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CABINET

DEFENCE AND OVERSEA POLICY COMMITTEE

CREDIT TERMS FOR BUSINESS WITH THE SOVIET UNION

Note by the Secretary of State for Trade

Rolls Royce Ltd, and possibly other British companies, have the opportunity to compete for over £200m worth of orders in connection with the gas pipeline which the Soviet Union intends to construct so as to augment the supply of natural gas from West Siberia to countries in both Eastern and Western Europe. Much of the finance and equipment is being found by Federal German firms but there are some items, particularly gas turbine generators for the pipeline compressor stations, which could come from Britain. German finance is being offered at the relatively low market rates prevailing in that country while France, which also aims to provide some equipment and is competing for the turbine business, is expected to offer officially-backed credit at a rate below that now applied under the OECD Consensus.

2. The Committee is invited to decide on the basis of the attached note by officials, which sets out relevant details and policy considerations, whether the UK should be prepared to match the expected French credit offer. Primarily this involves weighing the value of the business to be obtained against the political implications, but two further issues arise - whether or not the additional subsidy required to match cut-price credit is justified in economic terms and whether the UK should be prepared to match in other cases where this is justified in commercial terms.

3. My own view is that, provided that there are no untoward developments over the Soviet Union's involvement in Poland, we should regard matching credit as falling within our policy of continuing trade with the Soviet Union where this is beneficial to both sides. Subject to my colleagues views, I propose to instruct the Export Credits Guarantee Department that it may match credit offers for the pipeline business within the limits of its normal commercial judgment. The Department would also be authorised to match in other cases subject to its usual procedures.

J. N.

Department of Trade
1 Victoria Street
15 December 1980

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CREDIT TERMS FOR BUSINESS WITH THE SOVIET UNION

NOTE BY OFFICIALS

Rolls Royce are keen to participate via the supply of compressor station equipment in the £5 billion project to bring to Western Europe part of the production of the West Siberian gas field. They have little prospect of winning a contract against the French unless they are able to arrange UK finance on terms similar to those available from France. The Soviet Union has asked Rolls Royce's bankers (Midland) to submit financing proposals in early January 1981. This paper considers the case for allowing ECGD to match French terms and the implications for the Government's policy towards the Soviet Union. It has been prepared on the assumption that there will be no Soviet military intervention in Poland. If that does happen many of the considerations outlined below will be overturned by the need to impose strong economic sanctions against the Soviet Union. Grave doubt would be cast on any preferential credit for the Soviet Union and on Western participation in the pipeline project as a whole.

Current credit terms for the Soviet Union

Since the expiry of the 1975 British-Soviet credit agreement in February, which in line with other countries' arrangements conceded credit at specially low interest rates, ECGD's support for capital goods' sales to the Soviet Union has been available only on the credit terms allowed by the OECD Consensus. Other Western countries have been following the same policy. France however concluded a new credit agreement with the Soviet Union earlier this year which did not provide for subsequent increases in Consensus rates. These were raised by ¾% from 1 July and are currently 8% for credits of 2-5 years, 8.5% for credits over 5 years. Thus French companies have a ¾% advantage, at least until September 1981 when there is provision for review in the French agreement. The French authorities have confirmed that support in line with their credit agreement will be available for the pipeline project in question. French contractors are putting forward a bid which includes compressor modules containing gas generators manufactured to General Electric (US) design by the French company Alsthom. Under the rules of the Consensus, and in normal circumstances, this situation would provide a basis for matching by ECGD in cases where UK suppliers were in contention with the French for particular contracts with the Soviet Union.

The Germans who are likely to be one of the main suppliers of equipment do not subsidise interest rates and thus provide no basis for matching by ECGD, although it is expected that German suppliers will be making arrangements commercially to provide credit at similar interest rates to the French. Since February ECGD has underwritten no business for the Soviet Union on Consensus terms. Nor has the Soviet Union been willing to agree any lines of credit with British banks. They claim that British companies can expect no business unless more attractive interest rates are offered. Other countries eg Japan and Italy, have had similar pressure put on them to undercut the Consensus, but as far as we are aware none has yet succumbed.

Importance of the business to Rolls Royce

Depending on the final configuration of the Soviet pipeline project - by far the biggest of its sort in the world - RR could obtain orders for between 150 and 400 Avon industrial gas turbine generators or up to 300 industrial RB211 generators over the period 1982-85 valued at a maximum at about £220m. Even an order for 150 Avons would represent some 17% of the Industrial and Marine Division's (IMD) current business and would provide work for 400/500 people in Rolls and its UK sub-contractors, mainly in the Midlands and Scotland. RR estimate that over the four year period an order for 150 Avons would generate £30m in profit and a similar contribution to IMD's cash flow. IMD has been a small but not insignificant drain on group profits and cash flow, and the contract would help to reduce the company's overall financing needs and help to guarantee the future of the IMD.

There is also the possibility that Rolls Royce will join together with Cooper Energy Services (owned by a US company Cooper Bessemer) and perhaps a third company to bid for all or most of the compressor station work for the pipeline. Such a bid would be worth two or three times the £220m bid from Rolls Royce alone. Such a consortium would be able to draw upon the good reputation already earned by the Coberrow consortium (Rolls Royce, Coopers and Williams Bros) in completing a recent £100m compressor station contract in the Soviet Union.

The COCOM aspects of the project have been considered by the relevant departments. Versions of both the Avon and RB211 gas generators could be supplied to the Soviet Union without any reference having to be made to our COCOM partners.

Assuming that a Rolls Royce contract valued at £220m were financed in sterling with repayments over 8½ years the interest rate subsidy with financing at the current Consensus rate of 8.5% would be on an undiscounted basis approximately £73m based on an average cost of 10 year sterling funds of 14.08%. If finance were provided at 7.75% to match the French the increase in subsidy would be approximately £9.8m.

Implications for other business with the Soviet Union

At present other British companies are in negotiation for business worth about £250 million that would be likely to require credit support. In the case of about £100 million of this business there is known to be French competition which could lead in due course to requests for matching by ECGD. We could also expect pressure from the Soviet Union and British companies themselves to extend similar terms to cases where there was no French competition. Whether such pressure could be resisted successfully would depend on the extent to which other Western countries apart from France are prepared to adhere to current Consensus terms for business with the Soviet Union and whether France is prepared to return to Consensus terms on the review of their credit agreement in September 1981.

Implications for the Government's policy towards the Soviet Union

The decision not to renew the British-Soviet credit agreement was announced by the Foreign Secretary in the House of Lords on 16 January as part of our response to the invasion of Afghanistan. Nothing has happened in Afghanistan since January to justify a change in our policy. A decision to offer the Soviet Union credit at below standard Consensus rates would therefore no doubt be seen by the Russians as weakness on our part. Such a decision would also be likely to attract criticism in the UK, even though justified under the Consensus rules, given the political sensitivity of the matter of subsidised credit for the Soviet Union and the pressure on the Government since Afghanistan to take action to limit British/Soviet trade. The decision might also cause disappointment in Washington and might reinforce Japanese suspicions about what they are coming to see as the duplicity of the Western European reaction to the invasion of Afghanistan. The US however are prepared for their companies to put in bids for the pipeline project (Caterpillar have been given permission to bid for pipelaying equipment) and have said that the General Electric (GE) LM 2500 gas generator which is the closest competitor to the RB211 can be supplied; this is likely to be via European licensees of GE, eg John Brown Engineering. Exim Bank is prohibited by law from giving credit support for trade with the Soviet Union. Any US company bidding direct for pipeline business would thus be unable to get credit support.

OECD Consensus

In order to safeguard the OECD Consensus it is in our interests strongly to discourage other countries from offering more favourable terms. If we take the initiative in matching the French in the present case this might be used by others as the excuse to gain business by offering special terms in cases where matching was not justified under the Consensus rules. Our interest is to secure a united front with other Western countries to prevent the Soviet Union playing off one country against another to get the best terms. At a Community meeting on credit on 10 December all countries including France thought it was premature at that stage for firm commitments to be made on the pipeline project. Nevertheless Department of Trade officials note the Soviets' request to Midland and consider that there is advantage in both Rolls Royce and their bankers knowing at an early stage the basis on which they will be able to compete.

Summary

In coming to their decision whether to allow ECGD, if the need arises, to match in the Rolls Royce case Ministers will wish to consider inter alia:

(i) the importance of the business to Rolls Royce's Industrial and Marine Division

(ii) the number of jobs represented by the additional business

(iii) the implications for matching French competition in future cases and the cost involved

(iv) the likelihood of pressure from the Soviet Union and British companies for below Consensus interest rates where there is no French competition

(v) the effect on domestic opinion and on the attitudes or our allies and

(vi) in the case of a decision to allow ECGD to match, our concern that our allies should adhere to the Consensus in cases where there is no French competition and that France should return to current Consensus terms in September 1981.