2

Prime Minister

Sir Keith has decided - at least for the moment - not to press for the cost escalation concession. He says GEC may be able to get the contract without it. TL 17/3

CONFIDENTIAL

to the Dept

MT.

PRIME MINISTER

CASTLE PEAK "B" STATION, HONG KONG

At EX on Monday (EX(81)2nd) Cecil Parkinson and I were invited to reconsider the case for any further subsidy measures beyond the capitalisation of interest agreed at the meeting. We were invited to consult the Chairman of GEC with a view to persuading GEC to finance any further concession on the price offered.

2 Officials here have talked to GEC, and in addition to Babcocks since the latter are in fact responsible for more than 50% of the total contract price. Officials have also kept in continuing touch with the negotiations in Hong Kong.

3 Briefly, the negotiations in Hong Kong have concentrated upon the hardware prices: the CLP/Exxon side, advised by an American consultant, have challenged more than 60% of the price items. Between them the British companies have conceded more than £20 million to keep within the range of what CLP/Exxon argue as internationally competitive. So far, therefore, the contract prices appear to be moving towards agreement, though further pressures from the customer cannot be ruled out. Negotiations on the financing terms are under way.

CONFIDENTIAL

4 In officials' discussions with GEC and Babcocks the companies have pointed out that ECGD's Cost Escalation Scheme was drawn up in such a way as to provide an incentive to companies using the Scheme to control their costs by requiring them to meet 10% of the total cost of increases above the threshold. At a threshold of 7%, with inflation at 11%, the company's contribution over the whole order would be some £15 million. In the course of undertaking a hardware cost-cutting exercise, with possibly further demands from the customer to come, the companies were understandably reluctant to take on further liabilities, which would not arise if the hardware negotiations broke down. This seems a not unreasonable approach given the state of the negotiations.

5 CLP/Exxon have not intimated formally that they wish to question the Cost Escalation threshold. Obviously, until they do, the question of adjusting the threshold from 7% to 5%, at a net present value cost to the Government of £16 million, does not arise. From the outset it was envisaged that no concession would be made until demonstrably necessary.

6 In view of the concern of colleagues, our negotiators in Hong Kong will make no move on the Cost Escalation threshold issue. If it becomes crucial our negotiators are reasonably

sure that they could hold a final decision until Ministers can be contacted. If the issue does become crucial I shall press the companies again. For the moment, therefore, I would not press this, though I would wish to keep open the alternative of returning to colleagues if the threshold issue becomes the lynchpin for securing the order and if I cannot persuade the companies to bridge the entire gap or most of it.

7 The project remains of great industrial importance, with implications ranging far wider than Hong Kong itself; it would preserve good quality employment in the areas of highest unemployment in the United Kingdom; and its failure would have serious implications for the prospects of British industry in Hong Kong, an aspect particularly stressed by Sir Murray Macclehose when he called on me yesterday. I very much appreciate the readiness of colleagues to accept the capitalisation of interest.

8 I am copying this to Members of EX and to Sir Robert Armstrong.

Catherine Bell

pp K J

12 March 1981

(Approved by the
Secretary of State and
signed in his absence)

Ref: A04423

Hong Kong

CONFIDENTIAL

PRIME MINISTER

Castle Peak B Power Station, Hong Kong

BACKGROUND

At their meeting on 21st January the Committee approved a package of assistance, recommended by the Secretary of State for Industry in EX(81) 1, to enable United Kingdom industry to submit proposals for this contract without competing in international tender (EX(81) 1st Meeting). The main features of the assistance were support from Department of Industry funds of up to £20 million spread over the period 1981-1991 for consultancy services; and charging 1 per cent, rather than the standard 2 per cent, for the ECGD's Cost Escalation premium, at a cost of £17.5 million over the same period, and recognising that further flexibility and a reduction in the premium might be necessary to secure the contract.

2. In his letter of 2nd March to the Chancellor of the Exchequer, the Minister of State, Department of Trade, Mr. Parkinson, recommended two further specific concessions in the light of the negotiating position now reached:-

(i) That the ECGD should accept liability under their cost escalation scheme of the amount of annual cost increase incurred above a threshold of 5 per cent rather than the standard 7 per cent.

(ii) The offer, if necessary, of some measure of interest capitalisation so that interest due in the pre-commissioning period could be deferred, but not waived.

Mr. Parkinson proposes that the cost escalation concession should not be revealed to Parliament or to the European Commission.

3. These concessions are supported by the Secretary of State for Industry, in his letter of 5th March to the Chancellor of the Exchequer, and by the Foreign and Commonwealth Secretary in his minute of 6th March to the Chancellor.

4. The Chancellor of the Exchequer, however, in his letter of 6th March to the Secretary of State for Trade argues against reducing the cost escalation scheme threshold, although he is prepared to agree to interest capitalisation if this is judged essential to secure the contract. Mr. Ibbs, in his minute of 5th March to Mr. Lankester, has set out the CPRS's doubts on the degree of subsidy now proposed.

5. The note by Department of Industry officials, annexed to Mr. Parkinson's letter of 2nd March, purports to set out the facts on the subsidy. I understand that it is not, however, accepted by the Treasury. On their arithmetic the total subsidy before the present proposals were put forward represented 44 per cent of the total costs of the project - for the basic interest subsidy common to all ECGD support, for the costs of the cost escalation arrangements at a premium of 1 rather than 2 per cent, and for the costs of financing the consultancy services. The percentage for the subsidy goes up to 56 per cent on their calculations if allowance is now made for a cost escalation threshold of 5 per cent and for the extra interest subsidy involved in the capitalisation proposals. 56 per cent compares with the normal subsidy on ECGD schemes of around 35 - 40 per cent.

6. There is little doubt that the degree of subsidy is high but in considering it the Committee will wish to bear the following points in mind:-

(i) The consultancy services will be financed from the Department of Industry's present public expenditure allocation.

(ii) While capitalisation of interest is not always allowed, it is frequently used by ECGD and by our competitors.

(iii) Apart from the cost escalation concessions, ECGD's support will be on orthodox terms - they expect to negotiate adequate security for the loans, and the interest rate of $8\frac{1}{2}$ per cent and the credit period of 12 years from commissioning are both in line with OECD consensus arrangements; and

(iv) the costs of the ECGD concessions in the present public expenditure period will be negligible.

7. You will recall from the discussion of EX(81) 1 that the contract was thought to offer a chance of a major boost for our power plant industry and to be highly attractive:-

(i) It would be the largest power plant export order ever won by the United Kingdom.

(ii) In addition to GEC and Babcock, a good number of sub-contractors would benefit - see the list at Annex F of EX(81) 1.

(iii) There would be about 34,000 man years of work for United Kingdom firms from 1981 to 1989 with 68 per cent of this in Assisted Areas, and significant benefits for the Glasgow area and Larne in Northern Ireland - see Annex G of EX(81) 1 for details.

(iv) It could boost the United Kingdom's chances for further major orders in Hong Kong and the Far East - Department of Industry officials judge that, if GEC fail to get Castle Peak B, the Chinese will rule them out of the Guangdong project; see also the Foreign Secretary's minute of 6th March.

HANDLING

8. You will wish to ask Mr. Parkinson and the Secretary of State for Industry to make the case for the proposed concessions and to advise on the state of the negotiations. The Chief Secretary and Mr. Ibbs will then wish to elaborate on their doubts on the degree of subsidy which would be involved if the concessions were made in full. The Lord Privy Seal will want to comment on the wider implications of securing this order.

9. Subject to what Mr. Parkinson and the Secretary of State for Industry say, it seems that the negotiators who are now in Hong Kong need firm instructions this week. If this is right, you will need to confirm at the meeting that it is agreed that they can offer interest capitalisation if necessary and whether they can also offer reduction in the cost of escalation threshold to 5 per cent.

10. If the concessions are to be made you will wish to decide whether Parliament should be informed. The formal position on the previously proposed package was that unless the assistance is notified to, and cleared with, the European Commission it would be contrary to Community Law. At their last meeting the Committee did not, however, dissent from the Secretary of State for Industry's view that the Commission should not be informed of the assistance either now or later, and that Parliament should not be notified of it when the project was announced. While there are obvious risks in this it seems a necessary procedure to ensure that Commission delay and intervention does not mean the United Kingdom losing the contract; and it is the procedure followed by the last Government for Castle Peak A.

11. Whatever the Committee's decision on these proposals, you may also wish to endorse Mr. Ibbs's recommendation - paragraph 4 of his minute of 5th March to Mr. Lankester - that future cases should be presented against the background of broad and agreed criteria.

CONCLUSIONS

12. In the light of the discussion you will wish to record conclusions -

(i) confirming whether the negotiators may offer capitalisation of interest if necessary;

(ii) ruling on whether they may offer a reduction in the cost escalation threshold from 7 per cent to 5 per cent;

(iii) on whether Parliament should be informed of some, or all, of the arrangements;

(iv) on any more general conclusions on the criteria to be adopted for future cases.

(Peter Le Cheminant)

9th March 1981

FCS/81/33

MO

CHANCELLOR OF THE EXCHEQUER

1. I have seen Cecil Parkinson's letter of 2 March (supported by Keith Joseph in his letter of 5 March) seeking agreement for a reduction in the threshold of the ECGD Cost Escalation Cover Scheme for the Castle Peak 'B' project in Hong Kong from the normal 7% to 5% per annum.

2. I fully support this proposal on the grounds that the order, if secured, would make a sizeable contribution to promoting British commercial interests in Hong Kong and in the Far East generally. Moreover, I share the Governor's wish to see GEC win this contract for wider political reasons. Deep concern at the charging of full-cost fees for overseas students and the proposals in the British Nationality Bill have led to accusations in Hong Kong that the United Kingdom is less interested in the Territory. Success in winning this order by HMG making the financial terms as flexible as possible would be an indication that we are committed to maintaining our economic and political involvement in Hong Kong.

3. There are also strong trade promotion reasons for supporting the bid for this order. UK firms will wish to compete for several major projects in Hong Kong, including the extension of the Mass Transit Railway and the construction of a new international airport. The prestige for Britain in securing the Castle Peak 'B' order would greatly aid their efforts. Moreover, the Hong Kong market acts as a 'shop

/window'

window' for the rest of the region, especially China. If we are to win orders in these markets we must show ourselves to be competitive in Hong Kong. This is especially valid for the Guangdong Nuclear Power Station project, for which we must maintain the goodwill of the China Light and Power Company and its Chairman, Sir Lawrence Kadoorie. It is due to his efforts that GEC received the offer of exclusive negotiation for the Castle Peak 'B' contract. Failure on our part to provide attractive financial terms for Castle Peak 'B' could sour him in relation to the Guangdong Project.

4. I am copying this letter to the other members of the EX Committee and to Sir Robert Armstrong.

C

(CARRINGTON)

Foreign and Commonwealth Office
6 March 1981

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

6 March 1981

The Rt. Hon. John Biffen MP
Secretary of State for Trade

Dear Secretary of State,

CASTLE PEAK "B" POWER STATION PROJECT

Thank you for your letter of 2 March, in which you seek my agreement to two further concessions in the terms of ECGD support for this contract.

I recognise that Keith Joseph's paper for EX noted that further flexibility might be necessary to secure this business. But the concessions you propose would in fact, on the normal market related method of calculating subsidy costs, be more expensive than those we agreed at EX. I am already concerned about the level of subsidy in this case and to be faced with a further significant addition is very worrying. However, I am prepared to agree interest capitalisation, if this is judged essential to secure the contract. But I do not think we should alter the normal 7 per cent threshold for cost escalation cover, which is a key element in the terms of the scheme.

While I recognise the importance of this contract, I doubt whether the further increase in the already very high level of subsidy which would be involved if this concession were agreed could easily be defended. As you acknowledge, the total subsidy could then amount to £180 million or 56 per cent of UK content in NPV terms. In this context, I am also doubtful about the propriety of not informing Parliament of such a significant change in the terms of the scheme. I do not think we should necessarily be guided by the actions of our predecessors on Castle Peak "A".

Apart from the direct public expenditure costs involved, I am also worried about the repercussions of a concession in this case. I am not convinced by your argument that it would be possible to prevent this constituting a precedent; indeed all the signs are that NEI and other companies engaged in large project business will be quick to press for similar

/concessions.

concessions. The danger is of a very significant relaxation in the terms of the scheme which would involve a substantial and continuing burden on public expenditure.

I am copying this letter to the recipients of yours.

Yours sincerely,

Richard Tolkien,

for,

GEOFFREY HOWE

[approved by the Chancellor and signed in his absence]

-6 MAR 1981

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PV

3 pps

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Secretary of State for Industry

5 March 1981

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1P 3AG

Dear Geoffrey.

CASTLE PEAK "B" POWER STATION PROJECT

Cecil Parkinson's letter to you of 2 March sets out proposals developed jointly by officials from his and my Departments and ECGD to meet the pressures that are going to be confronted by our officials in the final negotiations for the "B" Station contract.

I share worries about the costs of supporting these large overseas projects. On the other hand a large part of the expenditure implications, particularly on the export credit interest make-up, stems from the level of interest rates and the comparative figures for lower inflation and interest rates illustrate clearly the impact of our present high rates.

This is an extremely important order from many standpoints and I go along with Cecil Parkinson's view that we should be ready to make these additional concessions if necessary to secure this order.

I am copying this letter to Cecil Parkinson, other members of the EX Committee and to Sir Robert Armstrong.

Ever.

Keith.

Nos / 1000s or slate?

Prime Minister

There is clear disagreement between the Treasury (supported by the CPRS) and DoI and DoT. The latter wish to increase the implied subsidy from a third to over 50%. This has to be resolved fast. We are [illegible] We have provisionally arranged a meeting of Ex at 4pm on Monday.

CONFIDENTIAL
COMMERCIAL - IN CONFIDENCE

Qa 05269

5 March 1981

To: MR LANKESTER

From: J R IBBS

34,000 man years - the implied subsidy would cost £5,300 per man year.

TL.

CASTLE PEAK B POWER STATION PROJECT

TL 8/3

1. When this project was discussed at EX Committee on 21 January, the cost of Government support appeared to be worth around one-third of the UK element of the contract. I sent you a minute expressing my concern in general about such high levels of subsidy, though in the special circumstances of Hong Kong I was prepared to accept that this power station order scraped through.

2. EX Committee were warned that the one-third may in the end, however, not be enough of an inducement for the Hong Kong utility to place the order with the UK. Now Cecil Parkinson in his letter to the Chancellor dated 2 March is proposing that our negotiators currently in Hong Kong should be allowed to concede a support level of over one-half. In fact, on the Treasury's agreed net present value basis of calculation, the proposed support of around £180 million would represent 56% of the £320 million that the contract is worth to the UK.

3. A subsidy of over 50% does appear to exceed normal commercial prudence. If it were to be justified, one would need very clear evidence of (a) the true importance of the order to the power plant industry, and (b) the value of retaining our position in the Hong Kong market (i.e. the volume of future business likely to arise and the size of subsidies then likely to be extracted). I am not satisfied that such judgements are possible on the evidence at present available. I suggest that those concerned should be asked to give as clear answers as possible to these questions before a decision is taken.

CONFIDENTIAL
COMMERCIAL - IN CONFIDENCE

4. If requests for subsidies of this magnitude are going to continue to come forward it would be as well to have a clear understanding of the justification in each case. To achieve this a set of broad criteria would be helpful: there are such criteria for inward investment, where the level of assistance is much lower than that proposed for this export contract. Questions to be answered would include (a) what is the export trade significance and is this being properly measured in current conditions where the balance of payments is far less of a consideration than it used to be, (b) what is the industrial justification and is an export subsidy the most effective way of spending money to assist the industry, and (c) is the subsidy conferring an undue benefit on a foreign economy and would it be better for the whole of any assistance to be deployed within the UK?

5. I am sending a copy of this to Private Secretaries of members of EX Committee and to Sir Robert Armstrong.

JR

4 major contracts
GEC. £257m

CONFIDENTIAL

DEPARTMENT OF TRADE
1 VICTORIA STREET
LONDON SW1H OET

TELEPHONE DIRECT LINE 01 215 5144
SWITCHBOARD 01 215 7877

From the
Minister for Trade

MB

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON SW1P 3AG

2 March 1981

Polish ships

£1/2 on construction costs

Dear Chancellor,

CASTLE PEAK "B" POWER STATION PROJECT

You will recall that EX Committee met on 21 January to consider the provision of Government support for GEC's attempt to negotiate a contract for this project. The Committee approved the proposals in paragraph 6 of Keith Joseph's paper (EX(81)1), one of which read as follows:

> "The halving of the ECGD Cost Escalation premium from about £35m to £17.5m, recognising that further flexibility and a reduction in premium may be necessary to secure the contract (this concession would be in addition to the normal assistance being provided to the contract by ECGD)."

In accordance with this decision my officials and Keith Joseph's have been considering what measures are necessary to enable GEC to offer a fully competitive price. Following representations by the company, DOI officials have produced a paper (attached) suggesting that the threshold for CEC cover should be 5% pa rather than the normal threshold of 7% pa. Cost Escalation Cover

I consider that in the circumstances of this particular contract such a concession would be both defensible and consistent with the decision of EX Committee. A similar concession was, indeed, made by our predecessors in respect of the "A" station, and the attached paper argues that the cost of the concession I propose would be in line with the cost of the concession in that case. I should emphasise that this concession is intimately related to the circumstances of this particular case, and that I intend to direct ECGD that it is not to be regarded as a precedent.

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2870

We also have to consider whether Parliament should be informed of this concession. Parliament has been told that the normal threshold is 7% pa; but when our predecessors made a similar concession, on the "A" station, to that which I now propose they took the view that formal notification to Parliament was unnecessary. I propose to follow this precedent, which would have the advantage of not attracting gratuitous criticism from the Commission.

If GEC are to be able to offer a fully competitive package, I think we shall also need to offer some measure of interest capitalisation. This technique is widely used by ECGD to allow UK exporters to offer the most attractive bids, and calls for the interest due in the pre-commissioning period to be deferred and repaid together with and over the same period as the principal repayments. Other credit insurers also use this technique, and we understand that some of them have already indicated to the customers that they are willing to offer not only interest capitalisation but also other features which we would have difficulty matching if the project were to go to international tender. For instance, both France and Japan are likely to offer to dispense with progress payments during the manufacturing period. The Japanese in particular are known to give high priority to winning a major power station order in Hong Kong because of the wider effects it would bring for their prestige in Southern Asia. Equally, the UK industry claims that its prospects would be severely damaged in this area if this order were lost. It is significant that the Japanese success in winning the (smaller) order for the Hong Kong Electric station, like the British success in winning the Mass Transit contract, depended at least in part on a concession of the sort I propose.

I would not, however, propose that ECGD should take the initiative in conceding capitalisation of interest; simply that they should be authorised to offer it should it be judged necessary to the success of the UK bid. Moreover, I propose that the ECGD team should seek to limit interest capitalisation so far as possible; it might not be necessary for the whole of the pre-commissioning interest to be capitalised, and I would propose to leave this question of degree to the judgement of the ECGD team on the spot. Capitalisation would not constitute a direct charge to ECGD's trading account, although the potential liability would be increased (in recognition of which an increased premium would be payable).

It is difficult to estimate the overall cost of Government support on the basis I propose, given the long manufacturing and repayment periods involved. Losses on CEC will depend on the levels of inflation prevailing during the manufacture of the project, which extends to 1989. The cost of interest support will depend on the level of short term interest rates prevailing throughout the rest of the century, when the final loan repayment is received. One can start from the basis of the current long term sterling market interest rate of 14%. Since this rate is conventionally held to yield a 3% real rate of return one can deduce from this a market expectation of long term inflation averaging 11%. On this basis the overall cost of the proposed support for this project would be about £180m (NPV), representing rather over 50% of the NPV of the UK element of the contract. Alternatively one can argue that the market's perception of future inflation fails to take adequate account of the success of our economic strategy. If, for example, long term inflation were to come out at only 7% pa and, consistent with such an average, interest rates were to average 10%, then this cost would reduce to £64m, representing under 20% of the NPV of the contract.

These figures are comparable with those for many projects in developing countries, where the Aid and Trade Provision is used as well as normal ECGD support.

I hope you will be able to agree to cover on the terms I propose above. Since the negotiator in Hong Kong will be pressed to indicate the final proposals in the very near future with a view towards reading a "yes" or "no" decision by the end of next week, I should be grateful for a very early response. I am copying this letter to the other members of EX Committee and to Sir Robert Armstrong.

Yours sincerely,

Matthew Cornebrook

f.P. CECIL PARKINSON

Approved by the Minister
but signed in his absence.

CASTLE PEAK "B" POWER STATION PROJECT

INTRODUCTION

Ministers approved the proposals in the Secretary of State for Industry's Memorandum EX1 (1) that support should be made available to help UK industry on this project by way of: -

- payment for certain consultancy services;
- a halving of the Cost Escalation Premium "recognising that further flexibility and a reduction in premium may be necessary to secure the contract".

It has now become apparent since the UK's offer was submitted last month that the client's evaluation is not confined to a comparison of base prices.

GEC were requested to offer a fixed price and a variable price subject to escalation and even with the support offered by the Cost Escalation Cover Scheme (CEC) the inflation applicable to Unit 4 to be borne by the client exceeds 56%. This is substantially higher than the client would experience were he to buy plant from our major competitors. Unless the support given under the CEC can be altered the UK offer for this prestige £550M project will be judged uncompetitive. This paper considers the options available.

THE COST ESCALATION COVER SCHEME

The CEC Scheme was introduced in 1975 with the objective of offsetting the effects of high inflation on major export contracts. The scheme is based on the principle that ECGD will be liable for a portion of the amount of annual cost increase incurred above a threshold. The threshold was originally set at 10% but subsequently lowered to 7%.

The scheme also assumes that the escalation takes place over the full period of manufacture which in this case equates approximately to 22.2% over 38 months for Unit 1. The mean point of manufacture is nevertheless about two-thirds along the manufacturing cycle and the 22.2% escalation effectively has to be achieved over 26.3 months before ECGD have a liability. With a 1% per annum premium to ECGD the annual inflation would have to exceed the following before the 7% threshold came in to play: -

	1% Premium
Unit 1	11.4% p.a.
Unit 2	10.3% p.a.
Unit 3	9.4% p.a.
Unit 4	9.1% p.a.

By comparison during the past $3\frac{1}{2}$ years annual inflation in competitor countries has moved as follows: -

Japan (Mitsubishi)	6.6%
Switzerland (Brown Boveri)	3.2%
Germany (KWU)	4.8%

In France (Alsthom) where inflation is higher, a cost escalation cover scheme exists with the added benefit of a lower threshold (6.5%) and some relief against exchange rate fluctuations.

REDUCATIONS IN THE THRESHOLD

While the CEC scheme aims to maintain the competitiveness of major UK manufacturing exports, it cannot achieve that with a 7% threshold. To reduce the cost increases borne by the client towards the levels of our competitors would however require a threshold of about 3-4%. This would be prohibitively expensive and an obvious subsidy.

An alternative approach is to accept that the CEC scheme also aims to minimise the risks associated with uncertain future inflation that otherwise have to be taken account of in the contractors fixed price. The contractor has limited influence over national inflation rates and if he reduced his fixed price in line with official inflation assumptions and the CEC threshold was set accordingly then there would only be a public expenditure liability if the actual inflation rose above the official estimates.

On the basis of Treasury forecasts of future rates of inflation for the PESC period, carried forward at the 1983/4 6% level through the balance of the manufacturing period, then the threshold could be set at 5% providing for a liability only if inflation exceeded: -

Unit 1	8.51%
Unit 2	7.69%
Unit 3	7.02%
Unit 3	6.80%

(1% premium assumed throughout)

The net cost (£m) would be:

Premium Level	Outturn Cost	NPV* Survey Prices	NPV* (DoT)
1%	34	19	14
0%	50	30	24

Expenditure (£m) over the PESC period would be:

1%	.98	.38	.22
0%	7.19	5.29	5.22

* NPV Survey Prices are outturn prices deflated to 1980/81 values on the basis of reciprocal of inflation assumptions. NPV/(DoT) are outturn prices deflated to 1980/81 values using the 14% discount factor as for the Export Assistance Exercise (notification to Ministers of estimated cost to the public purse of ECGD support for large projects).

For illustration purposes with a 6% threshold the total net costs (£M) could be:

Premium Level	Outturn Cost	NPV* Survey Prices
1%	18	9
0%	34	20

Alternatively it could be argued that contrary to Government policy, the reduction in inflation will not be sustained. If inflation were to rise from 6% in 1983/4 to 7% in 1984/5 and 8% thereafter through the manufacturing period, the costs (£M) could be as follows: -

Threshold	Premium Level	Outturn Cost	NPV Survey Prices
5%	1%	52	28
	0%	68	39
8%	1%	36	18
	0%	52	30

On the Castle Peak "A" Station ECGD effectively met inflation up to 4% and over 7% with GEC bearing the inflation betweeb 4-7%. The lowering of the threshold would have a similar effect to what was done on the "A" Station where the client is aware that a subvention was offered. The total estimated cost if net claims on the "A" Station are projected to be £39M at outturn prices on a contract value of £350M. The cost of a 5% threshold on a "B" Station valued at about £550M would be between £34M and £50M at outturn prices depending on the final premium charged.

CONCLUSION

The UK team will be hard-pressed to convince the client that the proposals lodged for the Castle Peak "B" Power Station are internationally competitive at the priced currently offered. Unless there is some improvement in the Cost Escalation Cover support the escalated prices, taking account of cost increases, will be seen to be even less competitive. To lower the CEC threshold to 5% to reflect government expectations of reducing inflation in the coming years, would enable the UK escalated price to be lowered with the cost of failure to sustain reduced inflation not being borne by the client or the contractor. Such an action need not result in any greater proportional call on the public purse in respect of the "B" Station than it did for the "A" Station.

RECOMMENDATION

Department of Industry officials accordingly recomment that the threshold of the Cost Escalation Cover Scheme be reduced from 7% to 5% in view of the considerable national importance of securing the £550M Castle Peak "B" Station project and on the basis that this concession will not set a precedent.