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MIS
Mr Khan
cc Mr Baker

14 APR 1986

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Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Paul Channon MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1

TO <i>Mr Simpson</i>	ECGD
FOR ADVICE (AND	COPIES TO
DRAFT REPLY IF	<i>PS JMET</i>
APPROPRIATE)	<i>PS Sir BH</i>
PLEASE BY:	<i>Mr Roberts</i>
<i>21-4-86</i>	<i>Mr Cull</i>
IF DEADLINE	<i>Mr Titchener</i>
CANNOT BE MET	<i>Mr Everett</i>
PLEASE PHONE	<i>OT4</i>
295 5422	

14 April 1986

Dec Paul

ECGD - £5 BILLION DEFENCE DEAL WITH SAUDI ARABIA

You wrote to Nigel Lawson about the proposal that ECGD should guarantee borrowings of up to the US dollar equivalent of £1 billion required to support the sale of Tornado and other aircraft and weapon systems to Saudi Arabia.

I have seen the Prime Minister's comment that we really have little alternative but to accept this risk in the light of the enormous importance of the Tornado order and of our relations with the Saudi government. I accept that, of course, but I feel that I ought to record my concern both at the way in which we were effectively obliged to make this decision and at the risks it entails.

My officials were originally assured that this was to be a cash deal, risk free for HMG; BAe being protected from the Saudi payments risk by advance payments. The possibility of risk for HMG only arose at a later date. In this case, the increased size of the deal, the Saudi requirement for early deliveries, the use of hypothecated oil sales for payment and the subsequent fall in the oil price gave rise to the need for borrowing partly to provide for the advance payments that BAe are due to receive. In this context it is worth recalling that BAe has already been paid by MOD for some of these aircraft. ECGD's involvement is only needed in order to guarantee very large further payments to BAe, greatly strengthening the company's cashflow beyond the immediate needs of the contract. ECGD's guarantee of any of this borrowing places a risk on the Exchequer while BAe remains protected much as before.

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89/174

We are now faced with a position where, having been warned late that ECGD cover would be required, the Exchequer is being drawn inexorably into financial commitments on this deal which would be difficult to control. We face a contingent liability of over £1 billion. If we are ever called to meet that liability this would be a substantial addition to the PSBR, though not technically to public expenditure, which would greatly constrain the Chancellor's options, in some future Budget. The Prime Minister has recently drawn my attention to the very large contingent liabilities the government is incurring in various fields. The largest group by far arises from the operations of ECGD. It is very important that we continue the tight controls which already apply to ECGD operations.

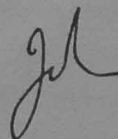
The risks are substantial: as Geoffrey Howe's letter points out there are reasons for concern about the failure of the Saudi economy to adjust to falling oil prices. The longer they delay the necessary action the more painful it will be and the greater the likelihood of payment delays. Geoffrey warns that we should avoid being drawn into providing further large credit facilities for Saudi Arabia. I agree. Once we have agreed to cover for this deal we will be substantially exposed in Saudi Arabia. Sharia Law, as you say, is a further major concern with this market although the risks here are difficult to assess.

I accept that there is little practical alternative to providing the guarantees required in this case. One welcome feature of this proposal is that the commercial parties will provide part of the loans required at their own risk. I am therefore prepared to agree that you may provide guarantees for an overdraft of the US dollar equivalent of £1 billion plus interest. However, in view of the risks involved, ECGD should endeavour to keep their actual exposure as low as possible and to obtain the best security and protection they can. In particular the guarantee should at the very least be subject to ECGD's normal terms and conditions including being subject to English Law, and advances under the guarantee should be for no more than the value of work done.

I should reiterate again the vital importance of early warning in any case where there is a possibility that substantial amounts of ECGD cover may be required.

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

Yours etc,



JOHN MacGREGOR