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ECGD

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

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

cc Mr. Petter  
OT4.  
Ms Sirey  
PER2A

*You should see this 2  
"news" which runs counter to  
earlier assurances from MOD  
that there would be no*

R E Adams Esq  
HM Treasury  
Parliament Street  
London  
SW1

*ECGD implications. I don't  
think we can accept the*

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SAUDI ARABIA - MILITARY AIRCRAFT FOR OIL ARRANGEMENTS

*The rest of paragraph 9 if the  
effect is to eliminate Sect. 2 cover for most  
other business. I should be grateful if RS  
would establish with ECGD the latest Sect. 2  
cover situation and the likely impact of this facility*

1 EGC's authority is sought under Section 2 to guarantee a maximum overdraft of £2,950m plus interest made available to facilitate the sale of Tornado, Hawk and other aircraft and other goods and services eg missiles, training, construction work to Saudi Arabia. Precise details of the deal are not yet known but it is likely to total about £8bn and to comprise 13 separate sub-arrangements under an overall umbrella contract and memorandum of understanding.

2 The contracts will be between the UK Ministry of Defence and the Saudi Government and will be mirrored by sub-contracts between MOD and BAe. These sub-contracts will be conditional ie BAe will be paid only as and when payments are received by MOD from the Saudis. The deal is essentially a countertrade arrangement and Shell/BP will undertake to lift and sell 200,000 or 300,000 barrels of oil a day (the precise amount is still to be agreed) under long term contracts (which will be confidential) the proceeds of which will be paid into an escrow account which will be used for making payments under the supply contracts. BAe will arrange advance payments under their contracts to ensure that they did not undertake work for which they had not already been paid and to cover any likely termination settlements.

3 The problem for the Saudis in the above arrangements is that there will be a mismatch between the timing of payments of oil proceeds into the escrow account and of payments due to MOD/BAe under the supply contracts. The oil proceeds might anyway not be sufficient because of fluctuations in oil prices. BAe would like to be able to offer the Saudis a facility to bridge this gap, and it has been proposed that the Saudis should have access to an overdraft facility on the escrow account to enable them to make the contractual payments to MOD/BAe when due. Negotiations are still going on and the figures are at present highly speculative but BAe consider that the amount of the overdraft facility required could go as high as £3bn in year 2/3 of the 6 year delivery period. (See Appendix A). However, they believe that the final figure will probably be much lower, possibly only some £1½bn.

4 We still have some way to go in considering the feasibility and practicality of such a facility but in outline we envisage an overdraft facility agreement between the banks and Saudis which would provide inter alia for

- i arrangements for payments into and out of the overdraft account;
- ii payment of interest on the overdraft in accordance with normal banking practice. The interest rate would be a fluctuating market rate;

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iii the overdraft would have a maximum limit for each year of the life of the facility as shown approximately in Appendix A against the word "shortfall". All the arrangements will imply a clear obligation on the part of the Saudis to keep within the limits.

iv if proceeds from oil sales were insufficient to meet the payments due to MOD/BAe which are in excess of the overdraft or to clear the overdraft when necessary or if the oil lifting arrangements fell through then the Saudis would have to pay cash.

v in the event of the Saudis failing to perform any of their obligations under the overdraft arrangements within a reasonable time (yet to be determined), then the overdraft facility would be cancelled and the outstanding balance would become repayable immediately. Such a default would arise if:

- a the overdraft is not reduced in line with the annual limits where necessary, or
- b the Saudis fail to pay interest at due date, or
- c any other condition of the overdraft is not fulfilled.

5 ECGDs guarantee would apply to the overdraft facility and not to the sale contracts, the subcontracts, the MOU or the oil lifting contracts. The guarantee would be against the Saudis failure to perform the terms of the overdraft and would be triggered by any of the events of default referred to in 4.v above. Thus, by reason of the cancellation arrangements in the event of default, our liability would be no greater than the maximum overdraft level (say £3bn) plus interest. In the event of total default however we would not envisage this amount being paid under our guarantee immediately but would be spread over the remaining life of the overdraft facility as though that facility had not been cancelled and, of course, subject to the Saudis remaining in default. An illustrative diagram of the proposed contractual relationships is attached at Appendix B.

6 The economic and financial position of Saudi Arabia has been widely discussed in recent months against the background of falling oil revenues. In 1981, revenues peaked at US\$111 billion; by 1984 they had fallen to US\$44 billion and the assumption is that 1985 will show a further sharp decline, to perhaps US\$26 billion. This reflects not only the falling world demand for the price of oil but also the fact that Saudi Arabia has until recently maintained its position as the swing producer within OPEC, bearing the brunt of falling demand. As a result the Kingdom has faced massive budgetary and current account deficits in recent years: the budget deficit for 1984-85 was Saudi Riyals 72bn (app US\$20bn) and the 1984 bop deficit has been preliminarily set at US\$13.4bn. These deficits have been to date financed by drawings on reserves (estimated in mid-1985 at around US\$90-100 billion) but clearly even reserves as massive as these cannot for long bear drawings of the order of US\$10-20bn pa. The Government has shown a lack of certainty - approaching at times something akin to bewilderment - in coming to terms with the economic situation. One tactic has been to reduce expenditure and although this is clearly desirable and essential its application has caused all manner of difficulties. Often existing projects had not been properly budgeted: budget cutbacks have led to payment delays and disputes and a generally lower level of economic activity which in turn has made life much harder for private sector companies.

7 Since October however Saudi Arabia has been making efforts to halt the decline in its oil sales and revenues. Sales under netback arrangements arranged with its Aramco partners have reached 2m bpd. The OPEC meeting in Geneva on 7-9 December marked a move away from defending price to defending market share. The implications of these moves are very uncertain; although Saudi Arabia is the best placed oil exporter to increase its output the assumption must be that there will be a sharp fall in prices next year.

8 For ECGD Saudi's financial problems have meant an unacceptably high level of claims in recent years: in the period 1980-85 (October) claims have totalled almost £35m, (on both private and public buyers) against recoveries of £8.8m and premium income of £14.2m. It was against this background that the Advisory Council agreed in September 1985 to regrade Saudi Arabia from A to B. The implementation of the Council's decision was deferred because of its possible implications for the signing of the initial agreement to the Tornado deal which was at that time at a crucial stage of negotiations. It is a matter which will be further discussed with the Council in early 1986.

9 Although we do not yet have firm figures for the proposed transaction, since both the Tornado and some other aircraft are collaborative projects involving Germany, Italy and Switzerland, a substantial proportion of the overall contract value will undoubtedly be foreign content. We believe it will be most difficult to get the Insurers of those countries to share in the risk of this novel facility and as you know the Germans for policy reasons refuse to support arms sales to non-Nato countries. In any event the value of the overdraft facility is likely to be far less than the value of the UK element in the transaction, and it is therefore proposed that we take the full commitment ourselves.

10 This would be a substantial commitment by any standards. However despite the problems which Saudi Arabia has faced over recent years it remains one of the world's richest markets and although the future - particularly of the oil market - remains uncertain we consider the risks involved to be acceptable particularly in view of the security involved (oil sales plus an unconditional payment obligation), and the fact that our exposure at any one time should be limited by the rollover nature of the facility. Before we give this proposal much further thought or give a positive indication to BAe, it would be helpful to have your views and your agreement that there are no objections at the present time to our taking a commitment of this size on this market under Section 2.

*— what will the impact be on the scope for other business to be covered under Sect 2?*

11 An early reply would be appreciated as BAe are hoping to reach agreement with the Saudis on some of the arrangements for this deal very shortly.

P HENLEY  
EGC Circulation

- T J H Downing Esq BOE
  - ✓ M Baker Esq DTI PEP
  - J Bowder Esq DTI Air
  - P Sullivan Esq FCO TR & ED
  - R Ludford Esq ODA APD
  - L Davidson Esq MOD (Defence Sales)
  - A D Harris Esq MOD (Defence Sales)
  - W.A. Pedder Esq DTI PEP
- LET2/18/12/85/1

## SAUDI ARABIA - CASH FLOW ANALYSIS

APPENDIX A

All costs in f\$M

Based on oil price of \$25 per barrel)	1986		1987		1988		1989		1990		1991		1992	
	1	2	1	2	1	2	1	2	1	2	1	2	1	2
	Oil Revenue 200,000/Day													
Increment	652	652	652	652	652	652	652	652	652	652	652	554		
Cumulative	652	1304	1956	2608	3260	3912	4564	5216	5868	6520	7074			
Oil Revenue 200,000/Day for 2 months 300,000 thereafter														
Increment	864	978	978	978	978	978	978	342						
Cumulative	864	1842	2820	3798	4776	5754	6732	7074						
Payment Profile														
Increment	1768	1061	1061	910	750	450	375	375	188	102	20	14		
Cumulative	1768	2829	3890	4800	5550	6000	6375	6750	6938	7040	7060	7074		
Shortfall 200,000/Day	1768	2177	2586	2844	2942	2740	2463	2186	1722	1172	540	NIL		
Shortfall 300,000/Day	1768	1965	2048	1980	1752	1224	621	18						
Expenditure Profile														
Increment	37	1192	719	1194	754	958	651	480	426	403	242	38	14	12
Cumulative	37	1229	1948	3142	3896	4854	5505	5985	6411	6814	7056	7094	7108	7120

