

RESTRICTED
Reference..... 14312
CONFIDENTIAL

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

W
13 February 1986

186/2
R E Adams Esq
HM Treasury
Parliament Street
LONDON SW1P 3AG

Approved after

EGC

W

Dear Bob

SAUDI ARABIA: MILITARY AIRCRAFT FOR OIL ARRANGEMENTS

We are grateful to the MoD for their letter of 10 February which sheds a little further light on ECGD's possible maximum exposure under this contract. There are still several unanswered questions, however. In particular, would ECGD formally be at risk for the prepayment in H1 1986 of £1.8 bn? This seems not to have been accounted for in MoD's figures and to the extent that this is drawn from the overdraft facility in advance of cash being received from the Saudi bank, there would appear to be an additional risk unless ECGD had recourse for this amount to BAe. However, if this payment is to be received in advance from the Saudis as a condition of the contract commencing, the problem does not arise. Secondly, if ECGD were also to have recourse to BAe for the amounts drawn to finance work in progress, the risk as described by MoD may be somewhat reduced. This arrangement would appear to be unobjectionable since, if the contract is terminated prematurely, BAe's existing work in progress would revert to the RAF contract which has been displaced by this sale of the Saudis. Without recourse to BAe, however, and assuming that ECGD would be at risk for the full amount of the prepayment (ie covering goods delivered plus the residual amount, which would be substantial in the first year of the contract), it appears to us on the basis of what is admittedly incomplete information that ECGD's maximum exposure could be around £3 bn (ie £1,768 mn paid in H1 plus £1061 mn work in progress and £285 mn termination costs, less £96 mn resale value). Perhaps ECGD will be able to indicate whether this is a contract value, or their total DML (the post have confirmed that the Saudis would be unlikely to accept liability for interest).

It is true that this risk would be reduced to the extent that the proceeds of the parallel oil transaction were accruing on an escrow account with a suitable bank outside Saudi Arabia on the lines indicated in ECGD's letter of 8 January: it had seemed from Telno 204 of 7 November that the Saudis had agreed such an arrangement. We understand from comments at the last meeting, however, that these funds would in practice be placed in a Saudi Government account with a Saudi bank, and that ECGD would have no

CONFIDENTIAL

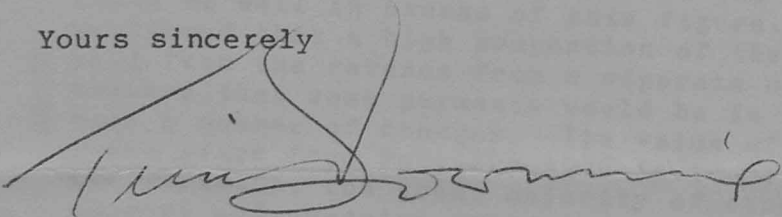
2

legal claim to them. In a parallel paper commissioned for this exercise, the possibility is canvassed that the Saudi Authorities might have to place large deposits with Saudi banks to protect their banking system. It may prove somewhat unrealistic to assume in these circumstances that they would simultaneously countenance massive withdrawals from Government accounts with the same banks. Those oil proceeds would, in any case, be significantly less at market prices (rather than the \$20 pb assumed by MoD), a fortiori if the price fell to, say, \$10 pb which (as indicated in my letter of 9 January) is a figure not excluded by some market participants.

Paragraph 2 of the MoD letter, unfortunately, did little to assuage our concern (raised by Telno 243 of 19 November) about how far the negotiators had ensured that the size of the commitment was fully appreciated by the economic policy makers in Saudi Arabia who have ultimate responsibility for making funds available to meet it. As is made clear in Telno 245 of 20 November, the Saudis regard the contract very much as a collaborative effort rather than merely a commercial venture. Even without such an express understanding, however, it is the essence of Islamic economic philosophy that the creditor should share the financial burden of any subsequent adverse developments. That consideration would apply with particular force if the creditor was aware of the true extent of the potential exposure when the contract was signed, or if the problem arose because of oil price developments which, though adverse for the Saudis, are (as the Chancellor has pointed out on several occasions) beneficial to the UK. For there is all too much evidence of Saudi reluctance to be bound by the letter of contractual commitments, as is evident from ECGD's claims record.

I am copying this letter to EGC members and also to J Hibberd (Cabinet Office), J Rollo (FCO), G Boyce (FCO), R van Slooten (ECGD), J Arnot and M Hall (DoE).

Yours sincerely



T J H Downing