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Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Michael Heseltine MP
Secretary of State for Defence
Ministry of Defence
Main Building
Whitehall
London
SW1A 2HB

22 May 1985

A handwritten signature in dark ink, appearing to read 'John Michael'.

TORNADOS FOR OMAN

You wrote to the Chancellor on 16 May seeking his agreement to make further concessions to the Omanis on this contract.

The issues you raise are, of course, for Norman Tebbit to consider in the first instance. However, although I fully appreciate the political and trade arguments which lead you to put forward the proposals, they raise serious difficulties both of principle and of cost. They would involve an increase of 300 per cent in the amount of subsidy necessary to win this contract and would involve additional public expenditure to provide inter alia support for the German component of Tornado that the German Government will not provide.

Your letter makes little mention of the concessions already made i.e. an increase in the amount of credit offered from 75 per cent to 85 per cent, a lengthening of the credit terms from 5 years to 8½ years, a reduction in ECGD's premium and an offer to guarantee (but not subsidise) the German portion of the contract. The further concessions which you seek seem likely to have very damaging consequences on the terms of future civil business in Oman itself, and on the terms of other arms sales in Oman, the Gulf and elsewhere. The fact that the Omanis are seeking a concessional interest rate of 9.5 per cent by direct analogy with the concessions we offered to Jordan is a clear demonstration of the damaging repercussions of such action. Each concession, but particularly the reduction in the interest rate, has an appreciable effect on public expenditure over a considerable time. The extra concessions you seek would add to public expenditure for the next 15 years with additional cost of some £7 million in the peak year.

I am also concerned about your suggestion that UK public expenditure should be used to subsidise the German element of these aircraft. I know that you have made efforts to

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persuade the German Government to provide support but so far these have been unsuccessful. Effectively therefore the UK taxpayer is being asked to foot the bill to subsidise German exports. Whether the cost falls on MOD or ECGD programmes, the principle is surely unacceptable. Moreover, although this is a subsidiary argument, the use of unsubsidised DM finance for the German portion will result in an effective reduction of the interest rate paid by the Omanis.

My own strong preference would therefore be to stick to the package now on offer with perhaps some marginal modifications to the delivery and credit periods.

If, however, you and others feel that the order is so important both for BAe in establishing Tornados export potential and for future business with the Omanis, the most appropriate course would seem to be for BAe rather than the Exchequer to bear those costs which go beyond those generally available i.e. the cost of subsidising the German component and the concessional interest rate. I am most reluctant to go beyond this and offer the 9½ per cent concessional interest rate from public funds without any assurance that further costly deterioration in credit terms could be avoided. In the last resort, if it has to be conceded, then, as with the Jordan case which has directly given rise to it, the cost of the interest rate reduction should fall on MOD programmes, subject of course to your being satisfied that this will help the overall UK defence effort and being prepared if necessary to defend the decision in public on that basis.

I am copying this letter to the Prime Minister, other members of OD and to Sir Robert Armstrong.

Agreed with Peter Rees

PETER REES