CONFIDENTIAL

DEPARTMENT OF INDUSTRY
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JU51
Secretary of State for Industry

1 November 1982

F E R Butler Esq
10 Downing Street
London SW1

Pl. Type the attached draft for the Prime Minister's signature and return the papers to me.
FERB 1.11

The letter is less than frank. Govt. can not do it - but we can merely try to bring financial institutions together. I think this should be made clearer soon after para 1.

Dear Robin,

NISSAN

We have now completed our study of options available to the Government in meeting Mr Kawamata's concern about Nissan's financing burden in the early years of the UK project. The options were identified and discussed in detail in the annex to our brief for the Prime Minister's meeting with Mr Ishihara; I attach a copy of this annex for convenience. Officials of the Treasury and Bank of England were closely involved in our study.

2 You will recall that the options were for the English Industrial Estates Corporation or Welsh Development Agency depending on location to build the factory and lease it to Nissan (Option (i)); or for the factory to built and equipped under a finance lease (Option (ii)). The two options could to some extent be combined.

3 On further reflection we see no real advantages, to Nissan or to ourselves, in Option (i) over Option (ii). Option (i) does, however, have potentially serious disadvantages. The EIEC or WDA could only build the factory for Nissan; they could not equip it. Moreover their formal ownership of the assets would increase public expenditure and the PSBR over the construction period (1983-1988) by the full cost of the factory - perhaps £120 million, with nearly half of this falling in 1984. There are no current PES provisions for this expenditure, and my Secretary of State sees no prospect that offsetting savings could be found, at least in the English factory-building programme. (We can, of course, only speak for that programme; but even if off-setting savings were more practicable in the event of a Welsh location, it would be most unfortunate to distort Nissan's choice of location, in which we have promised not to interfere, because of such domestic considerations. We could therefore not offer this option without the risk of increased public expenditure). not

4 A further difficulty is that the involvement of the EIEC or WDA could expose them to financial risk over the construction period. Moreover we should not want to risk diluting Nissan's own control of the project, since one spin-off we are hoping for is the exposure of British construction companies to the full rigour of Japanese negotiating practices and project management.

5 These difficulties would not necessarily be overriding if there was no alternative way of meeting Mr Kawamata's request. But our study of the finance leasing route (Option (ii)) suggests that it would in fact better meet Mr Kawamata's aims as well as our own. The attached draft letter to Mr Kawamata therefore outlines this proposal and relates it to his expressed concerns.

6 There are some points about the drafting of the letter to Mr Kawamata I should explain.

7 We are conscious that the finance leasing route is one which would probably be available to Nissan without Government intervention, though we have no evidence that they have yet given very serious thought to this, or any other, financing option for the project. We need to be careful not to present this as something exclusively in the Government's gift, while still presenting it as a concession from the Prime Minister to Mr Kawamata. We have done this by emphasising the exceptional scale of the project's demand for leasing finance (we doubt whether there have previously been individual transactions much over £100 million), and offering the "good offices" of the Bank of England in setting it up.

8 We considered whether to prepare a detailed description of the sort of finance leasing arangement Nissan might get, with indicative terms and conditions. However, the size and extended timescale of Nissan's project make this very difficult to do with any confidence. Even indicative figures could prove hostages to fortune, bearing in mind that these terms will be set not by Government but by the commercial lessors in the light of market conditions at the time.

9 There is a risk that if they are attracted by the leasing route, Nissan will seek an assurance about continuance of the current tax treatment of leased plant, to protect the advantageous terms of this form of finance. They have in the past made a similar demand regarding continuance of RDGs, and have - so far at least - been satisfied with a form of words falling well short of a firm undertaking.

10 If Nissan do choose to adopt the leasing route, this will have implications for the payment of RDGs and selective financial assistance (SFA). RDGs would have to be paid to the lessors, as

purchasers of the plant; however, the benefits thus accruing to them should be passed through to Nissan in the terms of the lease, so they should be no worse off. With SFA, our normal practice would be to reassess not only the phasing but the actual amount of SFA payable, on the grounds that the minimum SFA payment needed to achieve the project might be reduced by the reduced cost of leasing. If we intended to do so in this case, there is no doubt that the prospect would have to be mentioned in the letter to Mr Kawamata - where it would detract substantially, if not completely, from the positive message we want to get across. My Secretary of State takes the view that it would be quite inappropriate in the present circumstances, when the project is in the balance, to seek to renegotiate the amount of SFA if Nissan take up the leasing option. The actual phasing of payments might need to be looked at, to ensure that payments to Nissan did not at any time exceed their own outgoings - but this ought not to cause difficulty. On the understanding that there would be no reduction in SFA, we believe it would be tactically right, and defensible, not to mention the RDG and SFA implications in the present letter.

11 There will be other detailed points of some complexity which will need to be explored with Nissan, such as the prospect that the lessors would look for a full parent company guarantee. We believe that in replying to Mr Kawamata, the Prime Minister should concentrate on the essentials of the proposal, offering further discussions with officials from this Department and the Bank as necessary.

12 Apart from the direct response to Mr Kawamata's ideas on financing, we have also considered whether the Prime Minister's letter should take up two points made by Mr Ishihara both at his meeting with the Prime Minister and earlier with my Secretary of State, about local content and exports from the UK plant.

13 My Secretary of State was concerned that Mr Ishihara went out of his way to look for additional flexibility on local content, on which we believe we have reached a broadly satisfactory understanding with Nissan during our protracted negotiations. My Secretary of State would be extremely reluctant to indicate any significant additional flexibility here, both in substance and tactically - it could open the door for yet further demands if we once appeared willing to contemplate further concessions beyond those in the packages we have negotiated. However, on balance we believe that to include this point could damage the tone of the Prime Minister's message to Mr Kawamata, who is our main target in the present exchange, and even offer him further room for objection to the project.

14 We have however included a short reference to exports which reassures Nissan that there is no need for them to seek increased flexibility here, since the draft agreements are already in line with Mr Ishihara's wishes.

15 I apologise for the length of this letter, but we believe the Prime Minister would wish to understand our thinking not only on what we suggest should be included in her letter to Mr Kawamata, but also on what is omitted. I am sending copies of this letter to Margaret O'Mara (Treasury), Roger Bone (FCO) and John Rhodes (Trade).

Yours sincerely,

Jonathan Spencer

J P SPENCER
Private Secretary

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JU52

DRAFT REPLY FOR THE PRIME MINISTER TO SEND TO

Mr Katsuji Kawamata
Chairman
Nissan Motor Company Limited
17-1 Ginza 6-chome
Chuo-Ku
Tokyo

At our meeting in Tokyo, you explained ~~that the main source of~~ your concern ~~about~~ that the UK project ~~was the~~ would impose a heavy additional financing burden ~~which would arise for~~ on Nissan. In order to reduce the immediate impact of a UK investment you asked whether it would be possible for the British Government to build and fully equip a factory initially, and to recover the cost from your company over a period through a rental arrangement. I undertook to consider personally whether we could offer a solution to this problem.

~~I believe that~~ The inquiries I have made indicate that it should be possible to solve the problem through an arrangement ~~My proposal is~~ that the assets of the project should formally be under the ownership of a group of UK financial institutions who would lease them long term to Nissan on commercial terms. Under such an arrangement, Nissan would in practice remain in effective control of the design, construction and operation of the factory and its capital equipment.

As you know, there are taxation allowances relating to the cost of acquiring buildings and plant that can be set on a favourable basis against profits when assessing a company's liability for Corporation Tax in the UK. Your financial projections presented to the Department have shown that these allowances would not be able to be set against taxable profits for some years. Under present tax law, however, the lessors would be able to set these allowances against their own current profits when assessing their Corporation Tax liability. The financial benefits to them would be reflected in the leasing charges made by them to your company. While the exact terms naturally depend on market conditions, such charges might be expected to offer a significant advantage against the equivalent cost of UK bank borrowings by a prime commercial borrower. In the present market, some part of this benefit might be recognised by, for example, a three-year period during which no leasing charges at all would be made, with a commensurate increase in the charges made in ensuing periods. The terms and conditions of such a lease would be a matter for discussion with the lessors.

You may be aware that this form of leasing finance is an established part of current corporate financing in the UK. However, Nissan's investment would be of an unprecedented size for such financing, and would in certain years be likely to absorb a signiicant proportion of the UK's expected capacity for leasing finance. Nevertheless, with the Government's backing - to which I would lend my personal support - and through the good offices of the Bank of England, who would, at my request, use their best endeavours in bringing together appropriate partners, I believe that there is a good prospect that a suitable consortium of financial institutions could be encouraged to participate in order to facilitate Nissan's investment in this country.

As you know, I had a meeting on 18 October with Mr Ishihara, whom I was delighted to meet. He expressed the hope that we would be flexible over any conditions relating to exports. I was able to reassure him that we have always understood that you are unable to enter into commitments on the level of exports, though it is our common hope that a significant proportion of the output will eventually be exported.

Finally, may I say how much I ~~welcomed the constructive approach which you adopted during our discussion~~ appreciated the constructive discussion which we had in Tokyo. I hope in turn that the proposal I have outlined above will be helpful in meeting the ~~main~~ anxiety which you ~~have~~ expressed about the project. Naturally I should be delighted to arrange for representatives of the Government and the Bank of England to discuss these proposals further with Nissan ~~if at this stage~~ ~~whenever~~ if you feel that this would be helpful.

NISSAN - FINANCING PROPOSALS

1 At his meeting with the Prime Minister in Tokyo, the Nissan Chairman, Mr Kawamata, explained the main source of his concern about the UK project as being Nissan's heavy financing burden arising from their current major investments in overseas projects. He was particularly worried about the prospect that they would not recover their investment for at least 10 years. He wondered whether there was any possibility of an arrangement whereby the British Government would build and equip a factory initially, and recover the cost from Nissan over a period through a rental arrangement to minimise the immediate impact on Nissan's funds. The Prime Minister mentioned the Advance Factory Scheme, and told Mr Kawamata that she would consider personally what he had said and what further response she could make.

<u>The Options</u>

2 Officials are urgently considering the problem put by Mr Kawamata. Work on defining the options, and identifying their advantages and disadvantages to Nissan and to HMG continues. At present, two broad routes have been identified:

i) <u>Factory (but not plant) built at public expense and leased (or sold) to Nissan.</u>
This would involve the English Industrial Estates Corporation or the Welsh Development Agency, according to location, building a bespoke factory to Nissan's specification. The completed factory could then be leased to Nissan at a market rate. Such a lease would be negotiated to run for, say, 25 years with five year rent reviews; it could include an initial rent free period, and an option for Nissan to purchase at market rates after, say, five years. The EIEC and WDA's powers do not extend to purchasing manufacturing plant or machinery.

ii) Finance lease on buildings and plant

Under this option, the factory and its plant would be owned from the outset by a group of financial institutions with corporation tax liabilities - probably, in view of the size of the project, a syndicate including the four major clearing banks. The assets would simultaneously be on-leased to Nissan on terms which reflected the tax relieved by the assets' capital allowances and the RDGs received by the lessors. Compared with straightforward UK loan finance, the effect interest rate advantage might amount to 3 - 4%, or less if an interest free period was offered. This could have a present value to Nissan of some £50 million over the years to 1990.

3 Options (i) and (ii) are not mutually exclusive. Once the factory had been bult by the EIEC or WDA under option (i), it could be disposed of to a financial consortium for tax leasing on to Nissan. Whether or not option (i) was adopted for buildings, a tax lease might be appropriate for plant.

Assessment of Options

4 Option (i) is close to what Mr Kawamata asked the Prime Minister for in respect of factory building; but it is not an option which can extend to manufacturing plant. This means that used on its own it could only relieve Nissan's immediate cash out-flow by some £120 million (outturn) out of a total capital expenditure of some £615 million. Compared with option (ii), building and leasing the factory in this way would probably cost Nissan considerably more in financing/rental charges, since it would hold no tax advantages to the lessors; though as noted above construction under option (i) could be combined with a tax lease for the future stages.

5 For HMG, option (i) would involve a direct addition to the PSBR (net of any contribution from the existing PES provision of the EIEC or WDA) of some £120 million spread over the construction periods 1983-1988 (peaking at £55 million in 1984, with around £10 - £15 million in each of the other years). The PSBR addition would subsequently be offset by rental payments - or, if the lease or the factory were disposed of to a leasing consortium, Nissan or a pension fund, by the proceeds of such sale. There would however be no guarantee that the Exchequer costs would be fully recovered, bearing in mind the risks of construction cost overruns and adverse market movements during construction.

6 Option (ii) would in principle be available to Nissan with or without HMG intervention. Nonetheless, the size of the lease, and Nissan's apparent lack of familiarity with the details of UK project financing, may enable it to be presented as benefiting from Government support, perhaps by/recommending the scheme to Nissan, and offering the Bank of England's best endeavours to ensure that this form of finance would be available from the City. For Nissan, it has the advantage that it removes most of their expenditure (the total £615 million, including plant and equipment,less rental payments), and that it offers the most advantageous interest rates available. A potential disadvantage is that the interest benefit depends on continuation of the present treatment of tax leasing. Although the Government's intention is to maintain incentives to investment whether by this or other means, a request from Nissan for cast-iron guarantees would be awkward.

HMG

7 For HMG, such a lease at first sight implies a significant deferral of Corporation Tax receipts, amounting in total to some £300 million over the initial years of the project, although this would be recovered over the life of the lease. However, current market conditions suggest that an excess of demand for tax leasing over supply will continue, and therefore that this option would replace other tax leases in the economy, without net cost to the Exchequer. The displacement of other domestic industrial demand for tax leasing capacity could itself be seen as a disadvantage of this route.

8 A combination of option (i) during building construction and option (ii) for leasing the completed factory and for plant and machinery, could possibly be an attractive option for Nissan, though it may hold few advantages over option (ii) thoughout. For HMG, this route would still involve a short-term PSBR cost until the factory was disposed of, and a risk of incomplete recovery of Exchequer Costs.

Cash Flow versus Risk

9 It is not clear from what Mr Kawamata said to the Prime Minister exactly what is expected of the proposals HMG might make. What Mr Kawamata has asked for is a deferral of cash expenditures, with repayment, apparently on commercial terms, over the period "to minimise the immediate impact on Nissan's funds". The normal reason for avoiding a substantial front-end expenditures would either be to avoid increasing indebtedness - for example if a company was already highly geared - or to reduce exposure to risk. In essence, however, the leasing or rental proposals raised by Mr Kawamata and discussed above, amount simply to an alternative way of financing the project, and would be seen as such by potential lenders or lessors. The project itself remains largely unchanged in substance and, apart from the interest saving available through a tax lease, in exposure to risk. Nissan may indeed under Japanese accounting conventions be expected to capitalise such leases in their balance sheet, as they would certainly have to do in US accounting practice, so that the funding would not even be "off balance sheet". Officials find it hard to see that Nissan would actually have difficulty in raising bank borrowing, in Japan or in Europe, if they chose to do so; and if bankers were unwilling to lend to cover the project, they would equally be unready to arrange a finance lease.

10 If Mr Kawamata was more concerned about Nissan's actual financial exposure on the UK project, neither his proposal to the Prime Minister nor the two options outlined above would do much to help. The only way to reduce Nissan's exposure would be to increase HMG's, for example through changes in the amount of selective financial assistance, which has not been seriously at issue with the rest of Nissan management.

Conclusion

11 The options outlined above need further work before they could be exposed to Mr Kawamata; and in particular the PSBR implications of the Government-built factory route would require careful consideration. However, it seems quite possible that something which approaches Mr Kawamata's request could be presented by HMG. It is not certain that it would in reality be of much greater benefit to Nissan than they could achieve without Government intervention. Nonetheless, the ability to present a reasonable response to Mr Kawamata would be of great importance, whether because Nissan do not fully appreciate the availability of certain options (eg tax leasing on the proposed scale); or because Mr Kawamata is looking for a personal gesture from the British Prime Minister which would enable him to withdraw his opposition to the UK project without losing "face".

Officials are working urgently to prepare more substantive proposals for consideration by the Prime Minister, and eventual presentation to Mr Kawamata.

Department of Industry
15 October 1982

I attach a revised draft, which I have cleared with the Department of Industry.

FERB

8.11.

10 DOWNING STREET

Prime Minister

I attach below a letter to Mr. Kawamata, and, on top, a letter from the Department of Industry commentating on it. You will see that Industry, Treasury and the Bank have worked on it, and it seems to me that the result is positive and constructive.

If you agree I will arrange that copies of your letter should be restricted to those who have seen the draft and the Ambassador in Tokyo.

FER.B.

2.11.

CONFIDENTIAL

Japan

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CCS HMA, Tokyo
FCO
Tsy
Trade

10 DOWNING STREET

From the Principal Private Secretary

9 November 1982

Dear Jonathan,

NISSAN

The Prime Minister was extremely grateful for the advice in your letter of 1 November to me and for the draft letter to Mr Kawamata. I attach a copy of the letter to Mr Kawamata in the form in which the Prime Minister has now sent it.

I am copying this letter and the enclosure to the recipients of yours, and to Sir Hugh Cortazzi in Tokyo. I should ge grateful if all recipients would limit circulation of the Prime Minister's letter to those who have previously worked on it or have an operational need to see it.

Yours sincerely,

Robin Butler

Jonathan Spencer Esq.,
Department of Industry.

CONFIDENTIAL

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STRICTLY PERSONAL

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ccs HMA Tokyo
FCO.
Tsy
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D/I

10 DOWNING STREET

THE PRIME MINISTER

9 November 1982

Dear Mr Kawamata,

At our meeting in Tokyo, you explained your concern that the UK project would impose a heavy additional financing burden on Nissan. In order to reduce the immediate impact of a UK investment you asked whether it would be possible for the British Government to build and fully equip a factory initially, and to recover the cost from your company over a period through a rental arrangement. I undertook to consider personally whether we could offer a solution to this problem.

As I mentioned when we met in Tokyo, it would be possible for one of the relevant public agencies to build a factory and lease it to Nissan; but it is not the practice under our law for these agencies to equip a factory. So this would not be a complete solution to the problem which you raised.

However, the inquiries which I have made indicate that there is an alternative solution which would achieve the result you are seeking. This is an arrangement that the assets of the project should formally be under the ownership of a group of UK financial institutions who would lease them long term to Nissan on commercial terms. Under such an arrangement, Nissan would in practice remain in effective control of the design, construction and operation of the factory and its capital equipment.

This form of leasing finance is an established part of current corporate financing in the UK. However, Nissan's investment would be of an unprecedented size for such financing, and would in certain years be likely to absorb a significant proportion of the UK's expected capacity for leasing finance. Nevertheless, with the Government's backing - to which I would lend my personal support - and through the good offices of the Bank of England, who would, at my request, use their best endeavours in bringing together appropriate partners, I believe that there is a good prospect that a suitable consortium of financial institutions could be encouraged to participate in order to facilitate Nissan's investment in this country.

Such an arrangement could also offer some additional advantages. As you know, there are taxation allowances relating to the cost of acquiring buildings and plant that can be set on a favourable basis against profits when assessing a company's liability for Corporation Tax in the UK. Your financial projections presented to the Department have shown that these allowances would not be able to be set against taxable profits for some years. Under present tax law the lessors would be able to set these allowances against their own current profits when assessing their Corporation Tax liability. The financial benefits to them would be reflected in the leasing charges made by them to your company. While the exact terms naturally depend on market conditions, such charges might be expected to offer a significant advantage against the equivalent cost of UK bank borrowings by a prime commercial borrower. In the present market, some part of this benefit might be recognised by, for example, a three year period during which no leasing charges at all would be made, with a commensurate increase in the charges made in ensuing periods. The terms and conditions of such a lease would be a matter for discussion with the lessors.

As you know, I had a meeting on 18 October with Mr Ishihara, whom I was delighted to meet. He expressed the hope that we would be flexible over any conditions relating to exports. I was able to reassure him that we have always understood that you are unable to enter into commitments on the level of exports, though it is our common hope that a significant proportion of the output will eventually be exported.

Finally, may I say how much I appreciated the constructive discussion which we had in Tokyo. I hope in turn that the proposal I have outlined above will be helpful in meeting the anxiety which you expressed about the project. Naturally I should be delighted to arrange for representatives of the Government and the Bank of England to discuss these proposals further with Nissan if you feel that this would be helpful.

With every good wish,

Yours sincerely,

Margaret Thatcher

Mr. Katsuji Kawamata

Japan

FERB

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

9 November 1982

Dr. J P Spencer
Department of Industry

Dear Jonathan,

NISSAN

The Chancellor has seen a copy of your letter of 1 November. He is content with the terms of the draft letter to Mr Kawamata but has asked me to make one point about the covering letter.

The Chancellor accepts that in the present circumstances it would be inappropriate to renegotiate the SFA offer if Nissan take up the leasing option. However, he considers that if Nissan take advantage of leasing finance, there can be no question of any increase in the existing SFA offer. He has in mind the agreement earlier this year that Nissan should be offered an extra 2 per cent of SFA if this proved essential to clinch the deal. The Chancellor does not think that extra SFA would be justified if Nissan obtained the benefits of leasing finance which officials have estimated could have a present value benefit of £50 million.

I am copying this letter to Robin Butler (No.10), Roger Bone (FCO) and John Rhodes (Trade).

Yours sincerely,
Margaret O'Mara

MISS M O'MARA
Private Secretary

Japan:

Nissan