V601 (1)

CONFIDENTIAL

Prime Minister
The Dept. of Trade would be grateful for your views in the course of the weekend if possible.
2. Subject to views of EX colleagues, agree to (a) and (b) below and increased ECGD liability as at X overleaf?

A.J.C. 7/5

PRIME MINISTER

Yes mt.

INDIA: ORISSA STEEL PLANT

The negotiations between Davy and the Indian Government on this project, which have to be finalised by 15 May, have now reached a critical point. Serious difficulties remain over the price for the project. Davy have made it clear that they would still be able to build the plant specified at the time of the letter of intent in September 1981 at the price then offered, ie $2554m. However, since then the Indians have made major changes in the plant specifications, most importantly asking for a much larger and more expensive rolling mill. Davy's price has as a result increased to just over $3,000m.

The Indians have difficulties in confronting their Ministers with such a large increase attributable to their own changes in specification, and are arguing that the adjustment should be much smaller; there is currently a difference between the two sides of approximately $400m. Davy see no way of their bridging such a gap: their cost increases are real and they have little negotiating margin left - at most about $40m. Efforts are continuing to try and narrow the gap, but it is doubtful whether final agreement can be reached without some further gesture from HMG.

As a result of the enhanced specification and the transfer of the power plant from France, UK content has increased substantially, from about £580m to £780m. This will bring additional very welcome orders and employment mainly in areas of above average unemployment. Because UK content has risen, the subsidy value of the aid and other finance we have offered so far has fallen significantly; we could, within the subsidy levels earlier envisaged, offer further concessions if needed in the last resort to secure contract signature:

(a) By far the most significant concession we can offer is capitalization of pre-commissioning interest on the export credit loan. This would be worth about $55m to India and has other advantages for the Indians: it could well be a critical factor in overcoming current difficulties.

(b) So far we have only offered £10m of the £20m agreed by Ministers to meet the shortfall on the French credit mixte. The Indians have now said that this is insufficient, and that they will not accept RTA to top it up, as was envisaged when Ministers previously considered this. I would recommend that we give the High Commissioner discretion to offer the full extra £10m if it seemed appropriate as a final gesture to secure agreement.

mt.

CONFIDENTIAL

It will also be necessary to confirm export credit cover for the increased UK content. This will mean a major uplift in ECGD's Section 2 maximum liability for India, if support is also to be maintained for the super thermal power station (and associated coalmine). At present ECGD's liability for the 2 projects, together with existing firm business, totals £1,750m. The increase now needed for Orissa will raise this overall liability to some £2,450m. This does not allow for any increase which might be needed if the Indians want to propose alterations to the specifications for the power station, or to cover any new Section 2 business. In addition ECGD have commitments under Section 1 which could give a total ECGD exposure on India of some £3,000m. In my view the exposure on Orissa and the power station has to be faced; the political commitment to increased trade and co-operation reflected in these projects and other prospective business has to be backed up by willingness to provide the necessary credit; if not, others will step in. This will however have implications for ECGD's ability to continue to provide support for future Indian business which will have to be the subject of further discussions and submissions.

X.

Negotiations in India are reaching a climax, as the project has to be referred to the Indian Cabinet in time for a decision by 15 May which is the crucial date if the old Consensus interest rate of 7¾% is to be maintained. I would like to authorise our High Commissioner as soon as possible to make offers as set out above, if he needs to in order to secure final agreement.

I attach a note setting out the background and implications in more detail.

I am copying this to the members of EX Committee and to Kenneth Baker, Douglas Hurd, Neil Marten and Leon Brittain.

PR.

PETER REES
7 May 1982

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INDIA: ORISSA STEEL PLANT

Background

1. Agreement has now been reached on the major part of the contract which must be signed by 15 May to enable the Indians to benefit from the old interest rate of 7¾%. However some serious difficulties remain over Davy's price for the project. Davy state that they would still be able to build the plant specified at the time of the letter of intent in September 1981 at the original price i.e. $2554 million. However because the Indians have made major changes in the plant specifications since that date: most importantly changing a major part of the output from light sections to medium sections thereby requiring a heavier and more complex rolling mill; increasing the capacity of the rod mill; and introducing a number of improvements which are largely non essential adjustments, Davy's price has as a result increased to a total of $3057 million.

2. The Indians do not at present accept that increase in Davy's price. In their view there is at present a price gap of $400 million for which the responsibility for bridging falls to Davy. Davy maintain that the Indians have still not quantified the specification changes and the price gap, in detail, and believe that if this were done the differences between the two sides would be much smaller. However, efforts to reduce the difference by detailed discussion have not met with success so far.

Export Credit Cover

3. On the basis of Davy's revised prices, UK content has now risen to £780 million, from about £580m, as a result of changes in the specification and transfer of the power station from France to the UK. This is clearly welcome insofar as it brings more valuable business and employment to the UK. However the increased UK content also raises certain problems. There is a possibility that the very large increase in the UK content without a corresponding increase in the concessionality of the finance could bring the UK into contravention of the OECD's rules on mixed credits unless aid is increased. More importantly it creates the need for a substantially greater quantum of export credits. The final figure depends, of course, on the outcome of the negotiations, but at most ECGD's maximum liability (which includes cumulated interest) could rise to over £1,600m, from the present reserved figure of £900m. This presents a major issue in relation to the ECGD Section 2 limit for India, especially in view of the other substantial Indian business presently in the pipeline such as the super thermal power station.

4. ECGD's liability for the steel plant, the super thermal power station and other existing commitments would increase from £1750m to £2450m. Consideration is also being given to increasing the Section 1 limit for India from £200m to £500m. ECGD's total potential exposure under Sections 1 and 2, without allowing for any further section 2 business, could therefore be £3000m making India the UK's largest exposure market. No new problems have emerged in India since the existing section 2 limit of £1800m was agreed in February but much of the future hinges on India's success in the oil sector, its ability to control the

uptake of new commercial debt against a declining aid programme and to develop industry to bring about a reversal of the massive Trade and current account inbalances of recent years. Against this background, the increases outlined above, in ECGD's view, go beyond what they regard as a prudent level of commitment. If ECGD support is to be maintained for these projects at the revised figures, Ministerial instruction to this effect will be required.

5. The question of further Section 2 cover will also need to be considered in the light of decisions taken on these projects. This will be the subject of further discussions. Pending this review no further Section 2 commitments will be entered into. The potential level of Section 2 commitment implied by a decision to increase the level for the steel plant will also need to be drawn to the attention of ECGD's Advisory Council when it is asked to consider an increase in the Section 1 limit. The Council has already expressed concern about how far they can endorse cover under Section 1 in view of the liabilities building up under Section 2.

Other HMG Assistance

6. In view of the magnitude of the price difference outlined above, the value of injecting into the project further limited amounts of aid of the orders of magnitude which might be available is clearly limited. The only assistance of substance which HMG could offer at this stage would be the capitalisation of pre-commissioning interest on the UK content, which was formally requested by Davy last week. This would have a number of advantages for the Indians: the value in net present value terms is some $55m, it substantially improves the viability of the project because no requirement to pay interest arises until the plant is complete, and it would substantially reduce the quantum of eurocurrency borrowing required for the project. If France and Germany were also prepared to offer capitalization on their parts of the project the value would be greater, and this possibility is being pursued urgently by Davy. It is more likely that they will agree to this if HMG takes the lead. Capitalization would also be beneficial in relation to the financial return and balance of payments impact of the project as measured in the ODA's developmental appraisal. On the other hand, it would further increase ECGD's maximum liability for the project, by about £100m.

7. As regards additional aid, the question of compensating the Indians for the shortfall in the French credit mixte has also not yet been fully resolved. Ministers will recall that they agreed that up to £20m additional UK aid could be offered to the Indians following the reduction in the French offer. Initially, we offered £10m; the Indians have now requested an additional $14m of aid which in their view is necessary if they are to receive full compensation. They have stated that this should be aid additional to the £110m already offered, and that RTA local cost aid would not be acceptable. We have some sympathy with their arguments, and would suggest that this could appropriately be conceded as part of a final agreement. ODA has confirmed that it had already reserved sufficient resources to cover up to £10m of additional aid.

8. On the basis of UK content of £780m, at the current aid level, the effect of capitalization would be to raise the subsidy element from 40.41% to 43.06% (47.11% to 49.76% if RTA aid is taken into account). If up to £10m additional aid is conceded the maximum subsidy would rise

from 41.76% to 44.41% if capitalization is agreed (from 48.45% to 51.1% if RTA is included). Because of the increase in UK content, the maximum subsidy would be lower than at one time envisaged and agreed by Ministers, even taking into account the additional concessions of capitalization of precommissioning interest (NB: No allowance has been made in these figures for the value of the Industry Act guarantee to be offered in relation to interest during construction, as the amount to be paid cannot by its nature be predetermined. But if the £20m maximum guarantee envisaged were fully called, this would add 2.68 percentage points to the subsidy.)

Davy's Position

9. We have no doubt that Davy has little negotiating margin left, and that there is no question of Davy having used the specification changes as a means to boost their margins. Throughout the negotiation their German competitor, Demag, has been active on the sidelines awaiting any opportunity to re-enter the race, so strong competitive pressure on Davy continues to be exerted. It should also be noted that the ODA's consultants for the developmental appraisal, W S Atkins, were satisfied that the plant, on the basis of the revised specification, was realistically priced. The Department of Industry's Industrial Development Unit is also conducting an urgent review of Davy's price to confirm Davy assurances on this point.

Projects and Export Policy Division
Department of Trade
6 May 1982

File

CONFIDENTIAL

Trade

PM.

10 DOWNING STREET

From the Private Secretary

10 May, 1982

INDIA: ORISSA STEEL PLANT

The Prime Minister has seen Mr Rees' minute of 7 May recommending that we should offer further concessions if necessary in the last resort to secure signature of the contract between Davy and the Indian Government.

As you were told orally over the weekend, the Prime Minister is content subject to the views of EX colleagues that the concessions in sub-paragraphs a and b of Mr Rees' minute may be offered if necessary and also that export credit cover for the increased UK content may be confirmed.

I am sending a copy of this letter to the Private Secretaries to the members of EX Committee and to Neil McMillan (Department of Industry), Stephen Lamport (FCO), Michael Power (ODA) and Terry Mathews (HM Treasury).

A.J. COLES

Nicholas McInnes, Esq
Department of Trade

CONFIDENTIAL

10 DOWNING STREET

John

I have informed Mr. Hayes by telephone (Mr. Rees's APS) of the PM's agreement

Ala

9/5
2045 hrs.

CONFIDENTIAL

Trade

OVERSEAS DEVELOPMENT ADMINISTRATION
ELAND HOUSE
STAG PLACE LONDON SW1E 5DH

Telephone 01-213 5409

N. B. P. 12.

From the Minister

12 May 1982

Dear Peter,

INDIA: ORISSA STEEL PLANT

I have seen your minute of 7 May to the Prime Minister and Leon Brittan's letter of 10 May commenting on the same subject.

I am simply writing to confirm that, assuming that spending of the additional sum will be phased over the lifetime of the project, we could accommodate capital aid of £120 million within the overall resources planned for overseas aid. That is to say, we could accommodate the extra £10 million mentioned in paragraph 3(b) of your minute, over and above the £110 million already provisionally offered.

Leon Brittan mentions, in the third paragraph of his letter, local costs. So far as aid is concerned, we have of course been working on a figure of £50 million as our contribution of RTA local cost aid; this would be financed from within our prospective regular bilateral aid programme to India.

I am sending copies of this letter to the Prime Minister and to other members of EX Committee and to Leon Brittan, Kenneth Baker and Douglas Hurd.

Yours,

Neil

NEIL MARTEN

Peter Rees Esq QC MP
Minister for Trade

CONFIDENTIAL

Trade

(2)

Prime Minister

To note

AR 11/5

Treasury Chambers, Parliament Street, SW1P 3AG

Peter Rees Esq QC MP
Minister for Trade
Department of Trade
1 Victoria Street
London SW1H OET

10 May 1982

Dear Minister,

INDIA: ORISSA STEEL PLANT

I have seen your minute of 7 May to the Prime Minister about further concessions necessary to enable Davy's to conclude the contract for the construction of the steel plant at Orissa. I see that the Prime Minister has accepted your recommendations.

Yes - but subject to the views of EX colleagues. AR 11/5

Given the level of commitment to this project it would clearly not be practicable to pull out now. But taking this project and the superthermal power station together, our risk in this market will be at least £2.5 billion. Such a figure cannot be supported on the basis of a realistic consideration of the prospects for the Indian economy. Thus winning the contracts for the steel plant and the superthermal power station or either of them will rule out the possibility of taking on any further business in this market until there has been a significant improvement in the Indian economy.

I hope that it will be possible to clinch this business without offering capitalisation of precommissioning interest. It would in principle be undesirable to offer this concession particularly as we have tried so hard to avoid it in other markets. However since no finance is being given for local costs on this project the offer of capitalisation as a last resort is acceptable though there could be no question of doing this on the superthermal power station where some local costs are being financed.

The amount of subsidies being given in support of this project, both in cash terms and in proportion to the UK content are massive. So much so that we can hardly claim that winning the business was an indication of the competitiveness of British industry; indeed it is little short of a financial disaster.

I am sending copies of this letter to the Prime Minister and other Members of EX Committee and to Kenneth Baker, Douglas Hurd and Neil Marten.

yours sincerely

pp LEON BRITTAN

/ Approved by the Chief Secretary
and signed in his absence /