



CONFIDENTIAL

B.06868

PRIME MINISTER

c Sir Robert Armstrong

OD: Tornados for Turkey

BACKGROUND

FLAG A

In his undated minute of September 1984 the Secretary of State for Trade and Industry has set out proposals for providing export credit support for the prospective sale of 40 Tornado strike aircraft to Turkey. This minute updates the proposals set out in his minute to you of 10 August 1984 and shows a dramatic increase in both the total contract value of the order (£750 million to £985 million) and the resulting United Kingdom credit exposure (an increase from £600 million to £850 million). Mr Tebbit has expressed considerable concern about the level of ECGD credit exposure which would be incurred under the proposed deal, which has risen from £200 million in his minute of 10 August to £344 million in his September submission; however, in view of the political and industrial imperatives involved, he recommends that the risks should be accepted in the interest of securing the deal.

FLAG B

2. Support for Mr Tebbit's case has come from the Secretary of State for Defence in his minute of 3 October. Also the Minister of State, Foreign and Commonwealth Office (Baroness Young) in her minute of 20 August considered that in foreign policy terms the advantages of proceeding with the sale outweighed the disadvantages. The Chancellor of the Exchequer, however, in his minute of 21 August has indicated strong reservations about the ECGD credit exposure of £200 million proposed in Mr Tebbit's minute of 10 August and it is understood that his worries on this account have

FLAG C

FLAG D

FLAG E

CONFIDENTIAL

increased proportionately with Mr Tebbit's subsequent bid for a credit exposure of £344 million.

3. Neither the Secretary of State for Foreign and Commonwealth Affairs nor the Secretary of State for Defence can attend because of absence on duty overseas. They will be represented by the Minister of State, Foreign and Commonwealth Office (Mr Luce) and the Minister of State for Defence Procurement (Mr Butler). The Minister of State, Department of Trade and Industry (Minister for Trade) (Mr Channon) will represent the Secretary of State for Trade and Industry

HANDLING

4. You should invite the Minister for Trade to introduce the minute by the Secretary of State for Trade and Industry. The Minister of State, Foreign and Commonwealth Office and the Minister of State for Defence Procurement should also be asked to give their views on the political and military aspects respectively. The Chancellor of the Exchequer should be invited to advise on the credit exposure aspects of the Secretary of State for Trade and Industry's proposals. You may wish to structure the discussion to cover the following principal issues -

(a) The steep rise in price of the aircraft

The steep rise in the ECGD credit exposure envisaged in Mr Tebbit's earlier minute of 10 August is caused by the escalation in aircraft costs forecast by British Aerospace. You will wish to press the Minister for Trade for a further explanation of the 30 per cent rise in contract value as between the forecast of £750 million on 10 August and £985 million in September. Given this degree of escalation, the Committee will wish to satisfy themselves that the price being quoted is now soundly based and not likely to be subject to further rises which would have the effect of increasing credit exposure even further.



CONFIDENTIAL

(b) The political and military issues at stake

The political and military factors involved in this prospective sale have been fully set out by the Defence Secretary and by Baroness Young. Despite some concern about the impact on the Greeks and the Greek Cypriots, greater weight is attached to the need to encourage Turkey's progress towards a full restoration of democratic institutions and to strengthen NATO's southern flank.

(c) The industrial capability and employment issues at stake in the proposed sale

In the minutes under consideration, stress is placed on the importance of achieving this sale to bridge the gap in British Aerospace's work programme at Warton when the United Kingdom's Tornado production order tails off. The Chancellor of the Exchequer has questioned this argument on the basis that the future of the European Fighter Aircraft (EFA) is as yet uncertain. References are also made to the importance of the order to the Rolls Royce RB.199 engine programme. You will wish to assess how important this order is to ensuring a sufficient continuity of work in these key industrial areas to secure the maintenance of the United Kingdom's future capability to develop and produce conventional advanced military aircraft. How much time in keeping production lines open will an order of this relatively small size buy? Will the work involved help to sustain the critically important design teams as opposed to providing work for the production staff? The Minister for Trade and the Minister of State for Defence Procurement should advise on these issues.


CONFIDENTIAL

(d) Possible ways of reducing ECGD exposure

Given the difficulty of accepting an ECGD credit liability as great as the £344 million proposed, you may wish to explore all possible avenues to reduce this level of exposure:

i) Reduction in the number of aircraft. It is understood that this has been explored with Turkey and that 40 aircraft represents their minimum requirement. The Minister for Trade should be able to advise on the strength of their views.

ii) Reduction in the United Kingdom workshare of the order. The United Kingdom workshare of 58 per cent proposed is 10 per cent above the United Kingdom's normal workshare of about 48 per cent in this project largely because assembly of all 40 aircraft is assumed to take place at Warton. If the Germans assembled, say, half of the aircraft, it would reduce the United Kingdom workshare by a substantial amount, which in turn could be used to reduce the ECGD credit exposure. The Minister for Trade should advise on this issue.

iii) Persuading the Federal Republic of Germany and Italy to take a larger share of the credit exposure. Given the usual division of work and cost sharing between the three countries (48 per cent United Kingdom, 40 per cent Federal Republic of Germany and 12 per cent Italy), could our partners be persuaded to take a greater share of the credit exposure, at present based on a 58 per cent United Kingdom share? One argument to deploy would be the importance of this initial sale as the breakthrough needed to achieve success elsewhere.

CONFIDENTIAL

CONFIDENTIAL

It will in any case be important to establish that the Federal Republic of Germany would be prepared to support the sale in providing credit, given her inhibitions about arms deals in general. Could the Italians be persuaded to take a greater share given their particular interest in strengthening Turkish forces and so improving NATO's posture in the Mediterranean and the southern flank? The Minister of State for Defence Procurement and the Minister of State, Foreign and Commonwealth Office could advise on these issues.

iv) Industry to take a greater share of the credit exposure. In industry's original proposals set out in Mr Tebbit's minute of 10 August, Sir Raymond Lygo proposed that the credit exposure should be shared in the proportions two-thirds by industry and the commercial banks and one-third by ECGD. It is worth challenging why, in returning with an escalated contract value of £985 million as opposed to the earlier quotation of £750 million, Sir Raymond reduced industry's proposed share of credit exposure from two-thirds to 60 per cent while expecting ECGD to bear the consequential increase from one-third to 40 per cent. The Minister for Trade should advise on why industry and the commercial banks cannot be kept to their original proposal.

(e) Agreement of the maximum acceptable level of ECGD liability

Is the Chancellor of the Exchequer being realistic in wishing to restrict the ECGD exposure to £50 million? Despite the fact that the agreed ECGD credit exposure is £100 million of which £50 million has already been used up, is there not some additional ECGD credit

£ 344m }
£ 260m }
£ 80m }


CONFIDENTIAL

exposure which could be allowed in view of the clear national interest involved in permitting this deal, without recourse to direction of the ECGD Accounting Officer, the taking of the commitment outside ECGD's trading accounts, and the action with Parliament which this would imply?

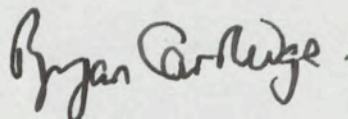
5. The proposal from the Secretary of State for Trade and Industry underlines the need for a general review to identify more satisfactory means of absorbing the large credit requirements implicit in major arms sales, without damage to civil trade. The decision reached at the OD meeting on 16 October to place this review under the leadership of the Secretary of State for Trade and Industry, in association with the Defence Secretary and the Chief Secretary, seems entirely appropriate in the light of this particular example.

CONCLUSION

6. Subject to the view taken in discussion of the viability of providing sufficient credit from all available sources for this prospective sale, you could guide the Committee to decide -

(a) whether there is any room for negotiating with our partners, the Federal Republic of Germany and Italy, a more even allocation of the credit exposure required;

(b) what division of the United Kingdom share of credit exposure between public and private sector sources should be set as the aim in continuing negotiations with British Aerospace.



B G Cartledge

19 October 1984

CONFIDENTIAL

PRIME MINISTER

19 October 1984

TORNADOS FOR TURKEY

How Good is the Deal?

Prime Minister
This is in your folder but I don't think you read it.
The last paragraph

My impression is that in addition to the strategic and industrial attractions, this contract is commercially attractive. It breaks down as follows:

might be worth mentioning.

C.D.P.

£m

| | | |
|---|---|------------|
| - | 40 aircraft at £15.2 million (a price 15-20% higher than that charged to the RAF) | 606 |
| - | add 20% for support and spares | 121 |
| - | escalation for inflation (6% pa) and contingencies | 258 |
| | | — |
| | | <u>985</u> |

The price for the aircraft and the escalation provision look comfortably padded. The research and development overheads of the aircraft are already covered by the sales to the three partners in Panavia, Britain, Germany and Italy. BAe therefore stand to do pretty well if they can secure a contract close to £985 million.

CONFIDENTIAL

Where Should the Liabilities Fall?

The ECGD should only do what it considers prudent. It is already in deep financial difficulties, with a cash deficit this year of £500 million. The liabilities should not be taken off ECGD and dumped on the Exchequer, otherwise there will be an avalanche of similar claims. Nor should liabilities be carried by the Departments which promote deals which ECGD cannot accept. If purchasers default MoD or DTI would almost certainly raise their public expenditure bids to cover the shortfall. In this case, it would be unreasonable to ask BAe to find more cover: they have done well to find as much private sector cover as they have.

An excessive risk premium might be the answer. You can insure almost anything, at a price. Why can't ECGD suggest a premium which, in their view, covers the risk of exceeding the prudential limit for Turkey by the amount proposed? Why not then ask BAe to pay this excess to ECGD or ask the Departments which are promoting the deal - MoD and DTI - to share the excess risk premium with BAe on a basis agreed between them? On the figures above, BAe could afford it. This approach could apply to all risky markets.


NICHOLAS OWEN