facility is considered necessary to help its successful conclusion 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 and that the Kingdom's political structure will survive intact the difficult period that lies ahead. In all 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 prove inadequate by reason of low oil receipts, then any excess will have to be provided from unguaranteed sources. Limiting ECGD's exposure in this way should, subject to a further review now in hand, enable ECGD to support other business in Saudi Arabia.

To sum up, we clearly have to recognise that the basis of the deal and the prospects for the Saudi economy have changed quite significantly since it was originally announced. Instead of strict cash terms, we are now asked to agree counter-trade in oil at depressed prices, coupled with a substantial overdraft guaranteed by ECGD. When the deal was struck, HMG also accepted an unspecific and potentially troublesome commitment to develop arrangements for industrial collaboration and the transfer of technology. The deal is far from risk free, but I think the risk is tolerable given the importance of the order for employment in the UK, for the export prospect of the Tornado, and for our relations with the Saudi Government at the highest levels.

I should therefore appreciate your agreement to the required ECGD cover.

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

Yours,

Paul

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PAUL CHANNON

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