

CONFIDENTIAL

COPY 1 of 10
588

MINISTRY OF DEFENCE :
APPROPRIATION ACCOUNTS 1990-91
CLASS I, VOTE 2 : DEFENCE PROCUREMENT
THE SAUDI ARABIAN AIRFORCE PROJECT

The Saudi Arabian Airforce Project
Background

CONFIDENTIAL

CONFIDENTIAL

Covering **CONFIDENTIAL**

~~DBS
452
1~~

DBS
520

CLASS I, VOTE 2 : DEFENCE PROCUREMENT

THE SAUDI ARABIAN AIRFORCE PROJECT

MINISTRY OF DEFENCE :

Page

APPROPRIATION ACCOUNTS 1990-91

CLASS I, VOTE 2 : DEFENCE PROCUREMENT

THE SAUDI ARABIAN AIRFORCE PROJECT

The Saudi Arabian Airforce Project 1

Background 2

ACCOUNTING REPORT BY THE COMPTROLLER GENERAL AND

PAYMENTS TO AND AUDITOR GENERAL

Funding arrangements 4

Accounting arrangements 5

The NATIONAL AUDIT OFFICE in practice 6

29 JANUARY 1992

ACCOUNTING FOR EQUIPMENT AND SERVICES SUPPLIED BY
THE DEPARTMENT

Equipment and Services supplied from
the Department's resources 7

Purchasing Tornado aircraft 11

CONFIDENTIAL

CONFIDENTIAL

MANAGEMENT APPROPRIATION ACCOUNTS 1990-91

CLASS I, VOTE 2 : DEFENCE PROCUREMENT

THE SAUDI ARABIAN AIRFORCE PROJECT

CONTENTS

	Page
INTRODUCTION	16
- The Saudi Arabian Airforce Project	1
- Background	2
ACCOUNTING FOR RECEIPTS FROM SAUDI ARABIA AND PAYMENTS TO BRITISH AEROSPACE	
- Funding arrangements	4
- Accounting arrangements	5
- The accounting arrangements in practice	6
ACCOUNTING FOR EQUIPMENT AND SERVICES SUPPLIED BY THE DEPARTMENT	20
- Equipment and Services supplied from the Department's resources	7
- Purchasing Tornado aircraft	11

CONFIDENTIAL

CONFIDENTIAL

MANAGEMENT FEE RECEIPTS

-	Figure 1 : Management Fee budgeted receipts and payments as at December 1991	13
-	The Department's use of the fee	14
•	The Department's administrative costs	16
•	Other Departmental contributions to the project	16
•	Payments to British Aerospace	17
-	Accounting arrangements	18
-	Accounting arrangements in practice	19
COMMERCIAL EXPLOITATION LEVY		
-	Amount of levy due	20
-	Payment of levy	23
Appendix 1 :	National Audit Office assessment of Replacement in Kind option	26

secure.area/06/02/92

db/reports/saudi rep/kd

APPROPRIATION ACCOUNTS (VOLUME 1 : CLASS 1, DEFENCE),
1990-91

REPORT OF THE COMPTROLLER AND AUDITOR GENERAL

CLASS I, VOTE 2 : DEFENCE PROCUREMENT

The Saudi Arabian Airforce Project

1. The Account shows a net subhead (H6) in respect of the Saudi Arabian Air Force Project. Underlying this accounting entry, but not shown on the face of the Account, are a number of accounting arrangements that reflect the involvement of the Ministry of Defence (the Department) in Project Al Yamamah - the sale of aircraft, equipment and support services to Saudi Arabia.

2. The Report describes the accounting arrangements for each of four main areas:

- a) RECEIPTS FROM SAUDI ARABIA AND PAYMENTS TO BRITISH AEROSPACE. Formally the sale agreement is between the United Kingdom and Saudi Arabian Governments but in practice the goods and services are supplied through British Aerospace acting under contract to

CONFIDENTIAL

aircraft, the Department. The Department therefore account
weapons, for receipts from Saudi Arabia and payments to
services British Aerospace (paragraphs 7 to 12).
competition, is the United Kingdom's largest export order.

b) RECEIPTS FROM BRITISH AEROSPACE. Some equipment
and services are being supplied by the Department
acting under subcontract to British Aerospace. The
Department account for receipts arising from this
work. The Department are also acting on behalf of
British Aerospace to supply Tornado aircraft from
the international consortium that manufactures them
(paragraphs 13 to 23).

c) MANAGEMENT FEE. The Department are managing the
project on behalf of Saudi Arabia for which they
receive and account for a management fee
(paragraphs 24 to 36).

d) COMMERCIAL EXPLOITATION LEVY. Some of the aircraft
and equipment sold were developed using funds
provided by the Department and collaborative
partners who are entitled to receive Commercial
Exploitation Levy in respect of this equipment
(paragraphs 37 to 48).

Background

3. The sale was agreed between the Kingdom of Saudi
Arabia and the United Kingdom in 1985. It comprises 134

CONFIDENTIAL

aircraft, including 72 Tornados, together with a range of weapons, role equipment, spares, support equipment and services. The sale, secured against intense international competition, is the United Kingdom's largest export order. It had an initial value of £5 billion, but the current programme is estimated to reach £24 billion by the year 2000.

4. In 1988 the Governments of Saudi Arabia and the United Kingdom entered into a further Formal Understanding setting out Saudi Arabia's interest in procuring substantial additional amounts of military equipment and services through an extension of Project Al Yamamah. Detailed discussions on how the Saudi Arabian requirements are to be implemented are still taking place.

5. The benefits of the sale are immense. Apart from the financial and employment benefits to the United Kingdom - in 1992 alone the programme generated an estimated 33,000 jobs - it has significant foreign policy implications. It develops further the close relationships between Saudi Arabia and the United Kingdom and played an important part in the recent Gulf War. During Operation 'Desert Storm' a high level of combat availability was achieved by the Tornado aircraft supplied to the Royal Saudi Air Force. They expressed great satisfaction with the performance of the aircraft and acknowledged the major role played by support staff from British Aerospace in this achievement.

CONFIDENTIAL

6. It is important that the accounting arrangements for the sale should be viewed against this background. In particular, the National Audit Office recognise the need for confidentiality to protect both Saudi Arabian national security interests and commercially sensitive information in arrangements of this type. Moreover, the fact that the National Audit Office are drawing the attention of account on Parliament to aspects of the accounting arrangements for the programme should not be taken as implying that special accounting arrangements should not be made for such projects.

a) **ACCOUNTING FOR RECEIPTS FROM SAUDI ARABIA AND PAYMENTS TO BRITISH AEROSPACE**

7. As noted at paragraph 2(a), the sale is between the United Kingdom and Saudi Arabian Governments. The Department have agreed to supply the equipment and services to Saudi Arabia and will account for receipts. In practice, however, all the necessary goods and services will be supplied through British Aerospace acting under contract to the Department. The contracts with British Aerospace mirror the Department's agreements with Saudi Arabia.

Funding Arrangements

8. Under their agreements with the Department, Saudi Arabia is required to make scheduled funding payments as the Project proceeds. To this end, Saudi Arabia funds the

CONFIDENTIAL

CONFIDENTIAL

programme through an oil trading scheme, substantial cash advances, and have arranged commercial and other loans, repayable from project revenues to meet temporary underfunding. Under the oil trading scheme, Saudi Arabia lifts a given amount of oil (currently 500,000 barrels a day) and markets it through a number of oil companies. The companies pass the proceeds to a Saudi owned bank account on which the Department have sole drawing rights.

11. Up until December 1989, the arrangements described in

9. For administrative convenience, funds from the Saudi-owned bank account are disbursed and accounted for by the Department monthly. The disbursements take two forms: payments to British Aerospace to meet their costs in accordance with the arrangements set out in contracts; and transfers to the Department's bank accounts in respect of the Department's management fee and the project team in Saudi Arabia.

Accounting Arrangements

10. The accounting arrangements for these transactions on the United Kingdom Defence Votes were agreed between the Department and Treasury in 1986. Receipts from Saudi Arabia and disbursements in respect of the management fee, the Department's project team in Saudi Arabia and to British Aerospace are accounted for in a series of suspense accounts operated by the Department. As part of the suspense account process the payments to British Aerospace also pass through the net subhead H6. Government Accounting procedures

CONFIDENTIAL

normally require the Appropriation Account to include a note setting out the actual gross expenditure and related gross receipts in respect of each net subhead within the vote. In this case, however, details are not shown in order to preserve confidentiality (paragraph 6).

The Accounting Arrangements in Practice

11. Up until December 1989, the arrangements described in paragraph 10 were properly applied. In January 1990, however, when payments to British Aerospace in United States dollars commenced, these were not recorded, through an oversight, on the suspense account. In consequence receipts of \$1.483 billion (sterling equivalent £820 million) and payments to British Aerospace of \$1.471 billion did not pass through the net subhead H6. Although the agreed accounting arrangements were not followed, all receipts and payments are recorded in the project's memorandum accounts and there is no suggestion that any of the funds have been lost or misapplied. Moreover, the Department have assured the National Audit Office that from 1 April 1991, all receipts and payments will pass through the appropriate suspense account.

12. As part of their examination of how the accounting arrangements operate, the National Audit Office looked to see whether recorded transactions were in accordance with specific authorities. At an early stage in the programme there was some suggestion in the Press that the United

CONFIDENTIAL

CONFIDENTIAL

Kingdom had paid large commissions to third parties in order to secure the sale. The Government have stated, however, that they have not paid any commissions. A test examination by the National Audit Office confirmed that receipts from the programme have either been passed on to British Aerospace or have been accounted for as Appropriations-in-Aid or remain as balances on the Departments bank accounts or at the Saudi International Bank. The examination found no evidence of commission payments being made to third parties.

(b) ACCOUNTING FOR EQUIPMENT AND SERVICES SUPPLIED BY THE DEPARTMENT

13. The Department have been involved in supplying equipment and services in two main areas. They have supplied to British Aerospace equipment, stores and training services and have acted as purchasing agent for British Aerospace for the Tornado aircraft acquired by Saudi Arabia.

Equipment and Services Supplied from the Department's Resources

14. The Department are supplying some services, such as training, to the project because only they possess the relevant expertise. In this role the Department are acting as sub contractor to British Aerospace and any payments they

CONFIDENTIAL

CONFIDENTIAL

receive from the Company are accounted for as Appropriations in Aid.

15. In addition, to meet the timescale required by Saudi Arabia, the Department agreed to divert 42 Tornado aircraft, together with spares and equipment, either from their own stocks or from production earmarked for them. British Aerospace paid the Department for the diverted stores and this again was accounted for as Appropriations in Aid. For the aircraft and remaining equipment, however, which accounted for 96 per cent of the value of total diversions, the Department negotiated, with British Aerospace, a replacement in kind arrangement.

16. Under this arrangement the Department agreed that British Aerospace and the other Tornado suppliers could retain contractual payments already made on the diverted aircraft and equipment and would receive future progress payments as if the aircraft were being delivered to the Royal Air Force. These payments are made from the Vote, as explained in a note to the Appropriation Account. In return, British Aerospace undertook to supply replacement aircraft, manufactured to a higher specification, some three years later than those originally due.

17. At the time they made the decision, the Department did not carry out a detailed evaluation of the replacement in kind option compared to seeking reimbursement, with interest, of the progress payments already made. In the

CONFIDENTIAL

Department's view a cost benefit analysis would have produced unreliable results since accurate information was not to hand and was not likely to become available for some time.

18. Additionally, they considered that the complexity of the administration process required to recover the United Kingdom's share of trilateral contractual payments from numerous Tornado suppliers could result in an under recovery of the sums due and there was also some doubt, in view of the Project underfunding which existed at that time, whether British Aerospace was necessarily in a position to return the progress payments to the Department. Moreover, in line with Departmental Policy, the replacement in kind option transferred all the financial risk to the contractor. British Aerospace themselves favoured the repayment option for that reason.

19. The Treasury agreed to the replacement in kind option without requiring the Department to carry out a full evaluation of the alternatives. In giving their approval, the Treasury emphasised that it was the responsibility of the Department's Accounting Officer to satisfy himself about the financial arrangements for the Project and to be able to demonstrate that they represent good value for money.

20. Against this background, the National Audit Office carried out their own financial evaluation of the options. Their evaluation based on information available in 1987 was

CONFIDENTIAL

CONFIDENTIAL

restricted to the airframe and engine owing to the lack of information concerning the replacement cost of other contract items. The evaluation accounted for 70 per cent of the value of the diverted items and showed that replacement in kind was some £55 million more expensive to the Exchequer than the refund option. The National Audit Office has reperformed their evaluation using the latest cost information available. This was provided by British Aerospace in November 1991. Their calculation used details of actual expenditure incurred up to the end of 1990-91 and details of the remaining 5 per cent of expenditure contractually committed up to completion of the replacement aircraft. The result of the evaluation is that replacement in kind is £36 million more expensive than the refund option (Appendix 1).

21. The National Audit Office's evaluation was based on information which was not available to the Department at the time the decision was made, but the National Audit Office consider that, in accordance with standard practice, the Department would have been able to generate at that time similar information to that used by the National Audit Office. The Department point out, however, that in the absence of firm pricing information, which is still not fully available, they would have had to use estimated data; a detailed evaluation based on unreliable data would have been of little utility. The National Audit Office consider that, in line with normal Departmental practice, the use of estimated data should not have prevented a detailed

CONFIDENTIAL

CONFIDENTIAL

evaluation being carried out. They accept, however, that any evaluation would have had to take account of the British uncertainties arising from the use of estimated data.

Purchasing Tornado Aircraft

22. It was determined that the terms of the Trinational Tornado Memorandum of Understanding made it necessary for British Aerospace to purchase Tornado aircraft through the Department and the NATO International Project Organisation. This view was given added strength by the arrangements put in place involving the diversion of RAF aircraft and to take advantage of batch pricing for the nations. The back to back contract arrangements between the Department and British Aerospace reflect the company's requirements and the Departments ordering through NAMMA (see footnote), covering the supply of 72 Tornados, 42 of which are replacements for those diverted from the Department. The Department, in turn, have agreed with its international partners to purchase, through NAMMO, the 72 Tornados.

Note: NAMMO is the NATO organisation that oversees the procurement of the Tornado aircraft. NAMMA is its administrative arm - equivalent to an international project office.

CONFIDENTIAL

CONFIDENTIAL

23. When the Tornado aircraft have been produced, ownership passes first to the Department and then to British Aerospace. For administrative simplicity, however, British Aerospace pay NAMMO for the aircraft direct. Because no funds flow through the Department, no transactions are recorded in the Department's accounts. At the request of the National Audit Office, the Department obtained retrospective approval from the Treasury for the way they have proceeded.

c) MANAGEMENT FEE RECEIPTS

24. The Department are managing the project on behalf of Saudi Arabia and for this service they receive a management fee (referred to in official documents as Departmental Expenses) of two percent of the total value of the programme. The Department estimate that this will produce revenue of £330 million by 1995-96 (Figure 1). In order to preserve confidentiality these receipts are accounted for in a suspense account and are not shown on the face of the Appropriation Account. The Treasury were informed of this.

TOTAL PAYMENTS	167.9	101.9	269.8
EXPECTED RECEIPTS	184.6	145.2	329.8
BUDGETED SURPLUS	16.7	43.3	60.0

CONFIDENTIAL

CONFIDENTIAL

Figure 1 : Management Fee Budgeted Receipts and Payments as at December 1991

	1985-91 £ million	1991-96 £ million	Total £ million
PAYMENTS			
Ministry of Defence Project Office	44.2	60.0	104.2
Ministry of Defence Contribution to the Project:			
- value to Royal Air Force of diverted aircraft	86.5	22.4	108.9
- miscellaneous assistance	6.9	0.9	7.8
- VAT provision		18.6	18.6
Payments to British Aerospace:			
- negotiating difficulties	12.3		12.3
- funding shortfall	18.0		18.0
TOTAL PAYMENTS	167.9	101.9	269.8
EXPECTED RECEIPTS	184.6	145.2	329.8
BUDGETED SURPLUS	16.7	43.3	60.0

CONFIDENTIAL

those that would occur if the Saudi Government were unable
The Department's Use of the Fee payment schedules or other
negotiations at a level and on terms which the Department

25. The Department are not required by the Saudi Arabian Government to account for how they use the management fee income. The agreement with Saudi Arabia states that the United Kingdom Government accept neither profit nor loss from their involvement in the project. But it goes on to say that "the statement that the United Kingdom Government accepts neither profit nor loss excludes the possibility that the Department Expenses may yield a profit or loss." The Department have informed the National Audit Office that this latter provision was agreed as a neutralising clause to ensure that the Project was not required by the Saudi Arabian Government to account for its use of the management fee income. The Department's view is that acceptance of neither profit or loss is a guiding principle of the Memorandum of Understanding.

26. From an early stage in the Project negotiations it was taken into consideration by the Department and British Aerospace that a two per cent fee was likely to produce more revenue than the Department would need to cover its costs. The Department agreed with British Aerospace that if the fee was set at this level, provided always that the Department's costs were recovered first, it could be used to fund payments in support of the project including payments to British Aerospace. This would include helping to meet British Aerospace's negotiating losses such as, for example,

CONFIDENTIAL

CONFIDENTIAL

those that would occur if the Saudi Government were unable or unwilling to conclude prices, payment schedules or other negotiations at a level and on terms which the Department agreed with British Aerospace were fair and reasonable in the circumstance of an export contract. No decision has yet been made as to the action to be taken to dispose of a surplus in the management fee at the end of the programme, should this arise.

27. In practice, the Department have used the fee for three main purposes:

- i) to meet the costs of their project teams;
- ii) to meet the costs of other contributions to the project by the Department, such as the opportunity cost of the loss to the Royal Air Force of diverted aircraft;
- iii) to help meet British Aerospace's unavoidable negotiating losses by prior agreement between the Department and the Company, where this was judged necessary to sustain the programme as a whole.

(paragraph 26).

Figure 1 sets out the Department's estimate (as at December 1991) of receipts and payments up until 1995-96.

CONFIDENTIAL

CONFIDENTIAL

i) The Department's administrative costs used the appropriate Treasury Discount Rates, with adjustments to 28. In order to manage the project, the Department have project teams in both the United Kingdom and in Saudi Arabia. The costs of the project team in the United Kingdom and some of the costs of the team in Saudi Arabia - around £12 million a year - are charged to the Vote. Amounts to cover these costs are transferred monthly from the management fee suspense account referred to at paragraph 24 to the relevant Appropriations in Aid subhead. For example, amounts to cover the salaries of project staff are transferred to subheads on Vote 1 and Vote 2. The remaining costs of the project team in Saudi Arabia are recovered direct from the Saudi Arabian Government. These are also accounted for as Appropriations in Aid.

ii) Other Departmental contributions to the project

29. In all cases the Department charge Saudi Arabia for additional services provided from its resources. In most cases this is done directly through the terms of Letters of Offer and Acceptance but in some cases the Department has found it necessary to recover some of its contributions to the project from the Management Fee. The largest such item is compensation to the RAF for the diversion of 42 Tornado aircraft. As a proxy for the opportunity cost of not having the aircraft for three years the Department have calculated the amount British Aerospace would have to pay if they made interest payments on the progress payments they had received

CONFIDENTIAL

CONFIDENTIAL

in respect of the diverted aircraft. They used the appropriate Treasury Discount Rates, with adjustments to take account of inflation. This produces a figure of £108.9 million to be recovered over the period of the programme. In addition, they have made a contingency provision of £18.6 million to cover a potential VAT liability (Figure 1).

iii) Payments to British Aerospace

30. To date, the Department have agreed, under the arrangement outlined at paragraphs 26 and 27, to make two payments totalling £30.3 million to British Aerospace in support of the project. They approved the first payment of £12.3 million in recognition of the difficulties the United Kingdom faced in negotiating a price for the aircraft that gave British Aerospace and their sub-contractors even a modest margin of profit. They approved the second payment of £18 million as an ex gratia contribution to help compensate British Aerospace for the loss of interest on the funding shortfall up to August 1986.

Accounting Arrangements

31. The Department told the National Audit Office that before agreeing to make these payments they had reviewed, at the offices of British Aerospace, detailed information on the profit that the company expected to make on the aircraft and on the initial provision of spares. In the light of this review, they were satisfied that the margins were

Q
*
K

CONFIDENTIAL

CONFIDENTIAL

likely to be low and that the prices agreed were close to the cost line.

32. The National Audit Office note that the Department have not yet evaluated the likely profitability of other parts of the project such as the supply of weapons and follow up provisioning of spares. This is because at the time of their review, prices for these had not been agreed with the Saudis. In addition, the Department did not take into account in their review the impact of British Aerospace's cash flow on their profit margins. This could be a significant factor in view of the fact that the funding shortfall has had major implications for company cashflow, although the National Audit Office note that the Company have received payments for the diverted aircraft from both the Department and Saudi Arabia. When more information is available, however, the Department plan to undertake a complete and detailed evaluation and the results of this will feed into their evaluation of the Company's liability for Commercial Exploitation Levy (paragraphs 37-48).

Accounting Arrangements

33. Normally, receipts and payments are recorded in an account subhead and would therefore impact on the figures shown on the face of the Account. In this case, however, payments to British Aerospace are netted off against receipts within the management fee suspense account. The Department explained that, in order to preserve the

CONFIDENTIAL

CONFIDENTIAL

necessary confidentiality, it would be undesirable for the transactions to pass visibly through the Vote. Furthermore, the Department expected much larger sums to be involved in future years.

34. The Department sought advice on this matter from the Treasury. On balance, the Treasury agreed with the Department that the payments to British Aerospace were in effect part of the contract payments to the company. They also agreed that the payments may be accounted for through the suspense account but on the understanding that the Department's Accounting Officer would need to be satisfied with what was proposed and be prepared to defend it.

Accounting arrangements in practice

35. In general, the accounting arrangements for payments to British Aerospace have operated as expected. The National Audit Office noted, however, that only £16.2 million of the £18 million referred to at paragraph 30 has been paid directly to British Aerospace. The balance was paid by the Department to third parties on the Company's behalf. The largest of these payments - to the value of £1.5 million - were to NAMMO in respect of their administrative costs.

36. The National Audit Office also noted that the Department have on occasions used the management fee to fund items requested by Saudi Arabia, the costs of which are

CONFIDENTIAL

CONFIDENTIAL

subsequently reimbursed from other project funds. Such items include the purchase of a car and provision of a chauffeur - total cost £88,000 - for Saudi official use, and helicopter services - to the value of £1.1 million - provided by Bristows Ltd in respect of flood relief in Bangladesh.

Q
K.F.

d) **COMMERCIAL EXPLOITATION LEVY**

37. The principle underlying Commercial Exploitation Levy is that when Defence equipment has been developed at government expense the tax-payer should share the financial benefit from any commercial use of the design. Receipts of Commercial Exploitation Levy are accounted for as Appropriations-in-Aid.

Amount of Levy Due

38. For Tornado aircraft and their spares the Department and their international collaborative partners have agreed that levy should be calculated as seven and a half percent of sale price. Levy proceeds will be collected by the Department and passed on to the International Project Office - NAMMA - to be distributed to the international partners according to the proportion of the development work that they funded. Proceeds have to be disbursed as soon as they are received but not later than the delivery of the last aircraft.

CONFIDENTIAL

CONFIDENTIAL

39. The National Audit Office consider that the agreement between the partners is imprecise and potentially confusing in two respects. Firstly, it does not specifically acknowledge that ~~levy is not due on the whole sale price but only on the portion of the price that is the result of development funded by Government.~~ For example, levy is not due on any special modifications that British Aerospace has funded to meet the needs of the export customer. Secondly, the agreement does not make clear at what stage levy should be collected by the Department and paid over by them to NAMMA. For example, it is not clear whether interim payments of levy should be made reflecting the rate of deliveries. The agreement specifies only that disbursements are to be made by NAMMA when received but not later than delivery of the final aircraft.

40. As regards Project Al Yamamah, British Aerospace The Department does not accept that these arrangements are potentially confusing. On the first point, it is a principle of all Commercial Exploitation Levy that it applies only to equipment where development was Government funded. On the second, the disbursement arrangements, as noted above, reflect the agreement reached between the Tornado partners.

41. As an alternative to applying levy at seven and a half As part of their audit of the Tornado International Project Office, the NATO Board of Auditors reviewed the arrangements in place for the collection and disbursement of levy. Amongst other things, they urged the International Project Office and its controlling organisation, NAMMO, to

CONFIDENTIAL

CONFIDENTIAL

take appropriate action to secure the payment of levy. They concluded that delays in agreeing prices should not delay payment of levy. They recommended that levy should be calculated using known price elements and, if required, adjusted afterwards. NAMMO have noted the Board's findings.

42. The Department have reviewed with the Tornado partners the Board's findings on recovery of levy in respect of sales to Saudi Arabia. The three partners are agreed that negotiations for the recovery of this levy are the responsibility of the United Kingdom and the United Kingdom is pursuing the issue. The Department have pointed out that an interim payment has already been made (see paragraphs 47 and 48 below).

43. As regards Project Al Yamamah, British Aerospace allows the Department full access to pricing data. The Department's formal position is that they expect to receive the full percentage levy. However, British Aerospace have notified the Department that the margin between cost and price for Tornado aircraft and initial spares will be insufficient to yield the full rate of levy.

44. As an alternative to applying levy at seven and a half percent, and in accordance with normal practice in the United Kingdom, British Aerospace proposed a profit sharing scheme. For leviable items other than Tornado aircraft in Project Al Yamamah, such as aircraft weapons, the company have agreed to pay the full percentage rate applied to that

CONFIDENTIAL

CONFIDENTIAL

portion of the price that derives from equipment developed using funds provided by the Department.

45. The Department accept that, because of British Aerospace's position set out in paragraphs 43 and 44 above, they are unlikely to be able to collect full levy on Tornado aircraft. They estimate that the value of the leviable elements of deliveries identifiable to date amounts to £1.7 billion, of which some £850 million is attributable to Tornado. On this basis the Department estimates the total realisable levy on deliveries to date at about £80-100 million, of which the United Kingdom's share of levy payments on Tornado will be a little under half.

Payment of Levy

46. Although deliveries of equipment began in March 1986 the Department did not start invoicing British Aerospace for levy until August 1987. Moreover, these invoices were in respect of weapons only. The Department have pointed out that a number of factors affect the speed at which levy can be collected. The Department's original intention was to complete pricing by 1987. However, information on the cost of Tornado aircraft became available from NAMMA much later than expected. The Tornado is produced and priced in batches. The Saudi Arabian Tornados are from the 5th, 6th and 7th batches. Information on the prices of the 5th batch was not available to the Department until August 1990; and the 6th and 7th batches have not yet been fully priced.

CONFIDENTIAL

Additionally, prices for many other items, especially spares, have not yet been agreed with the customer. It is, therefore, still not possible to establish accurately the full levy due. Furthermore, for much of the period since 1986 the Project has been seriously underfunded and British Aerospace's cashflow has been adversely affected.

47. To date, British Aerospace has been invoiced for levy totalling £42.5 million. This represents most of the identifiable levy due to date. Of this, British Aerospace has paid £15 million against the weapons levy invoices and £2.46 million against the aircraft and spares. A further £2 million was received in April 1991 as an interim payment against levy liability on Tornado aircraft. The Department told the National Audit Office that it was their aim in 1991-92 to complete negotiations with British Aerospace to maximise recovery of identifiable levy.

48. The Department do not believe that the mismatch between delivery and the recovery of levy has caused any loss to the Exchequer. As noted in paragraphs 37 and 38 arrangements agreed with their partners on Tornado provide for levy to be disbursed when received, but not later than the delivery of the last aircraft, which is not until 1992 at the earliest. Notwithstanding this, the Department discussed with their Tornado partners whether a case for interim recovery of levy could be pursued with British Aerospace without prejudicing the Department's ability to negotiate the most advantageous final levy deal. At that

CONFIDENTIAL

time their partners accepted their advice that such an approach might reduce the final settlement because British Aerospace had intimated that, in the event of an interim recovery, they might seek to offset the financing cost of any advance against the final payment. They agreed that the Department should seek full recovery when prices were agreed for the 7th batch of Tornados. It was only in July 1990 that the international partners requested a payment on account, which was achieved in April 1991.

Interest at 5 per cent
real rate of return⁽²⁾ 68 594

B. Refund ⁽¹⁾

Cost of 7th batch aircraft 18 IDS
8 constant prices in 1987 24 ADVs 558

Higher Cost of Replacement in Kind 36

Note 1: Evaluation covers cost of airframe and engine only.

Note 2: Compound interest calculated at the Treasury Discount Rate over the period that progress payments were retained.

Note 3: This evaluation used information available in November 1991. The National Audit Office performed a similar

CONFIDENTIAL

Appendix 1

National Audit Office Assessment of Replacement in Kind Option ⁽³⁾

£m

A. Replacement in Kind ⁽¹⁾

Value of progress payments	18 IDS	223	
	24 ADVs	<u>303</u>	
		526	
Interest at 5 per cent real rate of return ⁽²⁾		<u>68</u>	594

B. Refund ⁽¹⁾

Cost of 7th batch aircraft	18 IDS		
@ constant prices in 1987	24 ADVs	<u>558</u>	

Higher Cost of Replacement in Kind 36

Note 1: Evaluation covers cost of airframe and engine only.

Note 2: Compound interest calculated at the Treasury Discount Rate over the period that progress payments were retained.

Note 3: This evaluation used information available in November 1991. The National Audit Office performed a similar

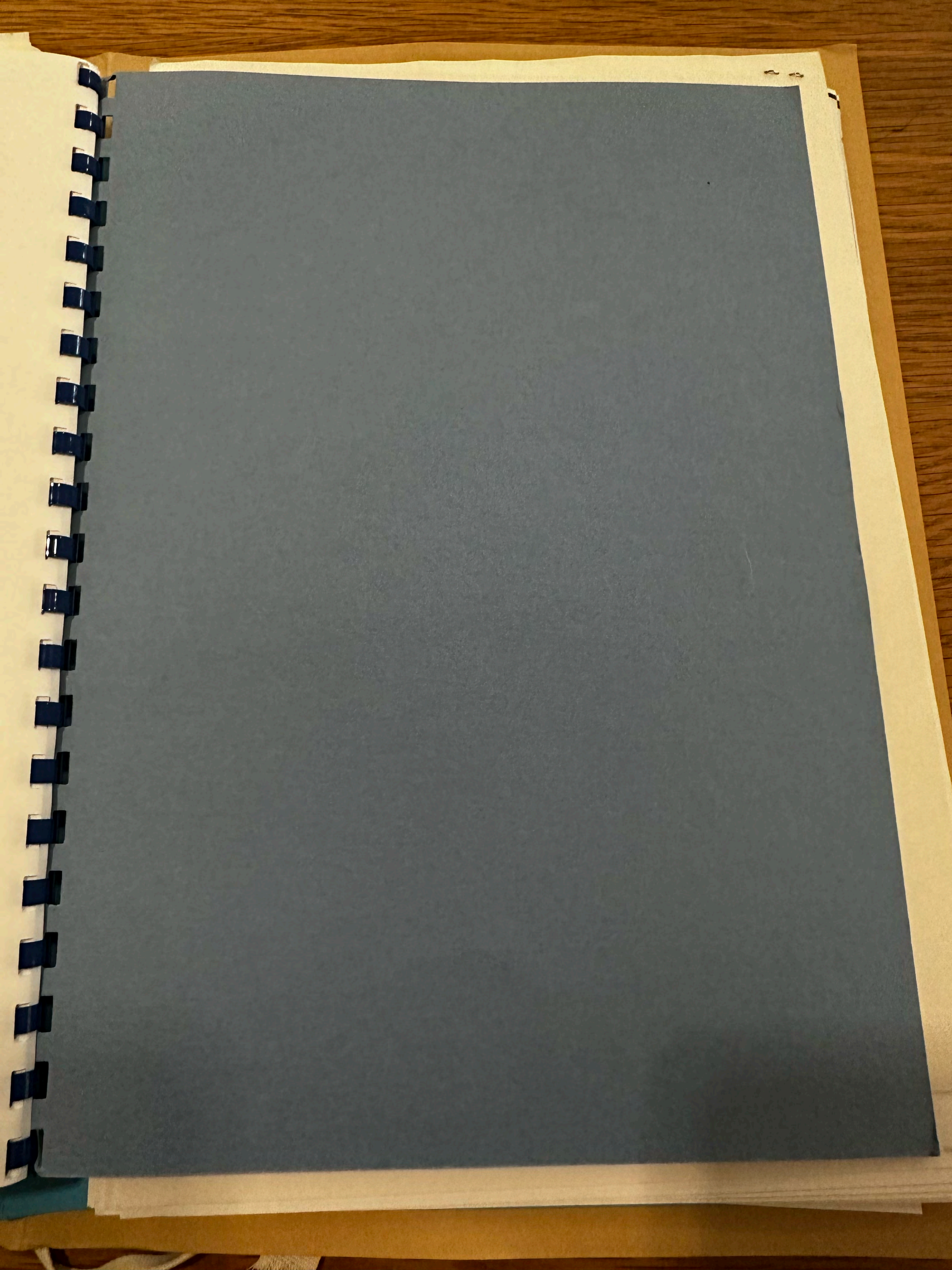
CONFIDENTIAL

CONFIDENTIAL

evaluation using information available in 1987. That evaluation indicated that replacement in kind was £55 million more expensive than the refund option.

Source of Data: British Aerospace.

CONFIDENTIAL



MINISTRY OF DEFENCE APPROPRIATION ACCOUNTS 1990-91
CLASS I VOTE 2

MATERIAL FOR DEALING WITH MEDIA ENQUIRIES

The Chairman of the Public Accounts Committee has examined a report received from the Comptroller and Auditor General on Vote 2 of the Ministry of Defence's accounts for 1990-91 dealing with the Department's involvement in arrangements for supplying Tornado aircraft and other equipment to the government of Saudi Arabia.

The Chairman has noted that the Department is acting in conformity with Treasury approvals and the rules of government accounting.

The Chairman has requested the Comptroller and Auditor General to continue monitoring the Department's involvement in this programme and to report again as and when he thinks it necessary and at the conclusion of the programme.

SUPPLEMENTARY

Why was the Comptroller and Auditor General's report not published?

The report from the Comptroller and Auditor General refers to confidential arrangements between the governments of the United Kingdom and of the Kingdom of Saudi Arabia.

Why was the report not discussed by the Committee as a whole?

The Committee agreed that the Chairman should deal with this report in this way.

Isn't this a cover up?

No; the Department's accounts covering its involvement in the project have been audited by the Comptroller and Auditor General who has reported accordingly to Parliament.

How the Public Accounts Committee deals with the Comptroller and Auditor General's report is for the Committee to decide.

Why did the Public Accounts Committee accept that the information in the Comptroller and Auditor General's report should not be published?

The Public Accounts Committee respected the confidentiality of arrangements between the governments of the United Kingdom and the Kingdom of Saudi Arabia, bearing in mind that the programme covered by these arrangements is of the greatest significance for British jobs and exports.

Commission Payments?

The Comptroller and Auditor General was given full access to the Department's accounts and associated papers and found no evidence of improper payments.

Handwritten initials/signature



CONFIDENTIAL REFERENCE
COMMERCIAL IN CONFIDENCE
MAIN BUILDING WHITEHALL
Telephone 071 821 821 (Direct Dia)
071 821 8200 (Switchboard)

FILE
copy 1.0:
19
PS/HDES
AUS(GF)
AUS(DES Admin)
Head of GF4
D Comm/SAP

PERMANENT UNDER-SECRETARY OF STATE
SIR MICHAEL QUINLAN GCB

SIR MICHAEL

PUS/E91/1011
20/6

8 October 1991

Dear Sir,

DRAFT CONFIDENTIAL REPORT ON CLASS 1 VOTE 2 APPROPRIATION
ACCOUNT: SAUDI AIR FORCE PROJECT

1. Many thanks for your letter of 23 September enclosing your proposed report on the accounting arrangements for the Al-Yamamah Project. I am grateful for the opportunity to comment and indeed for the consideration your staff have shown, in consulting us at working level, for the unusual sensitivity of this subject.

2. I have a few comments of my own on the text of the report as it stands, which I have asked my people to pursue with yours. We are also seeking the views of the Treasury Officer of Accounts, and may need to reflect his comments also. But my principal concern at this stage is over the important issue of handling, the conclusion to which could well colour my views on how extensively details of this Project should be set out in the report. I was therefore grateful for your invitation to consider this aspect of the matter further.

3. Our staffs have had extensive discussion on handling and the views that follow will not, I am sure, come unexpectedly to you. I am grateful for your acceptance that the report as a whole should be classified and I would be prepared to defend this approach (rather than partial publication) if necessary. I see grave dangers however in circulating a report, even on a confidential basis, to the Committee as a whole, and therefore in going beyond a report exclusively to the Committee Chairman. My reasons are as follows:

- a. This is an exceptional matter, and altogether more sensitive than the normal run of reports to the PAC. It concerns not, for the most part, UK taxpayers' money but our relations with an important overseas customer and the use of Saudi funds. The Saudis regard it as involving their most sensitive security interests. On our side very considerable commercial and foreign policy interests are at stake. MOD Ministers have consistently refused, in answer to PQs or other Parliamentary enquiries, to reveal details of Al-Yamamah of the sort that permeate this report. The FCO, whom we have consulted, will wish to be assured that the report will be handled with the greatest possible sensitivity. And

CONFIDENTIAL
COMMERCIAL IN CONFIDENCE

FCO and MOD Ministers would undoubtedly be concerned if there were doubts on this score.

- b. Apart from these broad considerations there are a number of particularly sensitive areas covered in the report. These include the scope and funding of the Project, much of which can be deduced from the range of information provided; commercially sensitive information, including the long section on Commercial Exploitation Levy, which could reopen debate with the Saudis about the pricing of the contracts; the diversion of Project funds mentioned in paragraph 36; and the size and disposition of the management fee. There is also the mention of the commissions issue which, although paragraph 12 of the report is uncontentious, could (however unjustifiably) provide a peg for very damaging press speculation (I have, for example, Adam Raphael's piece in The Observer of 8 April in mind here).
- c. Saudi reactions to insensitive exposure of their affairs are well known and can be strong and damaging. Conversely the assurance of confidentiality is undoubtedly an important consideration for the Saudis in dealing with us rather than (e.g.) the US. We have substantial potential new business at stake; and negotiations on this and on the funding of the current programme are at a delicate stage. There is specific current evidence that the Saudis at high level are already not uniformly pleased with us.
- d. Circulation to the full PAC runs the risk of disclosure. Committee members could not be expected to understand in all respects, or necessarily to share HMG's judgement on, the sensitivity of the information they would be handling, including the scope for upsetting the Saudis, who take an idiosyncratic view of such matters. And with the best will in the world, PAC members would be under great pressure to talk to journalists. You yourself mentioned to me that you were having to fend off enquiries about once a fortnight from Mr Adam Raphael. Mr Raphael's coverage of Al-Yamamah over a period of years is an example of the sort of reporting which, particularly if it could be linked to an official (but unpublished) report to Parliament, would be most damaging.
- e. The protections available (e.g. the new arrangements under which sensitive reports are not circulated but are available for PAC members to read only in the Clerk's office) may suffice for the normal run of classified reports, but there must be strong doubts (in view, I have to say, of the recent record, as well as of the particular pressures at d. above) on whether they would be good enough in this exceptional case. In any case

CONFIDENTIAL
COMMERCIAL IN CONFIDENCE

the new arrangements were only introduced in February 1991, and to the best of my knowledge have yet to be fully tested.

- f. I recognise the efforts made to minimise coverage of particularly sensitive issues. But (see (b) above) many areas of particular sensitivity for ourselves or the Saudis remain. Given the extent of this information, it is difficult to see how even a confidential report could be adequately sanitised if it were to go to the Committee as a whole in a form that members would regard as worth having.
- g. Furthermore, if, as must surely be expected, the Committee insisted on an evidence session - albeit a closed one - all efforts to sanitise the text could well prove fruitless; I do not see how members could be prevented from opening up wider and more sensitive avenues of enquiry. In a closed session the Accounting Officer's ability to decline to answer on the grounds of confidentiality must be open to question, unlike in the Select Committees where there are clear and, I believe, generally accepted guidelines for officials on the disclosure of classified information. I am not aware of any precedent in the PAC which would help define the scope, if any, for the Accounting Officer to resist enquiries into sensitive issues. Of course in the national interest, I believe I would be bound to do so; you will forgive me for predicting that I would then have an exceptionally difficult time. Furthermore, my refusal to answer on grounds of principle could well be interpreted both by the PAC and by the media as implying that HMG has something to hide.
- h. This could also read across to BAe's current problems in a number of ways. ~~The potential damage to the Company from disclosure would be severe. We would not wish to add to their difficulties, particularly when we and they are at a delicate stage of seeking to expand the Al-Yamamah programme. And the current appetite of the press for disclosures about BAe will put still more pressure on the Committee.~~

In short, as your report acknowledges, Al-Yamamah is a huge prize for British industry and sustains many thousands of jobs; given the avoidable risk in this case, it makes no sense to contemplate damaging our relations with such an important customer for the sake of giving wider circulation to a report which finds little of direct concern for the PAC in the Department's handling of the Project. Indeed, I hope you will feel able to assure Mr Sheldon that there is in the report no significant criticism of the Department which the Committee need feel was being suppressed by restrictive handling.

CONFIDENTIAL
COMMERCIAL IN CONFIDENCE

4. I understand that there are precedents for reports to be confined to the Chairman of the PAC with, if so required, a private hearing between the Chairman and the Accounting Officer. The parallels may not be exact, but Al-Yamamah is an exceptional issue. I could live with such an approach in this case.
5. I shall have a word with Malcolm MacIntosh about which of us should take this forward. But in all the circumstances I believe I should continue to deal with this matter.

PROPOSED TEXTUAL AMENDMENTS TO DRAFT BILL AMENDMENT ON PROJECT
AL-YAMAMAH (1992-93)

June 2001

Michael

1. Paragraph 1 amend the first sentence to read:
"For administrative convenience funds from the Saudi-owned bank accounts are disbursed and accounted for by the Department monthly."

2. Paragraph 10 amend the fourth sentence to read:
"Government Accounting procedures normally require the Appropriations Account to include a note setting out the actual gross expenditure and related gross receipts in respect of each sub-head within the vote."

3. Paragraph 13 amend the final sentence to read:

Sir John Bourn KCB
Comptroller and Auditor General
National Audit Office
Buckingham Palace Road
Victoria
London SW1W 9SP

4. Paragraph 20 Add a new final sentence:

"The Department point out, however, that the effects of recovering from the management fee the opportunity cost of

CONFIDENTIAL
COMMERCIAL IN CONFIDENCE

591

CONFIDENTIAL

minofev/kd
05/03/92
db/minutes

Summary Minutes of Evidence: taken in private before
Mr Robert Sheldon (Chairman, Public Accounts Committee) and
Sir Michael Shaw (Public Accounts Committee).

27 February 1992

Under consideration: Report of the Comptroller and Auditor General
on the Ministry of Defence Appropriation Account 1990-91 (Volume 1:
Class 1, Vote 2 - Defence Procurement): The Saudi Arabian Airforce
Project.

Witnesses:

Sir Michael Quinlan, GCB, Permanent Under Secretary of State,
Ministry of Defence

Mr Michael Bell, Principal Finance Officer, Ministry of Defence

Mr Michael Jenner, Commercial Director, Saudi Arabian Airforce
Project, Ministry of Defence.

In attendance:

Sir John Bourn, Comptroller and Auditor General

Mr Lew Hughes, Assistant Audit General, National Audit Office

CONFIDENTIAL

CONFIDENTIAL

dollars so that the sum passed through that subhead is. But all
Mr John Parsons, Director, National Audit Office accounts.

(Mr Bell). We have now invited Chairman

management people who are quite independent of the project office
1. How does the question of confidentiality influence the whole
of these proceedings? How has this been influenced by the attitude
of the Saudi Arabian Government?

Paragraph 11 of the Report says that the examination by the
(Sir Michael Quinlan). The whole project operates under a seal of
confidentiality. There is a very great sensitivity about the
project on the part of the Saudi Arabian Government. Open
government is alien to them. It is explicit that arrangements
should be confidential between them and us. We are reminded of
this constantly. British jobs are at risk here. wrong if we do

not discuss the subject. Can you give us an assurance that no
2. Paragraph 11 of the Report states that due to an oversight
over £800 million of receipts and payments relating to the sale
were not correctly recorded. This is very worrying indeed. How
did this happen? to support any suggestion that commission

payments have been made using public funds.
(Sir Michael Quinlan). I agree this was a very large amount. The
error has now been rectified and I would stress that no money has
been lost. It happened at the stage in the project when we started
work on bases and at that time the financing arrangements changed.

tell us how the national accounts would have been affected by this.
(Mr Jenner). Receipts started coming over in dollars for the first
time and what we failed to do was to open a suspense account for

CONFIDENTIAL

CONFIDENTIAL

dollars so that the sums passed through net subhead H6. But all these sums were recorded in the project's memorandum accounts.

(Mr Bell). We have now introduced arrangements whereby my cash management people - who are quite independent of the project office - check that all receipts and payments are accounted for properly. This should ensure that the problem does not recur.

3. Paragraph 12 of the Report says that the examination by the Comptroller and Auditor General found no evidence of commission payments being made to third parties. This examination related, of course, to project receipts and payments which passed through the Ministry of Defence. The Ministry would not have known what happened after project payments had been made to British Aerospace. We are aware of rumours about this and it would be wrong if we did not examine the subject. Can you give us an assurance that no public funds have gone the wrong way?

6. You did not undertake a full evaluation of the options for (Sir Michael Quinlan). Yes, I can give you the assurance that there is no basis to support any suggestion that commission payments have been made using public funds.

(Sir Michael Quinlan). Sir Michael Shaw replacement in kind was the best deal for us. was much simpler and will give us more

4. Returning to the accounting oversight of £800 million, can you tell me how the national accounts would have been affected by this.

contractors. There would also have been a risk for us, as the reclaimed money would have had to be surrendered as Exchequer Extra

CONFIDENTIAL

CONFIDENTIAL

(Sir Michael Quinlan). The account would have been unaffected because a net subhead is involved.

(Mr Hughes). I can confirm that the impact on the account would have been nil.

Chairman

5. Have you checked whether there have been any other oversights?

(Mr Bell). We have a procedure in place to ensure that it does not recur again. There is an independent check by my cash management people which would show up such oversights at once.

(Comptroller and Auditor General). We will continue to audit the transactions and this would throw up such oversights.

6. You did not undertake a full evaluation of the options for replacing diverted assets. You seem to be making heavy weather of this. Surely, it was not a difficult task. Why did you not undertake an evaluation?

(Sir Michael Quinlan). We believed that replacement in kind was the best deal for us. It was much simpler and will give us more up-to-date aircraft without further payment. The other option would have involved us in reclaiming payments from around 350 contractors. There would also have been a risk for us, as the reclaimed money would have had to be surrendered as Exchequer Extra

CONFIDENTIAL

CONFIDENTIAL

Receipts, and we would have had to provide finance afresh (of an uncertain amount) in later years. This might have been more awkward. We thought that the better thing to do was to put the risk on the contractor. He would then have to bear the risk of such things as exchange rate fluctuations. The replacement-in-kind option thus avoided financial risk, avoided the risk from a need to reprovide in the defence budget, and avoided the complexity of making recoveries from contractors.

(Mr Bell). As paragraph 18 of the Report points out British Aerospace favoured the repayment option because the replacement in kind option passed the financial risk to them.

7. Surely, you will need to undertake a full evaluation at some stage to show whether in practice you chose the more expensive option? If it shows that you did what action will you take to recover the money, say from the Management Fee?

(Sir Michael Quinlan). No, I would not see the need for a full evaluation after the event. We would only need to do so if there was any question of reclaiming money from the contractor and I do not think it would be appropriate to do so. We put the risk on the firm and we could not say after the event that we chose the wrong horse; we could not reclaim the money from British Aerospace. They were actually keen on the repayment option, and we backed our horse.

Sir Michael Shaw

CONFIDENTIAL

CONFIDENTIAL

(Sir Michael Quinlan). We don't expect to make a profit for us.
8. Had the aircraft involved already been delivered to the Royal Air Force?

(Sir Michael Quinlan). No, only progress payments had been made. We continued to make the payments as the aircraft were completed. The aircraft then went to the Saudis. British Aerospace owe us those aircraft but are in fact providing better aircraft for no further payment by the Ministry of Defence. British Aerospace have taken on the financial risks involved in providing an upgraded aircraft. They could not come back to us if they have problems.

Chairman

9. Figure 1, on page 13 shows a large budgeted surplus on the management fee. Why can't you make a decision on what to do with it now?

(Sir Michael Quinlan). We want to wait and see what the project needs. We can't cross that bridge now, but it is available to be used.

10. Paragraph 26 shows that you knew that a 2 per cent management fee would result in a genuine surplus and that British Aerospace knew that as well. What claims have British Aerospace got on the surplus?

12. Don't you think that the Treasury had an entitlement to this surplus?

CONFIDENTIAL

CONFIDENTIAL

(Sir Michael Quinlan). We don't expect to make a profit for HMG out of the management fee. It has been used once already to ease an overtight price for British Aerospace, and could be used in such ways again. The Treasury accept that this is not Exchequer money, that it is project money.

Sir Michael Shaw

11. Were the British Aerospace claims, over and above the contract price, sweeteners or relief for the unexpected?

(Sir Michael Quinlan). British Aerospace persuaded us that the price was too tight and we accepted paying a £12 million "easement". It was part of the contract, in effect - part of making the deal go. The £18 million payment to British Aerospace arose because of a funding shortfall, linked to fluctuations in the oil price. From August 1986 the Saudis agreed to pay interest on the shortfall, but up to then there was no interest payable, and this is what the payment related to. This was camel trading, partly linked to negotiating difficulties involving the repurchase of Lightning aircraft and spares. We agreed to look after that £18 million shortfall. I don't think it can be regarded as a sweetener; without it we could not have made a deal.

Chairman

12. Don't you think that the Treasury had an entitlement to this surplus?

CONFIDENTIAL

CONFIDENTIAL

(Sir Michael Quinlan). No.

13. Paragraph 31 tells us that you reviewed the profitability of the contract before you made the payments from the Management Fee to British Aerospace but the report then goes on to say that you did not take account of such things as the profitability of the follow up provisioning of spares. I know from my own experience that this is the area where high profits can be made. How will you seek to recoup this?

(Sir Michael Quinlan). We will take account of all this when we do the calculation for Commercial Exploitation Levy. Our initial feeling is that British Aerospace were screwed down very tightly.

Chairman

14. I am not wholly convinced by that.

(Mr Bell). The Commercial Exploitation Levy discussions will identify the profitability of the whole contract.

Sir Michael Shaw

15. Paragraph 36 indicates that you made payments from the Management Fee of £1.1 million to provide helicopters for relief to Bangladesh. What did that have to do with you?

CONFIDENTIAL

CONFIDENTIAL

(Sir Michael Quinlan). In one sense, nothing - there was no question of the Saudis not being prepared to pay for it. It was simply a question of the mechanics of payment.

(Mr Jenner). The Saudi request was for this to be paid for by the project, not by HMG as such.

16. Why did the Saudis not pay for it direct?

(Sir Michael Quinlan). They wished to avoid bureaucratic delay - they needed a quick reaction. But the Saudis would be upset if details of this were revealed; they have a great distaste for any revelations about their finances.

Chairman

17. Paragraph 39 shows that the levy agreement you have with your Tornado partners does not make clear whether payments of interim levy should be made to reflect the rate of deliveries. Why have you had such problems collecting interim payments and how much is subject to levy?

(Sir Michael Quinlan). About half the Tornado price is subject to levy. We are only entitled to levy where we have paid for the R&D; it is not due on special modifications for the Saudis. There are complicated arrangements for phased payments from British Aerospace, and we hope to get a good deal more in by the end of the year. There is a problem in fixing prices - the 5th batch of

CONFIDENTIAL

CONFIDENTIAL

aircraft were not priced until August 1990, and until that was done we could not get anything.

(Mr Bell). On the programme as a whole, we hope to extract £30 million of the £90 million odd due from British Aerospace by the end of the financial year.

18. Do you now accept that you will not get the full seven and a half per cent?

(Sir Michael Quinlan). We hope for £80 million - 100 million all told. It would be unrealistic now to refine our estimates any further - there is still uncertainty over prices. We hope to get another £10 million next month.

(Mr Jenner). Until one gets prices one can't assess completely what to invoice the company for. Some elements are only just being delivered. And the pricing of the 6th and 7th batch Tornados has still to be finalised; the final delivery is not until later in 1992.

19. When do you expect all accounts for the levy to be paid up?

(Sir Michael Quinlan). I would be disappointed if this was not done in, say, two years' time. We will try to get as much as we can quickly. But it is difficult to get money out of British Aerospace at the moment.

CONFIDENTIAL