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OD(80) 33

COPY NO

43

28 March 1980

CABINET

DEFENCE AND OVERSEA POLICY COMMITTEE

REVIEW OF THE UNITED KINGDOM RESPONSE TO PRESSURE FOR
VOLUNTARY MEASURES AGAINST IRAN

Note by the Secretaries

The Committee at their meeting on 19 March (OD(80) 8th Meeting, item 4) instructed the Secretary of the Cabinet to arrange for the preparation of an updated report on the United Kingdom response to United States pressure for voluntary sanctions against Iran, for the Committee's consideration on 2 April. The attached report by the Official Group on Iran (MISC 27) updates the Group's earlier report, circulated to Ministers under cover of a Note by the Secretaries (OD(80) 4).

2. Ministers are invited to endorse the conclusions in paragraph 6 of the attached report.

Signed ROBERT ARMSTRONG
R L WADE-GERY
R M HASTIE-SMITH

Cabinet Office

28 March 1980

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REVIEW OF THE UNITED KINGDOM RESPONSE TO PRESSURE FOR
VOLUNTARY MEASURES AGAINST IRAN

1. The purpose of this report is to consider the effects of maintaining those restrictions on economic relations with Iran to which Ministers agreed on 22 January (OD(80) 1st Meeting, Item 1). The paper does not consider what response should be made to the proposals in President Carter's message of 25 March to the Prime Minister.

2. In January the United States Government asked the United Kingdom and other allies to implement on a voluntary basis the sanctions against Iran set out in a United Nations Security Council Resolution, which was vetoed by the Soviet Union. Ministers decided that few of these measures could be implemented by the United Kingdom, for a variety of reasons -

- a. Legal: since without new legislation the United Kingdom does not have appropriate powers to apply many of the measures proposed, unless backed by a mandatory resolution of the United Nations Security Council.
- b. Political: since pressures of this kind could well reinforce extremist elements in Iran.
- c. Economics: since few countries were likely to apply the sanctions, which would thus become ineffective; countries which did would be vulnerable to retaliation, and few more so than the United Kingdom.

3. President Carter's message of 13 March recalled the United Kingdom's agreement to undertake three types of measures against Iran, and sought assurances that we would keep them in operation. These were -

- a. informal financial measures
- b. restraint on buying Iranian oil at prices sharply different from other OPEC producers
- c. a ban on the supply of military equipment.

The detailed position of each of these measures is set out in Annexes I, II and III. The broad position is, first, that the measures are all being applied, though in the case of oil prices our support has necessarily been qualified. Second, neither the financial nor the oil price measures are at present causing us damage or embarrassment; but control of oil prices may again become a difficult issue if reports that Iran is trying to raise prices by a further margin of \$2 a barrel are confirmed. Third, military equipment worth over £200 million is being held up and there is considerable risk of Iranian action to seek redress and perhaps compensation in the courts. Meanwhile, the decision of the Italians to deliver a helicopter for relief operations may be a sign of wavering in other countries' support for a continued ban on military exports.

4. The most immediate questions concern delivery of the fleet replenishment ship "Kharg", the position of which is described in detail in Annex IV. However, the essence of the problem is that it is possible to continue delaying delivery of the ship with the consequences a. of British Shipbuilders incurring additional costs of £70,000 per week; b. of a risk, likely to grow, that Iran could decide that she did not want the ship and could pin responsibility for the breach of contract on the shipbuilder. British Shipbuilders have asked to be indemnified against these costs and this risk, pointing out that both are directly attributable to government action and that they wish to meet the external financing limit set by Her Majesty's Government.

5. As to civil trade, it is not easy to distinguish the effects of the informal financial measures introduced in December from the consequences of removing ECGD cover for commercial reasons and the confused situation in Iran itself. The commercial factors are likely to be more important. To date ECGD has paid about £70 million in claims on Iran. A further £25 million of claims are under review and potential losses of £150 million have been notified to ECGD by exporters. Recoveries from Iran on claims payments have so far been minimal. At present there is no Iranian activity on the large defence contracts insured by ECGD but in two of the largest cases exporters are preparing termination accounts for the Iranians. In the light of this and the continuing economic difficulties in Iran, no new ECGD facilities have been issued during the last four months. Despite the difficulties, our exports to Iran were £60 million in January-February 1980, compared with £54 million in the same months last year.

CONCLUSIONS

6. We conclude that -

- i. there is no special difficulty about maintaining informal financial measures against Iran at their present level;
- ii. the difficulties and cost of holding up defence equipment ordered by Iran, especially the replenishment ship "Kharg", will increase but remain acceptable for the time being;
- iii. although there is no immediate pressure on British oil companies to pay "sharply different" prices for Iranian oil, this is an area in which we are very much more vulnerable than the United States to Iranian retaliation. We cannot go beyond the assurances we gave at an informal IEA meeting to use our best endeavours to meet the American request as part of a wider oil price restraint programme in which all countries participate effectively.
- iv. although ECGD have made substantial losses on trade with Iran, this is not as a result of United Kingdom implementation of the informal financial measures.

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IRANVoluntary financial measures

Following a request from the US Government on 17th December, major UK banks were asked by the Bank of England to implement the following non-statutory measures against Iran:-

- (a) not to offer new or increased credits to the Iranian Government or its agencies (but roll-overs, and short-term credits associated with commercial transactions, were allowed);
- (b) not to open new current or deposit accounts for the Iranian Government or its agencies;
- (c) not to accept substantial increases in existing non-dollar deposits from Iran.

The UK was not, however, prepared to go along with a fourth request from the US, namely to insist on prompt servicing of Iranian loans and to declare default in case of arrears; banks had to be left free to decide how best to exercise their rights. The banks were told that day-to-day transactions could continue, and they were still free to exercise their commercial judgment.

Broadly similar voluntary measures were introduced by a number of other major countries including the Germans, the Dutch, the French the Japanese, the Italians, the Canadians and the Swiss. The measures came into effect at varying dates; and in some countries were viewed in a somewhat cynical light. No publicity has been given to the existence of these measures, although leaks have appeared in the Press in various countries from time to time.

These measures are still in place. In the UK, they have had little or no damaging effect on banking business. In late February, the US Embassy requested us to continue to apply the measures; they were not complaining about the British banks, but felt that some countries had latterly become rather cavalier about applying the measures in relation to new credits. We have no conclusive evidence on this; but the indications are that some Japanese banks in particular are making an effort to pick up extra deposit business.

OIL PRICES

1. The United States President's request that companies should not accede to Iranian oil prices which are 'sharply different' from those being charged by other OPEC producers creates particular difficulties for UK companies.
2. UK and Japanese companies are particularly dependent on supplies from Iran. And we have recognised the possibility that action aimed directly at Iran might result in Iranian retaliation by denying supplies of oil to the countries concerned.
3. Although we told the Americans therefore that we would urge UK oil companies not to settle contracts with the Iranians at prices sharply different from those being charged by other producers, and impress on them the need to keep any increases in prices to a minimum, we also explained that at the end of the day the Government had to leave it to the companies' judgement whether to accept the best terms they can negotiate or to forgo their contracts. Indeed our understanding is that in most cases there are no direct controls available to stop oil companies from purchasing oil if they think it is in their commercial interests so to do. It was made clear that given the companies' dependence on Iranian oil it would be difficult for us to go further than this unless there is agreement on a world scale on a more wide-ranging attempt to control excessive oil prices generally; and unless there is some arrangement under which countries like the USA, who have better current access to oil supplies, are willing to help those countries or companies who are denied oil as a result of any action in Iran. Both Shell and BP have represented to us in the past, when we asked for their co-operation on prices, that they would expect to be helped out by American companies, if any co-operation on their part should lead to denial of supplies.
4. We have never had any explicit acceptance by the Americans of the need for a fully comprehensive system, or the need to institute safety net measures of any kind. The question of excessive price levels generally was however discussed recently in the IEA on an informal basis. Agreement was reached that there should be a system of informal consultations between major countries, on occasions where excessive prices appear to be demanded by any country, not particularly Iran.

5. If necessary therefore, we could participate in discussion of a system of this kind, provided it were fully effective and that all major oil importing countries participate. It would also be important that any action taken in this way was not regarded by OPEC as confrontational, but strengthened the hands of the moderate elements in OPEC. We should not go beyond the assurances given in the informal IEA meeting and we should make it clear that any system would depend on best endeavours of the governments concerned.

... contracts for the supply of ammunition for tanks and light armoured vehicles is about £160M. DMS Ltd are already technically in breach of these contracts because deliveries were stopped during the Iranian revolution and have not been resumed. Ammunition worth about £15M is ready for delivery now. Re-negotiation of prices for the remaining £150M worth of ammunition is taking account of escalation during the period of revolutionary disruption and time to re-start production have reached stalemate and production has not, as yet, resumed. The period for variation of price being offered by Iran is insufficient to cover ROP-estimated costs. There are no other likely buyers for some types of the type of ammunition that was in stock or in course of manufacture when production for Iran was stopped. The value of this ammunition is about £15M, a potential direct loss to defence votes.

Spare Parts for Tanks and Other Armoured Vehicles (Contractors: DMS Ltd)

2. No deliveries have been made against current contracts for the supply of armoured vehicle spares since early November 1979. The processing of urgent Iranian demands is proceeding in slow time. A stock of spares paid for by Iran and currently valued at about £15M is held in this country and the Iranians had asked for these to be transferred to Iran. The Iranians may lodge a claim against DMS Ltd for the value of the spares they own if deliveries are held up very much longer. It is possible that DMS could retain the spares against claims owed by Iran on other contracts, and advice is being sought on the legal conduct of such retention.

CURRENT DEFENCE EQUIPMENT BUSINESS SHOWING
POSSIBLE FINANCIAL IMPLICATIONS OF BREACH OF CONTRACT

Ammunition Contracts (Contractors: International Military Services Ltd (IMS Ltd) (government owned))

1. The total value outstanding on current contracts for the supply of ammunition for tanks and light armoured vehicles is about £160M.

IMS Ltd are already technically in breach of these contracts because deliveries were stopped during the Iranian revolution and have not been resumed. Ammunition worth about £25M is ready for delivery now. Re-negotiation of prices for the remaining £135M worth of ammunition to take account of escalation during the period of revolutionary disruption and time to re-start production have reached stalemate and production has not, of course, recommenced. The period for variation of price being offered by Iran is insufficient to cover ROF estimated costs. There are no other likely buyers for some types of the ~~ammunition~~ ammunition that was in stock or in course of manufacture when production for Iran was stopped. The value of this ammunition is about £33M, a potential direct loss to defence Votes.

Spares for Tanks and Other Armoured Vehicles (Contractor: IMS Ltd)

2. No deliveries have been made against current contracts for the supply of armoured vehicle spares since early November 1979. The processing of urgent Iranian demands is proceeding in slow time. A stock of spares paid for by Iran and currently valued at about £18M is held in this country and the Iranians had asked for these to be transferred to Iran. The Iranians may lodge a claim against IMS Ltd for the value of the spares they own if deliveries are held up very much longer. It is possible that IMS could retain the spares against debts owed by Iran on other contracts, and advice is being sought on the legal soundness of such retention.

Support Ships (Contractor: IMS Ltd)

3. IMS Ltd had a contract for the supply of four support ships to be built by Yarrow Shipbuilders (a subsidiary of British Shipbuilders). The contract was terminated but the present Iranian Government wished to revive the contract for at least two of the ships but they have not yet made a firm decision. Yarrows have the prospect of selling all four ships to other buyers and are pressing for a final decision on the two ships for Iran so that the way is cleared for negotiations with the other prospective buyers. The first ship is expected to be completed in May.

Fleet Replenishment Ship 'Kharg' (Contractor: Swant Hunter Shipbuilders Ltd (a subsidiary of British Shipbuilders))

4. The present position on 'Kharg' is set out in Annex IV.

Other Supply and Support Contracts with International Military Services Ltd

5. The following contracts between Iran and IMS Ltd, were repudiated by the Iranians immediately before the revolution and numerous claims and counter-claims remain to be resolved in respect of these and of a number of other contracts which, although not cancelled were suspended because funding was allowed to lapse or for other contractual reasons:

- i. Tank Project 4030.
- ii. Armoured Recovery Vehicles.
- iii. Bandar Abbas Dockyard.
- iv. 5th Echelon Base Workshop at Dorud.
- v. Military Industrial Complex at Isfahan.

6. Formal contact with Iran, and discussion of these contracts ceased when the hostages were seized last November and, apart from the meetings with Colonel Kamkar in London in February and the subsequent exchange of routine correspondence, have not been resumed.

7. A letter has now been received from the Iranian Ministry of National Defence couched in fairly strong terms, demanding progress in the negotiations and threatening legal action. This is being studied by officials and legal advisers and, in the light of their findings, guidance will be sought from Ministers as necessary.

Smaller Contracts

8. There may be other smaller private sector contracts of which we are at present unaware, e.g. for repairs of defence equipment in the UK, which may shortly give rise to requests for Export licences and there are a few applications for Export licences already being held up. It may become increasingly difficult to withhold licences without publicly giving the reason.

FLEET REPLENISHMENT SHIP 'KHARG'

1. When the Iranian Deputy Minister of National Defence (Colonel Kamkar) visited London in early February he agreed with Swan Hunter, subject to his Government's agreement, that delivery of the Kharg could be delayed until the end of March and that no further penalty for late delivery would accrue against Swan Hunter even if there was delay beyond that date for "political reasons". In return, Swan Hunter agreed to freeze the price of the vessel as at 31 August 1979. This agreement has effectively been ratified although, significantly, the Iranian Defence Ministry have sought to make Swan Hunter responsible for obtaining all necessary permits and licences (i.e. including an Export licence) before acceptance of the ship.
2. The Iranians have now requested and been given 30 days notice of delivery and the new contract acceptance date is 11 April. From that date, the possibilities of further administrative delay by Swan Hunter will be exhausted.
3. Swan Hunter have told the Iranians, with the approval of officials, that, without prejudice to their contractual obligations, they will support the Iranian application for an Export licence and use their best endeavours to see that it is granted. Thus, if the view is still held that the Kharg cannot be released, there may be no option but to refuse an Export licence. Consideration will need to be given to how long to delay any communication to Iran of a refusal for the ship to be commissioned and for an Export licence to be granted, as well as the terms in which the decision should be communicated. The Iranians are pressing MOD for a statement and have indicated that meanwhile they will withhold payment of the final instalment of £10M due on the ship. It may no longer be possible to avoid linking a

refusal with the situation in the US Embassy in Tehran but it is for consideration whether we should bring into any Government-to-Government talks on the subject the questions of compensation for damage to the British Embassy in Tehran, and of debts owed to HMG in the defence field which amount to about £7M. This might give us a better stance under international law, although care would need to be taken not to give the impression that the debts were the sole impediment to release of the Kharg.

4. One of the consequences of refusing an Export licence will be that Swan Hunter will incur expenses of £70K per week for interest on the outstanding balance, maintenance and security of the ship, insurance, etc, possibly rising to £90K per week if delivery is long delayed. A claim for such expenses against HMG would have no legal foundation since the Secretary of State for Trade has the right to refuse Export licences in pursuit of Government policy and there is no liability to compensation for loss in these circumstances.

Nevertheless, such additional expenses will increase Swan Hunter's losses. In the longer term, there is also the possibility of claims for extensive damages for breach of contract. British Shipbuilders have made representations to the Secretary of State for Industry on these matters and have sought an indemnity in relation to their cash limits.

5. Finally, under an overseeing agreement with IMS Ltd, Iran have the option to request Royal Navy assistance during post-acceptance operational sea trials in UK waters. A programme for such trials is being considered but has not yet been agreed. Although there is at present no binding contractual commitment, the offer made is in accordance with normal custom. Clearly, should there be a decision to release the Kharg in circumstances other than the safe release of the US hostages, the question of RN assistance would need very careful consideration so as to avoid offending the US.