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CDP 10/6.

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Paul Channon MP
Minister for Trade
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1E 6RB

18 June 1985

Dear Minister

IRAQ - TURKEY PIPELINE

attached

Thank you for your letter of 13 June about ECGD cover for the Turkish leg of the proposed Iraq-Turkey oil pipeline. This letter confirms what my private office told yours on Friday.

We have agreed that ECGD should take on no further exposure on Turkey until a further assessment of the market, which should be completed as quickly as possible, demonstrates that Turkey's prospects have improved to such an extent that additional cover is justified. I therefore entirely agree that BPEC's application for buyer credit support for the Turkish leg should be rejected and I am glad to see that they think that they will be able to get the private markets to take the Turkish payment and transfer risks and the medium term credit risks. Hopefully BPEC will be successful in this.

The two risks that the market cannot cover, the unfair calling of the on-demand bonds and contract frustration, both involve a Turkish risk which could possibly, though remotely, be triggered by a Turkish payments crisis. In view of the national interest in securing this business, you proposed providing cover against these risks. Provided that you expected to be able to hold the line on refusal to take on any other Turkish risks, including pre-credit risks, pending the further assessment of the market, I agreed, exceptionally, that you should cover these two risks as you proposed. This is the most that can prudently be justified in present circumstances and I hope that no further demands will be made for ECGD cover in respect of this part of the project.

On the Iraqi leg, I agree that the supplementary insurance against contract frustration may be set against the £200 million ceiling.

Copies of this letter go to members of EX.

Yours sincerely

J Broadbent

for PETER REES

[Approved by the Chief Secretary]

FCS/85/184

CHIEF SECRETARY TO THE TREASURY

The Iraq-Turkey Pipeline

1. I have seen Paul Channon's letter of 13 June to you about BPEC's request for ECGD to consider a limited package of insurance in their bid for the Iraq-Turkey Pipeline project.

2. I agree with Paul Channon's proposal to indicate support for BPEC in principle. As you know from our other correspondence on major projects in Turkey I wish the Turks to understand that we remain interested in their market.

3. I am copying this minute to members of EX.

GEOFFREY HOWE

Foreign and Commonwealth Office

17 June 1985

19/116/17166

cc PC

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215)
GTN 215) 5144
(Switchboard) 215 7877

From the Minister for Trade

Await Chief Sec's reply
CM

The Rt Hon Peter Rees QC MP
Chief Secretary
HM Treasury
Parliament Street
LONDON
SW1P 3AG

13 June 1985

Dear Peter,

THE IRAQ-TURKEY PIPELINE

BPEC have approached ECGD for medium-term credit support and supplementary insurance in respect of the Iraq-Turkey pipeline. This application has been considered by EGC who have agreed that ECGD could support buyer credit finance for the Iraqi leg, but that buyer credit support should be declined for the Turkish leg in line with our policy on Turkey. Your officials will be familiar with the background to the project, and details of terms, values, etc were circulated to EGC.

BPEC have appealed against this decision, and I have rejected any reconsideration of the basic issue. However, BPEC have asked whether ECGD could consider a limited package of insurance, which would exclude direct Turkish payment and transfer risks but would complement the funds and insurance they believe they can obtain from the private market.

<u>IRAQ</u>

BPEC have also asked us for supplementary insurance against contract frustration in respect of the Iraq leg. In normal circumstances, this would present ECGD with little difficulty, but the potential liabilities cannot be accommodated within the agreed market limit of £250m for long delivery contracts on cash terms against which such liabilities would usually be set. The maximum potential liability for ECGD here could be £39.1m against available cover of £30m. I do not, at this stage, wish to propose an increase in the £250m limit for cash contracts, nor on the other hand would we wish it to be blocked for other small-scale business by being allocated to this project. I propose instead that we set the liabilities against the £200m ceiling which EGC has already agreed for medium term pipeline liabilities which are taken on outside the limits established by the UK-Iraq Financial Protocol.

TURKEY

BPEC's bankers, Morgan Grenfell, believe that they will be able to arrange finance for BPEC's Turkish responsibilities from a combination of the private market and export credits from overseas. Although Turkey has recently been in the market to raise finance on its own books, Morgan Grenfell believe that the prospect of participation in Government-guaranteed finance for the balance of the project will be an adequate carrot to persuade lenders to take on Turkish risk on their own books. Whether they can or not, of course, remains to be seen.

BPEC have also received indications from the private insurance market for Turkish payment and transfer risk in the context of their contract, but there appear to be two problems:

> 1 their total indications are about \$50m, which would have to cover liabilities on both their contract and bonds. Their uncovered Turkish exposure on the contract is \$100m, and on bonds \$25m. There is therefore a gap of around \$75m between market capacity and amounts which BPEC would wish to insure;
>
> 2 the market will not cover losses arising out of causes originating in Iraq, for example cancellation of the project by the Iraq Government leading to suspension of work in Turkey and breach of contract by the Turkish buyer.

BPEC have therefore proposed that ECGD should limit its insurance on the contract to civil war risks, and to risks of loss in Turkey originating in Iraq. In other words, the private market would take the direct Turkish payment and transfer risks on the contract itself. (The lenders will, of course, also be taking the Turkish medium term credit risk). However, in order to overcome the problem of limited market capacity, BPEC have proposed that we should give unfair calling cover in respect of the on-demand bonds. Although this will still leave a gap of around \$50m of uncovered exposure, BPEC consider that through a combination of contractual conditions, and tailoring private market insurance to cover the maximum negative cash flow on their contract, they can reduce their own exposure to a tolerable level.

The BPEC package excludes from any ECGD cover the Turkish payment and transfer risks which are our major concern. There remain risks which could, however, be triggered by a foreign exchange or debt rescheduling crisis. These are as follows:

> (i) it could be argued that in an acute foreign exchange or political crisis in Turkey, the Government could reach sufficiently desperate straits that it will call all on-demand bonds held by state buyers as a means of generating foreign exchange, or for purposes of political retaliation of some kind. I do not consider that this is a significant risk. The Turkish Government has never called an on-demand bond in our experience, and no country has called bonds as a result of a debt rescheduling situation. Furthermore, Turkey is not in the same category as eg Iran or Libya where the organised calling of bonds is a more significant risk.

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(ii) the pipeline is scheduled for construction during the next 18 months, when arguably Turkey's external debt problem will be at its peak, and the likelihood of another foreign exchange crisis is high. If Turkey were to default on interest payments due on lending during this period, it is conceivable that the commercial banks and overseas Government credit agencies could shut down the loans being used to finance the project. Although ECGD would not be covering the direct payment or transfer risk under BPEC's contract, the project could be suspended, and if stoppage of work is acrimonious with a dispute between the parties, it is possible that bonds could be called. It is also possible that cessation of work in Turkey could lead to action by the Iraq Government to bring the project to a halt in their country, leading to losses both on Iraq guarantees and those on Turkey given that part of the BPEC proposal is that ECGD should cover Turkish losses arising out of causes in Iraq. However, I consider that such a chain reaction - stemming from Turkish payment difficulties - is somewhat unlikely. The commercial lenders are most likely to be secured by an escrow arrangement on the rental income from oil throughout and it will therefore be in their interest to see the project completed; similar considerations would apply to Government credit agencies whose reluctance to call default will be reinforced by the political implications of such an action. This latter argument is perhaps reinforced by experience derived from the construction of the first Iraq-Turkey pipeline during the late '70s's when Turkey's economic position was arguably far worse than now and its debts were being rescheduled. The project was completed on time and without interruption.

On balance, I consider that the strength of BPEC's national interest case, which has already been aired at official level, justifies ECGD taking on these indirect risks arising out of the BPEC package, and subject to EX's views, I would propose to indicate our support in principle.

Timing is now becoming very urgent. The list of contenders is likely to be whittled down to two this weekend. BPEC are hopeful of being one of the two final bidders, but face strong competition from the Italians who pipped them at the post for the Iraq-Saudi pipeline. They will almost certainly be asked to firm up on proposals for finance submitted with their tender, but their chances of success will be much diminished unless ECGD can support some supplementary insurance for Turkey, and normal cover for Iraq. I would therefore be most grateful for your reply before the weekend.

I am copying to members of EX.

Yours Paul

PAUL CHANNON