

OFFERING CIRCULAR

BEZEQ

The Israel Telecommunication Corp., Limited
(incorporated with limited liability in Israel)

€750,000,000

Euro Medium Term Note Programme

Under this €750,000,000 Euro Medium Term Note Programme (the "**Programme**"), BEZEQ — The Israel Telecommunication Corp., Limited ("**Bezeq**" or the "**Issuer**") may from time to time issue notes (the "**Notes**") denominated in any currency agreed between the Issuer and the relevant Dealer (as defined below).

The maximum aggregate nominal amount of all Notes from time to time outstanding under the Programme will not exceed €750,000,000 (or its equivalent in other currencies calculated as described herein), subject to increase as described herein.

The Notes may be issued on a continuing basis to one or more of the Dealers specified under "*Summary of the Programme*" and any additional Dealer appointed under the Programme from time to time by the Issuer (each a "**Dealer**" and together the "**Dealers**"), which appointment may be for a specific issue or on an ongoing basis. References in this Offering Circular to the "**relevant Dealer**" shall, in the case of an issue of Notes being (or intended to be) subscribed by more than one Dealer, be to all Dealers agreeing to subscribe for such Notes.

Application has been made to the Luxembourg Stock Exchange for Notes issued under the Programme during the period of 12 months from the date of this Offering Circular to be listed on the Luxembourg Stock Exchange. Notice of the aggregate nominal amount of Notes, interest (if any) payable in respect of Notes, the issue price of Notes and any other terms and conditions not contained herein which are applicable to each Tranche (as defined under "*Terms and Conditions of the Notes*") of Notes will be set out in a pricing supplement (the "**Pricing Supplement**") which, with respect to Notes to be listed on the Luxembourg Stock Exchange will be delivered to the Luxembourg Stock Exchange on or before the date of issue of the Notes of such Tranche.

The Programme provides that Notes may be listed on such other or further stock exchange(s) as may be agreed between the Issuer and the relevant Dealer. The Issuer may also issue unlisted Notes.

The Issuer may agree with any Dealer and Bankers Trustee Company Limited (the "**Trustee**") that Notes may be issued in a form not contemplated by the Terms and Conditions of the Notes herein, in which event (in the case of Notes intended to be listed on the Luxembourg Stock Exchange) a supplementary Offering Circular, if appropriate, will be made available which will describe the effect of the agreement reached in relation to such Notes.

Arrangers

Deutsche Bank

Merrill Lynch International

Dealers

ABN AMRO

Merrill Lynch International

Schroder Salomon Smith Barney

Deutsche Bank

Morgan Stanley Dean Witter

UBS Warburg

The date of this Offering Circular is 7th August, 2000

The Issuer, having made all reasonable enquiries, confirms that the information contained in or incorporated into this Offering Circular is true and accurate in all material respects and is not misleading, that the opinions and intentions expressed in this Offering Circular are honestly held and that there are no other facts the omission of which would make this Offering Circular or any of such information or the expression of any such opinions or intentions misleading. The Issuer accepts responsibility accordingly.

This Offering Circular is to be read in conjunction with all documents which are deemed to be incorporated herein by reference (see "*Documents Incorporated by Reference*"). This Offering Circular shall be read and construed on the basis that such documents are incorporated and form part of this Offering Circular.

The Issuer is a company incorporated in Israel and its shares are listed on the Tel Aviv Stock Exchange ("**TASE**"). As such, the Issuer is subject to Israeli law and regulations and reporting requirements thereunder.

None of the Dealers or the Trustee has independently verified the information contained herein. Accordingly, no representation, warranty or undertaking, express or implied, is made and no responsibility or liability is accepted by the Dealers or the Trustee as to the accuracy or completeness of the information contained or incorporated in this Offering Circular or any other information provided by the Issuer in connection with the Programme. None of the Dealers or the Trustee accepts any liability in relation to the information contained or incorporated by reference in this Offering Circular or any other information provided by the Issuer in connection with the Programme.

No person is or has been authorised by the Issuer to give any information or to make any representation not contained in or not consistent with this Offering Circular or any other information supplied in connection with the Programme or the Notes and, if given or made, such information or representation must not be relied upon as having been authorised by the Issuer, the Trustee or any of the Dealers.

Neither this Offering Circular nor any other information supplied in connection with the Programme or any Notes (i) is intended to provide the basis of any credit or other evaluation or (ii) should be considered as a recommendation by the Issuer, the Trustee or any of the Dealers that any recipient of this Offering Circular or any other information supplied in connection with the Programme or any Notes should purchase any Notes. Each investor contemplating purchasing any Notes should make its own independent investigation of the financial condition and affairs, and its own appraisal of the creditworthiness, of the Issuer. Neither this Offering Circular nor any other information supplied in connection with the Programme or the issue of any Notes constitutes an offer or invitation by or on behalf of the Issuer or the Trustee or any of the Dealers to any person to subscribe for or to purchase any Notes.

Neither the delivery of this Offering Circular nor the offering, sale or delivery of any Notes shall in any circumstances imply that the information contained herein concerning the Issuer is correct at any time subsequent to the date hereof or that any other information supplied in connection with the Programme is correct as of any time subsequent to the date indicated in the document containing the same. None of the Dealers or the Trustee expressly undertakes to review the financial condition or affairs of the Issuer during the life of the Programme or to advise any investor in the Notes of any information coming to its attention. Investors should review, *inter alia*, the most recently published documents incorporated by reference into this Offering Circular when deciding whether or not to purchase any Notes.

The Notes have not been and will not be registered under the United States Securities Act of 1933, as amended, (the "**Securities Act**") and are subject to U.S. tax law requirements. Subject to certain exceptions, Notes may not be offered, sold or delivered within the United States or to U.S. persons (see "*Subscription and Sale*").

This Offering Circular does not constitute an offer to sell or the solicitation of an offer to buy any Notes in any jurisdiction to any person to whom it is unlawful to make the offer or solicitation in such jurisdiction. The distribution of this Offering Circular and the offer or sale of Notes may be restricted by law in certain jurisdictions. The Issuer, the Trustee and the Dealers do not represent that this Offering Circular may be lawfully distributed, or that any Notes may be lawfully offered, in compliance with any applicable registration or other requirements in any such jurisdiction, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. In particular, no action has been taken by the Issuer, the Trustee or the Dealers which would permit a public offering of any Notes or distribution of this document in

any jurisdiction where action for that purpose is required. Accordingly, no Notes may be offered or sold, directly or indirectly, and neither this Offering Circular nor any advertisement or other offering material may be distributed or published in any jurisdiction, except under circumstances that will result in compliance with any applicable laws and regulations. Persons into whose possession this Offering Circular or any Notes may come must inform themselves about, and observe, any such restrictions on the distribution of this Offering Circular and the offering and sale of Notes. In particular, there are restrictions on the distribution of this Offering Circular and the offer or sale of Notes in the United States, the United Kingdom, Israel, Japan, France, Germany and The Netherlands (see "*Subscription and Sale*").

The Programme is, as of 7th August, 2000, rated A3 in respect of Notes with a maturity of more than one year by Moody's Investors Service Limited ("**Moody's**"), and A- in respect of Notes with a maturity of more than one year by Standard & Poor's Ratings Services, a Division of the McGraw-Hill Companies Inc. ("**Standard & Poor's**"). Notes issued under the Programme may be rated or unrated. Where an issue of Notes is rated, its rating will not necessarily be the same as the rating applicable to the Programme. A rating is not a recommendation to buy, sell or hold securities and may be subject to suspension, change or withdrawal at any time by the assigning rating agency.

All references in this document to "**U.S. dollars**", "**U.S.\$**" and "**\$**" refer to United States dollars, all references to "**shekels**" and "**NIS**" refer to new Israeli shekels, all references to "**sterling**" and "**£**" refer to pounds sterling and all references to "**euro**" and "**€**" refer to the currency introduced at the start of the third stage of European economic and monetary union pursuant to the Treaty establishing the European Community, as amended by the Treaty on European Union.

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In connection with the issue and distribution of any Tranche of Notes, the Dealer (if any) disclosed as the stabilising manager in the applicable Pricing Supplement may over-allot or effect transactions which stabilise or maintain the market price of the Notes of the Series (as defined below) of which such Tranche forms part at a level which might not otherwise prevail. Such stabilising, if commenced, may be discontinued at any time.

DOCUMENTS INCORPORATED BY REFERENCE

The following documents shall be deemed to be incorporated in, and to form part of, this Offering Circular:

(a) the most recently published audited consolidated annual financial statements and, if published later, the most recently published unaudited interim consolidated financial statements of the Issuer (see "*General Information*" for a description of the financial statements currently published by the Issuer); and

(b) all supplements or amendments to this Offering Circular circulated by the Issuer from time to time,

save that any statement contained herein or in a document which is deemed to be incorporated by reference herein shall be deemed to be modified or superseded for the purpose of this Offering Circular to the extent that a statement contained in any such subsequent document which is deemed to be incorporated by reference herein modifies or supersedes such earlier statement (whether expressly, by implication or otherwise).

The Issuer will provide, without charge, to each person to whom a copy of this Offering Circular has been delivered, upon the oral or written request of such person, a copy of any or all of the documents deemed to be incorporated herein by reference unless such documents have been modified or superseded as specified above. Requests for such documents should be directed to the Issuer at its office set out at the end of this Offering Circular. In addition, such documents will be available free of charge from the principal office in Luxembourg of Deutsche Bank Luxembourg S.A. (the "**Luxembourg Listing Agent**") for Notes listed on the Luxembourg Stock Exchange.

The Issuer will, in connection with the listing of the Notes on the Luxembourg Stock Exchange, so long as any Note remains outstanding and listed on such exchange, in the event of any material adverse change in the business, financial condition or otherwise of the Issuer which is not reflected in this Offering Circular, prepare a supplement to this Offering Circular or publish a new Offering Circular for use in connection with any subsequent issue of the Notes to be listed on the Luxembourg Stock Exchange.

If the terms of the Programme are modified or amended in a manner which would make this Offering Circular, as so modified or amended, inaccurate or misleading, a new offering circular will be prepared.

GENERAL DESCRIPTION OF THE PROGRAMME

Under the Programme, the Issuer may from time to time issue Notes denominated in any currency, subject to any applicable legal or regulatory restrictions and in accordance with any applicable laws, guidelines, regulations, restrictions or reporting requirements. A summary of the terms and conditions of the Programme and the Notes appears below. The applicable terms of any Notes will be agreed between the Issuer and the relevant Dealer prior to the issue of the Notes and will be set out in the Terms and Conditions of the Notes endorsed on, attached to, or incorporated by reference into, the Notes, as modified and supplemented by the applicable Pricing Supplement attached to, or endorsed on, such Notes, as more fully described under "*Form of the Notes*".

This Offering Circular and any supplement will only be valid for listing Notes on the Luxembourg Stock Exchange during the period of 12 months from the date of this Offering Circular in an aggregate nominal amount which, when added to the aggregate nominal amount then outstanding of all Notes previously or simultaneously issued under the Programme, does not exceed €750,000,000 or its equivalent in other currencies. For the purpose of calculating the euro equivalent of the aggregate nominal amount of Notes issued under the Programme from time to time:

(a) the euro equivalent of Notes denominated in another Specified Currency (as specified in the applicable Pricing Supplement in relation to the relevant Notes, described under "*Form of Pricing Supplement*") shall be determined by Deutsche Bank AG London (the "**Agent**", which expression shall include any successor agent) either, at the discretion of the Issuer, as of the date on which agreement is reached for the issue of Notes or on the preceding day on which commercial banks and foreign exchange markets are open for business in London and in Frankfurt am Main, in each case on the basis of the reference rate for the sale of the euro against the purchase of such Specified Currency published by the electronic information provider Reuters on page ECB 37 or such other screen page on that service or by such other information service provider which may be determined as the successor for the purposes of displaying such information or, if no such rate is available, on the basis of the exchange rate quoted by any leading bank selected by the Agent on the relevant day of calculation;

(b) the euro equivalent of Dual Currency Notes, Index Linked Notes and Partly Paid Notes (each as specified in the applicable Pricing Supplement in relation to the relevant Notes, described under "*Form of Pricing Supplement*") shall be calculated in the manner specified above by reference to the original nominal amount on issue of such Notes (in the case of Partly Paid Notes regardless of the subscription price paid); and

(c) the euro equivalent of Zero Coupon Notes (as specified in the applicable Pricing Supplement in relation to the relevant Notes, described under "*Form of Pricing Supplement*") and other Notes issued at a discount or a premium shall be calculated in the manner specified above by reference to the net proceeds received by the Issuer for the relevant Tranche.

SUMMARY OF THE PROGRAMME

The following summary does not purport to be complete and is taken from, and is qualified in its entirety by, the remainder of this Offering Circular and, in relation to the terms and conditions of any particular Tranche of Notes, the applicable Pricing Supplement. Words and expressions defined in "Form of the Notes" and "Terms and Conditions of the Notes" shall have the same meanings in this summary.

Issuer	BEZEQ — The Israel Telecommunication Corp., Limited
Description	Euro Medium Term Note Programme
Arrangers	Deutsche Bank AG London Merrill Lynch International
Dealers	ABN AMRO Bank N.V. Deutsche Bank AG London Merrill Lynch International Morgan Stanley & Co International Limited Salomon Brothers International Limited ⁽¹⁾ UBS AG, acting through its business group UBS Warburg and any other Dealers appointed in accordance with the Programme Agreement.
Certain Restrictions	<p>Each issue of Notes denominated in a currency in respect of which particular laws, guidelines, regulations, restrictions or reporting requirements apply will only be issued in circumstances which comply with such laws, guidelines, regulations, restrictions or reporting requirements from time to time (see "<i>Subscription and Sale</i>") including the following restrictions applicable at the date of this Offering Circular.</p> <p>Sterling</p> <p>Issues of Notes denominated in sterling shall comply with all applicable laws and regulations (as amended from time to time) of United Kingdom authorities. See "<i>Banking Act 1987 (Exempt Transactions) Regulations 1997</i>" under "<i>General Information</i>".</p> <p>Swiss Francs</p> <p>Issues of Notes denominated in Swiss francs or carrying a Swiss franc-related element with a maturity of more than one year (other than Notes privately placed with a single investor with no publicity) will be effected in compliance with the relevant regulations of the Swiss National Bank based on article 7 of the Federal Law on Banks and Savings Banks of 8th November, 1934 (as amended) and article 15 of the Federal Law on Stock Exchanges and Securities Trading of 24th March, 1995 in connection with article 2, paragraph 2 of the Ordinance of the Federal Banking Commission on Stock Exchanges and Securities Trading of 2nd December, 1996. Under the said regulations, the relevant Dealer or, in the case of a syndicated issue, the lead manager (the "Swiss Dealer"), must be a bank domiciled in Switzerland (which includes branches or subsidiaries of a foreign bank located in Switzerland) or a securities dealer duly licensed by the Swiss Federal Banking Commission pursuant to the Federal Law on Stock Exchanges and Securities Trading of 24th March, 1995. The Swiss Dealer must report certain details of the relevant transaction to the Swiss National Bank no later than the Issue Date of the relevant Notes.</p>
Trustee	Bankers Trust Company Limited
Agent	Deutsche Bank AG London

(1) Schroder is a trademark of Schroders Holdings plc and is used under licence by Salomon Brothers International Limited.

Programme Size	Up to €750,000,000 (or its equivalent in other currencies calculated as described under “ <i>General Description of the Programme</i> ”) outstanding at any time. The Issuer may increase the amount of the Programme in accordance with the terms of the Programme Agreement.
Distribution	Notes may be distributed by way of private or public placement and in each case on a syndicated or non-syndicated basis.
Currencies	Euro, sterling, U.S. dollars, yen and, subject to any applicable legal or regulatory restrictions, any other currency agreed between the Issuer and the relevant Dealer.
Redenomination	If so specified in the applicable Pricing Supplement, the Issuer may redenominate Notes issued in the currency of a country that subsequently participates in the third stage of European economic and monetary union, or otherwise participates in European economic and monetary union in a manner with similar effect to such third stage, into euro. The provisions relating to any such redenomination will be contained in the applicable Pricing Supplement.
Maturities	Such maturities as may be agreed between the Issuer and the relevant Dealer, subject to such minimum or maximum maturities as may be allowed or required from time to time by the relevant central bank (or equivalent body) or any laws or regulations applicable to the Issuer or the relevant Specified Currency.
Issue Price	Notes may be issued on a fully-paid or a partly-paid basis and at an issue price which is at par or at a discount to, or premium over, par.
Form of Notes	The Notes will be in bearer form and will, on issue, be represented by either a temporary global Note or a permanent global Note as specified in the applicable Pricing Supplement. Temporary global Notes will be exchangeable either for (i) interests in a permanent global Note or (ii) for definitive Notes as indicated in the applicable Pricing Supplement. Permanent global Notes will be exchangeable for definitive Notes upon either (i) not less than 60 days’ written notice from Euroclear and/or CBL (acting on the instructions of any holder of an interest in such permanent global Note) to the Agent as described therein or (ii) only upon the occurrence of an Exchange Event as described under “ <i>Form of the Notes</i> ”.
Fixed Rate Notes	Fixed interest will be payable on such date or dates as may be agreed between the Issuer and the relevant Dealer and on redemption, and will be calculated on the basis of such Day Count Fraction as may be agreed between the Issuer and the relevant Dealer.
Floating Rate Notes	Floating Rate Notes will bear interest at a rate determined: <ul style="list-style-type: none"> (i) on the basis of a reference rate appearing on the agreed screen page of a commercial quotation service; or (ii) on the same basis as the floating rate under a notional interest rate swap transaction in the relevant Specified Currency governed by an agreement incorporating the 1991 ISDA Definitions (as supplemented by the 1998 Supplement) and the 1998 ISDA Euro Definitions (each as published by the International Swaps and Derivatives Association, Inc., and as amended and updated as at the Issue Date of the first Tranche of the Notes of the relevant Series); or (iii) on such other basis as may be agreed between the Issuer and the relevant Dealer, as indicated in the applicable Pricing Supplement.

	<p>The margin (if any) relating to such floating rate will be agreed between the Issuer and the relevant Dealer for each Series of Floating Rate Notes.</p>
Index Linked Notes	<p>Payments of principal in respect of Index Linked Redemption Notes or of interest in respect of Index Linked Interest Notes will be calculated by reference to such index and/or formula or to changes in the prices of securities or commodities or to such other factors as the Issuer and the relevant Dealer may agree.</p> <p>Index Linked Notes which are issued or sold as a public offer (<i>appel public à l'épargne</i>) in France must be issued in compliance with the <i>Principes Généraux</i> from time to time set by the <i>Commission des Opérations de Bourse</i> and the <i>Conseil des Bourses de Valeurs</i> or any successor body thereto.</p>
Other provisions in relation to Floating Rate Notes and Index Linked Interest Notes	<p>Floating Rate Notes and Index Linked Interest Notes may also have a maximum interest rate, a minimum interest rate or both, as indicated in the applicable Pricing Supplement.</p> <p>Interest on Floating Rate Notes and Index Linked Interest Notes in respect of each Interest Period, as agreed prior to issue by the Issuer and the relevant Dealer, will be payable on such Interest Payment Dates, and will be calculated on the basis of such Day Count Fraction, as may be agreed between the Issuer and the relevant Dealer.</p>
Dual Currency Notes	<p>Payments (whether in respect of principal or interest and whether at maturity or otherwise) in respect of Dual Currency Notes will be made in such currencies, and based on such rates of exchange, as the Issuer and the relevant Dealer may agree, as indicated in the applicable Pricing Supplement.</p>
Zero Coupon Notes	<p>Zero Coupon Notes will be offered and sold at a discount to their nominal amount and will not bear interest.</p>
Redemption	<p>The applicable Pricing Supplement will indicate either that the relevant Notes cannot be redeemed prior to their stated maturity (other than in specified instalments, if applicable, or for taxation reasons or following an Event of Default) or that such Notes will be redeemable at the option of the Issuer and/or the Noteholders upon giving irrevocable notice to the Noteholders or the Issuer, as the case may be, on a date or dates specified prior to such stated maturity and at a price or prices and on such other terms as may be agreed between the Issuer and the relevant Dealer.</p> <p>The applicable Pricing Supplement may provide that Notes may be redeemable in two or more instalments of such amounts and on such dates as are indicated in the applicable Pricing Supplement.</p> <p>Unless otherwise permitted by then current laws and regulations, Notes (including Notes denominated in sterling) in respect of which the issue proceeds are to be accepted by the Issuer in the United Kingdom must have a minimum redemption amount of £100,000 (or its equivalent in other currencies), unless such Notes may not be redeemed until the third anniversary of their Issue Date and are to be listed on the stock exchange of a country within the European Economic Area (an "EEA Exchange").</p>
Denomination of Notes	<p>Notes will be issued in such denominations as may be agreed between the Issuer and the relevant Dealer save that the minimum denomination of each Note will be such as may be allowed or required from time to time by the relevant central bank</p>

(or equivalent body) or any laws or regulations applicable to the relevant Specified Currency.

Unless otherwise permitted by then current laws and regulations, Notes (including Notes denominated in sterling) in respect of which the issue proceeds are to be accepted by the Issuer in the United Kingdom will have a minimum denomination of £100,000 (or its equivalent in other currencies), unless such Notes may not be redeemed until the third anniversary of their Issue Date and are to be listed on an EEA Exchange.

Taxation

All payments in respect of the Notes will be made without deduction for or on account of withholding taxes imposed by the State of Israel or any political subdivision or any authority thereof or therein having power to tax, subject as provided in Condition 7. In the event that any such deduction is made, the Issuer will, save in certain limited circumstances provided in Condition 7, be required to pay additional amounts to cover the amounts so deducted.

Negative Pledge

The terms of the Notes will contain a negative pledge provision as further described in Condition 3.

Cross Default

The Notes will have the benefit of a cross default provision as further described in Condition 9.

Status of the Notes

The Notes will constitute direct, unconditional, unsubordinated and, subject to the provisions of Condition 3, unsecured obligations of the Issuer and will rank *pari passu* among themselves and (save for certain obligations required to be preferred by law) equally with all other unsecured and unsubordinated obligations of the Issuer, from time to time outstanding.

Rating

The Programme is, as of 7th August, 2000, rated A3 in respect of Notes with a maturity of more than one year by Moody's, and A- in respect of Notes with a maturity of more than one year by Standard & Poor's.

Notes issued under the Programme may be rated or unrated. Where an issue of Notes is rated, its rating will not necessarily be the same as the rating applicable to the Programme. A rating is not a recommendation to buy, sell or hold securities and may be subject to suspension, change or withdrawal at any time by the assigning rating agency.

Listing

Application has been made to list Notes issued under the Programme on the Luxembourg Stock Exchange. The Notes may also be listed on such other or further stock exchange(s) as may be agreed between the Issuer and the relevant Dealer in relation to each Series.

Unlisted Notes may also be issued.

The applicable Pricing Supplement will state whether or not the relevant Notes are to be listed and, if so, on which stock exchange(s).

Governing Law

The Notes will be governed by, and construed in accordance with, English law.

Selling Restrictions

There are restrictions on the offer, sale and transfer of the Notes in the United States, the United Kingdom, Israel, Japan, France, Germany and The Netherlands and in any other relevant jurisdiction and other restrictions may be required in connection with the offering and sale of a particular Tranche of Notes (see "Subscription and Sale").

United States Selling Restrictions

Regulation S, Category 2. TEFRA C or D, as specified in the applicable Pricing Supplement.

FORM OF THE NOTES

Each Tranche of Notes will be in bearer form and will initially be issued in the form of a temporary global note (a **“Temporary Global Note”**) or, if so specified in the applicable Pricing Supplement, a permanent global note (a **“Permanent Global Note”**) which will be delivered on or prior to the original issue date of the Tranche to a common depository (the **“Common Depository”**) for Morgan Guaranty Trust Company of New York, Brussels Office, as operator of the Euroclear System (**“Euroclear”**) and Clearstream Banking, société anonyme (**“CBL”**). Whilst any Note is represented by a Temporary Global Note, payments of principal, interest (if any) and any other amount payable in respect of the Notes due prior to the Exchange Date (as defined below) will be made against presentation of the Temporary Global Note only to the extent that certification (in a form to be provided) to the effect that the beneficial owners of interests in such Note are not U.S. persons or persons who have purchased for resale to any U.S. person, as required by U.S. Treasury regulations, has been received by Euroclear and/or CBL and Euroclear and/or CBL, as applicable, has given a like certification (based on the certifications it has received) to the Agent.

On and after the date (the **“Exchange Date”**) which is 40 days after the Temporary Global Note is issued, interests in such Temporary Global Note will be exchangeable (free of charge) upon a request as described therein either for (i) interests in a Permanent Global Note of the same Series or (ii) for definitive Notes of the same Series with, where applicable, receipts, interest coupons and talons attached (as indicated in the applicable Pricing Supplement and subject, in the case of definitive Notes, to such notice period as is specified in the applicable Pricing Supplement), in each case against certification of beneficial ownership as described above unless such certification has already been given. The holder of a Temporary Global Note will not be entitled to collect any payment of interest, principal or other amount due on or after the Exchange Date unless, upon due certification, exchange of the Temporary Global Note for an interest in a Permanent Global Note or for definitive Notes is improperly withheld or refused.

Payments of principal, interest (if any) or any other amounts on a Permanent Global Note will be made through Euroclear and/or CBL against presentation or surrender (as the case may be) of the Permanent Global Note without any requirement for certification.

The applicable Pricing Supplement will specify that a Permanent Global Note will be exchangeable (free of charge), in whole but not in part, for definitive Notes with, where applicable, receipts, interest coupons and talons attached upon either (i) not less than 60 days' written notice from Euroclear and/or CBL (acting on the instructions of any holder of an interest in such Permanent Global Note) to the Agent as described therein or (ii) only upon the occurrence of an Exchange Event. For these purposes, **“Exchange Event”** means that (i) an Event of Default (as defined in Condition 9) has occurred and is continuing, (ii) the Issuer has been notified that both Euroclear and CBL have been closed for business for a continuous period of 14 days (other than by reason of holiday, statutory or otherwise) or have announced an intention permanently to cease business or have in fact done so and no successor clearing system satisfactory to the Trustee is available or (iii) the Issuer has or will become subject to adverse tax consequences which would not be suffered were the Notes represented by the Permanent Global Note in definitive form. The Issuer will promptly give notice to Noteholders in accordance with Condition 13 if an Exchange Event occurs. In the event of the occurrence of an Exchange Event, Euroclear and/or CBL (acting on the instructions of any holder of an interest in such Permanent Global Note) or the Trustee may give notice to the Agent requesting exchange and, in the event of the occurrence of an Exchange Event as described in (iii) above, the Issuer may also give notice to the Agent requesting exchange. Any such exchange shall occur not later than 45 days after the date of receipt of the first relevant notice by the Agent.

The following legend will appear on all Notes which have an original maturity of more than 365 days and on all receipts and interest coupons relating to such Notes:

“ANY UNITED STATES PERSON WHO HOLDS THIS OBLIGATION WILL BE SUBJECT TO LIMITATIONS UNDER THE UNITED STATES INCOME TAX LAWS, INCLUDING THE LIMITATIONS PROVIDED IN SECTIONS 165(j) AND 1287(a) OF THE INTERNAL REVENUE CODE.”

The sections referred to provide that United States holders, with certain exceptions, will not be entitled to deduct any loss on Notes, receipts or interest coupons and will not be entitled to capital gains treatment of any gain on any sale, disposition, redemption or payment of principal in respect of such Notes, receipts or interest coupons.

Notes which are represented by a Global Note will only be transferable in accordance with the rules and procedures for the time being of Euroclear or CBL, as the case may be.

Pursuant to the Agency Agreement (as defined under "*Terms and Conditions of the Notes*"), the Agent shall arrange that, where a further Tranche of Notes is issued which is intended to form a single Series with an existing Tranche of Notes, the Notes of such further Tranche shall be assigned a common code and ISIN which are different from the common code and ISIN assigned to Notes of any other Tranche of the same Series until at least the expiry of the distribution compliance period (as defined in Regulation S under the Securities Act) applicable to the Notes of such Tranche.

Any reference herein to Euroclear and/or CBL shall, whenever the context so permits, be deemed to include a reference to any additional or alternative clearing system approved by the Issuer, the Agent and the Trustee or as otherwise specified in the applicable Pricing Supplement.

TERMS AND CONDITIONS OF THE NOTES

The following are the Terms and Conditions of the Notes which will be incorporated by reference into each Global Note (as defined below) and each definitive Note, in the latter case only if permitted by the relevant stock exchange (if any) and agreed by the Issuer and the relevant Dealer at the time of issue but, if not so permitted and agreed, such definitive Note will have endorsed thereon or attached thereto such Terms and Conditions. The applicable Pricing Supplement in relation to any Tranche of Notes may specify other terms and conditions which shall, to the extent so specified or to the extent inconsistent with the following Terms and Conditions, replace or modify the following Terms and Conditions for the purpose of such Notes. The applicable Pricing Supplement (or the relevant provisions thereof) will be endorsed upon, or attached to, each Global Note and definitive Note. Reference should be made to "Form of the Notes" for a description of the content of Pricing Supplements which will specify which of such terms are to apply in relation to the relevant Notes.

This Note is one of a Series (as defined below) of Notes issued by BEZEO — The Israel Telecommunication Corp., Limited (the "**Issuer**") constituted by a Trust Deed dated 7th August, 2000 (such Trust Deed as modified and/or supplemented and/or restated from time to time, the "**Trust Deed**") made between the Issuer and Bankers Trustee Company Limited (the "**Trustee**") which expression shall include any successor as trustee).

References herein to the "**Notes**" shall be references to the Notes of this Series and shall mean:

- (a) in relation to any Notes represented by a global Note (a "**Global Note**"), units of the lowest Specified Denomination in the Specified Currency;
- (b) any Global Note; and
- (c) any definitive Notes issued in exchange for a Global Note.

The Notes, the Receipts (as defined below) and the Coupons (as defined below) have the benefit of an Agency Agreement (such Agency Agreement as amended and/or supplemented and/or restated from time to time, the "**Agency Agreement**") dated 7th August, 2000 and made between the Issuer, Deutsche Bank AG London as issuing and principal paying agent and agent bank (the "**Agent**", which expression shall include any successor agent), the other paying agents named therein (together with the Agent, unless the context otherwise requires, the "**Paying Agents**", which expression shall include any additional or successor paying agents) and the Trustee.

Interest bearing definitive Notes have interest coupons ("**Coupons**") and, if indicated in the applicable Pricing Supplement, talons for further Coupons ("**Talons**") attached on issue. Any reference herein to Coupons shall, unless the context otherwise requires, be deemed to include a reference to Talons. Definitive Notes repayable in instalments have receipts ("**Receipts**") for the payment of the instalments of principal (other than the final instalment) attached on issue. Global Notes do not have Receipts, Coupons or Talons attached on issue.

The Pricing Supplement for this Note (or the relevant provisions thereof) is attached to or endorsed on this Note and supplements these Terms and Conditions and may specify other terms and conditions which shall, to the extent so specified or to the extent inconsistent with these Terms and Conditions, replace or modify these Terms and Conditions for the purposes of this Note. References to the "**applicable Pricing Supplement**" are to the Pricing Supplement (or the relevant provisions thereof) attached to or endorsed on this Note.

The Trustee acts for the benefit of the holders for the time being of the Notes (the "**Noteholders**" which expression shall, in relation to any Notes represented by a Global Note, be construed as provided below), the holders of the Receipts (the "**Receiptholders**") and the holders of the Coupons (the "**Couponholders**", which expression shall, unless the context otherwise requires, include the holders of the Talons) in accordance with the provisions of the Trust Deed.

As used herein, "**Tranche**" means Notes which are identical in all respects (including as to listing) and "**Series**" means a Tranche of Notes together with any further Tranche or Tranches of Notes which are (i) expressed to be consolidated and form a single series and (ii) identical in all respects (including as to listing) except for their respective Issue Dates, Interest Commencement Dates and/or Issue Prices.

Copies of the Trust Deed and the Agency Agreement are available for inspection during normal business hours at the principal office for the time being of the Trustee (being at 7th August, 2000 at Winchester House, 1 Great Winchester Street, London EC2N 2DB) and at the

specified office of each of the Paying Agents. Copies of the applicable Pricing Supplement are obtainable during normal business hours at the specified office of each of the Paying Agents save that, if this Note is an unlisted Note of any Series, the applicable Pricing Supplement will only be obtainable by a Noteholder holding one or more unlisted Notes of that Series and such Noteholder must produce evidence satisfactory to the relevant Paying Agent as to its holding of such Notes and identity. The Noteholders, the Receiptholders and the Couponholders are deemed to have notice of, and are entitled to the benefit of, all the provisions of the Trust Deed, the Agency Agreement and the applicable Pricing Supplement which are applicable to them. The statements in these Terms and Conditions include summaries of, and are subject to, the detailed provisions of the Trust Deed.

Words and expressions defined in the Trust Deed and the Agency Agreement or used in the applicable Pricing Supplement shall have the same meanings where used in these Terms and Conditions unless the context otherwise requires or unless otherwise stated and provided that, in the event of inconsistency between the Agency Agreement and the Trust Deed, the Trust Deed will prevail and, in the event of inconsistency between the Agency Agreement or the Trust Deed and the applicable Pricing Supplement, the applicable Pricing Supplement will prevail.

1. Form, Denomination and Title

The Notes are in bearer form and, in the case of definitive Notes, serially numbered, in the Specified Currency and the Specified Denomination(s). Notes of one Specified Denomination may not be exchanged for Notes of another Specified Denomination.

This Note may be a Fixed Rate Note, a Floating Rate Note, a Zero Coupon Note, an Index Linked Interest Note, a Dual Currency Interest Note or a combination of any of the foregoing, depending upon the Interest Basis shown in the applicable Pricing Supplement.

This Note may be an Index Linked Redemption Note, an Instalment Note, a Dual Currency Redemption Note, a Partly Paid Note or a combination of any of the foregoing, depending on the Redemption/Payment Basis shown in the applicable Pricing Supplement.

Definitive Notes are issued with Coupons attached, unless they are Zero Coupon Notes in which case references to Coupons and Couponholders in these Terms and Conditions are not applicable.

Subject as set out below, title to the Notes, Receipts and Coupons will pass by delivery. The Issuer and the Paying Agents will (except as otherwise required by law) deem and treat the bearer of any Note, Receipt or Coupon as the absolute owner thereof (whether or not overdue and notwithstanding any notice of ownership or writing thereon or notice of any previous loss or theft thereof) for all purposes but, in the case of any Global Note, without prejudice to the provisions set out in the next succeeding paragraph.

For so long as any of the Notes is represented by a Global Note held on behalf of Morgan Guaranty Trust Company of New York, Brussels office, as operator of the Euroclear System ("**Euroclear**" and/or Clearstream Banking, société anonyme ("**CBL**", each person (other than Euroclear or CBL) who is for the time being shown in the records of Euroclear or of CBL as the holder of a particular nominal amount of such Notes (in which regard any certificate or other document issued by Euroclear or CBL as to the nominal amount of such Notes standing to the account of any person shall be conclusive and binding for all purposes save in the case of manifest error) shall be treated by the Issuer, the Trustee and the Paying Agents as the holder of such nominal amount of such Notes for all purposes other than with respect to the payment of principal or interest on such nominal amount of such Notes, for which purpose the bearer of the relevant Global Note shall be treated by the Issuer, the Trustee and any Paying Agent as the holder of such nominal amount of such Notes in accordance with and subject to the terms of the relevant Global Note and the expressions "**Noteholder**" and "**holder of Notes**" and related expressions shall be construed accordingly. Notes which are represented by a Global Note will be transferable only in accordance with the rules and procedures for the time being of Euroclear or CBL, as the case may be.

References to Euroclear and/or CBL shall, whenever the context so permits, be deemed to include a reference to any additional or alternative clearing system approved by the Issuer, the Agent and the Trustee or otherwise specified in the applicable Pricing Supplement.

2. Status of the Notes

The Notes and any relative Receipts and Coupons are direct, unconditional, unsubordinated and (subject to the provisions of Condition 3) unsecured obligations of the Issuer and rank *pari passu* among themselves and (save for certain obligations required to be preferred by law) equally with all other unsecured and unsubordinated obligations of the Issuer, from time to time outstanding.

3. Negative Pledge

So long as any of the Notes remains outstanding, the Issuer will not create or have outstanding any mortgage, charge, lien, pledge or other security interest (each a “**Security Interest**” upon, or with respect to, any of its present or future business, undertaking, assets or revenues (including any uncalled capital) to secure any Relevant Indebtedness (as defined below) or any guarantee or indemnity in respect of any Relevant Indebtedness, unless the Issuer shall, in the case of the creation of a Security Interest, before or at the same time and, in any other case, promptly, take any and all action necessary to ensure that:

- (a) all amounts payable by it under the Notes, the Coupons, the Receipts and the Trust Deed are secured by the Security Interest equally and rateably with the Relevant Indebtedness or guarantee or indemnity to the satisfaction of the Trustee; or
- (b) such other Security Interest or other arrangement (whether or not it includes the giving of a Security Interest) is provided either (A) as the Trustee shall in its absolute discretion deem not materially less beneficial to the interests of the Noteholders or (B) as shall be approved by an Extraordinary Resolution (which is defined in the Trust Deed as a resolution duly passed by a majority of not less than three-fourths of the votes cast thereon) of the Noteholders.

For the purposes of this Condition, “**Relevant Indebtedness**” means any Indebtedness for Borrowed Money described in subparagraph (B) of the definition thereof in Condition 9(b) which is for the time being, or is capable of being, quoted, listed or ordinarily dealt in on any stock exchange, over-the-counter or other securities market other than any such Indebtedness for Borrowed Money which is, or is capable of being, quoted, listed or ordinarily dealt in solely on a stock exchange, over-the-counter or other securities market in Israel.

4. Interest

(a) Interest on Fixed Rate Notes

Each Fixed Rate Note bears interest on its outstanding nominal amount (or, if it is a Partly Paid Note, the amount paid up) from (and including) the Interest Commencement Date at the rate(s) per annum equal to the Rate(s) of Interest. Interest will be payable in arrear on the Interest Payment Date(s) in each year up to (and including) the Maturity Date.

Except as provided in the applicable Pricing Supplement, the amount of interest payable on each Interest Payment Date in respect of the Fixed Interest Period ending on (but excluding) such date will amount to the Fixed Interest Amount. Payments of interest on any Interest Payment Date will, if so specified in the applicable Pricing Supplement, amount to the Broken Amount so specified.

As used in these Terms and Conditions, “**Fixed Interest Period**” means the period from (and including) an Interest Payment Date (or the Interest Commencement Date) to (but excluding) the next (or first) Interest Payment Date.

If interest is required to be calculated for a period other than a Fixed Interest Period, such interest shall be calculated by applying the Rate of Interest to each Specified Denomination, multiplying such sum by the applicable Day Count Fraction and rounding the resultant figure to the nearest sub-unit of the relevant Specified Currency, half of any such sub-unit being rounded upwards or otherwise in accordance with applicable market convention.

“**Day Count Fraction**” means, in respect of the calculation of an amount of interest in accordance with this Condition 4(a):

- (i) if “**Actual/Actual (ISMA)**” is specified in the applicable Pricing Supplement:
 - (A) in the case of Notes where the number of days in the relevant period from (and including) the most recent Interest Payment Date (or, if none, the Interest Commencement Date) to (but excluding) the relevant payment date (the “**Accrual Period**”) is equal to or shorter than the Determination Period during which the Accrual Period ends, the number of days in such Accrual Period divided by the

- product of (1) the number of days in such Determination Period and (2) the number of Determination Dates (as specified in the applicable Pricing Supplement) that would occur in one calendar year; or
- (B) in the case of Notes where the Accrual Period is longer than the Determination Period during which the Accrual Period ends, the sum of:
- (1) the number of days in such Accrual Period falling in the Determination Period in which the Accrual Period begins divided by the product of (x) the number of days in such Determination Period and (y) the number of Determination Dates (as specified in the applicable Pricing Supplement) that would occur in one calendar year; and
 - (2) the number of days in such Accrual Period falling in the next Determination Period divided by the product of (x) the number of days in such Determination Period and (y) the number of Determination Dates that would occur in one calendar year; and
- (ii) if “30/360” is specified in the applicable Pricing Supplement, the number of days in the period from (and including) the most recent Interest Payment Date (or, if none, the Interest Commencement Date) to (but excluding) the relevant payment date (such number of days being calculated on the basis of a year of 360 days with 12 30-day months) divided by 360.

In these Terms and Conditions:

“**Determination Period**” means the period from (and including) a Determination Date to but excluding the next Determination Date; and

“**sub-unit**” means, with respect to any currency other than euro, the lowest amount of such currency that is available as legal tender in the country of such currency and, with respect to euro, means one cent.

(b) *Interest on Floating Rate Notes and Index Linked Interest Notes*

(i) *Interest Payment Dates*

Each Floating Rate Note and Index Linked Interest Note bears interest on its outstanding nominal amount (or, if it is a Partly Paid Note, the amount paid up) from (and including) the Interest Commencement Date and such interest will be payable in arrear on either:

- (A) the Specified Interest Payment Date(s) in each year specified in the applicable Pricing Supplement; or
- (B) if no Specified Interest Payment Date(s) is/are specified in the applicable Pricing Supplement, each date (each such date, together with each Specified Interest Payment Date, an “**Interest Payment Date**”) which falls the number of months or other period specified as the Specified Period in the applicable Pricing Supplement after the preceding Interest Payment Date or, in the case of the first Interest Payment Date, after the Interest Commencement Date.

Such interest will be payable in respect of each Interest Period (which expression shall, in these Terms and Conditions, mean the period from (and including) an Interest Payment Date (or the Interest Commencement Date) to (but excluding) the next (or first) Interest Payment Date).

If a Business Day Convention is specified in the applicable Pricing Supplement and (x) if there is no numerically corresponding day on the calendar month in which an Interest Payment Date should occur or (y) if any Interest Payment Date would otherwise fall on a day which is not a Business Day, then, if the Business Day Convention specified is:

- (1) in any case where Specified Periods are specified in accordance with Condition 4(b)(i)(B) above, the Floating Rate Convention, such Interest Payment Date (i) in the case of (x) above, shall be the last day that is a Business Day in the relevant month and the provisions of (B) below shall apply *mutatis mutandis* or (ii) in the case of (y) above, shall be postponed to the next day which is a Business Day unless it would thereby fall into the next calendar month, in which event (A) such Interest Payment Date shall be brought forward to the immediately preceding Business Day and (B) each subsequent Interest Payment Date shall be

- the last Business Day in the month which falls the Specified Period after the preceding applicable Interest Payment Date occurred; or
- (2) the Following Business Day Convention, such Interest Payment Date shall be postponed to the next day which is a Business Day; or
 - (3) the Modified Following Business Day Convention, such Interest Payment Date shall be postponed to the next day which is a Business Day unless it would thereby fall into the next calendar month, in which event such Interest Payment Date shall be brought forward to the immediately preceding Business Day; or
 - (4) the Preceding Business Day Convention, such Interest Payment Date shall be brought forward to the immediately preceding Business Day.

In these Terms and Conditions, "**Business Day**" means a day which is both:

- (A) a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in London and any Additional Business Centre specified in the applicable Pricing Supplement; and
- (B) either (1) in relation to any sum payable in a Specified Currency other than euro, a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in the principal financial centre of the country of the relevant Specified Currency (if other than London and any Additional Business Centre and which, if the Specified Currency is Australian dollars or New Zealand dollars, shall be Sydney/Melbourne and Auckland/Wellington, respectively) or (2) in relation to any sum payable in euro, a day on which the Trans-European Automated Real-Time Gross Settlement Express Transfer (TARGET) System (the "**TARGET System**") is operating.

(ii) *Rate of Interest*

The Rate of Interest payable from time to time in respect of Floating Rate Notes and Index Linked Interest Notes will be determined in the manner specified in the applicable Pricing Supplement.

(A) *Screen Rate Determination for Floating Rate Notes*

Where Screen Rate Determination is specified in the applicable Pricing Supplement as the manner in which the Rate of Interest is to be determined, the Rate of Interest for each Interest Period will, subject as provided below, be either:

- (1) the offered quotation; or
- (2) the arithmetic mean (rounded if necessary to the fifth decimal place, with 0.000005 being rounded upwards, in the case of the London inter-bank offered rate ("**LIBOR**"), or to the third decimal place, with 0.0005 being rounded upwards, in the case of the Euro-zone inter-bank offered rate ("**EURIBOR**")) of the offered quotations,

(expressed as a percentage rate per annum) for the Reference Rate which appears or appear, as the case may be, on the Relevant Screen Page as at 11.00 a.m. (London time, in the case of LIBOR, or Brussels time, in the case of EURIBOR) on the Interest Determination Date in question plus or minus (as indicated in the applicable Pricing Supplement) the Margin (if any), all as determined by the Agent. If five or more of such offered quotations are available on the Relevant Screen Page, the highest (or, if there is more than one such highest quotation, one only of such quotations) and the lowest (or, if there is more than one such lowest quotation, one only of such quotations) shall be disregarded by the Agent for the purpose of determining the arithmetic mean (rounded as provided above) of such offered quotations.

The Agency Agreement contains provisions for determining the Rate of Interest in the event that the Relevant Screen Page is not available or if, in the case of (1) above, no such offered quotation appears or, in the case of (2) above, fewer than three such offered quotations appear, in each case as at the time specified in the preceding paragraph.

If the Reference Rate from time to time in respect of Floating Rate Notes is specified in the applicable Pricing Supplement as being other than LIBOR or EURIBOR, the Rate of Interest in respect of such Notes will be determined as provided in the applicable Pricing Supplement.

(B) *ISDA Determination for Floating Rate Notes*

Where ISDA Determination is specified in the applicable Pricing Supplement as the manner in which the Rate of Interest is to be determined, the Rate of Interest for each Interest Period will be the relevant ISDA Rate plus or minus (as indicated in the applicable Pricing Supplement) the Margin (if any). For the purposes of this sub-paragraph (A), “**ISDA Rate**” for an Interest Period means a rate equal to the Floating Rate that would be determined by the Agent under an interest rate swap transaction if the Agent were acting as Calculation Agent for that swap transaction under the terms of an agreement incorporating the 1991 ISDA Definitions (as supplemented by the 1998 Supplement) and the 1998 ISDA Euro Definitions, each as amended and updated as at the Issue Date of the first Tranche of the Notes, published by the International Swaps and Derivatives Association, Inc. (the “**ISDA Definitions**”) and under which:

- (1) the Floating Rate Option is as specified in the applicable Pricing Supplement;
- (2) the Designated Maturity is a period specified in the applicable Pricing Supplement; and
- (3) the relevant Reset Date is either (i) if the applicable Floating Rate Option is based on LIBOR or on EURIBOR, the first day of that Interest Period or (ii) in any other case, as specified in the applicable Pricing Supplement.

For the purposes of this sub-paragraph (A), “**Floating Rate**”, “**Calculation Agent**”, “**Floating Rate Option**”, “**Designated Maturity**” and “**Reset Date**” have the meanings given to those terms in the ISDA Definitions.

(iii) *Minimum Rate of Interest and/or Maximum Rate of Interest*

If the applicable Pricing Supplement specifies a Minimum Rate of Interest for any Interest Period, then, in the event that the Rate of Interest in respect of such Interest Period determined in accordance with the provisions of paragraph (ii) above is less than such Minimum Rate of Interest, the Rate of Interest for such Interest Period shall be such Minimum Rate of Interest.

If the applicable Pricing Supplement specifies a Maximum Rate of Interest for any Interest Period, then, in the event that the Rate of Interest in respect of such Interest Period determined in accordance with the provisions of paragraph (ii) above is greater than such Maximum Rate of Interest, the Rate of Interest for such Interest Period shall be such Maximum Rate of Interest.

(iv) *Determination of Rate of Interest and calculation of Interest Amounts*

The Agent, in the case of Floating Rate Notes, and the Calculation Agent, in the case of Index Linked Interest Notes, will at or as soon as practicable after each time at which the Rate of Interest is to be determined, determine the Rate of Interest for the relevant Interest Period. In the case of Index Linked Interest Notes, the Calculation Agent will notify the Agent of the Rate of Interest for the relevant Interest Period as soon as practicable after calculating the same.

The Agent will calculate the amount of interest (the “**Interest Amount**”) payable on the Floating Rate Notes or Index Linked Interest Notes in respect of each Specified Denomination for the relevant Interest Period. Each Interest Amount shall be calculated by applying the Rate of Interest to each Specified Denomination, multiplying such sum by the applicable Day Count Fraction and rounding the resultant figure to the nearest sub-unit of the relevant Specified Currency, half of any such sub-unit being rounded upwards or otherwise in accordance with applicable market convention.

“**Day Count Fraction**” means, in respect of the calculation of an amount of interest for any Interest Period:

- (A) if “**Actual/365**” or “**Actual/Actual**” is specified in the applicable Pricing Supplement, the actual number of days in the Interest Period divided by 365 (or, if any

portion of that Interest Period falls in a leap year, the sum of (1) the actual number of days in that portion of the Interest Period falling in a leap year divided by 366 and (2) the actual number of days in that portion of the Interest Period falling in a non-leap year divided by 365);

- (B) if "Actual/365 (Fixed)" is specified in the applicable Pricing Supplement, the actual number of days in the Interest Period divided by 365;
 - (C) if "Actual/365 (sterling)" is specified in the applicable Pricing Supplement, the actual number of days in the Interest Period divided by 365 or, in the case of an Interest Payment Date falling in a leap year, 366;
 - (D) if "Actual/360" is specified in the applicable Pricing Supplement, the actual number of days in the Interest Period divided by 360;
 - (E) if "30/360", "360/360" or "Bond Basis" is specified in the applicable Pricing Supplement, the number of days in the Interest Period divided by 360 (the number of days to be calculated on the basis of a year of 360 days with 12 30-day months (unless (1) the last day of the Interest Period is the 31st day of a month but the first day of the Interest Period is a day other than the 30th or 31st day of a month, in which case the month that includes that last day shall not be considered to be shortened to a 30-day month, or (2) the last day of the Interest Period is the last day of the month of February, in which case the month of February shall not be considered to be lengthened to a 30-day month)); and
 - (F) if "30E/360" or "Eurobond Basis" is specified in the applicable Pricing Supplement, the number of days in the Interest Period divided by 360 (the number of days to be calculated on the basis of a year of 360 days with 12 30-day months, without regard to the date of the first day or last day of the Interest Period unless, in the case of the final Interest Period, the Maturity Date is the last day of the month of February, in which case the month of February shall not be considered to be lengthened to a 30-day month).
- (v) *Notification of Rate of Interest and Interest Amounts*

The Agent will cause the Rate of Interest and each Interest Amount for each Interest Period and the relevant Interest Payment Date to be notified to the Issuer, the Trustee and, not later than the first day of the relevant Interest Period, any stock exchange on which the relevant Floating Rate Notes or Index Linked Interest Notes are for the time being listed and notice thereof to be published in accordance with Condition 13 as soon as possible after their determination but in no event later than the fourth London Business Day thereafter. Each Interest Amount and Interest Payment Date so notified may subsequently be amended (or appropriate alternative arrangements made by way of adjustment) without prior notice in the event of an extension or shortening of the Interest Period. Any such amendment will be promptly notified to each stock exchange on which the relevant Floating Rate Notes or Index Linked Interest Notes are for the time being listed and to the Noteholders in accordance with Condition 14. For the purposes of this paragraph, the expression "**London Business Day**" means a day (other than a Saturday or a Sunday) on which banks and foreign exchange markets are open for business in London.

- (vi) *Determination or Calculation by Trustee*

If for any reason at any relevant time the Agent, or as the case may be, the Calculation Agent defaults in its obligation to determine the Rate of Interest or to calculate any Interest Amount in accordance with sub-paragraph (ii)(A) or (B) above or as otherwise specified in the applicable Pricing Supplement, as the case may be, and in each case in accordance with (iv) above, the Trustee shall determine the Rate of Interest at each such rate as, in its absolute discretion (having such regard as it shall think fit to the foregoing provisions of this Condition, but subject always to any minimum or maximum Rate of Interest specified in the applicable Pricing Supplement), it shall deem fair and reasonable in all the circumstances or, as the case may be, the Trustee shall calculate the Interest Amount(s) in such manner as it shall deem fair and reasonable in all the circumstances and each such determination or calculation shall be deemed to have been made by the Agent or the Calculation Agent, as applicable.

(vii) *Certificates to be final*

All certificates, communications, opinions, determinations, calculations, quotations and decisions given, expressed, made or obtained for the purposes of the provisions of this Condition 4(b), whether by the Agent or, if applicable, the Calculation Agent or the Trustee, shall (in the absence of wilful default, bad faith or manifest error) be binding on the Issuer, the Agent, the Trustee, the Calculation Agent (if applicable), the other Paying Agents and all Noteholders, Receiptholders and Couponholders and (in the absence as aforesaid) no liability to the Issuer, the Noteholders, the Receiptholders or the Couponholders shall attach to the Agent or, if applicable, the Calculation Agent or the Trustee in connection with the exercise or non-exercise by it of its powers, duties and discretions pursuant to such provisions.

(c) *Interest on Dual Currency Interest Notes*

The rate or amount of interest payable in respect of Dual Currency Interest Notes shall be determined in the manner specified in the applicable Pricing Supplement.

(d) *Interest on Partly Paid Notes*

In the case of Partly Paid Notes (other than Partly Paid Notes which are Zero Coupon Notes), interest will accrue as aforesaid on the paid-up nominal amount of such Notes and otherwise as specified in the applicable Pricing Supplement.

(e) *Accrual of interest*

Each Note (or in the case of the redemption of part only of a Note, that part only of such Note) will cease to bear interest (if any) from the date for its redemption unless, upon due presentation thereof, payment of principal is improperly withheld or refused. In such event, interest will continue to accrue as provided in the Trust Deed.

5. Payments

(a) *Method of payment*

Subject as provided below:

- (i) payments in a Specified Currency other than euro will be made by credit or transfer to an account in the relevant Specified Currency (which, in the case of a payment in Japanese yen to a non-resident of Japan, shall be a non-resident account) maintained by the payee with, or, at the option of the payee, by a cheque in such Specified Currency drawn on, a bank in the principal financial centre of the country of such Specified Currency (which, if the Specified Currency is Australian dollars or New Zealand dollars, shall be Sydney/Melbourne or Auckland/Wellington, respectively); and
- (ii) payments in euro will be made by credit or transfer to a euro account (or any other account to which euro may be credited or transferred) specified by the payee or, at the option of the payee, by a euro cheque.

Payments will be subject in all cases to any fiscal or other laws and regulations applicable thereto in the place of payment, but without prejudice to the provisions of Condition 7.

(b) *Presentation of definitive Notes, Receipts and Coupons*

Payments of principal in respect of definitive Notes will (subject as provided below) be made in the manner provided in paragraph (a) above only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of definitive Notes, and payments of interest in respect of definitive Notes will (subject as provided below) be made as aforesaid only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of Coupons, in each case at the specified office of any Paying Agent outside the United States (which expression, as used herein, means the United States of America (including the States and the District of Columbia, its territories, its possessions and other areas subject to its jurisdiction)).

Payments of instalments of principal (if any) in respect of definitive Notes, other than the final instalment, will (subject as provided below) be made in the manner provided in paragraph (a) above against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of the relevant Receipt in accordance with the preceding paragraph. Payment of the final instalment will be made in the manner provided in paragraph (a) above only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of the relevant Note in accordance with the preceding para-

graph. Each Receipt must be presented for payment of the relevant instalment together with the definitive Note to which it appertains. Receipts presented without the definitive Note to which they appertain do not constitute valid obligations of the Issuer. Upon the date on which any definitive Note becomes due and repayable, unmatured Receipts (if any) relating thereto (whether or not attached) shall become void and no payment shall be made in respect thereof.

Fixed Rate Notes in definitive form (other than Dual Currency Notes, Index Linked Notes or Long Maturity Notes (as defined below)) should be presented for payment together with all unmatured Coupons appertaining thereto (which expression shall for this purpose include Coupons falling to be issued on exchange of matured Talons), failing which the amount of any missing unmatured Coupon (or, in the case of payment not being made in full, the same proportion of the amount of such missing unmatured Coupon as the sum so paid bears to the sum due) will be deducted from the sum due for payment. Each amount of principal so deducted will be paid in the manner mentioned above against surrender of the relative missing Coupon at any time before the expiry of 10 years after the Relevant Date (as defined in Condition 7) in respect of such principal (whether or not such Coupon would otherwise have become void under Condition 8) or, if later, five years from the date on which such Coupon would otherwise have become due, but in no event thereafter.

Upon any Fixed Rate Note in definitive form becoming due and repayable prior to its Maturity Date, all unmatured Talons (if any) appertaining thereto will become void and no further Coupons will be issued in respect thereof.

Upon the date on which any Floating Rate Note, Dual Currency Note, Index Linked Note or Long Maturity Note in definitive form becomes due and repayable, all unmatured Coupons and Talons (if any) relating thereto (whether or not attached) shall become void and no payment or, as the case may be, exchange for further Coupons shall be made in respect thereof. A "**Long Maturity Note**" is a Fixed Rate Note (other than a Fixed Rate Note which on issue had a Talon attached) whose nominal amount on issue is less than the aggregate interest payable thereon.

If the due date for redemption of any definitive Note is not an Interest Payment Date, interest (if any) accrued in respect of such Note from (and including) the preceding Interest Payment Date or, as the case may be, the Interest Commencement Date shall be payable only against surrender of the relevant definitive Note.

(c) *Payments in respect of Global Notes*

Payments of principal and interest (if any) in respect of Notes represented by any Global Note will (subject as provided below) be made in the manner specified above in relation to definitive Notes and otherwise in the manner specified in the relevant Global Note against presentation or surrender, as the case may be, of such Global Note at the specified office of any Paying Agent outside the United States. A record of each payment made against presentation or surrender of any Global Note, distinguishing between any payment of principal and any payment of interest, will be made on such Global Note by the Paying Agent to which it is presented and such record shall be *prima facie* evidence that the payment in question has been made.

(d) *General provisions applicable to payments*

The holder of a Global Note shall be the only person entitled to receive payments in respect of Notes represented by such Global Note and the Issuer will be discharged by payment to, or to the order of, the holder of such Global Note in respect of each amount so paid. Each of the persons shown in the records of Euroclear or CBL as the beneficial holder of a particular nominal amount of Notes represented by such Global Note must look solely to Euroclear or CBL, as the case may be, for his share of each payment so made by the Issuer to, or to the order of, the holder of such Global Note.

Notwithstanding the foregoing provisions of this Condition, if any amount of principal and/or interest in respect of Notes is payable in U.S. dollars, such U.S. dollar payments of principal and/or interest in respect of such Notes will be made at the specified office of a Paying Agent in the United States if:

- (i) the Issuer has appointed Paying Agents with specified offices outside the United States with the reasonable expectation that such Paying Agents would be able to make payment in U.S. dollars at such specified offices outside the United States of the

full amount of principal and interest on the Notes in the manner provided above when due;

- (ii) payment of the full amount of such principal and interest at all such specified offices outside the United States is illegal or effectively precluded by exchange controls or other similar restrictions on the full payment or receipt of principal and interest in U.S. dollars; and
- (iii) such payment is then permitted under United States law without involving, in the opinion of the Issuer, adverse tax consequences to the Issuer.

(e) *Payment Day*

If the date for payment of any amount in respect of any Note, Receipt or Coupon is not a Payment Day, the holder thereof shall not be entitled to payment until the next following Payment Day in the relevant place and shall not be entitled to further interest or other payment in respect of such delay. For these purposes, "**Payment Day**" means any day which (subject to Condition 8) is:

- (i) a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in:
 - (A) the relevant place of presentation; and
 - (B) any Additional Financial Centre specified in the applicable Pricing Supplement; and
- (ii) either (1) in relation to any sum payable in a Specified Currency other than euro, a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in the principal financial centre of the country of the relevant Specified Currency (if other than the place of presentation and any Additional Financial Centre and which, if the Specified Currency is Australian dollars or New Zealand dollars, shall be Sydney/Melbourne and Auckland/Wellington, respectively) or (2) in relation to any sum payable in euro, a day on which the TARGET System is operating.

(f) *Interpretation of principal and interest*

Any reference in these Terms and Conditions to principal in respect of the Notes shall be deemed to include, as applicable:

- (i) any additional amounts which may be payable with respect to principal under Condition 7 or under any undertakings given in addition thereto, or in substitution therefor, pursuant to the Trust Deed;
- (ii) the Final Redemption Amount of the Notes;
- (iii) the Early Redemption Amount of the Notes;
- (iv) the Optional Redemption Amount(s) (if any) of the Notes;
- (v) in relation to Notes redeemable in instalments, the Instalment Amounts;
- (vi) in relation to Zero Coupon Notes, the Amortised Face Amount (as defined in Condition 6(e)); and
- (vii) any premium and any other amounts (other than interest) which may be payable by the Issuer under or in respect of the Notes.

Any reference in these Terms and Conditions to interest in respect of the Notes shall be deemed to include, as applicable, any additional amounts which may be payable with respect to interest under Condition 7 or under any undertakings given in addition thereto, or in substitution therefor, pursuant to the Trust Deed.

6. **Redemption and Purchase**

(a) *Redemption at maturity*

Unless previously redeemed or purchased and cancelled as specified below, each Note (including each Index Linked Redemption Note and Dual Currency Redemption Note) will be redeemed by the Issuer at its Final Redemption Amount specified in, or determined in the manner specified in, the applicable Pricing Supplement in the relevant Specified Currency on the Maturity Date.

(b) *Redemption for tax reasons*

The Notes may be redeemed at the option of the Issuer in whole, but not in part, at any time (if this Note is neither a Floating Rate Note nor an Index Linked Interest Note) or on any Interest Payment Date (if this Note is either a Floating Rate Note or an Index Linked Interest Note), on giving not less than 30 nor more than 60 days' notice to the Agent and, in accordance with Condition 14, to the Noteholders (which notice shall be irrevocable), if:

- (i) on the occasion of the next payment due under the Notes, the Issuer has or will become obliged to pay additional amounts as provided or referred to in Condition 7 to any greater extent than would have been required under Condition 7 had a payment in respect of the Notes been required to be made on the date on which agreement is reached to issue the first Tranche of Notes, as a result of any change in, or amendment to, the laws or regulations of a Tax Jurisdiction (as defined in Condition 7), or any change in the application or official interpretation of such laws or regulations, which change or amendment becomes effective on or after the date on which agreement is reached to issue the first Tranche of the Notes; and
- (ii) such obligation cannot be avoided by the Issuer taking reasonable measures available to it,

provided that no such notice of redemption shall be given earlier than 90 days prior to the earliest date on which the Issuer would be obliged to pay such additional amounts were a payment in respect of the Notes then due.

Prior to the publication of any notice of redemption pursuant to this Condition, the Issuer shall deliver to the Trustee and the Agent a certificate signed by two Directors of the Issuer stating that the Issuer is entitled to effect such redemption and setting forth a statement of facts showing that the conditions precedent to the right of the Issuer so to redeem have occurred, and an opinion of independent legal advisers of recognised standing to the effect that the Issuer has or will become obliged to pay such additional amounts as a result of such change or amendment. The Trustee shall be entitled to accept such statement and opinion as sufficient evidence of the conditions precedent set out above, in which case they shall be conclusive and binding on the Noteholders, the Receiptholders and the Couponholders.

Notes redeemed pursuant to this Condition 6(b) will be redeemed at their Early Redemption Amount referred to in paragraph (e) below together (if appropriate) with interest accrued to (but excluding) the date of redemption.

(c) *Redemption at the option of the Issuer (Issuer Call)*

If Issuer Call is specified in the applicable Pricing Supplement, the Issuer may, having given:

- (i) not less than 15 nor more than 30 days' notice to the Noteholders in accordance with Condition 14; and
- (ii) not less than 15 days before the giving of the notice referred to in (i), notice to the Trustee and the Agent;

(which notices shall be irrevocable and shall specify the date fixed for redemption), redeem all or some only of the Notes then outstanding on any Optional Redemption Date and at the Optional Redemption Amount(s) specified in, or determined in the manner specified in, the applicable Pricing Supplement together, if appropriate, with interest accrued to (but excluding) the relevant Optional Redemption Date. Any such redemption must be of a nominal amount not less than the Minimum Redemption Amount or not more than a Higher Redemption Amount, in each case as may be specified in the applicable Pricing Supplement. In the case of a partial redemption of Notes, the Notes to be redeemed ("**Redeemed Notes**") will be selected individually by lot, in the case of Redeemed Notes represented by definitive Notes, and in accordance with the rules of Euroclear and/or CBL, in the case of Redeemed Notes represented by a Global Note, not more than 30 days prior to the date fixed for redemption (such date of selection being hereinafter called the "**Selection Date**"). In the case of Redeemed Notes represented by definitive Notes, a list of the serial numbers of such Redeemed Notes will be published in accordance with Condition 14 not less than 15 days prior to the date fixed for redemption. The aggregate nominal amount of Redeemed Notes represented by definitive Notes shall bear the same proportion to the aggregate nominal amount of all Redeemed Notes as the aggregate nominal amount of definitive Notes outstanding bears to the aggregate nominal amount of the Notes outstand-

ing, in each case on the Selection Date, provided that such first mentioned nominal amount shall, if necessary, be rounded downwards to the nearest integral multiple of the Specified Denomination, and the aggregate nominal amount of Redeemed Notes represented by a Global Note shall be equal to the balance of the Redeemed Notes. No exchange of the relevant Global Note will be permitted during the period from (and including) the Selection Date to (and including) the date fixed for redemption pursuant to this paragraph (c) and notice to that effect shall be given by the Issuer to the Noteholders in accordance with Condition 14 at least five days prior to the Selection Date.

(d) *Redemption at the option of the Noteholders (Investor Put)*

If Investor Put is specified in the applicable Pricing Supplement, upon the holder of any Note giving to the Issuer in accordance with Condition 14 not less than 15 nor more than 30 days' notice the Issuer will, upon the expiry of such notice, redeem, subject to, and in accordance with, the terms specified in the applicable Pricing Supplement, such Note on the Optional Redemption Date and at the Optional Redemption Amount together, if appropriate, with interest accrued to (but excluding) the Optional Redemption Date.

If this Note is in definitive form, to exercise the right to require redemption of this Note the holder of this Note must deliver such Note at the specified office of any Paying Agent at any time during normal business hours of such Paying Agent falling within the notice period, accompanied by a duly completed and signed notice of exercise in the form (for the time being current) obtainable from any specified office of any Paying Agent (a "**Put Notice**") and in which the holder must specify a bank account (or, if payment is required to be made by cheque, an address) to which payment is to be made under this Condition.

Any Put Notice given by a holder of any Note pursuant to this paragraph shall be irrevocable.

(e) *Early Redemption Amounts*

For the purpose of paragraph (b) above and Condition 9, each Note will be redeemed at the Early Redemption Amount calculated as follows:

- (i) in the case of a Note with a Final Redemption Amount equal to the Issue Price, at the Final Redemption Amount thereof;
- (ii) in the case of a Note (other than a Zero Coupon Note but including an Instalment Note and a Partly Paid Note) with a Final Redemption Amount which is or may be less or greater than the Issue Price or which is payable in a Specified Currency other than that in which the Note is denominated, at the amount specified in, or determined in the manner specified in, the applicable Pricing Supplement or, if no such amount or manner is so specified in the applicable Pricing Supplement, at its nominal amount; or
- (iii) in the case of a Zero Coupon Note, at an amount (the "**Amortised Face Amount**") calculated in accordance with the following formula:

Early Redemption Amount = $RP \times (1 + AY)^y$ where:

"**RP**" means the Reference Price;

"**AY**" means the Accrual Yield; and

"**y**" is a fraction the numerator of which is equal to the number of days (calculated on the basis of a 360-day year consisting of 12 months of 30 days each) from (and including) the Issue Date of the first Tranche of the Notes to (but excluding) the date fixed for redemption or (as the case may be) the date upon which such Note becomes due and repayable and the denominator of which is 360,

or on such other calculation basis as may be specified in the applicable Pricing Supplement.

(f) *Instalments*

Instalment Notes will be redeemed in the Instalment Amounts and on the Instalment Dates. In the case of early redemption, the Early Redemption Amount will be determined pursuant to paragraph (e) above.

(g) *Partly Paid Notes*

Partly Paid Notes will be redeemed, whether at maturity, early redemption or otherwise, in accordance with the provisions of this Condition and the applicable Pricing Supplement.

(h) *Purchases*

The Issuer or any Subsidiary of the Issuer may at any time purchase Notes (provided that, in the case of definitive Notes, all unmatured Receipts, Coupons and Talons appertaining thereto are purchased therewith) at any price in the open market or otherwise. If purchases are made by tender, tenders must be available to all Noteholders alike. Such Notes may be held, reissued, resold or, at the option of the Issuer, surrendered to any Paying Agent for cancellation.

(i) *Cancellation*

All Notes which are redeemed will, subject to paragraph (h) above, forthwith be cancelled (together with all unmatured Receipts, Coupons and Talons attached thereto or surrendered therewith at the time of redemption). All Notes so cancelled and any Notes purchased and cancelled pursuant to paragraph (h) above (together with all unmatured Receipts, Coupons and Talons cancelled therewith) shall be forwarded to the Agent and cannot be reissued or resold.

(j) *Late payment on Zero Coupon Notes*

If the amount payable in respect of any Zero Coupon Note upon redemption of such Zero Coupon Note pursuant to paragraph (a), (b), (c) or (d) above or upon its becoming due and repayable as provided in Condition 9 is improperly withheld or refused, the amount due and repayable in respect of such Zero Coupon Note shall be the amount calculated as provided in paragraph (e)(iii) above as though the references therein to the date fixed for the redemption or the date upon which such Zero Coupon Note becomes due and repayable were replaced by references to the date which is the earlier of:

- (i) the date on which all amounts due in respect of such Zero Coupon Note have been paid; and
- (ii) five days after the date on which the full amount of the moneys payable in respect of such Zero Coupon Note has been received by the Agent or the Trustee and notice to that effect has been given to the Noteholders in accordance with Condition 13.

7. Taxation

All payments of principal and interest in respect of the Notes, Receipts and Coupons by the Issuer will be made without withholding or deduction for or on account of any present or future taxes or duties of whatever nature imposed or levied by or on behalf of any Tax Jurisdiction unless such withholding or deduction is required by law. In such event, the Issuer will pay such additional amounts as shall be necessary in order that the net amounts received by the holders of the Notes, Receipts or Coupons after such withholding or deduction shall equal the respective amounts of principal and interest which would otherwise have been receivable in respect of the Notes, Receipts or Coupons, as the case may be, in the absence of such withholding or deduction; except that no such additional amounts shall be payable with respect to any Note, Receipt or Coupon presented for payment:

- (a) in the State of Israel; or
- (b) by or on behalf of a holder who is liable for such taxes or duties in respect of such Note, Receipt or Coupon by reason of his having some connection with a Tax Jurisdiction other than the mere holding of such Note, Receipt or Coupon; or
- (c) to a Paying Agent if the payment could have been made by another Paying Agent without such withholding or deduction; or
- (d) more than 30 days after the Relevant Date (as defined below) except to the extent that the holder thereof would have been entitled to an additional amount on presenting the same for payment on such thirtieth day assuming that day to have been a Payment Day (as defined in Condition 5(e)).

As used herein:

- (i) "**Tax Jurisdiction**" means the State of Israel or any political subdivision or any authority thereof or therein having power to tax; and
- (ii) the "**Relevant Date**" means the date on which such payment first becomes due, except that, if the full amount of the moneys payable has not been duly received by the Agent or in accordance with the Trust Deed by the Trustee on or prior to such due date, it means the date on which, the full amount of such moneys having been so

received, notice to that effect is duly given to the Noteholders in accordance with Condition 14.

8. Prescription

The Notes, Receipts and Coupons will become void unless presented for payment within a period of 10 years (in the case of principal) and five years (in the case of interest) after the Relevant Date (as defined in Condition 7) therefor.

There shall not be included in any Coupon sheet issued on exchange of a Talon any Coupon the claim for payment in respect of which would be void pursuant to this Condition or Condition 5(b) or any Talon which would be void pursuant to Condition 5(b).

9. Events of Default

- (a) The Trustee at its discretion may, and if so requested in writing by the holders of at least one-quarter in aggregate nominal amount of the Notes then outstanding or if so directed by an Extraordinary Resolution of the Noteholders shall (subject to being indemnified to its satisfaction), give notice to the Issuer that the Notes are, and they shall accordingly forthwith become, immediately due and repayable at their Early Redemption Amount, together with accrued interest as provided in the Trust Deed, after the occurrence of any of the following events (each an “**Event of Default**”):
- (i) if default is made in the payment of any principal or interest due in respect of the Notes or any of them and the default continues for a period of seven days in the case of principal and 14 days in the case of interest; or
 - (ii) if the Issuer fails to perform or observe any of its other obligations under these Terms and Conditions or the Trust Deed and (except in any case where the Trustee considers such failure is incapable of remedy when no such continuation or notice as is hereinafter mentioned will be required) the failure continues for the period of 30 days next following the service by the Trustee on the Issuer of notice requiring the same to be remedied; or
 - (iii) if (A) any Indebtedness for Borrowed Money (as defined below) of the Issuer or any of its Principal Subsidiaries (as defined below) becomes, or becomes capable of being declared, due and repayable prematurely by reason of an event of default (however described); or (B) the Issuer or any of its Principal Subsidiaries fails to make any payment in respect of any Indebtedness for Borrowed Money on the due date for payment thereof as extended by any originally applicable grace period; or (C) any security given by the Issuer or any of its Principal Subsidiaries in relation to any Indebtedness for Borrowed Money becomes enforceable; or (D) default is made by the Issuer or any of its Principal Subsidiaries in making any payment due under any guarantee and/or indemnity given by it in relation to any Indebtedness for Borrowed Money of any other person, PROVIDED that no event of default or prepayment event subsisting on the Issue Date of the first Tranche of the Notes or arising at any time under any Existing Indebtedness as a result of a Change of Control shall constitute an Event of Default under paragraph (iii)(A) and for the purposes of such Existing Indebtedness, paragraph (iii)(C) shall be deemed to be amended by the insertion of the words “and any step has been taken to enforce such security” after the words “becomes enforceable” at the end of such paragraph and PROVIDED FURTHER that no event described in this paragraph (iii) shall constitute an Event of Default unless the Indebtedness for Borrowed Money or other relative liability either alone or when aggregated with other Indebtedness for Borrowed Money and/or other liabilities relative to all (if any) other events which shall have occurred and be continuing shall amount to at least U.S.\$10,000,000 (or its equivalent in any other currency or currencies); or
 - (iv) if any order is made by any competent court or resolution passed for the winding up or dissolution of the Issuer or any of its Principal Subsidiaries, save for the purposes of reorganisation on terms previously approved in writing by the Trustee or by an Extraordinary Resolution of the Noteholders; or
 - (v) if the Issuer or any of its Principal Subsidiaries ceases or threatens to cease to carry on the whole or substantially the whole of its business, save for the purposes of reorganisation on terms previously approved in writing by the Trustee or by an Extraordinary Resolution of the Noteholders, or the Issuer or any of its Principal Subsidiaries

stops or threatens to stop payment of, or is unable to, or admits inability to, pay, its debts (or any class of its debts) as they fall due, or is deemed unable to pay its debts pursuant to or for the purposes of any applicable law, or is adjudicated or found bankrupt or insolvent; or

- (vi) if (A) proceedings are initiated against the Issuer or any of its Principal Subsidiaries under any applicable liquidation, insolvency, composition, reorganisation or other similar laws, or an application is made for the appointment of an administrative or other receiver, manager, administrator or other similar official, or an administrative or other receiver, manager, administrator or other similar official is appointed, in relation to the Issuer or any of its Principal Subsidiaries or, as the case may be, in relation to the whole or a part of the undertaking or assets of any of them, or an encumbrancer takes possession of the whole or a part of the undertaking or assets of any of them, or a distress, execution, attachment, sequestration or other process is levied, enforced upon, sued out or put in force against the whole or a part of the undertaking or assets of any of them and (B) in any case (other than the appointment of an administrator) is not discharged within 60 days; or
- (vii) if the Issuer or any of its Principal Subsidiaries initiates or consents to judicial proceedings relating to itself under any applicable liquidation, insolvency, composition, reorganisation or other similar laws or makes a conveyance or assignment for the benefit of, or enters into any composition or other arrangement with, its creditors generally (or any class of its creditors) or any meeting is convened to consider a proposal for an arrangement or composition with its creditors generally (or any class of its creditors);

provided that, in the case of any Event of Default other than those referred to in paragraphs (i) and, in relation to the Issuer, (iv) above, the Trustee shall have certified in writing to the Issuer that such Event of Default is, in its opinion, materially prejudicial to the interests of the Noteholders.

(b) *Definitions*

For the purposes of this Condition:

- (i) **“Change of Control”** means the State of Israel reducing, announcing an intention to reduce or taking any other step with a view to reducing any of its shareholding from time to time in the Issuer;
- (ii) **“Existing Indebtedness”** means any Indebtedness for Borrowed Money of the Issuer outstanding on 7th August, 2000 and any refinancing of such indebtedness by the lenders or holders thereof on substantially similar terms other than as to maturity, rate of interest or other economic terms;
- (iii) **“Indebtedness for Borrowed Money”** means any present or future indebtedness (whether being principal, premium, interest or other amounts) for or in respect of (A) money borrowed, (B) any notes, bonds, debentures, debenture stock, loan stock or other securities offered, issued or distributed whether by way of public offer, private placement, acquisition consideration or otherwise and whether issued for cash or in whole or in part for a consideration other than cash, or (C) any liability under or in respect of any acceptance or acceptance credit;
- (iv) **“Principal Subsidiary”** at any time shall mean a Subsidiary of the Issuer:
 - (A) whose gross revenues attributable to the Issuer (consolidated in the case of a Subsidiary which itself has Subsidiaries) represent not less than 15 per cent. of the consolidated gross revenues of the Issuer, all as calculated respectively by reference to the then latest audited accounts (consolidated or, as the case may be, unconsolidated) of such Subsidiary and the then latest audited consolidated accounts of the Issuer; or
 - (B) whose total assets (consolidated in the case of a Subsidiary which itself has Subsidiaries) represent not less than 20 per cent. of the consolidated total assets of the Issuer, all as calculated respectively by reference to the then latest audited accounts (consolidated or, as the case may be, unconsolidated) of such Subsidiary and the then latest audited consolidated accounts of the Issuer; or

- (C) to which is transferred the whole or substantially the whole of the undertaking and assets of a Subsidiary of the Issuer which immediately before the transfer is a Principal Subsidiary,

all as more particularly defined in the Trust Deed.

A report (whether or not addressed to the Trustee) by the Auditors (as defined in the Trust Deed) that in their opinion a Subsidiary of the Issuer is or is not or was or was not at any particular time or throughout any specified period a Principal Subsidiary shall, in the absence of manifest error, be conclusive and binding on all parties; and

“**Subsidiary**” means a company whose accounts are either fully or proportionately consolidated with the accounts of the Issuer in accordance with generally accepted auditing standards in Israel in effect on 7th August, 2000.

10. Substitution

The Trustee may, without the consent of the Noteholders, Receiptholders or Couponholders, agree with the Issuer to the substitution in place of the Issuer (or of any previous substitute) as the principal debtor under the Notes, the Receipts, the Coupons and the Trust Deed of any wholly-owned Subsidiary of the Issuer, subject to the Notes, the Receipts and the Coupons being unconditionally and irrevocably guaranteed by the Issuer and to the Trustee being satisfied that the interests of the Noteholders will not be materially prejudiced thereby and certain other conditions set out in the Trust Deed being complied with.

11. Replacement of Notes, Receipts, Coupons and Talons

Should any Note, Receipt, Coupon or Talon be lost, stolen, mutilated, defaced or destroyed, it may be replaced at the specified office of the Agent upon payment by the claimant of such costs and expenses as may be incurred in connection therewith and on such terms as to evidence and indemnity as the Issuer may reasonably require. Mutilated or defaced Notes, Receipts, Coupons or Talons must be surrendered before replacements will be issued.

12. Paying Agents

The names of the initial Paying Agents and their initial specified offices are set out below.

The Issuer is entitled, with the prior written approval of the Trustee, to vary or terminate the appointment of any Paying Agent and/or appoint additional or other Paying Agents and/or approve any change in the specified office through which any Paying Agent acts, provided that:

- (a) there will at all times be an Agent and a Paying Agent with its specified office in a country outside the Tax Jurisdiction;
- (b) so long as the Notes are listed on any stock exchange or admitted to listing by any other relevant authority, there will at all times be a Paying Agent with a specified office in such place as may be required by the rules and regulations of the relevant stock exchange or any other relevant authority; and
- (c) in the event of the Proposed EU Withholding Tax Directive (as defined in the Agency Agreement) being adopted, there will, to the extent it is possible, at all times be a Paying Agent with a specified office in a city in continental Europe outside the European Union.

In addition, the Issuer shall forthwith appoint a Paying Agent having a specified office in New York City in the circumstances described in Condition 5(d). Any variation, termination, appointment or change shall only take effect (other than in the case of insolvency, when it shall be of immediate effect) after not less than 30 nor more than 45 days' prior notice thereof shall have been given to the Noteholders in accordance with Condition 14.

In acting under the Agency Agreement, the Paying Agents act solely as agents of the Issuer and, in certain circumstances, of the Trustee and do not assume any obligation to, or relationship of agency or trust with, any Noteholders, Receiptholders or Couponholders. The Agency Agreement contains provisions permitting any entity into which any Paying Agent is merged or converted or with which it is consolidated or to which it transfers all or substantially all of its assets to become the successor paying agent.

13. Exchange of Talons

On and after the Interest Payment Date on which the final Coupon comprised in any Coupon sheet matures, the Talon (if any) forming part of such Coupon sheet may be surrendered at the specified office of the Agent or any other Paying Agent in exchange for a further Coupon sheet including (if such further Coupon sheet does not include Coupons to (and including) the final date for the payment of interest due in respect of the Note to which it appertains) a further Talon, subject to the provisions of Condition 8.

14. Notices

All notices regarding the Notes will be deemed to be validly given if published (i) in a leading English language daily newspaper of general circulation in London, and (ii) if and for so long as the Notes are listed on the Luxembourg Stock Exchange, a daily newspaper of general circulation in Luxembourg. It is expected that such publication will be made in the *Financial Times* in London and the *Luxemburger Wort* in Luxembourg. The Issuer shall also ensure that notices are duly published in a manner which complies with the rules and regulations of any stock exchange (or any other relevant authority) on which the Notes are for the time being listed. Any such notice will be deemed to have been given on the date of the first publication or, where required to be published in more than one newspaper, on the date of the first publication in all required newspapers.

Until such time as any definitive Notes are issued, there may, so long as any Global Notes representing the Notes are held in their entirety on behalf of Euroclear and/or CBL, be substituted for such publication in such newspaper(s) the delivery of the relevant notice to Euroclear and/or CBL for communication by them to the holders of the Notes and, in addition, for so long as any Notes are listed on a stock exchange and the rules of that stock exchange (or any other relevant authority) so require, such notice will be published in a daily newspaper of general circulation in the place or places required by that stock exchange (or any other relevant authority). Any such notice shall be deemed to have been given to the holders of the Notes on the seventh day after the day on which the said notice was given to Euroclear and/or CBL.

Notices to be given by any Noteholder shall be in writing and given by lodging the same, together (in the case of any Note in definitive form) with the relative Note or Notes, with the Agent. Whilst any of the Notes are represented by a Global Note, such notice may be given by any holder of a Note to the Agent through Euroclear and/or CBL, as the case may be, in such manner as the Agent and Euroclear and/or CBL, as the case may be, may approve for this purpose.

15. Meetings of Noteholders, Modification and Waiver

The Trust Deed contains provisions for convening meetings of the Noteholders to consider any matter affecting their interests, including the sanctioning by Extraordinary Resolution of a modification of any of the provisions of these Terms and Conditions, the Notes, the Receipts, the Coupons or the Trust Deed. Such a meeting may be convened by the Issuer or Noteholders holding not less than 10 per cent. in nominal amount of the Notes for the time being remaining outstanding. The quorum at any such meeting for passing an Extraordinary Resolution is one or more persons holding or representing not less than 50 per cent. in nominal amount of the Notes for the time being outstanding, or at any adjourned meeting one or more persons being or representing Noteholders whatever the nominal amount of the Notes so held or represented, except that at any meeting the business of which includes the modification of certain provisions of these Terms and Conditions, the Notes, the Receipts, the Coupons or the Trust Deed (including modifying the date of maturity of the Notes or any date for payment of interest thereon, reducing or cancelling the amount of principal or the rate of interest payable in respect of the Notes or altering the currency of payment of the Notes, the Receipts or the Coupons), the quorum shall be one or more persons holding or representing not less than two-thirds in nominal amount of the Notes for the time being outstanding, or at any adjourned such meeting one or more persons holding or representing not less than one-third in nominal amount of the Notes for the time being outstanding. An Extraordinary Resolution passed at any meeting of the Noteholders shall be binding on all the Noteholders, whether or not they are present at the meeting, and on all Receiptholders and Couponholders.

The Trustee and the Issuer may agree, without the consent of the Noteholders, Receiptholders or Couponholders, to:

- (a) any modification of any of the provisions of these Terms and Conditions, the Notes, the Receipts, the Coupons or the Trust Deed which, in the opinion of the Trustee, is not materially prejudicial to the interests of the Noteholders; or
- (b) any modification of any of the provisions of these Terms and Conditions, the Notes, the Receipts, the Coupons or the Trust Deed which is of a formal, minor or technical nature or is made to correct a manifest error or to comply with mandatory provisions of the law.

Any such modification shall be binding on the Noteholders, the Receiptholders and the Couponholders and any such modification shall be notified to the Noteholders in accordance with Condition 13 as soon as practicable thereafter.

The Trust Deed contains provisions for convening a single meeting of the Noteholders and the holders of Notes of other Series in certain circumstances where the Trustee so decides.

16. Further Issues

The Issuer shall be at liberty from time to time without the consent of the Noteholders, the Receiptholders or the Couponholders to create and issue further notes having terms and conditions the same as the Notes or the same in all respects save for the amount and date of the first payment of interest thereon and so that the same shall be consolidated and form a single Series with the outstanding Notes. The Trust Deed contains provisions for convening a single meeting of the Noteholders and the holders of notes of other Series in certain circumstances where the Trustee so decides.

17. Contracts (Rights of Third Parties) Act 1999

No rights are conferred on any person under the Contracts (Rights of Third Parties) Act 1999 to enforce any term of this Note, but this does not affect any right or remedy of any person which exists or is available apart from that Act.

18. Governing Law and Submission to Jurisdiction

(a) Governing law

The Trust Deed, the Agency Agreement, the Notes, the Receipts and the Coupons are governed by, and shall be construed in accordance with, English law.

(b) Submission to jurisdiction

The Issuer has in the Trust Deed agreed, for the exclusive benefit of the Trustee, the Noteholders, the Receiptholders and the Couponholders, that the courts of England are to have jurisdiction to settle any disputes which may arise out of or in connection with the Trust Deed, the Notes, the Receipts and/or the Coupons and that accordingly any suit, action or proceedings (together referred to as "**Proceedings**") arising out of or in connection with the Trust Deed, the Notes, the Receipts and/or the Coupons may be brought in the English courts.

The Issuer has in the Trust Deed irrevocably waived any objection which it may have now or hereafter to the laying of the venue of any such Proceedings in any English court and any claim that any such Proceedings have been brought in an inconvenient forum and has further irrevocably agreed that a judgment in any such Proceedings brought in the English courts shall be conclusive and binding upon it and may be enforced in the courts of any other jurisdiction.

(c) Appointment of Process Agent

The Issuer has in the Trust Deed appointed Law Debenture Corporate Services Limited at its registered office at Princes House, 95 Gresham Street, London EC2V 7LY as its agent for service of process, and undertakes that, in the event of Law Debenture Corporate Services Limited ceasing so to act or ceasing to be registered in England, it will appoint such other person as the Trustee shall approve as its agent for service of process in England in respect of any Proceedings. Nothing herein shall affect the right to serve proceedings in any other manner permitted by law.

(d) Waiver of immunity

To the extent that the Issuer may claim sovereign or other similar immunity from jurisdiction, execution following judgment or settlement, the Issuer has in the Trust Deed irrevoca-

bly and unconditionally waived with respect to the Trust Deed, the Notes, the Receipts and the Coupons any right to claim sovereign or other similar immunity from jurisdiction or execution and any similar defence and has irrevocably and unconditionally consented to the giving of any relief or the issue of any process, including without limitation, the making, enforcement or execution against any property whatsoever (irrespective of its use or intended use) of any order or judgment made or given in connection with any Proceedings. This provision is without prejudice to the rights of the Issuer in respect of any suits, actions or proceedings which do not arise out of or in connection with the Trust Deed, the Notes, the Receipts and the Coupons.

(e) *Limitation on enforcement*

Without derogating from any rights claimed by the Israeli Government with respect to certain properties and notwithstanding the above paragraphs of this Condition 18, none of the Trustee, the Noteholders, the Receiptholders or the Couponholders shall have any right to seek, enforce or execute any order or judgment made or given in connection with any Proceedings, or to take any other action to enforce Proceedings, against two properties which the Issuer occupies under a lease, namely (i) 479,000 square metres near Rishpon on which a broadcasting station is located and operated by the Issuer, and (ii) 1,300,000 square metres at Sakia (close to the Hiria dump) on which a reception station and warehouses of the Issuer are located. Such exclusion regarding these two properties shall not derogate from any of Bezeq's rights, claims or arguments in connection with such properties or its disputes with the Government of Israel.

For limitations on the transfer of certain assets, see "The Issuer — Relationship with Government — Government Control and Privatisation" and "The Issuer — Properties".

FORM OF PRICING SUPPLEMENT

Set out below is the form of Pricing Supplement which will be completed for each Tranche of Notes issued under the Programme.

[Date]

BEZEQ

The Israel Telecommunication Corp., Limited

Issue of [Aggregate Nominal Amount of Tranche] [Title of Notes]

under the €750,000,000
Euro Medium Term Note Programme

[The Notes constitute [commercial paper/shorter term debt securities/longer term debt securities]⁽¹⁾ issued in accordance with regulations made under section 4 of the Banking Act 1987. The Issuer of the Notes is not an authorised institution or a European authorised institution (as such terms are defined in the Banking Act 1987 (Exempt Transactions) Regulations 1997). Repayment of the principal and payment of any interest or premium in connection with the Notes has not been guaranteed.]⁽²⁾

This document constitutes the Pricing Supplement relating to the issue of Notes described herein. Terms used herein shall be deemed to be defined as such for the purposes of the Conditions set forth in the Offering Circular dated 7th August, 2000. This Pricing Supplement is supplemental to and must be read in conjunction with such Offering Circular.

[Include whichever of the following apply or specify as "Not Applicable" (N/A). Note that the numbering should remain as set out below, even if "Not Applicable" is indicated for individual paragraphs or sub-paragraphs.]

1. (i) Series Number: []
(ii) Tranche Number: []
(If fungible with an existing Series, details of that Series, including the date on which the Note become fungible)
2. Specified Currency or Currencies: []
3. Aggregate Nominal Amount:
— Tranche: []
— Series: []
4. Issue Price of Tranche: [] per cent
5. Specified Denominations: []
[]
6. [(i)] Issue Date [and Interest Commencement Date]: []
[(ii)] Interest Commencement Date (if different from the Issue Date): []
7. Maturity Date: [Fixed rate — specify date/
Floating rate — Interest Payment Date falling in or nearest to [specify month]]

(1) Include "commercial paper" if Notes must be redeemed before their first anniversary. Include "shorter term debt securities" if Notes may not be redeemed before their first anniversary but must be redeemed before their third anniversary. Include "longer term debt securities" if Notes may not be redeemed before their third anniversary.

(2) Unless otherwise permitted, text to be included for all Notes (including Notes denominated in sterling) in respect of which the issue proceeds are accepted by the Issuer in the United Kingdom.

- 8. Interest Basis:** [[] per cent. Fixed Rate]
 [[LIBOR/EURIBOR] +/- [] per cent.
 Floating Rate]
 [Zero Coupon]
 [Index Linked Interest]
 [Dual Currency Interest]
 [*specify other*]
 (further particulars specified below)
- 9. Redemption/Payment Basis:** [Redemption at par]
 [Index Linked Redemption]
 [Dual Currency Redemption]
 [Partly Paid]
 [Instalment]
 [*specify other*]
- 10. Change of Interest Basis or Redemption/
 Payment Basis:** [*Specify details of any provision for
 change of Notes into another Interest
 Basis or Redemption/Payment Basis*]
- 11. Put/Call Options:** [Investor Put]
 [Issuer Call]
 [(further particulars specified below)]
- 12. Status of the Notes:** Unsubordinated
- 13. Listing:** [Luxembourg/*specify other*/None]
- 14. Method of distribution:** [Syndicated/Non-syndicated]
- PROVISIONS RELATING TO INTEREST (IF ANY) PAYABLE**
- 15. Fixed Rate Note Provisions** [Applicable/Not Applicable]
*(If not applicable, delete the remaining
 sub-paragraphs of this paragraph)*
- (i) Rate(s) of Interest: [] per cent. per annum [payable
 [annually/semi-annually/quarterly] in
 arrear]
*(If payable other than annually, consider
 amending Condition 4)*
- (ii) Interest Payment Date(s): [[] in each year up to and including
 the Maturity Date]/[*specify other*]
*(NB: This will need to be amended in the
 case of long or short coupons)*
- (iii) Fixed Interest Amount(s): [] per [] in nominal amount
- (iv) Broken Amount(s): [*Insert particulars of any initial or final
 broken interest amounts which do not
 correspond with the Fixed Interest
 Amount*]
- (v) Day Count Fraction: [30/360 or Actual/Actual (ISMA) or *specify
 other*]
*(NB: if interest is not payable on a
 regular basis (for example, if there are
 Broken Amounts specified) Actual/Actual
 (ISMA) may not be a suitable Day Count
 Fraction)*

- (vi) Determination Date(s): [] in each year
[Insert interest payment dates except where there are long or short periods. In these cases, insert regular interest payment dates]
(NB: Only relevant where Day Count Fraction is Actual/Actual (ISMA))
- (vii) Other terms relating to the method of calculating interest for Fixed Rate Notes: [None/Give details]
- 16. Floating Rate Note Provisions** [Applicable/Not Applicable]
(If not applicable, delete the remaining sub-paragraphs of this paragraph)
- (i) Specified Period(s)/Specified Interest Payment Dates: []
- (ii) Business Day Convention: [Floating Rate Convention/Following Business Day Convention/Modified Following Business Day Convention/Preceding Business Day Convention/[specify other]]
- (iii) Additional Business Centre(s): []
- (iv) Manner in which the Rate of Interest and Interest Amount is to be determined: [Screen Rate Determination/ISDA Determination/specify other]
- (v) Party responsible for calculating the Rate of Interest and Interest Amount (if not the Agent): []
- (vi) Screen Rate Determination:
 — Reference Rate: []
(Either LIBOR, EURIBOR or other, although additional information is required if other — including fallback provisions in the Agency Agreement)
 — Interest Determination Date(s): []
(Second London business day prior to the start of each Interest Period if LIBOR (other than sterling or euro LIBOR), first day of each Interest Period if sterling LIBOR and the second day on which the TARGET System is operating prior to the start of each Interest Period if — Interest Determination Date(s): EURIBOR or euro LIBOR)
 — Relevant Screen Page: []
(In the case of EURIBOR, if not Telerate 248 ensure it is a page which shows a composite rate or amend the fallback provisions appropriately)
- (vii) ISDA Determination:
 — Floating Rate Option: []
 — Designated Maturity: []
 — Reset Date: []
- (viii) Margin(s): [+/-] [] per cent. per annum
- (ix) Minimum Rate of Interest: [] per cent. per annum

- (x) Maximum Rate of Interest: [] per cent. per annum
- (xi) Day Count Fraction: [Actual/365
Actual/365 (Fixed)
Actual/365 (sterling)
Actual/360
30/360
30E/360
Other]
(See Condition 4 for alternatives)
- (xii) Fall back provisions, rounding provisions and any other terms relating to the method of calculating interest on Floating Rate Notes, if different from those set out in the Conditions: []
- 17. Zero Coupon Note Provisions** [Applicable/Not Applicable]
(If not applicable, delete the remaining sub-paragraphs of this paragraph)
- (i) Accrual Yield: [] per cent. per annum
- (ii) Reference Price: []
- (iii) Any other formula/basis of determining amount payable: []
(Consider applicable day count fraction if euro denominated)
- (iv) Day Count Fraction in relation to Early Redemption Amounts and late payment: [Conditions 6(e)(iii) and 6(j) apply/specify other]
- 18. Index Linked Interest Note Provisions** [Applicable/Not Applicable]
(If not applicable, delete the remaining subparagraphs of this paragraph)
- (i) Index/Formula: [give or annex details]
- (ii) Calculation Agent responsible for calculating the principal and/or interest due: []
- (iii) Provisions for determining coupon where calculation by reference to Index and/or Formula is impossible or impracticable: []
- (iv) Specified Period(s)/Specified Interest Payment Dates: []
- (v) Business Day Convention: [Floating Rate Convention/Following Business Day Convention/Modified Following Business Day Convention/Preceding Business Day Convention/specify other]
- (vi) Additional Business Centre(s): []
- (vii) Minimum Rate of Interest: [] per cent. per annum
- (viii) Maximum Rate of Interest: [] per cent. per annum
- (ix) Day Count Fraction: []
- 19. Dual Currency Note Provisions** [Applicable/Not Applicable]
(If not applicable, delete the remaining sub-paragraphs of this paragraph)
- (i) Rate of Exchange/method of calculating Rate of Exchange: [give details]
- (ii) Calculation Agent, if any, responsible for calculating the principal and/or interest payable: []

- (iii) Provisions applicable where calculation by reference to Rate of Exchange impossible or impracticable: []
- (iv) Person at whose option Specified Currency(ies) is/are payable: []

PROVISIONS RELATING TO REDEMPTION

20. Issuer Call: [Applicable/Not Applicable]
(If not applicable, delete the remaining sub-paragraphs of this paragraph)

- (i) Optional Redemption Date(s): []
- (ii) Optional Redemption Amount(s) and method, if any, of calculation of such amount(s): []
- (iii) If redeemable in part:
 - (a) Minimum Redemption Amount: []
 - (b) Higher Redemption Amount: []
- (iv) Notice period (if other than as set out in the Conditions): []

21. Investor Put: [Applicable/Not Applicable]
(If not applicable, delete the remaining sub-paragraphs of this paragraph)

- (i) Optional Redemption Date(s): []
- (ii) Optional Redemption Amount(s) and method, if any, of calculation of such amount(s): []
- (iii) Notice period (if other than as set out in the Conditions): []

22. Final Redemption Amount [Nominal Amount/specify other/see Appendix]

23. Early Redemption Amount(s) payable on redemption for taxation reasons or on event of default and/or the method of calculating the same (if required or if different from that set out in Condition 6(e)): []

GENERAL PROVISIONS APPLICABLE TO THE NOTES

24. Form of Notes: [Temporary Global Note exchangeable for a Permanent Global Note which is exchangeable for Definitive Notes [on 60 days' notice given at any time/only upon an Exchange Event]]
 [Temporary Global Note exchangeable for Definitive Notes on and after the Exchange Date]
 [Permanent Global Note exchangeable for Definitive Notes [on 60 days' notice given at any time/only upon an Exchange Event]]

25. Additional Financial Centre(s) or other special provisions relating to Payment Dates: [Not Applicable/give details] *(Note that this item relates to the place of payment and not Interest Period end dates to which items 17(iii) and 19(vi) relate)*

26. Talons for future Coupons or Receipts to be attached to Definitive Notes and dates on which such Talons mature): [Yes/No. If yes, give details]

27. **Details relating to Partly Paid Notes:** [Not Applicable/*give details. NB: a new form of Temporary Global Note and/or Permanent Global Note may be required for Partly Paid issues*]
amount of each payment comprising the Issue Price and date on which each payment is to be made and consequences of failure to pay, including any right of the Issuer to forfeit the Notes and interest due on late payment:
28. **Details relating to Instalment Notes:**
 (i) Instalment Amount(s): [Not Applicable/*give details*]
 (ii) Instalment Date(s): [Not Applicable/*give details*]
29. **Redenomination applicable:** Redenomination [not] applicable
(if Redenomination is applicable, specify the terms of the redenomination in an Annex to the Pricing Supplement)
30. **Other terms or special conditions:** [Not Applicable/*give details*]
31. **Governing law:** English law

DISTRIBUTION

32. (i) If syndicated, names of Managers: [Not Applicable/*give names*]
 (ii) Stabilising Manager (if any): [Not Applicable/*give name*]
33. **If non-syndicated, name of relevant Dealer:** []
34. **Whether TEFRA D or TEFRA C rules applicable or TEFRA rules not applicable:** [TEFRA D/TEFRA C/TEFRA not applicable]
35. **Additional selling restrictions:** [Not Applicable/*give details*]

OPERATIONAL INFORMATION

36. **Any clearing system(s) other than Euroclear and CBL and the relevant identification number(s):** [Not Applicable/*give name(s) and number(s)*]
37. **Delivery:** Delivery [against/free of] payment
38. **Additional Paying Agent(s) (if any):** []
 ISIN: []
 Common Code: []

[Listing Application

This Pricing Supplement comprises the details required to list the issue of Notes described herein pursuant to the listing of the €750,000,000 Euro Medium Term Note Programme of BEZEQ — The Israel Telecommunication Corp., Limited]

Responsibility

The Issuer accepts responsibility for the information contained in this Pricing Supplement.

Signed on behalf of the Issuer:

BEZEQ — The Israel Telecommunication Corp., Limited

By: _____
Duly authorised

If the applicable Pricing Supplement specifies any modification to the Terms and Conditions of the Notes as described herein, it is envisaged that, to the extent that such modification relates only to Conditions 1, 4, 5, 6, 7 (except Condition 6(b)), 11, 12, 13, 14 (insofar as such Notes are not listed or admitted to trade on any stock exchange) or 16, they will not necessitate the preparation of a supplement to this Offering Circular. If the Terms and Conditions of the Notes of any Series are to be modified in any other respect, a supplement to this Offering Circular will be prepared, if appropriate.

USE OF PROCEEDS

The net proceeds from each issue of Notes will be applied by the Issuer for its general corporate purposes, including the possibility of repaying existing debt.

CAPITALISATION

The table below sets forth the consolidated capitalisation of Bezeq at 31st March, 2000:

	<u>As at 31st March, 2000</u>
	<i>(in NIS⁽¹⁾ thousands)</i>
Long-Term Debt	4,329,189
Short-Term Debt	1,941,309
Convertible Debentures	82,159
Shareholders' Equity	7,427,277
Share capital	
— authorised: 835,000,000 ordinary shares of NIS 1 each	
— issued: 796,499,302 ordinary shares of NIS 1 each	
Total capitalisation and indebtedness	<u>13,779,934</u>

Note:

(1) NIS of March 2000.

As at 30th June, 2000, short-term debt decreased to NIS 1,597,425 and long-term debt increased to NIS 4,480,976.

Save as disclosed herein, there has been no material change in the consolidated capitalisation of Bezeq since 31st March, 2000.

THE ISSUER

Introduction

Bezeq was established in 1980 as a state-owned company and commenced its operations in 1984. Together with its subsidiaries, it is the principal telecommunications operator in Israel. Bezeq and its subsidiaries (the "**Group**") offer a wide range of telecommunications services, including domestic and international telephone services, data communication services, leased lines, corporate networks, mobile telephone services and telecommunications services to other telecommunications operators. The Israeli telecommunications market has in recent years been exposed to increasing competition pursuant to Government policy. Prior to 1994, Pelephone Communications Ltd. ("**Pelephone**"), a company owned in equal shares by Bezeq and Motorola Israel, Ltd. ("**Motorola**"), a subsidiary of Motorola Inc., was the sole mobile telephone network operator in Israel. Prior to 1997, Bezeq's wholly-owned subsidiary, Bezeq International Ltd. ("**Bezeq International**"), was the sole operator of international telecommunications services in Israel. Bezeq is currently not allowed to offer the above-mentioned services that are provided by its subsidiaries. Bezeq's wholly-owned subsidiary, BezeqCall Communications Ltd. ("**Bezeq-Call**"), provides installation and maintenance services for telecommunications equipment on customers' premises. Since 1994, such services have been open to competition. Bezeq's statutory exclusive right to provide domestic fixed line telecommunications services was repealed in June 1999 with a view to opening the domestic fixed line market to competition in the near future. However, the Government has not yet issued any further licences for these services and Bezeq continues to be the sole operator of domestic fixed line telecommunications in Israel (see "*Activities — Competition in Domestic Services*"). Bezeq also holds 30 per cent. of the share capital of D.B.S. Satellite Services (1998) Ltd. ("**DBS**"), a company licensed to provide direct broadcast satellite services which commenced operations in July 2000.

The State of Israel currently holds approximately 54.6 per cent. of Bezeq's ordinary shares (on a fully diluted basis) but is expected to privatise all or part of this holding. As a state-controlled company, Bezeq is subject to extensive Government regulation (see "*Relationship with Government — Government Control and Privatisation*"). Bezeq's shares are listed and traded on the TASE and as a result Bezeq is subject to certain regulatory requirements, including reporting requirements, under Israeli securities laws.

History and Overview of Telecommunications Industry in Israel

From the foundation of the State of Israel in 1948 the Government, through the Ministry of Communications (the "**MoC**") and its predecessors, designed, built and operated the Israeli telecommunications infrastructure and provided telecommunications services throughout Israel. In 1984, pursuant to an agreement between the Government and Bezeq (the "**1984 Agreement**"), the MoC transferred its national telecommunications infrastructure, operations and related properties to Bezeq in exchange for equity and debt which, as at 1st April, 2000, was fully repaid (see "*Properties*"). Bezeq has operated and developed the infrastructure either directly or through subsidiaries, since the transfer.

At various stages since 1993, the Government has introduced competition in the Israeli telecommunications market and the Group's statutory exclusive right in all markets has been repealed. By the end of 1994, Cellcom Israel Ltd. ("**Cellcom**") joined Pelephone as a second mobile telephone operator. Partner Communications Company Ltd. ("**Partner**") began operating as a third mobile telephone operator in October 1998. In July 1997, two new international telecommunications operators, Golden Lines Ltd. ("**Golden Lines**") and Barak I.T.C. — The International Telecommunications Services Corporation Ltd. ("**Barak**"), began providing international telecommunications services in direct competition with Bezeq International. The anticipated arrival of full competition in the domestic telecommunications market and the growing competition in both the cellular telecommunications market and the international telecommunications market may have an adverse effect on the Group's financial position. In the broadcasting sector, three cable television operators currently provide multi-channel broadcasting services in Israel, covering separate geographical areas. DBS is currently the only multi-channel broadcast provider that competes with these operators in broadcasting services.

Relationship with Government

Regulation

The telecommunications market in which the Group operates is highly regulated by various Government agencies, primarily by the Minister of Communications (the "**Minister**"). The provi-

sion of telecommunications services and the operation of telecommunications facilities require a licence which is granted by the Minister under the Telecommunications Law, 1982 (the “**Telecommunications Law**”). Bezeq has a licence to provide fixed line domestic telephony, infrastructure and related services in Israel, Bezeq International has a licence to provide international telecommunications services and Internet services and Pelephone has a licence to provide cellular services. Licence holders need to comply with various conditions set out in laws, regulations, orders and their respective licences.

In addition, Bezeq and its subsidiaries Bezeq International and BezeqCall, being state-controlled entities, are subject to further regulation, which is not applicable to other operators (see “*Relationship with Government — Government Control and Privatisation*”). The Group is also subject to the scrutiny of the Restrictive Trade Practices Commissioner.

Initially, Bezeq enjoyed a statutory exclusive right to provide telecommunications services and operate telecommunications facilities. The scope of this statutory exclusive right has gradually been limited and competition has been introduced into several segments of the telecommunications market. In June 1999 Bezeq’s statutory exclusivity for the provision of domestic fixed line services was repealed. The burden of regulation imposed on the Group has generally decreased as segments of the market have opened to competition and the Group’s market share in these segments declined. Hence, Bezeq International and Pelephone, which face fierce competition in international telecommunications and cellular services respectively, have benefited from a less rigid regulatory regime than Bezeq. Although the MoC has announced its intention to introduce competition into the market for domestic fixed line services in the near future, such competition has not yet been introduced and at present Bezeq continues to be subject to extensive regulation. Bezeq assumes that it shall continue to be subject to a high level of regulation in the foreseeable future, despite the introduction of competition. The MoC has informed Bezeq that it intends to issue it with a new licence that shall replace its existing licence in connection with the opening of the domestic fixed line services market to competition.

Regulation by the Minister applies mainly to two areas — operations and tariffs.

Operations

Bezeq is under a continuing obligation to offer fixed line telecommunications services to the entire Israeli population, regardless of whether it is profitable to provide these services. Bezeq is restricted from providing telecommunications services other than those stipulated in its licence or approved by the Minister. It has differences of opinion with the MoC regarding the proper interpretation of such restriction, as well as regarding other restrictions on its operations alleged by the MoC. To date, these differences of opinion have not had any material impact on Bezeq’s operations. However, no assurance can be given that this will continue to be the case as Bezeq develops its business.

In addition, Bezeq is permitted to provide services in certain competitive markets, such as international and cellular telecommunications and maintenance of certain equipment, only through its subsidiaries, Bezeq International, Pelephone and BezeqCall. Bezeq’s licence requires both a strict structural and operational separation between Bezeq and its subsidiaries. All transactions between Bezeq and these subsidiaries should be done at arm’s length, while allowing other operators to enter into similar transactions with Bezeq on a non-discriminatory basis. In addition, under the terms of Bezeq’s licence, the management and operation of the subsidiaries are separate from those of Bezeq itself, the number of its employees or directors that Bezeq can appoint to the board of directors of its subsidiaries may be limited from June 2001 and Bezeq employees that have access to sensitive market information concerning a subsidiary’s competitors cannot be appointed to such subsidiary’s board of directors.

Tariffs

Most of the tariffs for Bezeq’s telecommunications services are regulated and require the approval of the Minister and of the Minister of Finance. The tariffs for services which generate a substantial part of Bezeq’s revenues also require the approval of the Finance Committee of the Knesset, the Israeli parliament.

In the past tariffs were set with the result that certain services (such as international telecommunications) subsidised other services (such as domestic voice services). In 1990 a tariff framework was set for Bezeq’s services. The framework was designed to produce a reasonable rate of return on Bezeq’s shareholders’ equity whilst taking into account costs and expenses.

Under the framework, tariffs for services such as domestic telecommunications are updated periodically by a percentage equal to the rise in the Israeli consumer price index less an efficiency factor based on a price cap regulatory regime which is usually recommended once every five years by a public tariffs committee. On 1st April, 1999, Bezeq's tariffs were reduced by an average of approximately 8 per cent. which led to a decrease in Bezeq's business results. As part of this reduction, Bezeq's interconnect fees from the cellular and international operators were reduced by approximately 60 per cent. Bezeq has objected to the reduction in interconnection fees and it is currently discussing the issue with the MoC. With effect from 1st May, 2000, Bezeq's tariffs were further reduced by an average of approximately 2.43 per cent.

Under this tariff regime Bezeq maintains that changes in its cost base (such as changes in depreciation policy) should be reflected in the tariff base (see note 9D to the financial statements set out in "*Audited Annual Financial Statements*"). The MoC has informed Bezeq that it does not agree with Bezeq's position, but that the matter is under examination. Bezeq intends to take legal action regarding this matter. Bezeq may offer alternative tariff baskets for service packages. Such baskets need to be approved by the Minister and the Minister of Finance. Currently Bezeq offers basket rates for a limited number of services including Internet connectivity.

A public committee appointed to consider the rules of competition recommended that the regulation of Bezeq's tariffs for domestic services will be re-examined once its market share approaches 60 per cent. and the structural and operational limitations referred to above will be eliminated once its market share drops below 60 per cent.

Royalties and Transactions with Government

Bezeq and Bezeq International (in common with the other international operators) pay the Government royalties at a rate of 5 per cent. of most of their revenues. Telephone (in common with the other cellular telecommunications providers) pays royalties at a rate of 8 per cent. of its revenues from basic cellular services.

Bezeq transacts a large volume of business with government ministries and agencies and government companies. Such Government business accounted for approximately 5 per cent. of revenues in 1999 and together represents Bezeq's largest customer. Bezeq provides services to the Israeli Defense and Security Forces on terms which provide that the Ministry of Defence funds infrastructure investments in lieu of discounts on services provided by Bezeq (see note 29 to the financial statements set out in "*Audited Annual Financial Statements*").

Government Control and Privatisation

The Government has a 54.6 per cent. shareholding in Bezeq. As a consequence, Bezeq and those of its subsidiaries in which it holds more than 50 per cent. of the share capital, including Bezeq International and BezeqCall, are deemed to be a "Government Company" and "Subsidiary Government Companies" respectively and, as such, are heavily regulated by the Government Companies Law, 1975 (the "**GCL**"). Under the GCL, a number of decisions taken by Government Companies are subject to governmental approval, such as the establishment of companies, the purchase of shares in existing companies and the election of a chief executive officer ("**CEO**") and chairperson of the board of directors. The Minister and the Prime Minister also appoint the majority of Bezeq's directors, subject to the vote of the general meeting (see "*Management*"). In addition, as a Government Company and as Subsidiary Government Companies, respectively Bezeq, Bezeq International and BezeqCall are generally required to tender their contracts for goods and services.

On a number of occasions, the Government has decided to reduce its shareholding in Bezeq and to privatise the Group. The Government first listed Bezeq's shares on the TASE in 1990 and since that time it has reduced its shareholding through a combination of public offerings and one sale to a third party. In 1999 the Government sought to further reduce its holding from 54.6 per cent. on a fully diluted basis to not less than 40 per cent. through a public offering and TASE listing which did not complete. In connection with that offering, Bezeq's shareholders resolved to amend Bezeq's Articles of Association to maintain the requirement for governmental approval of resolutions relating to certain matters such as, *inter alia*, share capital, modification of shareholders' rights, acquisition and establishment of companies and joint ventures and the appointment of the CEO and the Chairperson of Bezeq even after the holding of the Government falls below 50 percent. Under Bezeq's Articles of Association, the requirement to seek such approval shall continue as long as the Government holds at least 10 per cent. of Bezeq's share capital but will expire once Bezeq is controlled by a third party. The public offering planned for 1999 was

eventually cancelled by the Government due to consequences resulting from a dispute between Bezeq and the Government regarding certain properties (see "*Properties*" and note 9B to the financial statements set out in "*Audited Annual Financial Statements*"). Subsequently, the Government announced its intention to sell its holdings in Bezeq and the Government Companies Authority submitted a draft proposal of a Government resolution to Bezeq. Bezeq has commented on such draft but no decision has yet been made by the Government and there is no certainty as to the process that will be taken for the privatisation. The privatisation of Bezeq may trigger certain pre-payment and event of default provisions in previous loans and debentures entered into by Bezeq (see notes 14(D) and 15(C) to the financial statements set out in "*Audited Annual Financial Statements*" and "*Liquidity and Capital Resources*").

Under the Telecommunications Order (determination of essential service provided by Bezeq — The Israeli Telecommunications Corp. Ltd.), 1997, the Minister's approval is required to hold certain threshold percentages of the share capital of Bezeq or to gain control of Bezeq. In addition, under such order, Bezeq may not, without the prior approval of the Minister, transfer (including under court order) certain assets, including its holdings in subsidiaries and cable and transmission networks, to third parties. Should Bezeq cease to provide essential services, or should there be a likelihood of this happening, the Minister may appoint an external manager to direct Bezeq's operations.

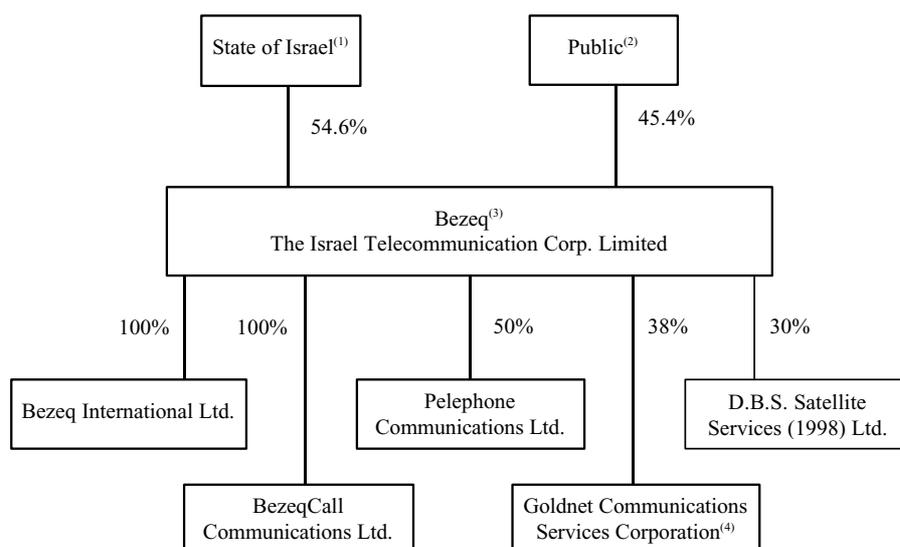
In preparation for Bezeq's planned privatisation, Bezeq, its employees and the Government are currently discussing the rights of Bezeq's employees in connection with the privatisation, including an early retirement plan. Such plan is expected to be similar to Bezeq's former early retirement plans (see "*Employees*"). There can be no assurance that an agreement will be reached on such early retirement plans. As to the employees' position regarding the privatisation process, see "*Employees — Labour Relations*" (the "*Commissioner*").

Anti-Trust Regulation

In 1995 the Restrictive Trade Practices Commissioner declared Bezeq to have a monopoly in international telecommunications services, telecommunications infrastructure, basic telephony services and transmission of broadcasting services to the public and, as a monopoly, Bezeq is subject to certain legal restrictions. In 1997 the Commissioner determined that Bezeq International had abused its power in the market for international telecommunications services in a manner that would be detrimental to the public interest, although he did not exercise his powers to issue directives to Bezeq International as to what actions it should take. Bezeq International appealed against the Commissioner's determination, but has recently discontinued the proceedings in such appeal. Under law, the determination of the Commissioner is considered *prima facie* evidence in legal proceedings. However, Bezeq International believes that it has good arguments against the implementation of such presumption, on the grounds of a lack of fair hearing. (See notes 21A(6) and 21A(9) to the financial statements set out in "*Audited Annual Financial Statements*").

Group Structure

The following chart sets out the structure of Bezeq and its principal subsidiaries:



Notes:

- (1) In May 1999 the Shareholders resolved to amend Bezeq's Articles of Association with the effect that the State of Israel will continue to exercise certain measures of control over Bezeq for so long as it holds at least 10 per cent. of Bezeq's share capital and provided that no third party has acquired control of Bezeq (see "Relationship with Government – Government Control and Privatisation").
- (2) Zeevi Communications Holding Ltd. (the "Zeevi Group") owns approximately 19.9 per cent. of Bezeq's share capital.
- (3) At 31st May, 2000 Bezeq's share capital consisted of 835,000,000 ordinary shares of NIS 1 each, of which 796,691,164 were issued and fully paid up. The shares are listed on the TASE.
- (4) Bezeq has agreed to purchase an additional 11 per cent. interest in Goldnet Communications Services Corporation ("Goldnet") from AT&T. In addition, Bezeq has the option to buy from AT&T, and AT&T has the option to sell to Bezeq, AT&T's remaining 5 per cent. interest in Goldnet. Bezeq is also negotiating the option to acquire from another partner a 20.9 per cent. interest in Goldnet. Such purchase and options are subject to the approval of the MoC.

Pursuant to its licence, Bezeq is permitted to provide services in certain competitive markets only through subsidiaries. Accordingly, Bezeq transferred its international telecommunications operations to Bezeq International and established BezeqCall for the provision of installation and maintenance services for telecommunications systems and equipment. Goldnet, a partnership among Bezeq, Malam Systems Ltd. and AT&T Middle East Ltd., provides a wide range of data communications services.

Activities

The table below sets forth a breakdown of the consolidated revenues of each of the Group's main sectors of activity, in New Israeli shekels and as a percentage of Bezeq's total consolidated revenues, for each of the last five years:

	Year ended 31st December,									
	1995		1996		1997		1998		1999	
	NIS millions ⁽¹⁾	%								
Domestic calls ⁽²⁾	3,482	37	3,526	36	3,332	35	3,305	35	2,750	30
Fixed fees ⁽³⁾	1,287	14	1,243	13	1,418	15	1,574	17	1,819	20
International communications ⁽⁴⁾	2,719	29	2,492	26	1,663	17	1,105	11	892	10
Cellular telephone services ⁽⁵⁾	1,272	14	1,584	16	2,363	25	2,678	28	2,838	31
Installation and equipment sales ⁽⁶⁾	195	2	559	6	504	5	506	5	479	5
Miscellaneous ⁽⁷⁾	368	4	301	3	299	3	346	4	365	4
Total	<u>9,323</u>	<u>100%</u>	<u>9,705</u>	<u>100%</u>	<u>9,579</u>	<u>100%</u>	<u>9,514</u>	<u>100%</u>	<u>9,143</u>	<u>100%</u>

Notes:

- (1) NIS of December 1999.
- (2) Includes customer charges for domestic calls within Israel (including interconnect charges for calls from a fixed line to a cellular line (including Pelephone's lines)) and revenues from calling card sales.

- (3) Includes monthly line rental fees for basic telephone lines, data communications lines, private exchanges, customer premises equipment and leased lines and customer charges for value added services such as voice mail, conference calling and caller identification.
- (4) Includes customer charges for outgoing international calls, gross settlement fees from foreign operators for incoming international calls, access fees and interconnect charges from the international operators (other than Bezeq International) for use of Bezeq's network and fees for various services provided to the international operators including rental of transmission facilities.
- (5) Includes customer airtime charges for calls from a fixed line to a cellular line transferred to the cellular operators, interconnect charges from the cellular operators (including Pelephone, net of adjustments) for use of Bezeq's network, 50 per cent. proportionate share of Pelephone's revenues, royalties from Pelephone for use of certain transferred equipment and fees for various services provided to the cellular operators including rental of transmission equipment.
- (6) Includes line and equipment installation charges and equipment sale charges.
- (7) Includes revenues for certain services provided to cable television companies and other telecommunications operators (such as billing and network construction) and revenues from the Palestinian telecommunications company, ships at sea, satellite services and telex services. In addition, includes other telecommunications revenues such as collection fees, Bezeqnet Service, detailed billing and Bezeqcard fees.

The activities of the Group can be divided into three main categories, namely domestic fixed line services, international services and cellular services.

Domestic Fixed Line Services

Domestic fixed line telecommunications services ("**domestic services**") represent the Group's principal business and consist of basic voice services, such as switched voice and facsimile transmission, data services and a variety of value-added ancillary services.

The following table sets forth certain information regarding Bezeq's domestic services and key relevant changes in Israeli economy for each of the last five years:

	Year ended 31st December,				
	1995	1996	1997	1998	1999
Total number of active subscriber lines (in thousands) . . .	2,343	2,549	2,675	2,819	2,877
Lines used by private customers (in thousands) ⁽¹⁾	1,710	1,810	1,872	1,973	2,014
Lines used by corporate customers (in thousands) ⁽¹⁾⁽²⁾	633	739	803	846	863
Number of subscriber lines per 100 inhabitants	42	44	45	47	47
Annual line growth rate	10%	9%	5%	5%	2%
Percentage of lines connected to digital exchanges	92	100	100	100	100
Growth in GDP of Israel ⁽³⁾	7.1%	4.7%	2.4%	1.9%	2.2%
Population of Israel (in thousands) ⁽³⁾	5,612	5,758	5,900	6,036	6,219
Annual Growth rate of Israeli population ⁽³⁾	2.57%	2.59%	2.47%	2.31%	3.03%

Notes:

- (1) The split between private and corporate customers is based on Bezeq's estimate as subscribers are not required to state if they are business or private customers.
- (2) Including government authorities and public agencies.
- (3) Data from the Israeli Central Bureau for Statistics (for 1995 to 1998) and from the Economic Intelligence Unit of the Bank of Israel (for 1999).

Domestic services generated revenues of NIS 5,413 million in 1999, representing approximately 59 per cent. of Bezeq's consolidated revenues. Domestic calls represented approximately 30 per cent. of Bezeq's consolidated revenues and fixed charges, such as fixed fees and installation charges, represented approximately 25 per cent. of such revenues.

At 31st March, 2000, Bezeq had just over 2.9 million active telephone lines. In the past few years, Bezeq has made significant investments to meet subscriber demand for lines and to modernise its network. From 1995 to 1999, Bezeq added approximately 534,000 subscriber lines (including ISDN lines), increasing line penetration from approximately 42 to 47 lines per 100 inhabitants during that period. Bezeq intends to further increase its penetration rate by pursuing an aggressive marketing campaign and by offering discounts on line installation to encourage residential customers to subscribe for additional lines. Currently, the percentage of households with two subscriber lines is approximately 14 per cent.

Domestic Voice Services

Base Services. As part of its basic switched telephony service package, Bezeq offers subscribers call waiting, call forwarding, touch-tone dialling, repeat dialling, return calling (which allows a subscriber to dial the number from which the last call was placed to such customer), automatic call back (which establishes an automatic connection between a customer and a busy line as soon as the busy line is free), and line repair services.

Value Added Services. Bezeq offers value-added services at an extra cost, such as speed dialling, voice mail and conference call facilities, caller identification, toll-free numbers and calling cards. Bezeq is continuously looking to improve its existing services and add new value-added services to its service offering. Bezeq is currently planning the introduction of new services for residential customers such as a single number facility (assigning the same telephone number for both the customer's fixed line home telephone and his mobile telephone) and advanced reminder and voice mail services. Various new services will also be offered to business customers, subject to requisite approvals.

Public Payphones. Bezeq currently operates approximately 22,000 public payphones located throughout Israel, representing a penetration rate of approximately four public payphones per 1,000 inhabitants. All of Bezeq's public payphones are card operated, accepting pre-paid calling cards. Bezeq's public payphones allow access to each of the three international telephone operators. Pursuant to applicable regulation, Bezeq is obliged to install public telephones in every local authority depending on the number of households in that local authority, as well as, *inter alia*, in schools, hospitals, ports, airports, railway stations and shopping malls.

Calling Cards. Bezeq offers Telecard, a pre-paid calling card, for use in public payphones in Israel, and Bezeqcard, a calling card for use in Israel and abroad with charged calls being billed to the customers as part of their fixed line billing statement. Bezeq has a variety of advanced security procedures in place which it believes significantly reduces calling card fraud and related expenses and, to date, Bezeq has experienced a relatively low reported fraud level.

Services to Telecommunications Providers

Bezeq provides services to other telecommunications providers, such as interconnect services and transmission services to connect other providers' networks to Bezeq's network, transmission services among other network sites, billing services, international network infrastructures, satellite services and rights to use submarine cables.

Domestic Data Services and Technologies

The Group provides a range of data communication and related services through a variety of networks and technologies. These services consist primarily of data transmission and network services for business customers, as well as on-line services for business and residential customers. The following are some of the principal data services and technologies offered by the Group:

Sifranet. Since 1986 Bezeq has designed and managed customised data networks under the name Sifranet. Sifranet combines digital point-to-point private lines, using a variety of interfaces and speeds, allowing for high performance and high capacity data transfer, particularly well-suited to meet the needs of customers with multiple locations. Sifranet provides access to various data and information services, including financial information from the TASE, medical data banks and news services.

Isranet. Isranet is a switched data transfer service introduced in 1982 and based on packet switching technology which enables connection with computer networks in Israel and abroad. Bezeq intends to maintain the Isranet network, but endeavours to introduce those of its customers who need quicker, higher quality and larger capacity performance to its Sifranet network and its frame relay services.

Goldnet Services. Since 1992 Goldnet, a partnership in which Bezeq currently holds a 38 per cent. interest (see note 4 under "*Group Structure*"), has provided a wide range of data communications services, primarily for business customers. Goldnet maintains a communications node installed by AT&T in Israel (one of seven installed worldwide) that provides access to 160 countries and 40 communications networks worldwide. These services include local and international electronic mail, Internet access and related services, connections to financial institutions, on-line information services (such as TASE's stock quotes and access to the Israeli Registrar of Companies) and access to international databases. Bezeq is planning to introduce new applications through Goldnet which are expected to strengthen Bezeq's position in the business sector as well as generate increased Internet traffic on Bezeq's network, such as e-commerce and secured information services.

Leased Lines. Since 1986 Bezeq has offered point-to-point digital and analogue leased line services. These services provide direct point-to-point connection for data services as an alternative to the public switched network. For its leased lines, Bezeq charges an installation fee and a usage fee based on the distance of the call carried, in the case of an analogue line, or based on

the speed of the line, in the case of a digital line. At present, Bezeq installs digital leased lines and only provides maintenance to existing analogue leased lines.

Frame Relay. Since 1994 Bezeq has provided high speed, high quality and high capacity data transfer using advanced frame relay technology.

ISDN Services. Since 1996 Bezeq has offered ISDN, a digital telephone line containing two fast and parallel communications channels over copper access lines.

ADSL Service. Since 1999 Bezeq has been conducting a field study for ADSL services and is negotiating with the MoC the terms of the full roll-out of ADSL services in the near future. ADSL enables high speed transmission of data through ordinary copper telephone lines.

ATM Services. In 2000 Bezeq introduced a data network based on asynchronous transfer mode ("**ATM**") technology. ATM services will be offered mainly to large customers and Internet service providers ("**ISPs**").

Internet Services

Bezeqnet. Since 1997, Bezeq has offered Bezeqnet, a dial-up service which enables subscribers with a personal computer and modem to access various independent ISPs who provide direct access to the Internet on a per call basis. Bezeq collects a per minute fee for use of Bezeqnet (together with call charges at either local rates for the duration of the connection or in accordance with a basket rate) and an Internet access fee, which is passed on to the ISP after deduction of a collection fee. In addition to services aimed at occasional Internet users, Bezeqnet also provides connectivity services between permanent subscribers of ISPs and the ISPs. Bezeq receives a fee from the ISPs for its connectivity services and only charges such users the cost of the call, at local rates.

Bezeq International's Internet Services. Since 1999 Bezeq International has provided direct Internet access services as part of its strategic decision to operate Internet-related services. Bezeq International is currently one of the largest Israeli ISPs. By 31st December, 1999 Bezeq International had over 70,000 subscribers, most of which were residential customers who represented approximately 80 per cent. of Bezeq International's revenues from Internet activities. In 1999, Bezeq International acquired the business of Trendline Information and Communications Services Ltd., a provider of Internet access services, and of ISDN-NET Ltd., an ISP. At 12th July, 2000 Bezeq International held approximately 32.5 per cent. of the share capital of Walla! Communications Ltd. ("**Walla**"). Walla operates a portal to the Internet and constructs, develops and hosts Internet sites. On 25th May, 2000, Bezeq International entered into an agreement with Maariv Holdings Ltd. and Most Holdings Ltd. for the establishment of an ISP joint venture which would coordinate the Internet activities in Israel of the three partners. The parties have proposed a merger between the ISP joint venture and Walla. The completion of the transaction is subject to various governmental and other consents that have not yet been granted. At the Government Companies Authority's request, Bezeq International has clarified and provided further information in relation to the transaction.

GoNext. GoNext, a subsidiary of Pelephone (51 per cent.) was established in 2000 to provide cellular Internet services.

Broadcasting Services

Bezeq operates and maintains technical transmission services for the public broadcasting system in Israel. Bezeq provides broadcasting services (other than programming) for two television stations and nine radio stations in Israel. Currently, it also provides certain infrastructure services for all three cable television operators in Israel. Bezeq's subsidiary, DBS, (in which Bezeq has a 30 per cent. interest) received a license for satellite television broadcasts in January 1999. DBS commenced operations in July 2000. DBS competes with the three cable television broadcasters in multi-channel services in Israel. As of 31st March, 2000, Bezeq's share in the accumulated losses of DBS amounted to a total of approximately NIS 40 million and Bezeq expects DBS to continue incurring losses during the first years of its operations.

Domestic Traffic

The following table sets out certain information on Bezeq's domestic traffic for each of the last five years:

	Year ended 31st December,				
	1995	1996	1997	1998	1999
Calls (completed connections)					
Number of calls (in millions)					
Local ⁽¹⁾	4,154	4,376	4,301	4,374	4,312
Domestic long distance ⁽²⁾	2,466	2,865	3,214	3,561	3,895
Total	<u>6,620</u>	<u>7,241</u>	<u>7,515</u>	<u>7,935</u>	<u>8,207</u>
Annual growth rate	12%	9%	4%	6%	3.5%
Usage minutes					
Number of minutes (in millions)					
Local ⁽¹⁾	11,184	11,933	12,365	13,418	14,619
Domestic long distance ⁽²⁾	7,292	8,248	8,940	9,644	10,303
Total	<u>18,476</u>	<u>20,181</u>	<u>21,305</u>	<u>23,062</u>	<u>24,922</u>
Annual growth rate	15%	9%	6%	8%	8%
Average number of usage minutes per line ⁽³⁾	8,248	8,251	8,157	8,395	8,785

Notes:

- (1) Local calls include all calls which, according to regulations, are defined as land to land calls at a local tariff and also calls to information services at an additional charge.
- (2) Domestic long distance calls include all domestic calls, including land to land calls which are not local and land to mobile calls.
- (3) Calculated according to an annual average of connected lines.

From 1995 to 1999, the number of completed domestic calls increased by 24 per cent., mainly due to the increase in the number of fixed lines installed to accommodate increased demand and population growth. In addition, call completion rates and average usage per line have increased during this period due to the value-added services (such as voice mail, call waiting, call forwarding, call holding and last number redialling) offered by Bezeq over its digitalised network. During the same period, the aggregate number of call minutes increased by 35 per cent. from approximately 18,476 million to 24,922 million. However, Bezeq recently experienced a decline in the average number of outgoing calls per line, as well as in the average number of outgoing voice minutes per line, primarily as the result of increased cellular phone usage and the installation of second lines in homes, which lines generally have a lower volume of traffic.

Bezeq estimates that approximately 20 per cent. of its domestic traffic as at December 1999 (in terms of usage minutes) was attributable to Internet usage and Bezeq believes that the considerable demand for Internet services will result in a continuous increase in Internet usage minutes.

Domestic Tariff Structure

Bezeq's revenues from domestic services are derived primarily from domestic call charges (land to land, land to mobile and mobile to land), monthly line rental fees (fixed fees), one-time line installation charges and revenues from equipment sales and charges for value-added services. Pursuant to applicable regulations, Bezeq is generally not permitted to differentiate between types of customer in the fees it charges for line installation, monthly line rental and call charges.

Tariffs charged by Bezeq for most of its domestic fixed line telephone services are generally established by regulations and are subject to Government approval (see "Relationship with Government — Regulation").

As from 1st May, 2000, Bezeq changed its method of charging for calls from a system based on metering units to a system based on the duration of the call in seconds, subject to a minimum charge.

The following table sets forth the initial line installation charges, monthly line rental fees and the cost of domestic local and long-distance calls for each of the last five years:

	At 31st December,				
	1995	1996	1997 (in NIS ⁽¹⁾)	1998	1999
Standard connection fee	457	498	514	532	532
Standard monthly line rental fee	20.4	20.4	30.0	31.1	36.1
Local call of up to five minutes ⁽²⁾	0.227	0.248	0.256	0.265	0.208
One minute domestic long distance call ⁽²⁾	0.68	0.74	0.51	0.53	0.42

Notes:

(1) In current NIS.

(2) The tariffs for local and domestic long distance calls shown in this table are the highest tariff rates within each category. As of 1st May, 2000, calls are subject to a minimum charge of NIS 0.231.

Competition in Domestic Services

As from 1st June, 1999, Bezeq's statutory exclusive right to provide domestic fixed line services was repealed. No other operator has yet been granted the necessary governmental licences authorising it to provide domestic services, but Bezeq expects that other operators will be allowed to operate domestic fixed line services in the near future. Bezeq expects that the MoC will grant licences and will publish tenders for frequencies required for the use of certain technologies such as LMDS to provide such services. Such licences will probably be granted after the enactment of the necessary regulations. It is expected that these regulations and licences will include limitations on cross-ownership that will apply to the Group as well as its interested parties. Bezeq believes that the introduction of competition in the domestic telecommunications sector may adversely impact its financial position.

Following the introduction of competition in the domestic telecommunications market operators will, unless permitted to use other infrastructures including those of Bezeq (unbundling), need to build new domestic network infrastructures (facility-based competition) which will compete with Bezeq's network. Draft legislation prepared by the MoC expands further the Minister's authority to instruct operators of public telecommunications networks (including Bezeq) to allow the unbundling and co-location of network services. Bezeq has objected to the possibility of the unbundling of its network services. Potential competitors for the domestic fixed line market include cellular operators, cable television companies and entities holding fibre optic cable networks such as the Israeli Electric Corp., Israel Railroads and the Cross Israel Highway.

Competition from Cellular Operators. Bezeq is already facing competition in the domestic telecommunications market from the cellular operators. The rapid growth of the cellular usage in Israel has contributed to the reduced usage of Bezeq's domestic network as subscribers often prefer to use their cellular telephone even when a fixed line alternative is available. Bezeq is seeking to reverse this trend through a focused marketing campaign aimed at informing customers of the lower cost of fixed line calls as compared to cellular calls. However, Bezeq believes that cellular operators may offer more competitive rate packages and thereby increase the competition with the fixed line services offered by Bezeq. It is expected that some of the cellular operators will compete for a licence to provide domestic telecommunications services. Under draft regulations, Pelephone will be restricted in its holdings in an applicant for a licence to provide domestic telecommunications services because of Bezeq ownership.

Competition from Cable TV Companies. Existing or future cable television operators, upon receipt of the requisite approvals, are also expected to compete with Bezeq with respect to the provision of domestic services. The three cable television operators already benefit from an extensive cable infrastructure throughout Israel that may be modified to carry telecommunications services. The cable television operators, which operate on a regional basis, do not currently compete against each other and mergers are expected as the domestic market opens to competition. According to an opinion issued by the Attorney General, the MoC may not grant licenses to provide domestic services to the cable operators without enacting appropriate legislation. Under draft legislation prepared by the MoC, the Minister shall be authorised to issue, upon request, to cable TV operators licences to provide telecommunications services, subject to certain conditions. Upon the issue of such a licence, the receiving cable TV operator would lose its exclusive right to provide cable TV services in its geographical area, and others would be able to request licences to provide cable TV services in that area. The contemplated legislation requires that the

telecommunications services licences and the TV broadcasting licences be held separately by affiliated companies.

Bezeq has taken, and is continuing to implement, various measures to prepare for the introduction of competition in the market for domestic telecommunications services. These measures include improvement and modernisation of Bezeq's network infrastructure to accommodate advanced telecommunications services, expansion of the services offered to subscribers, such as data communication services, reorganisation of its internal structure (including cost and workforce reduction initiatives and consolidation of customer services divisions) and increased marketing efforts.

Universal Service Obligation

Pursuant to the terms of its licence, Bezeq is required to provide universal services, namely services to all persons in all regions of Israel, including installing telephone lines in any location, even if the provision of such services is not profitable. Similarly, Bezeq is generally prohibited from discriminating among subscribers in any manner, including by the cost of services or the range of services provided. These obligations, also known as universal service obligation ("USO") will continue to be in effect following the introduction of competition in the market for domestic services. It is expected that new operators entering the domestic fixed line market will not be subject to a full USO and will be allowed to eventually limit their operations to specific geographical areas of the country (within which areas they will provide a universal service). Under a recent amendment to the Telecommunications Law, the Minister may set the means to fund the USO subsequent to the opening of the market to effective competition.

Domestic Marketing and Customer Service

In response to the planned introduction of competition in the domestic telephone services market, Bezeq has significantly increased its marketing efforts. In addition, Bezeq has developed a targeted marketing strategy for each type of customer. For instance, each major account is assigned a dedicated account manager to interface with the customer and respond to customer questions and requests. Currently, 24 account managers located in four different regions handle approximately 270 customer accounts. The middle market is currently serviced by 107 marketing representatives in 18 different locations.

Bezeq advertises its services in the press, on television, on radio, by direct mail and through its account managers with the aim to increase public awareness of Bezeq's services and to encourage increased use of its services. As part of its marketing campaign, Bezeq uses various promotions. Bezeq carries out surveys of its customers on a regular basis to identify customer concerns and satisfaction levels as well as to identify demand for new products and services. Bezeq believes that a highly efficient, responsive and prompt customer service is essential for its success, particularly in maintaining customer loyalty in an increasingly competitive market. Pursuant to the terms of its licence, Bezeq is required to meet certain service quality requirements.

Billing

In preparation for the opening of the domestic telephone services market to competition, Bezeq is currently seeking to implement a new billing system after a previous project with a supplier of billing systems failed (see note 9E to the financial statements set out in "*Audited Annual Financial Statements*").

International Services

International telecommunications services consist of incoming and outgoing international voice and data traffic and switched transit traffic through Israel. Historically, Bezeq has been the sole provider of direct international telecommunications services in Israel, although various companies have offered indirect calling services since 1988. In June 1996, Bezeq transferred its international telephone services to its wholly-owned subsidiary Bezeq International and, following the opening of the international telecommunications market to competition, Barak and Golden Lines commenced operations in July 1997 in direct competition with Bezeq International. Despite the introduction of competition, Bezeq International has been able to maintain a significant market share in the international telecommunications services market. At the end of 1999, the MoC initiated a customer pre-selection balloting of subscribers to the three international operators (see note 1E(2) to the financial statements set out in "*Audited Annual Financial Statements*").

International telecommunications services generated revenues of NIS 892 million in 1999, representing approximately 10 per cent. of Bezeq's consolidated revenues. These revenues consist of customer charges for outgoing international calls, gross settlement fees from foreign operators for incoming international calls, access fees, transit fees and interconnect charges from the international operators (other than Bezeq International) for use of Bezeq's network and fees for various services provided to the international operators, including rental of transmission facilities. The international operators are required pursuant to the terms of their respective licences to pay Bezeq for the use of its domestic network and for the handling of the international operators' traffic originating or terminating on Bezeq's domestic network. The payment obligation consist of interconnect charges and access fees. Interconnect charges are paid to Bezeq for all traffic which originates or terminates on its network. Access fees are paid to Bezeq for traffic transmitted or received through an international operator's system, including traffic which originates or terminates on one of the cellular systems, whether or not such traffic was routed through Bezeq's system. Access fees are payable through the end of 2001 at gradually declining rates and will cease to be payable after 1st January, 2002. Transit fees are paid to Bezeq for traffic transmitted to or from an international operator's system, originating from or, as the case may be, terminating on a cellular operator's system. Bezeq International and the other two international operators also pay Bezeq installation and fixed monthly fees for transmission lines between Bezeq's switches and the switches of the international operators.

International Voice Services

Bezeq International offers various voice services, such as international direct dialling, international toll-free numbers and international directory inquiries. Bezeq International also provides international calling cards such as Globus, Globus Business and a pre-paid calling card, Globus-card, for use in public payphones in Israel.

International Data Services

Bezeq International provides a range of international data communication and related services through a variety of networks and technologies, such as virtual private networks, frame relay services, video conferencing facilities, ISDN services and ATM technology.

International Traffic

Bezeq International provides dialling and transit services to approximately 220 countries. However, the majority of international traffic is generated by a limited number of destinations. Bezeq International's largest outgoing and incoming international traffic route is between Israel and North America. In 1999, approximately 38 per cent. of the volume of outgoing traffic consisted of calls to North America and approximately 51 per cent. of the volume of incoming traffic consisted of calls from North America.

The following table sets forth certain information on the Group's international traffic for each of the last five years:

	Year ended 31st December,				
	1995	1996 ⁽¹⁾	1997	1998	1999
Outgoing calls (in millions of minutes)					
North America	92	103	145	124	140
Other	174	212	167	216	229
Total	<u>266</u>	<u>315</u>	<u>312</u>	<u>340</u>	<u>369</u>
Annual growth in outgoing traffic	21%	19%	(1)%	9%	9%
Incoming calls (in millions of minutes)					
North America	231	252	207	110	132
Other	189	215	187	144	128
Total	<u>420</u>	<u>467</u>	<u>394</u>	<u>254</u>	<u>260</u>
Annual growth in incoming traffic	16%	11%	15.6%	(33.5)%	2%
Ratio of incoming to outgoing traffic	1.58	1.48	1.26	0.75	0.70

Note:

(1) Prior to 1st June, 1996, Bezeq's international traffic was carried by Bezeq and subsequent thereto by Bezeq International.

There is currently an imbalance between total outgoing international traffic and total incoming international traffic, with the amount of outgoing traffic being greater than the amount of

incoming traffic and Bezeq expects this trend to continue. This is mainly due to the introduction of competition and the resulting decrease in tariffs for calls from Israel to other countries. As a result the Group is a net payer of settlement fees to foreign operators.

International Tariff Structure

Prior to the introduction of competition, Bezeq International's tariffs were strictly regulated and its charges for each destination required governmental approval. In bidding for their licences, the new international operators committed to maximum weighted average tariffs. Such tariffs were, on average, between one-quarter and one-third of the rates of Bezeq International prior to the introduction of competition. At the same time, for so long as its market share does not exceed 60 per cent. in terms of traffic, Bezeq International was allowed to reduce its rates in order to compete more efficiently and a more flexible price control regime, based on Bezeq International's market share, was introduced. See "*Relationship with Government—Operations*".

Competition in International Telecommunications Services

Until 1997 the Group was the sole provider of direct international telecommunications services in Israel, although various companies have offered limited services since 1988. Following the opening of the international telecommunications market to competition in 1996, two new operators, Barak and Golden Lines, commenced operations in July 1997 in direct competition with Bezeq International. The MoC has undertaken to limit the number of international operators in Israel to three until January 2002. The licences of the two new operators require them to price their services through January 2002 at levels that are below those charged by the Group prior to the introduction of competition in that market. In July 1997, in an effort to retain its market share and remain competitive, Bezeq International reduced its tariffs significantly. Although the entry of these new competitors into the international telecommunications market, particularly with their low tariffs, has resulted in a substantial increase in the size of the market, Bezeq International's market share and revenues and profits from this market have decreased substantially and may continue to decrease. Nevertheless, despite the introduction of competition, Bezeq International has been able to maintain a significant position in the international telecommunications market. Bezeq International's strategy is generally to price particularly competitively in key routes including the United States and certain western European countries.

Cellular Services

The Group provides mobile telephone services through Pelephone, which Bezeq holds in equal shares with Motorola. In 1994, Bezeq was allotted fifty per cent. of the ownership and control of Pelephone, in exchange for certain infrastructure equipment. Cellular services generated revenues of NIS 2,838 million in 1999, representing approximately 31 per cent. of Bezeq's consolidated revenues. These revenues consist of airtime charges for calls from a fixed line to a cellular line transferred to the cellular operators, interconnect charges from the cellular operators (including Pelephone, net of adjustments) for use of Bezeq's network, transmission charges, Bezeq's proportionate share of Pelephone's revenues (net of adjustments), royalties from Pelephone for use of certain transferred equipment and fees for various services provided to the cellular operators including rental of transmission equipment. Transmission charges for mobile to land calls and land to mobile calls are collected according to rates per minute set in regulations. Pelephone's financial statements are proportionately consolidated with those of Bezeq.

As of March 2000, due to changes in Bezeq's arrangements with the cellular operators and accounting policies, airtime charges for land to mobile calls are no longer recorded in cellular revenues and expenses. This will result in significant reductions in cellular revenues and expenses.

From 1995 to 1999, Pelephone experienced subscriber growth, from approximately 230,000 at 31st December, 1995 to approximately 1,110,000 at 31st December, 1999. Pelephone believes that the cellular penetration rate in Israel at the end of 1999 was approximately 46 per cent., representing some 2,880,000 subscribers (of which 1,110,000 were Pelephone's subscribers).

The following table sets forth some information on Pelephone's activities for each of the last five years:

	At 31st December,				
	1995	1996	1997	1998	1999
Total subscribers (in thousands)	230	535	810	930	1,110
Pelephone's cellular subscribers per 100 inhabitants ..	4.2%	8.7%	13.8%	15.8%	17.6%
Average number of subscribers (in thousands) ⁽¹⁾	182	382	672	872	1,021
Total revenues (in NIS millions)	1,644	2,306	2,637	3,011	2,975
Average annual revenues per subscriber (in NIS) ⁽²⁾ ...	9,033	6,037	3,924	3,453	2,913

Notes:

(1) Represents the average number of Pelephone subscribers during the period.

(2) Based on the average number of Pelephone subscribers during the period.

In 1999, Pelephone's profitability and quality of service suffered a major drawback as the result of the fraudulent "cloning" of the telephone numbers of its subscribers in the analogue network. Upon becoming aware of the fraud, Pelephone took steps to stop it and prevent any reoccurrence at a considerable financial cost. The costs and expenses incurred by Pelephone as a result of the fraud had an adverse effect on Pelephone's results for 1999. However, with new anti-fraud hardware and software systems in place and the expansion of its digital network which will eventually replace the analogue network, Pelephone believes that such fraudulent acts are unlikely to affect its operations in the future. Despite the fraud crisis, Pelephone's subscriber base continued to grow in 1999.

Pelephone's 1999 results were also affected by growing competition in the cellular market, the erosion of its tariffs and the investments relating to the deployment of its digital network.

Cellular Services

Pelephone offers a range of quality voice, data and fax cellular telephone services throughout Israel, as well as cellular telephone rental services for use abroad. Until 1998 Pelephone used a Narrow Band Advanced Mobile Phone System ("**N-AMPS**") analogue technology platform operating with a total of 2 x 12 MHz in the range of 825 MHz to 892 MHz frequencies for its service. To accommodate future growth as well as satisfy the condition in its licence that it upgrades its system, Pelephone began in October 1998 to deploy a digital network using Code Division Multiple Access ("**CDMA**") technology to operate alongside the existing N-AMPS network, while also continuing to upgrade the existing N-AMPS network. By June 2000, Pelephone's CDMA digital network had already over 600,000 subscribers. Pelephone believes the CDMA technology offers certain advantages over the existing N-AMPS analogue system, such as increased capacity, reduced maintenance and infrastructure costs per subscriber, capability for advanced digital services and handsets with an extended battery life. Pelephone believes that the implementation of the CDMA technology did not cause any interruption in Pelephone's operations or services.

Pelephone offers both residential and business subscribers a variety of value-added services in addition to basic cellular voice telephone service. As part of Pelephone's basic service package, subscribers receive call waiting, repeat dialling, call forwarding and no answer and busy transfer (calls are automatically transferred to a customer designated number when the cellular phone is engaged or not answered). For an extra charge, additional services such as voice mail, e-mail and conference call facilities and three digit dialling for news updates, weather, traffic and airline information are available. In addition, Pelephone offers business customers value-added services such as computerised software for call and charge analysis.

Pelephone offers a number of pre-paid cellular services, which dispense with monthly fees and commitment to a certain subscription period. At 1st June, 2000, Pelephone's pre-paid customers amounted to approximately 200,000. Pelephone's latest services include IZI, a pre-paid service launched in April 2000 which is available through both the analogue and digital network. By June 2000, IZI already had 80,000 subscribers.

Cellular Traffic

The following table sets out certain information on the Group's cellular traffic for each of the last five years:

	Year ended 31st December,				
	1995	1996	1997	1998	1999
Number of usage minutes (in millions)	1,160	2,180	2,983	3,342	3,645
Annual growth rate	not available	88%	37%	9%	12%
Average number of usage minutes per subscriber	530	430	320	300	295

From 1995 to 1999, the number of cellular calls completed on Pelephone's service increased, mainly due to the increase in the number of Pelephone's subscribers. In addition, call completion rates and average usage per line have increased during this period due to the value-added services (such as voice mail, call waiting, call forwarding, call holding and last number redialling) offered by Pelephone.

Cellular Tariff Structure

Pelephone derives revenue from its cellular service from monthly service charges, traffic charges and fees for certain value-added services and handset sales and leasing. Pelephone offers its customers a wide variety of pricing plans with varied rates for peak and off-peak calls. Pelephone also offers discounted rates to corporate customers with multiple subscribers and soldiers serving in the Israel Defense Forces as well as a regional discount, pursuant to which airtime rates are based on the location from which the calls are placed and discounted for calls placed from a specified "home" region. The traffic charge rate-per-minute varies based on a number of factors including the time of day of the call and whether the call is made on a business day, a weekend or a public holiday. The average monthly service charge is currently NIS 29.68.

The following table sets forth certain information relating to Pelephone's peak tariffs for the periods indicated:

	At 31st December,				
	1995	1996	1997 (in NIS)	1998	1999
Monthly service charge (per line)	74	74	74	36.86	29.68
Airtime rate (per minute)	0.6158	0.5050	0.4776	0.5366	0.4986

Pelephone currently determines its own airtime charges. However, the Minister can, under certain circumstances, regulate such charges. The MoC has recently distributed a draft of regulations under which the airtime charges for calls terminating on the cellular operators' systems shall be regulated. Should such regulations be approved, Pelephone's revenues may be materially affected.

Pursuant to regulations and the terms of their respective licences, Pelephone and each of the other cellular operators are required to pay royalties to the Government at a rate of 8 per cent. per annum of their basic cellular services revenues. Royalties for an amount of approximately NIS 75 million are currently under dispute between the Ministry of Finance and Pelephone (an equal amount was paid by Pelephone under protest). Pursuant to legal advice, Pelephone has made a provision for part of the amount in dispute.

Cellular Competition

In 1993 the Israeli cellular market was opened to competition and by the end of 1998 two new operators had commenced offering cellular services in direct competition with Pelephone. The expected entry in the near future of a fourth cellular operator is expected to intensify competition in the Israeli cellular market and Pelephone recently adopted a new strategy whereby it will endeavour to increase its market share substantially over the next two years. This would be achieved through a new pricing structure and increased marketing of the CDMA digital network, initially at a fairly considerable cost to Pelephone.

The cellular systems of the three cellular operators are based on different technologies, which means that handsets and telephone numbers must be replaced when switching from operator to operator. Pelephone believes that this discourages certain subscribers from switching between operators and views marketing as an important factor in the acquisition of subscribers (see "Cellular Marketing and Customer Service"). Pelephone believes that network capacity is another of its competitive advantages.

Pelephone also faces competition from MIRS Communications Ltd. ("**MIRS**"), a company controlled by Motorola that specialises in cellular services to closed user groups. The MoC is considering granting to MIRS a licence to provide cellular services to the public.

Cellular Marketing and Customer Service

Pelephone is seeking to expand its customer base to both business and private customers principally through innovative service offerings tailored to meet various subscriber group needs, strong advertising campaigns and innovative tariff structures. The penetration of cellular telephone services in Israel increased substantially since 1995, partly due to a new calling party payment system and partly due to the entrance into the market of Cellcom and Partner.

To increase sales, Pelephone has established a distribution network throughout Israel consisting of approximately 80 direct distributors, more than 177 certified dealers and 19 stores, which together represent in excess of 276 points of sale.

Pelephone maintains a twenty-four hour a day, seven days a week customer service hotline to provide subscribers with technical, billing and general information. To improve customer service, Pelephone has established 24 regional service centres offering repair, installation and sale services. These centres are strategically located throughout Israel. In addition, Pelephone assigns individual customer service representatives to business subscribers to ensure appropriate support to these generally larger and more sophisticated users.

Financial Restatement

At the beginning of 1999, Pelephone made a change in its accounting policy regarding the costs of acquiring new subscribers, from expensing the entire amount in one year to spreading the expense over several years based on the subscriber's commitment period. Following such change, and after discussions with the Israeli Securities Authority Bezeq's board of directors resolved on 27 July 2000 to restate Bezeq's financial reports to reflect the accumulated effect of the change in the accounting policy. The restatement does not materially affect the financial reports, and shall result in an increase of Bezeq's share in Pelephone's profits for 1999 by approximately NIS 1.5 million (such increase shall be off-set in Bezeq's financial reports in future years).

Investments Outside of Israel

Bezeq has invested in two projects outside of Israel. Bezeq owns 16 per cent. of Fascel Ltd., a cellular services operator in India (see note 8E to the financial statements set out in "*Audited Annual Financial Statements*" and note 4(b) to the financial statements set out in "*Unaudited Interim Financial Statements*") and 33 per cent. in Emitel Telecommunication Corp. Ltd., a fixed-line telecommunications services provider in Hungary (see note 4(a) to the financial statements set out in "*Unaudited Interim Financial Statements*").

Principal Suppliers

The Group obtains telecommunications-related services and equipment from numerous suppliers. The Group is dependent on several main suppliers. If one of the main suppliers of a service or equipment were to be unwilling or unable to supply such service or equipment, the Group could experience disruptions in the operation of its business (see note 21A(10) to the financial statements set out in "*Audited Annual Financial Statements*").

Network Infrastructure and Technology

From 1995 to 1999, Bezeq invested approximately NIS 11,294 million to refurbish and modernise its telecommunications infrastructure, including the replacement of its analogue exchanges with digital exchanges, the development of a modern signal system for inter-exchange connections throughout the country, the development of advanced transmission systems using fiber optics and the expansion and refurbishment of the access network. Bezeq has achieved full digitalisation of its switching network and, as a result, Bezeq is able to provide its customers with numerous value-added services as well as reduce connection intervals and errors. During the next five years Bezeq intends to invest in its telecommunications infrastructure for projects such as the introduction of ATM switches to enable switching of broadband communication (including multimedia) as well as narrowband communication throughout Bezeq's network and the introduction of ADSL access to provide broadband access to subscribers. (See — "*Domestic Fixed Line Services — Domestic Data Services and Technologies*"). Bezeq's investment strategy is to remain in the forefront of all technological advancement.

Domestic Fixed Line Telecommunications Network

Bezeq's domestic fixed line telecommunications network is comprised of numerous local access networks interconnected by a backbone network. By the end of 1996, Bezeq had completed an extensive programme to convert all of its switches to digital signal technology.

Bezeq uses fibre optic cables throughout its domestic backbone network. Fibre optic cables provide enhanced service quality in terms of clarity and speed. At 31st December, 1999, Bezeq had expanded the use of fibre optic cable to approximately 100 per cent. of its trunk network and to approximately 25 per cent. of its local network, representing approximately 6,000 kilometres of fibre optic cable in its trunk network and approximately 7,000 kilometres of fibre optic cable in its local network. Bezeq has also modernised and substantially upgraded its local access networks, increasing the number of access lines in its local network from approximately 2.34 million lines at the end of 1995 to approximately 2.88 million lines at the end of 1999. Less than 1 per cent. of Bezeq's domestic infrastructure consists of microwave radio network used to carry video, voice and data.

International Telecommunications Network

Bezeq International provides international telephone service through international exchanges that serve as gateways between Bezeq's domestic network and the global international network, consisting of [two] submarine cables, terrestrial cables, microwave and satellite transmissions and international digital exchanges. In addition, Bezeq uses its domestic network to connect customers to the exchanges of the new international operators and to connect such operators' exchanges to the international network. The international transmission network infrastructure has fully-digitalised international switching and transmission. Bezeq uses submarine fibre optic cables providing connections to Palermo, Cyprus and Egypt through which international calls can be routed to over 50 countries. Bezeq International purchased user rights on additional submarine fibre optic cables that are not directly connected to Israel for communications with Europe, North America and other countries. Bezeq International is currently examining a possible investment in a submarine cable network.

Bezeq provides satellite capacity through Intelsat, in which Bezeq is a signatory, as well as a shareholder in New Skies Satellites Ltd. (which operates approximately one fifth of Intelsat's satellites). Bezeq is currently constructing a land earth station which will enable it to provide certain Immarsat services, and is in the process of signing an operating agreement with Immarsat. In addition, Bezeq is currently negotiating the purchase from the MoC of shares held by the MoC in Immarsat. Bezeq's satellite services provide access to Europe, America, Russia and the Far East. Bezeq International has 1,397 channels through its satellite connections.

Cellular Telecommunications Network

Pelephone has made substantial investments in its cellular telephone network that provides nationwide coverage. Pelephone historically has used an advanced N-AMPS analogue technology platform but, to accommodate the anticipated continued expansion of Pelephone's subscriber base and traffic without adversely effecting service quality, in 1998 Pelephone began deploying a digital network using CDMA technology to operate alongside the existing N-AMPS analogue network.

Pelephone's cellular infrastructure is based primarily on 14 switches that are connected to approximately 860 radio sites nationwide. Each radio site covers a specific geographical area and includes an antenna for receiving and transmitting and a computerised control system. The sites are connected to a switch which includes a digital exchange that is responsible for the connection among all the sites and among the sites and Bezeq's exchanges.

Pelephone's N-AMPS infrastructure equipment, and most of the subscriber end line equipment, are manufactured by Motorola, Inc. and are sold to Pelephone at a discount.

Employees

General

At 31st May, 2000 Bezeq had 6,518 employees, 85.6 per cent. of whom were employed pursuant to permanent collective labour agreements and 2.5 per cent. of whom were employed pursuant to temporary collective labour agreements. The remaining 11.9 per cent. were employed under individual employment contracts. More than half of Bezeq's employees at 31st May, 2000 were technicians. At that date, 30 per cent. of Bezeq's employees performed administrative functions and 8.2 per cent. were engineers.

The table below sets out information regarding Bezeq's employees for each of the last five years:

	Year ended 31st December,				
	1995	1996	1997	1998	1999
Number of employees					
Permanent contracts	7,790	7,645	7,478	6,629	5,989
Temporary contracts	848	434	312	248	135
Individual contracts	301	542	545	607	692
Total	<u>8,939</u>	<u>8,621</u>	<u>8,335</u>	<u>7,484</u>	<u>6,816</u>

Bezeq's employees are divided into three general groups, each of which is subject to different employment terms. The first group of approximately 775 employees is comprised of senior managers and other employees which are employed pursuant to individual employment contracts with Bezeq. The second group of approximately 5,580 permanent employees is comprised of approximately 2,080 employees who were Government employees employed by the MoC when Bezeq started its operations in 1984 and were transferred to Bezeq and approximately 3,500 employees who were hired by Bezeq after it commenced operating. This entire second group is subject to collective labour agreements. The third group is comprised of professional temporary employees hired by Bezeq on an "as needed" basis through temporary employment agreements and is also subject to collective labour agreements. In addition Bezeq uses temporary workers provided by employment agencies pursuant to agreements between Bezeq and the employment agencies. At 31 December, 1999, such temporary workers (both full-time and part-time workers) accounted for 1,750 positions within Bezeq. Under legislation due to come into effect in approximately six months time, a temporary worker provided by an employment agency becomes an employee of the actual work place after nine months of work (not counting periods prior to the enactment of the legislation). In addition, temporary workers will be entitled to the same employment rights enjoyed by employees of the work place holding similar positions and seniority. Bezeq is examining possible measures regarding the status of such temporary workers and cannot currently estimate the impact of such legislation on its operating expenses.

The general terms and conditions of employment for all of Bezeq's employees are determined by the Israeli labour laws, which regulate working conditions such as minimum wages, basic working hours, wage protection, annual leave, social security, health insurance and severance pay. In addition, as long as Bezeq is a state-owned company, it is subject to Government regulation pursuant to which any changes in wages and benefits at variance with those applicable to civil servants require approval by the Minister of Finance.

Voluntary Early Retirement Plans

In a continuing effort to increase efficiency and streamline its workforce with a view to enhancing Bezeq's ability to compete, particularly in the domestic telephone market following the introduction of competition, on 23rd November, 1997 special collective labour agreements were entered into between Bezeq, the Histadrut (the national labour union) and the employees' representatives to regulate the terms of an early retirement plan and to alter the organisational structure of Bezeq. The terms of this early retirement plan provided for the retirement of approximately 1,800 employees by 31st December, 1999 at a total cost not exceeding NIS 1.4 billion. To date, Bezeq has paid or reserved a total of NIS 1.3 billion for the early retirement plan and has funded the costs of the plan (which have had a significant negative impact on Bezeq's operating income in recent years) through internally generated funds. By 30th June 2000, a further 489 employees had retired within the framework of the plan and in 1999 Bezeq reserved a further NIS 390 million to cover such employees. Bezeq, its employees and the Government agreed (and such consent was given effect by a labour court decision) to extend the retirement plan to March 2001 and Bezeq intends to implement certain structural changes concurrently with the implementation of the plan (see note 17D of the financial statements set out in "Audited Annual Financial Statements"). In connection with the planned privatisation, Bezeq, its employees and the Government are currently discussing another early retirement plan and the possible means of funding such plan. There can be no assurance as to when and if such an agreement will be reached (see "Relationship with Government — Government Control and Privatisation").

Pension Benefits

Pursuant to certain collective labour agreements, Bezeq provides certain pension benefits to its employees and has contributed to funds to cover severance pay liabilities. Employees who were transferred to Bezeq from the MoC in 1984 may elect to receive pension benefits in accordance with either the *Keren Makefet* (Pension Fund) rules or the Government Service Law (Pension), 1970.

Labour Relations

During the past five years, Bezeq has experienced several work stoppages and strikes which disrupted its business. Since 1995, there have been several strikes, most of which were protests against Government policies rather than against Bezeq. The last two work disruptions took place in March and May 2000. Each work disruption lasted several days in reaction to the planned opening of the domestic fixed line market to competition and Bezeq's privatisation prior to an agreement as to Bezeq's employees' rights including an early retirement plan being reached. Negotiations between employees, Bezeq and the Government are currently taking place. Although Bezeq cannot predict the likelihood of any future work stoppage or strike and certain actions that Bezeq or the Government has taken or intends to take may contribute to the employees staging a strike.

Properties

Bezeq's principal properties consist of numerous plots of land, buildings and telecommunications facilities, including exchanges, transmission equipment, office facilities and retail outlets, located throughout Israel. At 31st December, 1999 Bezeq owned, leased or used approximately 542,900 built square metres on approximately 6,935,000 square metres of land in Israel.

A considerable portion of Bezeq's real estate was transferred to Bezeq pursuant to the **1984 Agreement**. Properties subject to long-term leases granted to Bezeq by the State of Israel, typically for terms of up to 49 years renewable for an additional term of 49 years and properties held by Bezeq jointly with the postal authority, which like Bezeq originated from the MoC, are also subject to a 1993 agreement between the Israel Land Administration and Bezeq (the "**1993 Agreement**"). Pursuant to the 1993 Agreement, Bezeq may use these two types of properties for the purpose of telecommunications operations and related purposes. The 1993 Agreement also contains limitations on the modification, transfer and use of such properties. Bezeq is currently in disagreement with the Government on the validity of the 1993 Agreement and of certain of its terms. In addition, the Government has transferred to Bezeq a significant number of properties for automatically renewable leases of two years. The 1984 Agreement stipulates that the Government may terminate such a renewable lease if the land is required by it for a preferable use. In such event, the Government must offer Bezeq, to Bezeq's satisfaction, appropriate substitute properties within reasonable distance and cover the costs of transfer to such substitute property. In 1997 the Government gave Bezeq notice that all renewable leases were to be terminated as of the end of January 1998 (a similar notice was given and rejected in 1994). Bezeq believes that the action taken by the Government was unlawful and rejected it. The Government opposes Bezeq's interpretation of the 1984 Agreement and has stated that the correct interpretation is that it has a right to repossess, without reimbursement or compensation to Bezeq at all, including giving alternative property or any other payment, any property that is not being used for the original needs or purposes for which it was leased or if the Government is no longer interested in such need or purpose. Discussions with the Government on this matter have not yet been successful and there can be no assurance that such dispute, as well as the dispute regarding the 1993 Agreement, will be resolved in the near future. Bezeq does not record the value of the properties subject to the renewable leases in its financial reports, for accounting reasons.

In addition to the properties transferred under the 1984 Agreement, Bezeq owns, leases and uses other properties.

Bezeq's rights in certain of the properties used by it are not properly documented or registered.

Legal Proceedings and Tax Assessments

Legal Proceedings

Bezeq and other members of the Group are party to lawsuits and administrative proceedings incidental to the ordinary course of business. Except for the proceedings referred to elsewhere in this Offering Circular, including the notes to the financial statements set out in "*Audited Annual Financial Statements*" (in particular notes 9B, 9E and 21A) and in "*Unaudited Interim Financial*

Statements' (in particular note 6), no member of the Group is a party to any legal proceeding and no such proceeding is known by Bezeq to be contemplated by the Governmental authorities or third parties which, if adversely determined, could have a material adverse effect on Bezeq or the Group. Bezeq believes that adequate provision has been recorded in its financial statements to the extent deemed necessary in respect of such claims. In addition, in July 2000, Bezeq received a class action claim in the amount of approximately NIS 900 million in respect of charges to residential customers for certain value added services. Bezeq is currently considering the claim and has been advised by its external legal counsel, on the basis of an initial review, that Bezeq has some sound arguments.

Tax Assessments

Bezeq and Pelephone have received final tax assessments (as a result of the statute of limitations having elapsed) up to and including 1993. Bezeq's other subsidiaries have not yet received any final tax assessments.

Bezeq is currently undergoing an assessment review by the income tax authorities for the years 1994 to 1998 inclusive. In December 1999, tax assessments were issued to Bezeq in respect of 1994 only. According to the assessment, Bezeq must pay additional taxes in the amount of approximately NIS 408 million for 1994, including interest and CPI-linkage. Most of the additional tax derives from a liability for capital gains tax from the sale of infrastructure equipment to Pelephone in exchange for the transfer of a 50 per cent. interest in Pelephone to Bezeq. Bezeq is disputing the assessment and has filed an objection to the demand (see note 11E to the financial statements set out in "*Financial Statements'*").

Environmental Issues

There have been allegations concerning the risks associated with the transmission of radiowaves from telecommunications infrastructure, mobile telephones, transmitters and associated equipment. There can be no assurance that Bezeq or other members of the Group may not be affected by the actual or perceived risks associated with radiowave transmission.

Liquidity and Capital Resources

Bezeq generates significant operating cash flow which, together with debt financing, it uses to finance its capital expenditure and working capital needs. With the completion of the digitalisation of its switches in 1996, Bezeq's capital expenditure requirements have gradually reduced, although its subsidiaries continue to require significant capital resources to fund investments in technology. The Group's capital expenditure budget for the year ended 31st December, 2000 is approximately NIS 2.0 billion.

As at 30th June, 2000, Bezeq had approximately NIS 5.2 billion of long term debt outstanding, approximately NIS 1.3 billion of which contains provisions requiring or allowing early repayment in the event that the Government announces its intention to reduce its shareholding in Bezeq to below 50 per cent. and approximately NIS 2.5 billion of which contains provisions requiring or allowing early repayment in the event that the State of Israel's shareholding in Bezeq is reduced below 26 per cent. (see notes 14D and 15C to the financial statements set out in "*Audited Annual Financial Statements'*"). Bezeq expects that some of its lenders will seek repayment of their loans in such circumstances and Bezeq may consider replacing or refinancing a portion of these loans, although there can be no assurance that Bezeq will succeed in such plans. Bezeq International, Pelephone and DBS will require additional funding to finance their operations and capital expenditure programmes.

RECENT DEVELOPMENTS AND OUTLOOK

Whilst Bezeq cannot predict with any certainty the Group's results for the year ending 31st December, 2000, it expects sales volumes in the domestic fixed line market to remain relatively flat, with some growth in sales volume in the cellular market. Revenues will continue to be impacted by the average 8 per cent. tariff reduction introduced in April 1999 and will be further impacted by the average 2.43 per cent. tariff reduction introduced on 1st May 2000, as well as by the change to its billing method from metered units to usage minutes. Moreover, due to changes in settlement arrangements with the three cellular operators, airtime revenues generated from domestic fixed line to cellular telephone connections (which Bezeq collects for, and passes onto all three cellular operators) will no longer be recorded in Bezeq's financial statements. Although this will lead to a significant reduction in total revenues it will not affect operating income as cellular telephone payments are deducted as an operating expense. The anticipated opening of fixed domestic communications services to competition, in addition to the growing competition in cellular and international communications sectors, is expected to have a materially adverse effect on the Group's business results.

As part of a continuing strategy to reduce its debt burden and refinance existing debt with longer term refinancing arrangements, Bezeq repaid approximately NIS 1.4 billion of net interest-bearing debt in 1999, thereby considerably reducing its interest expense. To date, the benefits of this reduction in interest expense have been partially off-set by increased financing expenses of Bezeq's subsidiaries (mainly Pelephone), devaluation or appreciation of the NIS as compared to changes in the exchange rate between the U.S. dollar and the NIS, and reduced interest income in a lower interest rate environment. Bezeq expects that Bezeq International, Pelephone and DBS will continue to make losses for the year ending 31st December, 2000, partly as a consequence of investments in technology and infrastructure to enable them to compete in their markets.

Bezeq believes that its existing infrastructure and network will give it an advantage in competing with any new operator in the domestic fixed line market and, if privatised, that Bezeq would benefit from more flexibility to compete. To meet the demands of increasing competition Bezeq has continued to increase efficiency and streamline its workforce. In addition, the Group continues to invest in maintaining and developing infrastructure and technology, improving customer services and marketing and exploring new telecommunications and related projects with the aim of maintaining its strength in the market.

MANAGEMENT

Board of Directors

Bezeq's Articles of Association provide that the board of directors of Bezeq may consist of no more than 17 members at any time (subject to two additional directors being appointed as described below). The Articles of Association provide that members of the board of directors of Bezeq are elected at the general meeting of shareholders by a majority of 60 per cent. of the shareholders represented and voting at such meeting. In addition, pursuant to the Articles of Association and the GCL, so long as Bezeq is a Government Company, the Minister and the Prime Minister together can appoint two additional directors from Bezeq's employees. If such additional two directors are appointed, the general meeting of shareholders may appoint an additional two directors (thus bringing the maximum overall number of directors to 19). For the appointment of directors by the Minister and the Prime Minister, see "*Relationship with Government — Government Control and Privatisation*".

Under recent legislation, Bezeq, as a publicly traded company, is required to elect at its general meeting of shareholders two "external directors" that are unaffiliated with it or with any entity controlling Bezeq or any entity controlled by Bezeq. Such external directors are appointed for an initial term of three years that may be extended for one additional term of three years and are not subject to early termination except under specific circumstances. At Bezeq's general meeting of shareholders on 23rd July, 2000, after failing to obtain the required majority under law which must include a certain amount of votes from Bezeq's minority (i.e. non-government) shareholders, no candidate to serve as an external director was approved. Bezeq intends to continue its efforts to procure the election of external directors.

Each director, other than the external directors, is elected to a term ending on the date of the annual general meeting following the general meeting in which she or he was elected, except that directors appointed prior to 1st May, 1999 shall continue in their office for the terms provided at the time of their appointment (a period of three years from appointment). A director may be removed either by a resolution of the shareholders of Bezeq at a general meeting, or for reasons such as the director becoming bankrupt, being found guilty of certain offences, or under the GCL (such as for not participating in a certain number of meetings). Bezeq's board of directors currently consists of 15 members, all of whom have been appointed by the Minister and the Prime Minister.

Bezeq's board of directors establishes the principles of strategy, organisation and financing to be used by Bezeq. The board of directors appoints the executive officers of Bezeq.

The members of the board of directors of Bezeq are as follows:

<u>Name</u>	<u>Name</u>
Ido Disenchik (Chairman ⁽¹⁾)	Shlomo Levin
Haim Assa	Miriam Mazar
Yosef Banano	Azriel Nevo
Avi Barak	Amnon Neubach
Jacob Ben-Gur	Rami Nomkin
Moshe Bloomkin	Hava Shechter
Shlomit Eytan	Iris Stark
Gabi Last	

Note:

(1) Subject to the appointment, in writing, by the Minister and the Prime Minister.

The business address of each of the members of the board of directors of Bezeq is 2 Azrieli Center, Bezeq Building, Tel Aviv 61620, Israel.

Senior Management

The members of the senior management of Bezeq are as follows:

<u>Name</u>	<u>Position</u>
Ilan Biran	Chief Executive Officer
Oren Lieder	Chief Financial Officer
Avi Gabay	Vice President, Economics
Paul Weissbach	Vice President, Engineering & Planning
Pnina Shenhav	Vice President, Marketing & Sales
Michal Even-Chen	Vice President, Business Development
Raz Heiferman	Vice President, Information Technology
Gideon Kadusi	Vice President, Management Resources
Bosmat Chelouche	General Counsel
Zvi Shapira	Internal Auditor
Amnon Fachima	Corporate Secretary
Nati Bialistock-Cohen	Anti-Trust Compliance Officer
Ella Bar-Or	Spokesperson
Abraham Shlomovitz	Head of Tel Aviv & Sharon Operating Division
Rafi Rahat	Head of Central Area Operating Division
Yossi Malka	Head of Haifa & North Operating Division
Aviel Rahamim	Head of Jerusalem & South Operating Division
Zalman Kodan	Head of Operational Control

ISRAELI TAXATION

The following is a summary of the Issuer's understanding of current law and practice in Israel relating to certain aspects of the taxation of the Notes. Some aspects do not apply to certain classes of taxpayer (such as dealers). Prospective holders of Notes who may be subject to tax in a jurisdiction other than Israel or who may be unsure as to their tax position should seek their own professional advice.

Generally, an Israeli withholding tax of 25 per cent. applies to payments of interest under the Notes. Withholding tax may, however, be reduced by (i) an appropriate double taxation treaty to which Israel is a party and the "interest" article in the treaty which provides for a full or partial exemption from withholding on interest payments, or (ii) a ruling which the Israeli Ministry of Finance may, in its discretion, make and which provides for a full or partial exemption from withholding on interest payments. Bezeq has been granted an exemption from the Israel income tax authority, whereby 90 per cent. of the interest payable on the Notes will be exempt from withholding tax, while the remaining 10 per cent. interest shall be taxed at a rate of 25 per cent.

Pursuant to the Terms and Conditions of the Notes the Issuer will, subject to certain exceptions, pay such additional amounts as shall be necessary in order that the net amounts received in respect of the Notes after the withholding shall equal the amounts which would otherwise have been receivable in respect of the Notes in the absence of such withholding.

A holder of a Note who derives income from a Note will be subject to Israeli taxation on the income if the income is received in Israel. A holder of a Note who realises a gain on the disposal of a Note will be subject to Israeli taxation on capital gains if the holder is, or is deemed to be, resident in Israel for the purposes of the relevant provisions in the tax laws of Israel.

SUBSCRIPTION AND SALE

The Dealers have, in a programme agreement (the "**Programme Agreement**") dated 7th August, agreed with the Issuer a basis upon which they or any of them may from time to time agree to purchase Notes. Any such agreement will extend to those matters stated under "*Form of the Notes*" and "*Terms and Conditions of the Notes*". In the Programme Agreement, the Issuer has agreed to reimburse the Dealers for certain of their expenses in connection with the establishment of the Programme and the issue of Notes under the Programme and to indemnify the Dealers against certain liabilities incurred by them in connection therewith.

United States

The Notes have not been and will not be registered under the Securities Act and may not be offered or sold within the United States or to, or for the account or benefit of, U.S. persons except in certain transactions exempt from the registration requirements of the Securities Act.

The Notes are subject to U.S. tax law requirements and may not be offered, sold or delivered within the United States or its possessions or to a United States person, except in certain transactions permitted by U.S. tax regulations. Terms used in this paragraph have the meanings given to them by the U.S. Internal Revenue Code of 1986 and regulations thereunder.

Each Dealer has represented and agreed, and each further Dealer appointed under the Programme will be required to represent and agree, that it will not offer, sell or deliver Notes (i) as part of their distribution at any time or (ii) otherwise until 40 days after the completion of the distribution, as determined and certified by the relevant Dealer or, in the case of an issue of Notes on a syndicated basis, the relevant lead manager, of all Notes of the Tranche of which such Notes are a part, within the United States or to, or for the account or benefit of, U.S. persons. Each Dealer has further agreed, and each further Dealer appointed under the Programme will be required to agree, that it will send to each dealer to which it sells any Notes during the distribution compliance period a confirmation or other notice setting forth the restrictions on offers and sales of the Notes within the United States or to, or for the account or benefit of, U.S. persons. Terms used in this paragraph have the meanings given to them by Regulation S under the Securities Act.

Until 40 days after the commencement of the offering of any Series of Notes, an offer or sale of such Notes within the United States by any dealer (whether or not participating in the offering) may violate the registration requirements of the Securities Act if such offer or sale is made otherwise than in accordance with an available exemption from registration under the Securities Act.

Each issuance of Index Linked Notes or Dual Currency Notes shall be subject to such additional U.S. selling restrictions as the Issuer and the relevant Dealer may agree as a term of the issuance and purchase of such Notes, which additional selling restrictions shall be set out in the applicable Pricing Supplement.

United Kingdom

Each Dealer has represented and agreed, and each further Dealer appointed under the Programme will be required to represent and agree, that:

(i) in relation to Notes which have a maturity of one year or more, it has not offered or sold and, prior to the expiry of the period of six months from the issue date of such Notes, will not offer or sell any such Notes to persons in the United Kingdom except to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses or otherwise in circumstances which have not resulted and will not result in an offer to the public in the United Kingdom within the meaning of the Public Offers of Securities Regulations 1995 (as amended);

(ii) it has only issued or passed on and will only issue or pass on in the United Kingdom any document received by it in connection with the issue of any Notes to a person who is of a kind described in Article 11(3) of the Financial Services Act 1986 (Investment Advertisements) (Exemptions) Order 1996 (as amended) or is a person to whom such document may otherwise lawfully be issued or passed on; and

(iii) it has complied and will comply with all applicable provisions of the FSA with respect to anything done by it in relation to any Notes in, from or otherwise involving the United Kingdom.

Israel

The Issuer has not filed an application with the Israel Securities Authority for the publication of this Offering Circular as would have been required by the Securities Law 1968 ("**Securities Law**") in order to permit a public offering of Notes in Israel. Accordingly, Notes shall not be offered to the public in Israel.

Each of the Dealers has agreed, and each further Dealer appointed under the Programme will be required to agree, that it will only offer, sell, or distribute Notes in Israel in compliance with the Securities Law and any other applicable Israeli laws and regulations.

Japan

The Notes have not been and will not be registered under the Securities and Exchange Law of Japan (the "**Securities and Exchange Law**") and each Dealer has agreed and each further Dealer appointed under the Programme will be required to agree that it will not offer or sell any Notes, directly or indirectly, in Japan or to, or for the benefit of, any resident of Japan (which term as used herein means any person resident in Japan, including any corporation or other entity organised under the laws of Japan), or to others for re-offering or resale, directly or indirectly, in Japan or to a resident of Japan except pursuant to an exemption from the registration requirements of, and otherwise in compliance with, the Securities and Exchange Law and any other applicable laws and regulations of Japan.

France

Each of the Dealers and the Issuer has represented and agreed, and each further Dealer appointed under the Programme will be required to represent and agree that, in connection with their initial distribution, it has not offered or sold and will not offer or sell, directly or indirectly, Notes to the public in the Republic of France, and has not distributed or caused to be distributed and will not distribute or cause to be distributed to the public in the Republic of France, the Offering Circular or any other offering material relating to Notes, and that such offers, sales and distributions have been and shall only be made in France to (i) qualified investors (*investisseurs qualifiés*) and/or (ii) a restricted group of investors (*cercle restreint d'investisseurs*), all as defined in and in accordance with Article 6 of *ordonnance* no. 67-833 dated 28th September, 1967 (as amended) and *décret* no. 98-880 dated 1st October, 1998.

Where an issue of Notes is effected as an exception to the rules relating to an *appel public à l'épargne* in the Republic of France (public offer rules) by way of an offer to a restricted circle of investors (as referred to in (ii) above), such investors must, to the extent that the Notes are offered to 100 or more of such investors, provide certification as to their personal relationship of a professional or family nature with a member of the management of the Issuer. In the context of such exception, investors in the Republic of France may only participate in the issue of Notes for their own account in accordance with the conditions set out in *décret* no. 98-880 dated 1st October, 1998. Notes may only be issued, directly or indirectly, to the public in the Republic of France in accordance with articles 6 and 7 of *ordonnance* no. 67-833 dated 28th September, 1967 (as amended).

Germany

Each Dealer has agreed and each further Dealer appointed under the Programme will be required to agree that it will not offer and sell Notes in the Federal Republic of Germany otherwise than in compliance with the Securities Sales Prospectus Act (*Wertpapier-Verkaufsprospektgesetz*) of 13th December, 1990 (as amended) and any other laws applicable in the Federal Republic of Germany governing the issue, offering and sale of securities.

The Netherlands

Each Dealer has represented and agreed and each further Dealer appointed under the Programme will be required to represent and agree that it has not, directly or indirectly, offered or sold and will not, directly or indirectly, offer or sell in The Netherlands any Notes other than to persons who trade or invest in securities in the conduct of a profession or business (which include banks, stockbrokers, insurance companies, pension funds, other institutional investors and finance companies and treasury departments of large enterprises).

General

Each Dealer has agreed and each further Dealer appointed under the Programme will be required to agree that it will comply with all applicable securities laws and regulations in force in any jurisdiction in which it purchases, offers, sells or delivers Notes or possesses or distributes

this Offering Circular and will obtain any consent, approval or permission required by it for the purchase, offer, sale or delivery by it of Notes under the laws and regulations in force in any jurisdiction to which it is subject or in which it makes such purchases, offers, sales or deliveries and neither the Issuer nor any of the other Dealers shall have any responsibility therefor.

None of the Issuer and the Dealers represents that Notes may at any time lawfully be sold in compliance with any applicable registration or other requirements in any jurisdiction, or pursuant to any exemption available thereunder, or assumes any responsibility for facilitating such sale.

With regard to each Tranche, the relevant Dealer will be required to comply with such other restrictions as the Issuer and the relevant Dealer shall agree and as shall be set out in the applicable Pricing Supplement.

GENERAL INFORMATION

Authorisation

The establishment of the Programme and the issue of Notes have been duly authorised by a resolution of the Public Offering and Privatisation Committee of the Board of Directors of the Issuer dated 31st July, 2000.

Listing of Notes on the Luxembourg Stock Exchange

Application has been made to list Notes issued under the Programme on the Luxembourg Stock Exchange. A legal notice relating to the Programme and the constitutional documents of the Issuer are being lodged with the Registrar of the District Court in Luxembourg (*Greffier en Chef du Tribunal d'Arrondissement de et à Luxembourg*) where such documents may be examined and copies obtained. The Luxembourg Stock Exchange has allocated the number 12413 to the Programme for listing purposes.

Documents Available

So long as Notes are capable of being issued under the Programme, copies of the following documents will, when signed or published, be available free of charge from the registered office of the Issuer and from the specified offices of the Paying Agents for the time being in London and Luxembourg:

- (i) the Memorandum and Articles of Association (with an English translation thereof) of the Issuer;
- (ii) the consolidated audited financial statements of the Issuer in respect of the financial years ended 31st December, 1998 and 1999. The Issuer currently prepares audited consolidated accounts on an annual basis;
- (iii) the most recently published audited annual financial statements of the Issuer and the most recently published unaudited interim consolidated and non-consolidated (if any) financial statements of the Issuer (with an English translation thereof). The Issuer currently publishes unaudited consolidated interim accounts on a quarterly and semi-annual basis. The Issuer does actually not publish non-consolidated interim accounts;
- (iv) the Programme Agreement, the Agency Agreement, the Trust Deed and the forms of the Global Notes, the Notes in definitive form, the Receipts, the Coupons and the Talons;
- (v) a copy of this Offering Circular;
- (vi) any future offering circulars, prospectuses, information memoranda and supplements including Pricing Supplements (save that a Pricing Supplement relating to an unlisted Note will only be available for inspection by a holder of such Note and such holder must produce evidence satisfactory to the Issuer and the Paying Agent as to its holding of Notes and identity) to this Offering Circular and any other documents incorporated herein or therein by reference; and
- (vii) in the case of each issue of listed Notes subscribed pursuant to a subscription agreement, the subscription agreement (or equivalent document).

Clearing Systems

The Notes have been accepted for clearance through Euroclear and CBL. The appropriate Common Code and ISIN for each Tranche of Notes allocated by Euroclear and CBL will be specified in the applicable Pricing Supplement. If the Notes are to clear through an additional or alternative clearing system the appropriate information will be specified in the applicable Pricing Supplement.

Significant or Material Change

Save as disclosed in this Offering Circular, there has been no significant change in the financial or trading position of the Issuer or its subsidiaries (the "**Group**") since 31st March, 2000 and there has been no material adverse change in the financial position or prospects of the Group since 31st December, 1999.

Litigation

Save as provided herein and in the notes to the financial statements set out herein, neither the Issuer nor any other member of the Group is or has been involved in any legal or arbitration proceedings (including any proceedings which are pending or threatened of which the Issuer is

aware) which may have or have had in the 12 months preceding the date of this document a significant effect on the financial position of the Issuer or the Group.

Auditors

The auditors of the Issuer are KPMG Somekh Chaikin, who have audited the Issuer's accounts, without qualification, in accordance with generally accepted auditing standards in Israel for each of the three financial years ended on 31st December, 1999.

Banking Act 1987 (Exempt Transactions) Regulations 1997

Notes (including Notes denominated in sterling) in respect of which the issue proceeds are to be accepted by the Issuer in the United Kingdom and which are issued pursuant to an exempt transaction under regulation 13(1) or (3) of the Banking Act 1987 (Exempt Transactions) Regulations 1997 (the "**Regulations**") will constitute commercial paper, shorter term debt securities or longer term debt securities (in each case as defined in the Regulations), as specified in the applicable Pricing Supplement, in each case issued in accordance with regulations made under section 4 of the Banking Act 1987. The Issuer is not an authorised institution or a European authorised institution (as such terms are defined in the Regulations) and repayment of the principal and payment of any interest or premium in connection with such Notes will not be guaranteed.

March 28, 2000

**Auditor's Report to the Shareholders of
Bezeq The Israel Telecommunication Corp. Limited**

We have audited the accompanying balance sheets of Bezeq The Israel Telecommunication Corp. Limited (the "Company") as at December 31, 1999 and December 31, 1998, and the consolidated balance sheets as at such dates and the related statements of income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 1999. These financial statements are the responsibility of the Company's Board of Directors and its Management. Our responsibility is to express an opinion on these financial statements based on our audits.

We did not audit the financial statements of certain subsidiaries, whose assets constitute approximately 3% and approximately 5% of the total consolidated assets as at December 31, 1999 and December 31, 1998, respectively, and whose revenues constitute approximately 7%, 8% and 14% of the total consolidated revenues for the years ended December 31, 1999, 1998 and 1997, respectively. The financial statements of those subsidiaries were audited by other auditors whose reports thereon were furnished to us. Our opinion, insofar as it relates to amounts emanating from the financial statements of such subsidiaries, is based solely on the said reports of the other auditors. Furthermore, the data included in the financial statements relating to the net asset value of the Company's investments in affiliates and to its equity in their operating results is based on the financial statements of such affiliates, some of which were audited by other auditors.

We conducted our audits in accordance with generally accepted auditing standards, including standards prescribed by the Auditors' Regulations (Manner of Auditor's Performance), 1973. Such standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by the Board of Directors and by Management, as well as evaluating the overall financial statement presentation. We believe that our audits and the reports of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and on the reports of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of the Company and the consolidated financial position of the Company and its subsidiaries as at December 31, 1999 and December 31, 1998 and the results of their operations, the changes in the shareholders' equity and their cash flows for each of the three years in the period ended December 31, 1999, in conformity with generally accepted accounting principles. Furthermore, in our opinion, the financial statements referred to above are prepared in conformity with the Securities Regulations (Preparation of Annual Financial Statements), 1993.

As explained in Note 2, the abovementioned financial statements are stated in values adjusted for the changes in the general purchasing power of the Israeli currency, in accordance with opinions of the Institute of Certified Public Accountants in Israel.

Without qualifying our opinion, we draw attention to the uncertainties relating to the following matters, for which the maximum possible exposure is significant:

1. The anticipated opening of the communications sector to competition, changes in tariffs and their effect on the Company's financial position and operating results, as described in Note 1.
2. A program for an additional reorganization, as described in Note 17D (2).
3. Claims made against the Company and against investee companies, as described in Note 21A.

KPMG Somekh Chaikin
Certified Public Accountants (Isr.)

AUDITED ANNUAL FINANCIAL STATEMENTS

Balance Sheets

In terms of shekels of December 1999

Note	Consolidated		Company		
	December 31, 1999	December 31, 1998	December 31, 1999	December 31, 1998	
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	
ASSETS					
Current assets					
Cash and cash equivalents	3	664,237	932,287	486,162	805,031
Short-term investments	4	301,140	385,825	294,457	158,014
Trade receivables	5	1,522,844	1,552,672	1,008,146	1,071,572
Other receivables and debit balances	6	482,522	439,239	388,048	411,233
Inventory		110,210	57,033*	—	—
		<u>3,080,953</u>	<u>3,367,056</u>	<u>2,176,813</u>	<u>2,445,850</u>
Materials and spare parts		<u>231,248</u>	<u>234,848*</u>	<u>231,248</u>	<u>234,848</u>
Investments and long-term receivables					
Deposits and debit balances	7	275,743	316,557	257,492	277,702
Investments in investee companies	8	75,498	36,546	1,479,571	1,540,981
		<u>351,241</u>	<u>353,103</u>	<u>1,737,063</u>	<u>1,818,683</u>
Fixed assets					
Cost	9	28,751,669	28,665,372	25,643,973	26,024,730
Less — accumulated depreciation		16,095,221	14,750,634	14,573,613	13,596,938
		<u>12,656,448</u>	<u>13,914,738</u>	<u>11,070,360</u>	<u>12,427,792</u>
Other assets					
Deferred charges and other assets	10	255,230	22,781	13,225	19,853
Deferred taxes	11	237,737	334,837*	248,816	348,177
		<u>492,967</u>	<u>357,618</u>	<u>262,041</u>	<u>368,030</u>
		<u>16,812,857</u>	<u>18,227,363</u>	<u>15,477,525</u>	<u>17,295,203</u>
LIABILITIES					
Current liabilities					
Short-term bank credit	12	271,006	—	—	—
Current maturities of:					
Debenture issued to the					
Government of Israel	13	470,954	941,316	470,954	941,316
Long-term bank loans	14	1,053,418	1,090,549	983,615	1,043,133
Other debentures	15	225,517	206,518	225,517	206,518
Trade payables	16	1,156,374	997,469	654,624	527,309
Dividend payable		301,565	—	301,565	—
Employee severance benefits	17	351,185	637,707	351,185	637,707
Other current liabilities	18	825,777	1,066,020	694,358	928,084
		<u>4,655,796</u>	<u>4,939,579</u>	<u>3,681,818</u>	<u>4,284,067</u>
Long-term liabilities					
Debenture issued to the Government					
of Israel	13	—	470,658	—	470,658
Long-term loans	14	3,236,604	3,619,892	2,862,097	3,332,147
Other debentures	15	1,253,620	1,213,815	1,253,620	1,213,815
Convertible debentures	19	—	419,470	—	419,470
Employee severance benefits	17	78,463	93,118	79,375	91,714
Deferred taxes	11	19,362	24,556*	—	—
Deferred revenues	20	78,780	85,121	110,383	122,178
		<u>4,666,829</u>	<u>5,926,630</u>	<u>4,305,475</u>	<u>5,649,982</u>
Convertible debentures	19	<u>233,699</u>	<u>—</u>	<u>233,699</u>	<u>—</u>
Contingent liabilities					
	21	—	—	—	—
Shareholders' equity					
	22	<u>7,256,533</u>	<u>7,361,154</u>	<u>7,256,533</u>	<u>7,361,154</u>
		<u>16,812,857</u>	<u>18,227,363</u>	<u>15,477,525</u>	<u>17,295,203</u>

Israel (Izzy) Tapoohi
Chairman of the Board

Iris Stark
Member of the Board

Ilan Biran
CEO

Date of approval of the financial statements: March 23, 1999

The notes to the financial statements are an integral part thereof.

Statements of Operations
In terms of shekels of December 1999

	Note	Consolidated			Company		
		1999	1998	1997	1999	1998	1997
		NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues from telecommunications services							
	23	<u>9,143,350</u>	<u>9,514,025*</u>	<u>9,578,576*</u>	<u>7,458,820</u>	<u>7,680,869*</u>	<u>7,314,733*</u>
Costs and expenses							
Operating and general expenses							
	24	<u>5,111,469</u>	<u>4,988,371*</u>	<u>5,057,104*</u>	<u>3,927,405</u>	<u>3,939,791*</u>	<u>3,766,011*</u>
Depreciation							
	9	<u>2,720,919</u>	<u>2,509,146</u>	<u>2,500,971</u>	<u>2,293,311</u>	<u>2,127,913</u>	<u>2,160,359</u>
Royalties to the Government of Israel							
		<u>301,358</u>	<u>354,672</u>	<u>388,359</u>	<u>208,207</u>	<u>248,033</u>	<u>272,310</u>
		<u>8,133,746</u>	<u>7,852,189</u>	<u>7,946,434</u>	<u>6,428,923</u>	<u>6,315,737</u>	<u>6,198,680</u>
Operating income							
		<u>1,009,604</u>	<u>1,661,836</u>	<u>1,632,142</u>	<u>1,029,897</u>	<u>1,365,132</u>	<u>1,116,053</u>
Financing expenses							
On debentures issued to the Government of Israel							
		<u>56,060</u>	<u>101,695</u>	<u>209,022*</u>	<u>56,060</u>	<u>101,695</u>	<u>209,022*</u>
Banks and others, net (including inflationary erosion in value)							
	25	<u>304,012</u>	<u>354,119</u>	<u>421,533</u>	<u>308,627</u>	<u>375,907</u>	<u>420,074</u>
		<u>360,072</u>	<u>455,814</u>	<u>630,555</u>	<u>364,687</u>	<u>477,602</u>	<u>629,096</u>
Earnings after financing expenses							
		<u>649,532</u>	<u>1,206,022</u>	<u>1,001,587</u>	<u>665,210</u>	<u>887,530</u>	<u>486,957</u>
Other income (expenses), net							
	26	<u>(558,458)</u>	<u>42,762*</u>	<u>(1,262,726)*</u>	<u>(482,770)</u>	<u>51,419*</u>	<u>(1,249,069)*</u>
Earnings (loss) before income tax							
		<u>91,074</u>	<u>1,248,784</u>	<u>(261,139)</u>	<u>182,440</u>	<u>938,949</u>	<u>(762,112)</u>
Tax benefit (income tax)							
	11	<u>(62,796)</u>	<u>(491,230)</u>	<u>37,957</u>	<u>(70,379)</u>	<u>(374,297)</u>	<u>232,908</u>
Earnings (loss) after income tax							
		<u>28,278</u>	<u>757,554</u>	<u>(223,182)</u>	<u>112,061</u>	<u>564,652</u>	<u>(529,204)</u>
Equity in earnings (losses) of investee companies							
	8	<u>(21,550)</u>	<u>6,468</u>	<u>(22,039)</u>	<u>(105,333)</u>	<u>199,370</u>	<u>283,983</u>
Net earnings (loss)							
		<u>6,728</u>	<u>764,022</u>	<u>(245,221)</u>	<u>6,728</u>	<u>764,022</u>	<u>(245,221)</u>
Earnings per share							
Primary and diluted earnings (loss) per NIS 1 par value of common shares (in NIS)							
	27	<u>0.02</u>	<u>1.00</u>	<u>(0.33)</u>	<u>0.02</u>	<u>1.00</u>	<u>(0.33)</u>

* Reclassified

The notes to the financial statements are an integral part thereof.

Statement of Changes in Shareholders' Equity
In terms of shekels of December 1999

	Share capital	Receipts from issue of warrants	Capital reserve share premium (5)	Capital reserve in respect of transactions between the Company and a controlling shareholder	Retained earnings	Total
	NIS thousands					
Balance as at January 1,						
1997	4,078,550	—	200,741	—	2,293,649	6,572,940
Changes in 1997 —						
Net loss	—	—	—	—	(245,221)	(245,221)
Final dividend for preceding year — net (1)	—	—	—	—	(81,456)	(81,456)
Compensation to the Company's employees from the State	—	—	—	5,555	—	5,555
Balance as at						
December 31, 1997	4,078,550	—	200,741	5,555	1,966,972	6,251,818
Changes in 1998 —						
Net earnings	—	—	—	—	764,022	764,022
Public issues	—	80,587	—	—	—	80,587
Issue to employees (2)	4,637	—	35,806	—	—	40,443
Offer to employees	—	—	—	3,482	—	3,482
Compensation to the Company's employees from the State	—	—	—	26,613	—	26,613
Exercise of warrants (3) ...	31,542	(80,587)	240,721	—	—	191,676
Conversion of convertible debentures (4)	237	—	2,276	—	—	2,513
Balance as at						
December 31, 1998	<u>4,114,966</u>	<u>—</u>	<u>479,544</u>	<u>35,650</u>	<u>2,730,994</u>	<u>7,361,154</u>
Changes in 1999 —						
Net earnings	—	—	—	—	6,728	6,728
Dividend for preceding year	—	—	—	—	(301,565)	(301,565)
Conversion of convertible debentures (6)	17,903	—	172,313	—	—	190,216
Balance as at						
December 31, 1999	<u>4,132,869</u>	<u>—</u>	<u>651,857</u>	<u>35,650</u>	<u>2,436,157</u>	<u>7,256,533</u>

Notes:

- (1) Including inflationary erosion of dividend, which was proposed in the previous year and paid in the current year.
- (2) 4,215,844 ordinary shares of NIS 1 par value were issued to employees.
- (3) Pursuant to a prospectus from February 27th, 1998 the Company issued to the public 29,250,000 warrants exercisable into Company shares (Series C). These options were converted into 29,250,000 ordinary shares with a par value of NIS 1 each.
- (4) 2,336,657 par value convertible debentures were converted into 230,895 ordinary shares of a par value of NIS 1 each.
- (5) After deduction of assigned issue expenses in the amount of NIS 3,977,000 in respect of 1998.
- (6) 178,187,698 par value convertible debentures were converted into 17,607,480 ordinary shares with a par value of NIS 1 each.

The notes to the financial statements are an integral part thereof.

Statement of Cash Flows
In terms of shekels of December 1999

	Consolidated			Company		
	1999	1998	1997	1999	1998	1997
	NIS thousands			NIS thousands		
Cash flows generated by operating activities						
Net earnings (loss)	6,728	764,022	(245,221)	6,728	764,022	(245,221)
Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities (see A below) ...	<u>2,368,426</u>	<u>2,254,565</u>	<u>3,666,605</u>	<u>2,139,072</u>	<u>1,730,248</u>	<u>3,044,133</u>
Net cash inflow generated by operating activities	<u>2,375,154</u>	<u>3,018,587</u>	<u>3,421,384</u>	<u>2,145,800</u>	<u>2,494,270</u>	<u>2,798,912</u>
Cash flows generated by investing activities						
Acquisition of fixed and other assets ..	(1,417,578)	(1,862,647)	(2,065,689)	(920,584)	(1,236,799)	(1,630,413)
Proceeds from disposal of fixed assets	20,112	65,016	44,413	16,311	51,473	22,309
Investment in long-term deposits and investments	(15,820)	(100,035)*	(41,013)*	(4,989)	(65,370)*	(34,687)*
Proceeds from long-term deposits and investments	112,707	20,430*	296*	83,194	18,954*	—*
Decrease (increase) in short-term investments, net	85,002	(8,222)	(266,669)	(136,126)	(41,436)	(227)
Decrease (increase) in materials and spare parts	(80,034)	87,749*	90,538*	(80,033)	87,748	87,333
Disposal (investment) in investee companies	(60,502)	4	(4,618)	(43,923)	(3,364)	(97,319)
Investments in other assets	(290,430)	—	—	(130)	—	—
Net cash outflow generated by investment activities	<u>(1,646,543)</u>	<u>(1,797,705)</u>	<u>(2,242,742)</u>	<u>(1,086,280)</u>	<u>(1,188,794)</u>	<u>(1,653,004)</u>
Cash flows generated by financing activities						
Repayment of debentures issued to the Government of Israel	(938,612)	(928,504)	(927,702)	(938,612)	(928,504)	(927,702)
Issue of other debentures (net of issue expenses)	263,253	69,103	304,422	263,253	69,103	304,422
Repayment of other debentures	(206,575)	(240,792)	(229,785)	(206,575)	(240,792)	(229,785)
Receipt of long-term loans	720,809	725,248	712,526	559,319	610,702	579,332
Repayment of long-term loans	(1,106,542)	(1,270,100)	(738,248)	(1,055,774)	(1,185,110)	(713,721)
Receipt (repayment) of short-term bank credit	271,006	(18,823)	(20,147)	—	(7,785)	7,785
Dividend paid	—	—	(222,898)	—	—	(222,898)
Proceeds from issue of shares to employees (net of issue expenses) ..	—	26,502	—	—	26,502	—
Proceeds from issue of share options (net of issue expenses)	—	80,587	—	—	80,587	—
Proceeds from convertible debentures and options on them (net of issue Expenses)	—	407,719	—	—	407,719	—
Proceeds from exercise of options	—	191,676	—	—	191,676	—
Net cash inflow (outflow) generated by financing activities	<u>(996,661)</u>	<u>(957,384)</u>	<u>(1,121,832)</u>	<u>(1,378,389)</u>	<u>(975,902)</u>	<u>(1,202,567)</u>
Increase (decrease) in cash and cash equivalents	(268,050)	263,498	56,810	(318,869)	329,574	(56,659)
Cash and cash equivalents at beginning of year	932,287	668,789	611,979	805,031	475,457	532,116
Cash and cash equivalents at end of year	664,237	932,287	668,789	486,162	805,031	475,457

* Reclassified

The notes to the financial statements are an integral part thereof.

	Consolidated			Company		
	1999	1998	1997	1999	1998	1997
	NIS thousands			NIS thousands		
A — Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities						
Revenues and expenses not involving cash flows:						
Depreciation	2,720,919	2,509,146	2,500,971	2,293,311	2,127,913	2,160,359
Provision for decrease in value	106,380	14,623	—	106,380	14,623	—
Deferred taxes	79,290	164,068	(330,075)	72,884	172,998	(317,689)
Company's equity in losses (earnings) of Investee companies, net	21,550	(6,468)	22,039	105,333	(115,400)	(238,114)
Provision for decrease in value of affiliate	(14,919)	—	87,074	(14,919)	—	87,074
Increase (decrease) in employee severance benefits, net	(301,177)	(745,385)	1,053,583	(298,861)	(745,286)	1,052,449
Loss (gain) on disposal of fixed assets	(16,391)	(4,686)	604	(17,454)	(13,027)	6,619
Imputed salaries expense	—	44,036	5,555	—	44,036	5,555
Erosion (appreciation) of and interest on Long-term deposits and investments	16,933	(68,202)*	24,200*	16,933	(68,202)*	24,200*
Erosion (appreciation) of short-term Investments, net	(317)	5,272	(3,599)	(317)	5,272	(9,013)
Appreciation (erosion) of long-term Liabilities:						
Debenture issued to the Government of Israel ..	(2,408)	(21,916)	18,853	(2,408)	(21,916)	18,853
Other debentures	817	(5,961)	20,082	817	(5,961)	20,082
Long-term loans	(36,222)	246,755	72,898	(34,985)	233,955	69,396
Convertible debentures	140	(807)	—	140	(807)	—
Amortization and other adjustments	58,818	8,336	5,725	7,595	7,982	5,725
Changes in asset and liability items:						
Decrease (increase) in trade receivables	54,801	(51,630)	189,152	86,477	(60,970)	212,433
Decrease (increase) in other Receivables and debit balances	(105,595)	117,748	(64,764)	(25,266)	92,430	(60,345)
Increase (decrease) in inventory	(81,943)	(25,065)*	22,985*	—	—	—
Increase in trade payables	92,884	9,109	116,675	67,483	19,206	41,868
Increase (decrease) in other current liabilities ...	(218,793)	64,156	(114,358)	(212,276)	41,965	(111,379)
Increase in deferred revenues	(6,341)	1,436	39,005	(11,795)	1,437	76,060
	<u>2,368,426</u>	<u>2,254,565</u>	<u>3,666,605</u>	<u>2,139,072</u>	<u>1,730,248</u>	<u>3,044,133</u>
B — Non-cash transactions						
Acquisition of fixed assets, materials and spare parts on credit	<u>324,161</u>	<u>258,361</u>	<u>298,571</u>	<u>263,327</u>	<u>203,377</u>	<u>227,788</u>
Sale of fixed assets on credit	<u>23,051</u>	<u>—</u>	<u>—</u>	<u>23,051</u>	<u>—</u>	<u>—</u>
Proposed dividend	<u>301,565</u>	<u>—</u>	<u>—</u>	<u>301,565</u>	<u>—</u>	<u>—</u>
Transfer of fixed assets, net, after Deduction of provision for taxes in an affiliate	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>(6,739)</u>

* Reclassified

The notes to the financial statements are an integral part thereof.

NOTES TO THE FINANCIAL STATEMENTS AS AT DECEMBER 31, 1999

NOTE 1 — GENERAL

- A. "Bezeq" — The Israel Telecommunication Corp. Limited (hereinafter — the Company) is controlled by the State of Israel and therefore, is subject to the provisions of the Government Companies Law, 5735-1975. The Company operates under a general license awarded under the Telecommunications Law, 5742-1982, which authorizes it to engage in telecommunication business and provide telecommunication services. The Company's license, which was granted on March 1, 1994 (and amended on various dates), sets out the terms under which the Company shall operate, and provides, inter alia, that the Company shall continue to provide telephone and related services, and infrastructure services, and shall operate through subsidiaries which will engage in providing services in areas which were opened to competition. Under the license, the management of the subsidiaries is to be separate from the management of the Company. It was also determined that the provision of new services by the Company is contingent upon receipt of a license from the Ministry of Communications. Limits were also imposed on the extent of the Company's financial exposure with regard to projects undertaken outside Israel. The limits are U.S. \$20 million in respect of a single project, and an overall amount of U.S. \$100 million in respect of all projects. The Minister of Communications may permit the Company to exceed these limits for specified periods.
- B. The Company's operations are supervised by the Government and most of the tariffs for its services are determined in accordance with Section 15 of the Telecommunications Law, 5742-1982, and are updated according to regulations.

In October 1998, the committee for the arrangement of the Company's tariffs submitted its recommendations for a new tariff arrangement from January 1, 1999.

According to the announcement of the Director General of the Ministry of Communications in March 1999, the Ministers of Communications and Finance decided to adopt the recommendations of the committee for the arrangement of the Company's tariffs, with certain amendments. Below are the principal recommendations:

- (1) The decrease in the average level of telecommunications tariffs during the new tariff arrangement period will be 6.03%, in view of the rise in the rate of inflation beyond that foreseen by the committee.

Taking into account that application of the new arrangement was postponed from January 1, 1999 to April 1, 1999, the reduction in tariffs for 1999 alone was an actual 8.04%, since the increase in usage fees took effect only on May 1, 1999 and not on April 1, 1999, the overall reduction on April 1, 1999 amounted to 7.7%, and the percentage which will be added on January 1, 2000 will be 1.72%.

- (2) The efficiency factor of the Company's tariffs ("the efficiency factor") averaged 6% in 1999 and will average 7% in 2000. This factor will be updated in the three years 2001 to 2003 to between 3.5% — 8%, depending on the average rate of increase in Company aggregate outputs in the years 1999-2000.
- (3) In order to enable the Company to compete in the Internet access market, the Company will be permitted to offer a reduced package for these services.
- (4) The Ministries of Telecommunications and Finance will act to change the existing arrangement between the Broadcasting Authority and the Company so that within four years, the payments of the Broadcasting Authority will cover the costs of the services which the Broadcasting Authority will purchase from the Company, or an alternative arrangement.

Commencing April 1, 1999, the tariffs of the Company were updated in accordance with the regulations that were approved by the Finance Committee of the Knesset. Below are the principal updates:

- The price of call units was reduced by 21.34%.
- Usage fees per fixed line were raised by 16% (effective from May 1, 1999).
- The fee for the segment in land-to-mobile calls that passes through the Bezeq network was reduced by 63%.
- Interconnect fees for international operators were reduced by 65%.
- Data communication service tariffs, among them the Sifranet service, were raised by an average rate of 51.5%, and frame relay service by an average rate of 42%.

Under the regulations, starting from January 1, 2000 the efficiency factor will be 7%. The regulations do not include the examination and adaptation mechanism of the efficiency factor as appears in the notice of the Director General of the Ministry of Communications from March 1999.

The tariff update that was scheduled for January 1, 2000 was postponed, at the request of the Company and in coordination with the Ministry of Communications, to May 1, 2000. Pursuant to the decision of the Finance and Economics Committees of the Knesset from March 13, 2000, a change was made in the method of charging for calls, principally a change from charging by call unit to charging by time, as well as a reduction in the Company's tariffs by an average rate of 2.43%. The Company also decided to offer a number of tariff baskets to Internet users which will signify a reduction in tariffs.

- C. As of April 1, 1997, the Company and its subsidiary, Bezeq International Ltd. are required to pay royalties to the Government of Israel at the rate of 5% of their revenues (until then the rate was 8%). Pelephone Communications Ltd. is required to pay royalties at the rate of 8% of its revenues.

- D. In June 1995, the Director General of the Anti-Trust Authority declared the Company a monopoly in the following areas: basic telephone service, telecommunications infrastructure services, two-way unrestricted international telephone services, including international telephone service for incoming calls and relay transfer and transmission services for public broadcasting. In March 2000 application was made to the Director General of the Anti-Trust Authority for cancellation of the announcement of the Company as a monopoly in the area of basic telephone service. In its application, the Company requests the comments of the Director General to its claim that this area includes both fixed telephony and mobile telephony, and since the announcement the status of the Company therein has changed.
- E. Below are the significant changes which have occurred in recent years with regard to the monopoly which the Company enjoyed in providing telecommunications services in Israel, pursuant to the 1992 amendment of Section 50 of the Telecommunications Law, 5742-1982:

(1) Cellular Services

Cellular services are currently provided by three companies, of which one — Pelephone Communications Ltd. — is 50% owned by the Company.

The Ministry of Communications is considering making a change in the general license for cellular services, which was awarded to the companies. The proposed change would change the method of calculating incoming call tariffs, and if applied, is liable to have a materially adverse effect on the future operating expenses of a proportionally consolidated company, Pelephone Communications Ltd. The management of Pelephone Communications Ltd. opposes the proposed change and the issue is being discussed with the Ministry of Communications.

(2) International Communication Services

At the beginning of July 1997, two new companies began providing international communication services at tariffs that were significantly lower than those then in effect. The subsidiary company Bezeq International Ltd. also lowered its tariffs by more than 50%. Interconnect fees with operators around the world were also lowered considerably. The tariffs of the subsidiary are fixed at its discretion owing to the decline of its market share to below 60%. If its market share returns to more than 60%, the table of tariffs will be changed in accordance with rules set by the Ministry of Communications.

At the beginning of July 1997, new regulations were promulgated for the purpose of requiring all the companies operating international telecommunication services to pay the Company a fee for "interconnect services". In addition, the general license awarded to the international operators obligates them to pay a fee to the Company for "access services" until December 31, 2001 which will be linked to the U.S. dollar, the currency basket and to the CPI.

Pursuant to an amendment to the license of Bezeq International Ltd. relating to the process of allocating subscribers to the various operators, Bezeq International Ltd. and the Company filed petitions in the High Court of Justice. On September 26, 1999, a decision on the petitions was handed down, with the consent of the parties, whereby the allocation process would be carried out in two stages:

- (a) In stage one — and not later than December 1, 1999 — all customers not yet lawfully allocated would be approached in a letter worded by the Ministry of Communications, in which they would be requested to select one of the international operators.
- (b) In stage two — for a subscriber who had not given notice of his selection of an international communications operator, the dial codes 00 and 188 will be blocked, and he will have the option of using the individual dial codes of each operator (012, 013 and 014). Stage two was to be completed by May 1, 2000 at the latest.

The court also decided that customers, who were registered as subscribers by the other competing companies up to the time of the referendum, would be deemed to be the subscribers of those companies and need not be approached. On the other hand, customers who registered during the "Family and friends" campaign of Bezeq International Ltd. would not be deemed to be allocated to that company. Furthermore, the court ruled, "without giving a specific opinion", that the competing companies would retain the right to sue for damages allegedly incurred by them due to postponement of the date of allocation of customers to the international communications operators.

Following the decision, the general license of the international operators was amended in accordance with the above decision of the High Court of Justice.

Implementation of the allocation process as in the court ruling is liable to have a materially adverse effect on Bezeq International Ltd. and its operations. In 1999 Bezeq International recorded direct expenses of approximately NIS 76 million in respect of the allocation process. The company also incurred costs for the technical operation of the allocation. Pursuant to the amendment to the Company's license, the international operators must bear these costs, except for the cost of the initial allocation of the subscriber.

On November 4, 1999 the Minister of Communications signed an amendment to the license of Bezeq International Ltd., obligating the company to present a bank guarantee in the amount of 20 million dollars for fulfillment of all the terms of its license. In the opinion of the management of Bezeq International Ltd., based on the opinion of its legal advisers, it is not required to present such a guarantee. Up to the date of approval of the financial statements, no guarantee had been presented.

The Company, based on the assessment of Bezeq International Ltd., estimates that following the changes in the business environment in which Bezeq International Ltd. has been operating since the start of competition, additional changes are likely to occur in international communications, inter alia, in tariffs, market share and traffic ratio. This could lead to a material decrease in the financial results of the Group.

(3) Domestic Communication Services

An inter-ministerial committee established for the purpose of examining policy for the telecommunication industry and the opening of the industry to competition submitted its recommendations to the Minister of Finance and the Minister of Communications in December 1996. These included, inter alia, a recommendation for the amendment of Section 50 of the Telecommunications Law, 5742-1982, enabling the Minister of Communications to grant others a general license for the provision of telecommunication services in a nationwide telephone network.

The Government adopted the recommendations of the committee. The Ministers of Finance and Communications then appointed a team to formulate detailed recommendations (hereinafter — the Implementation Team). The Implementation Team submitted its recommendations to the Ministers on October 30th, 1997, and in September 1998 submitted a series of revisions to those recommendations, clarifying several issues that had been inadequately explained and changing some other recommendations. The changes include:

- (a) A licensee will be permitted to provide a certain service of his choice, fulfilling all the conditions and duties relating to the provision of that service, without being obligated to provide any other service except for auxiliary services. Accordingly, the licensee will be able to operate in one or more of the fields of infrastructure, transmission, data communications and voice telephony.
- (b) The new operators will be permitted to provide their services all over the country, but will be required to provide them in a "broad region of demand". This region will be defined in the license of each operator, and will include twelve "natural regions". The broad region of demand of a cable television services licensee will be a group of concession regions that includes all the concession regions of that licensee. Definition of the natural regions is based on an administrative division of the country into 41 such "natural regions". The broad region of demand of the Company is the entire country.

The Ministry of Communications applied to the public in November 1998, requesting it to present a position on the terms of the general license for providing domestic telecommunications services, and the conditions and criteria for granting the license. The request incorporated a draft of a general license for a domestic operator and a draft license for the Company, which would replace its existing license. The Company submitted its response to the request.

In February 1999, Section 50 of the Telecommunications Law, 5742-1982 was repealed. The section granted the Company exclusivity in providing nationwide telecommunication services in a national network of telephones under the general license. The repeal took effect on June 1, 1999, but activities of new operators in domestic fixed-line communications will be permitted only from the date on which the Ministry of Communications awards them a general license.

On August 22nd, 1999, two government decisions were adopted concerning the acceleration and increase of competition in domestic communications during 1999, and in the area of mobile personal communications during 2000. In addition, as part of the steps for the acceleration of competition, the Ministry of Communications intends to publish tenders for awarding licenses for LMDS broadband wireless access.

In January 2000, under the Arrangement in the State Economy Law, a number of amendments were inserted into the Telecommunications Law, which the Ministry of Communications believed were necessary prior to opening the communications market to full competition.

The reduction in tariffs on April 1st, 1999 has led to a significant downturn in the business results of the Company. This trend is expected to continue as a result of the reduction in tariffs which will take effect on May 1st, 2000, the opening of fixed-line domestic communication services to full competition, and the increasing competition in the areas of cellular and international communications, which cannot be estimated at this stage.

- F.** On October 20, 1999, the Ministerial Committee for Privatization resolved to require the Government Companies Authority, in coordination with the relevant government ministries, to submit to the Ministerial Committee for Privatization a proposed resolution for the privatization of all of the State's holdings in the Company, together with a document setting out the considerations for determining the percentage of control core to be sold.

Following the above decision, on November 22nd, 1999 the Government Companies Authority submitted to the Company a proposal for privatization of the Company by way of a private placement. In accordance with Section 59B(d) of the Government Companies Law, 5735-1975, the preliminary response of the Board of Directors of the Company was submitted to the Government Companies Authority.

The Company is unable to estimate if, when and how all or some of the State's shares in the Company will be sold.

On May 12th, 1999, the General Meeting of the Shareholders of the Company resolved to approve changes in the Company's bylaws, some of which would take effect immediately and some on the date on which the State's holdings in the issued and paid up capital of the Company would fall to 50% or less.

In the Company's opinion, the result of these provisions in the bylaws is that even after the State's holdings fall below 50%, the Government will continue to control it as long as the State holds 10% or more of the share capital of the Company, unless another person controls the Company pursuant to approval under the Telecommunications Order.

NOTE 2 — SIGNIFICANT ACCOUNTING PRINCIPLES AND REPORTING POLICIES

A. Definitions

In these financial statements —

- (1) *Consolidated company*— A company whose financial statements are fully consolidated, directly or indirectly, with the financial statements of the Company.
- (2) *Proportionately consolidated company*— A company whose financial statements are proportionally consolidated, directly or indirectly, with the financial statements of the Company.
- (3) *Affiliate*— A company, other than a subsidiary or a proportionately consolidated company and including a partnership, the Company's investment in which is stated, directly or indirectly on the equity basis.
- (4) *Investee company*— A subsidiary, proportionately consolidated company or an affiliate.
- (5) *Related party*— as defined in opinion No. 29 of the Institute of Certified Public Accountants in Israel (hereinafter — "ICPAI").
- (6) *Interested party*— as defined in the Securities Law, Section 1 Paragraph (1)
- (7) *Controlling interest*— as defined in the Securities Regulations (Presentation of transactions between a company and its controlling interests in the financial statements) 5756-1996.
- (8) *CPI*— the Consumer Price Index published by the Central Bureau for Statistics.

B. Financial Statements Adjusted for the Effect of Inflation

- (1) The financial statements have been prepared on the basis of historical cost adjusted for the effect of the changes in the general purchasing power of the Israeli currency. (Financial statement data on the Company in nominal historical values appears in Note 32.)
- (2) The adjusted value of non-monetary assets does not purport to reflect their market or economic value, but rather the balance of their historical cost adjusted for the effect of the changes in the general purchasing power of the shekel.
- (3) The terms "cost" as used herein means "adjusted cost".
- (4) All of the comparative figures (including those of monetary items), have also been adjusted to the CPI of the end of the current reporting period.

C. Use of Estimates

Preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions which affect the reported amounts of assets and liabilities and disclosure relating to contingent assets and liabilities, as well as amounts of revenues and expenses for the report period. Actual results may differ from these estimates.

- D. The items of the financial statements have been classified and are presented in the order arising from the nature of the Company's business as a communications company.

E. Principles of Adjustment

(1) *Balance sheet*

Non-monetary items (mainly fixed assets, materials and spare parts, investments stated at cost) have been adjusted on the basis of the changes in the CPI from the index in respect of the month in which the item was acquired or arose, to the index in respect of balance sheet month.

Monetary assets are stated in the adjusted balance sheet at their historical value at balance sheet date.

The net asset value of the investments in investee companies is determined on the basis of the adjusted financial statements of such investees.

(2) *Statement of operations*

Statement of operation items were adjusted on the basis of changes in the CPI as follows:

- (a) Income and expenses deriving from non-monetary items (such as depreciation, amortization, changes in materials and spare parts, prepaid expenses, deferred income, etc.) or from provisions included in the balance sheet (such as for vacation pay, employee vacation expense allowance, etc.), were adjusted on the basis of the same specific indices which were applied to the related balance sheet items.
- (b) Other statement of operation items (such as sales, purchases, current production costs, etc.), other than the financing item, were adjusted on the basis of the changes in the CPI from the date of receipt of payment until the index in respect of balance sheet month.

- (c) The Company's equity in operating results of investee companies was determined on the basis of the adjusted financial statements of those companies.
- (d) The financing item reflects interest income and expenses in real terms, erosion of financial items during the year, earnings and losses from the disposal and revaluation of marketable securities, and earnings and losses from derivatives.
- (e) Income tax:

Current income tax expense is comprised of advance payments made during the year plus amounts payable (or less amounts refundable) at balance sheet date. The advance payments were adjusted on the basis of the changes in the CPI from each date of payment until balance sheet date while the amounts payable or refundable at year end were not adjusted. Therefore, the current income tax expense includes also the erosion in the value of the advance payments, from payment date until the balance sheet date. See Notes 2N and 11D relating to deferred taxes.

(3) *Statement of shareholders' equity*

A dividend that was announced and actually paid in the report year was adjusted on the basis of the CPI at date of payment. A dividend that was declared/proposed in the report year but had not been distributed as at balance sheet date, was stated unadjusted.

(4) *Adjustments on the basis of the foreign currency exchange rates and foreign companies*

The net asset value of an affiliate that operates autonomously in a foreign country is determined on the basis of the financial statement of the affiliate, adjusted to the changes in the purchasing power of the currency in which they were prepared and translated into NIS according to the representative exchange rate as at balance sheet date.

F. Consolidation of the Financial Statements

- (1) The consolidated financial statements include the financial statements of those companies over which the Company has control. Jointly controlled companies are consolidated by the proportionate consolidation method.
- (2) A list of subsidiaries, affiliates, other companies and rates of holding is included in a schedule of the financial statements.
- (3) For the purpose of the consolidation, the amounts appearing in the financial statements of the subsidiaries were taken after adjustments required by the application of the uniform accounting policies used by the Group.
- (4) Intercompany balances and transactions between subsidiaries were eliminated upon consolidation.
- (5) The excess of the net asset value upon acquisition over the cost of the investment (hereinafter — "negative goodwill") is attributed to fixed assets in accordance with Opinion No. 57 of the ICPAI and is amortized accordingly.

G. Investments in Investee Companies

- (1) Investments in affiliates are accounted for by the equity method. In determining the equity of the investments in these companies, the amounts as they are included in the financial statements of the companies are taken into account after making certain adjustments necessitated by application of generally accepted accounting principles.
- (2) On the financial statements of an affiliate that are adjusted according to changes in the foreign currency exchange rate — see Note 2E(4).
- (3) One affiliate incurred losses in amounts exceeding its shareholders' equity. The Company recorded its share in the losses of the affiliate up to the amount of its investment in the affiliate, plus a loss likely to be incurred by the Company as a result of guarantees which it gave for that affiliate.

H. Marketable Securities

Current investments in marketable securities are carried at market value on the stock exchange as at the balance sheet date. The changes in the value of the securities are recognized on a current basis.

I. Provision for Doubtful Debts

In the opinion of management, the provisions for doubtful debts in the financial statements properly reflect the loss inherent in debts, the collection of which is considered doubtful. In determining the propriety of the provisions, management considered, among other things, the risk assessment as derived from the information in its possession concerning the financial situation of the debtors, the scope of their operations, and the period of arrears in clearing their debt. Doubtful debts which management believes cannot be collected are written off in the Company's books following a management decision. The financial statements also contain a general provision for doubtful debts.

J. Inventory

Inventory of equipment and user equipment are presented at the lower of cost or book value, which is determined mainly by the First In First Out method.

As part of its current operations, a proportionately consolidated company upgrades user equipment for its customers. As a result, inventory includes user equipment returned from customers, as well as spare parts that are used by the company for the repair of user equipment in the framework of the insurance it provides for its customers.

K. Materials and Spare Parts

Materials and spare parts are valued at the lower of cost (which is determined by the "moving-average" method) or market. Materials are intended primarily for use as components of fixed assets.

L. Fixed Assets

- (1) Fixed assets are stated at cost.
- (2) The cost of an asset under self-construction includes material, labor and sub-contracting costs but not exceeding their value to the business.
- (3) Improvements and enhancements are added to the cost of assets, while maintenance and repairs are charged to expense as incurred.
- (4) In the event of a decrease in the value of assets to the business, a provision is recorded accordingly for decrease in value.
- (5) Capitalization of credit costs — the Company is preparing to apply Accounting Standard No. 3.
- (6) Depreciation is calculated by the straight-line method, based on the estimated useful lives of the assets.

The annual depreciation rates are:

	<u>% depreciation</u>	<u>Until 1999</u>	<u>As of 1999</u>
Buildings	4	4	4
Digital switching equipment	10	8.3	10
Transformer and power equipment.....	10—20	20	20
Network equipment	4—12.5	4.33	5
Subscriber equipment and public telephones	14.3—20	20	20
Motor vehicles	15	15	15
Office equipment.....	10—20	20	20
Computers.....	10—33	20	33
Cellular telephone equipment	10—20	20	20

Improvements to leased premises are depreciated throughout the term of the lease (including the Company's option to extend the lease period), that does not exceed the economic life of the asset.

On a change in the depreciation rate, see Note 9D.

M. Other Assets

- (1) Cost of issue of debentures and raising loans
These costs (treated as a non-monetary item) are amortized over the term of the debentures pro rata to the balance of the debentures in circulation.
- (2) Cost of acquiring a subscriber
Since 1999, Pelephone Communications Ltd. has been capitalizing its net direct costs paid to a third party in respect of the sale of subscribers who signed an undertaking to remain customer of Pelephone (where violation of the undertaking leads to payment of a penalty by the customer and depreciation of the asset). These costs appear in the balance sheet under Other assets, and are amortized throughout the minimum period of the subscribers' undertaking, which is 36 months.
- (3) Rights of representation of a communications corporation.
The rights of representation of a communications corporation are depreciated for the period of financial benefit over 10 years.

N. Deferred Taxes

The companies in the Group allocate taxes for temporary differences. Temporary differences are differences between the value of assets and liabilities for tax purposes and their book value in the balance sheet. Such allocation of taxes is made for differences relating to assets whose consumption or depreciation is deductible for tax purposes. Deferred tax balances (asset or liability) are calculated according to the liability approach using the tax

rates which will be in effect at the time of utilization of the deferred taxes, or upon realization of tax benefits, as they are known at the date of approval of the financial statements.

The main factors for which deferred taxes were not calculated are these:

- (1) The amounts of the adjustment for changes in the purchasing power of the shekel which relate mainly to buildings and private cars, in accordance with the principles stated by the ICPAI.
- (2) Investments in investee companies, since the Company intends to hold these investments and not to realize them.
- (3) A deferred tax asset in respect of timing differences where the likelihood of realizing the benefit is questionable.

O. Revenue Recognition

Income is recognized on the accrual basis.

P. Derivative Financial Instruments

- (1) Forward currency contracts intended to hedge foreign currency exposure of assets and liabilities are included in the Statement of Operations, concurrently with accounting reference to the hedged item.
- (2) Derivative financial instruments not designated for hedging are presented in the balance sheet at their fair value. Changes in the fair value are attributed to the Statement of Operations in the period in which they occurred.

Q. Balances in Foreign Currency and Linked Balances

Assets (excluding securities) and liabilities in or linked to foreign currency are stated at the representative exchange rates published by Bank of Israel as at the balance sheet date. Assets (excluding securities) and liabilities linked to the CPI are stated on the basis of the contractual linkage terms of each balance.

Following are details of the CPI and the U.S. dollar exchange rates:

	<u>December 31, 1999</u>	<u>December 31, 1998</u>	<u>% of change 1999</u>	<u>% of change 1998</u>	<u>% of change 1997</u>
CPI — in points	168.53	166.30	1.34	8.62	6.99
US dollar exchange rate \$1 — in NIS...	4.153	4.160	(0.17)	17.65	8.76

R. Earnings Per Share

Earnings per share are calculated in accordance with Opinion No. 55 of the ICPAI. In calculating the diluted earnings per share, account was taken of convertible securities issued by the Company which were not included in the calculation of the primary earnings per share if their conversion or exercise does not lead to an increase in earnings per share. Fully-diluted earnings per share are not presented as the effect of dilution is not significant.

S. Debentures Convertible into Shares

Debentures convertible into shares are classified according to likelihood of conversion, as determined in Opinion No. 53 of the ICPAI. Debentures that are not expected to be converted are included as liabilities at their liability value. Debentures that are expected to be converted are included between the item Long term liabilities and Shareholders' equity, at liability value or capital value, whichever is higher.

T. Issue to Employees

The benefit component in respect of an issue to employees (as well as in respect of the sales offer and employee compensation by the State) is charged as imputed salaries expense in the Statement of Operations and as an imputed addition to the Company's equity.

U. Adaptation to the Year 2000

Costs required for adapting and converting the Company's existing software so as to distinguish between years of the twentieth century and years of the twenty-first century (adaptation to the year 2000), were recorded as current expenses at the time they were incurred.

NOTE 3 — CASH AND CASH EQUIVALENTS

	Consolidated		Company	
	December 31, 1999	December 31, 1998	December 31, 1999	December 31, 1998
	NIS thousands			
Israeli currency	641,462	831,500	483,463	804,891
Foreign currency	<u>22,775</u>	<u>100,787</u>	<u>2,699</u>	<u>140</u>
	<u>664,237</u>	<u>932,287</u>	<u>486,162</u>	<u>805,031</u>

Cash equivalents include bank deposits with an original maturity not exceeding three months.

NOTE 4 — SHORT-TERM INVESTMENTS

	Consolidated		Company	
	December 31, 1999	December 31, 1998	December 31, 1999	December 31, 1998
	(NIS thousands)			
Marketable securities:				
Government debentures				
Linked to the CPI	56,584	57,489	56,584	57,489
Linked to the U.S. dollar exchange rate	8,604	9,802	8,604	9,802
Unlinked	35,834	31,332	35,834	31,332
Debentures convertible to shares	5,828	2,561	5,828	2,561
Other debentures	14,258	9,812	14,258	9,812
Mutual fund participation certificates	<u>179,704</u>	<u>47,018</u>	<u>173,349</u>	<u>47,018</u>
	300,812	158,014	294,457	158,014
Short-term bank deposits — in Shekels	<u>328</u>	<u>227,811</u>	<u>—</u>	<u>—</u>
	<u>301,140</u>	<u>385,825</u>	<u>294,457</u>	<u>158,014</u>

NOTE 5 — TRADE RECEIVABLES

	Consolidated		Company	
	December 31, 1999	December 31, 1998	December 31, 1999	December 31, 1998
	NIS thousands			
In respect of domestic services:				
On open account	1,184,220	1,138,061	791,111	809,772
Income receivable	411,363	450,465	358,162	383,955
Credit cards and post-dated checks	103,404	102,414	86,159	96,443
Investee companies	712	925	2,419	2,371
In respect of international services	<u>170,032</u>	<u>193,423</u>	<u>20,079</u>	<u>16,166</u>
	1,869,731	1,885,288	1,257,930	1,308,707
Less provision for doubtful debts	<u>346,887</u>	<u>332,616</u>	<u>249,784</u>	<u>237,135</u>
	<u>1,522,844</u>	<u>1,552,672</u>	<u>1,008,146</u>	<u>1,071,572</u>

NOTE 6 — OTHER RECEIVABLES AND DEBIT BALANCES

	Consolidated		Company	
	December 31, 1999	December 31, 1998	December 31, 1999	December 31, 1998
	NIS thousands			
Deferred tax asset (see Note 11D)	234,152	221,536	214,377	187,900
Income tax refundable	185,768	112,128	139,804	122,490
Consolidated company	—	—	—	16,962
Prepaid expenses	21,540	21,248	6,202	6,632
Other receivables and debit balances	<u>41,062</u>	<u>84,327</u>	<u>27,665</u>	<u>77,249</u>
	<u>482,522</u>	<u>439,239</u>	<u>388,048</u>	<u>411,233</u>

NOTE 7 — DEPOSITS AND DEBIT BALANCES

	Consolidated		Company	
	December 31, 1999	December 31, 1998	December 31, 1999	December 31, 1998
	NIS thousands			
Bank deposit for the purpose of Granting loans to employees(1)	257,492	255,413	257,492	255,413
Forward currency transactions	—	22,289	—	22,289
Earmarked deposits	—	22,936	—	—
Trade receivables(2)	18,251	15,919	—	—
	<u>275,743</u>	<u>316,557</u>	<u>257,492</u>	<u>277,702</u>

- (1) The deposit is unlinked and bears interest, the rate of which at balance sheet date was approximately 5% (after deduction of commission). The Company is responsible for the loans to the employees. Withdrawal of the deposit is contingent upon repayment of the loans.
- (2) Deferred interest income is the difference between the amount of the original debt and its present value on the date the income is recognized. Present value is calculated at effective interest linked to the CPI at a rate of about 6% per annum.

NOTE 8 — INVESTMENTS IN INVESTEE COMPANIES

A. Composition:

	December 31, 1999	December 31, 1998
	NIS thousands	
Affiliated companies		
Shares —		
Cost	115,134	108,433
Post-acquisition losses	(49,957)	(28,407)
Provision for decrease in value	(43,480)	(87,074)
	<u>21,697</u>	<u>(7,048)</u>
Other investments —		
Long-term loans(1)	53,801	—
Total consolidated balance sheet(2)	<u>75,498</u>	<u>(7,048)</u>
Subsidiaries		
Shares —		
Cost	354,326	370,905
Post-acquisition earnings	53,258	155,697
	<u>407,584</u>	<u>526,602</u>
Proportionately Consolidated Company		
Shares —		
Cost	253,657	253,657
Post-acquisition earnings	705,890	687,234
Depreciation of surplus equity over cost attributed to fixed assets	36,942	36,942
	<u>996,489</u>	<u>977,833</u>
Total Company balance sheet(2)	<u>1,479,571</u>	<u>1,497,387</u>

- (1) The loans are linked to the CPI, do not bear interest and have an undetermined maturity date.
- (2) Stated as follows:

	Consolidated		Company	
	December 31, 1999	December 31, 1998	December 31, 1999	December 31, 1998
	NIS thousands			
Investment in investee companies	75,498	36,546	1,479,571	1,540,981
Current liabilities (see Note 18)	—	(43,594)	—	(43,594)
	<u>75,498</u>	<u>(7,048)</u>	<u>1,479,571</u>	<u>1,497,387</u>

A list of the Group companies is presented in a schedule to the financial statements.

B. Investment Movement in 1999 Was As Follows:

	<u>Consolidated</u>	<u>Company</u>
	NIS thousands	
Balance as at the beginning of the year	(7,048)	1,497,387
Movement during the year:		
Investment in shares	6,701	(9,878)
Equity in losses	(21,550)	(105,333)
Forfeiture of guarantees for an affiliated company (see E below)	28,675	28,675
Cancellation of provision for guarantee for an affiliated company (see E below) ...	14,919	14,919
Balance as at the end of the year	<u>21,697</u>	<u>1,425,770</u>

C. Summary of Company Equity in Assets, Liabilities, Income and Expenses of a Proportionately Consolidated Company as Included in the Consolidated Statements

	<u>December 31,</u>	<u>December 31,</u>
	NIS thousands	
	1999	1998
Current assets	<u>416,046</u>	<u>345,378</u>
Other assets	<u>1,488,081</u>	<u>1,183,969</u>
Current liabilities	<u>595,941</u>	<u>291,445</u>
Long-term liabilities	<u>385,316</u>	<u>284,590</u>

	<u>For the year ended December 31</u>		
	<u>1999</u>	<u>1998</u>	<u>1997</u>
	NIS thousands		
Revenues	<u>1,159,855</u>	<u>1,162,601*</u>	<u>1,013,280*</u>
Costs and expenses	<u>1,324,410</u>	<u>937,516*</u>	<u>1,033,972*</u>

* Reclassified

D. Basic Telecommunication Project in India

The Company submitted a bid, together with others, through a jointly owned company, in respect of tenders issued by the Indian Government for the setting up of a basic telecommunication system in India. The letter of intent and the draft concession agreements for development of the basic telephone system in four districts, which were awarded to the jointly owned company in which the Company has an interest, were transferred to the jointly owned company. The jointly owned company did not sign the letter of intent or the draft agreements since, inter alia, in its opinion, the draft agreements did not conform with the terms of the tender. When the jointly owned company submitted its bid for the tender, it provided the Indian Ministry of Communications with bank guarantees, of which Bezeq's share is RS (Indian rupees) 273 million (approximately NIS 27 million).

At the end of June 1996, the Indian Ministry of Communications sought to foreclose on the guarantees. On September 19, 1997 the court issued a permanent injunction which prevents the Indian Ministry of Communications from foreclosing on the guarantees. The Indian Ministry of Communications appealed against the injunction at the end of October 1997.

The Company's management and its legal advisors are at present unable to forecast the outcome of these legal proceedings and, therefore, no provision has been included in the financial statements in respect thereof.

E. Cellular Communications Project in India

The Company, through a company jointly owned with others, is engaged in constructing a cellular communications system in the State of Gujarat in India. The Company owns 16% of the jointly owned company. Until balance sheet date, the Company had invested approximately NIS 62 million in this company and had, together with the other joint owners, provided bank guarantees to secure the obligations of the jointly owned company. The Company's share of such guarantees is approximately RS 293 million (approximately NIS 29 million). Furthermore, the jointly owned company has undertaken towards an equipment vendor to comply with certain financial ratios, if it should require further credit. Pursuant to that undertaking, the Company could be required to invest an additional amount due to an obligation in favor of the equipment vendor.

At the beginning of 1997 the jointly owned company began providing communications services to subscribers. The jointly owned company has not completed raising the necessary financing for the continuation of its operations, and, therefore the license fee payments were not made on time.

In the opinion of the Company these events reflect a continuing process that increases the probability of a loss from the Company's investment in the jointly owned company to such a high level as to necessitate that the investment be written off and a provision be created for the said investment and guarantees.

Accordingly, following the resolution of the Board of Directors on February 23rd, 1998 to write off the investment balance and to create a provision for the full amount of the guarantees (including the obligations towards the equipment vendor as mentioned above), a provision of approximately NIS 43 million was made for the balance of the investment as at December 31st, 1997 (after recording the Company's share in losses of the jointly-owned company in the amount of NIS 20 million, based upon unaudited financial statements prepared by the jointly owned company). An additional provision of approximately NIS 44 million was made in respect of the balance of guarantees given to or on behalf of the jointly owned company as at the same date.

Following the ruling of the Indian court in April and June 1999, the guarantees given by the Company were foreclosed in favor of the government of India, in the amount of \$6.9 million (approximately NIS 29 million).

In August 1999 the government of India announced the transition to payment of license fees as a percentage of revenues rather than a fixed amount as it had been previously. The balance of the license fee up to July 31st, 1999 must be paid, and therefore the shareholders were required to increase their investment in the company. In November 1999 the equipment vendor in whose favor the Company was guarantor, gave notice of cancellation of the Company's guarantee. Accordingly, the provision in the financial statements for the guarantee for the equipment vendor, in the amount of NIS 15 million, was canceled.

In December 1999 the Company increased the guarantee in favor of the government of India by another RS 70 million (approximately NIS 6.9 million), and in February 2000 increased its investment in the joint company by another \$5.4 million (approximately NIS 22.4 million).

In the opinion of the Company's management, the change in the license fee payment policy makes the investment more economical. Nevertheless, since the joint company has not yet succeeded in making financing arrangements with financial institutions and has not issued audited financial statements, the probability of the investment producing a loss still exists.

F. Telephone Communications Ltd. ("Pelephone")

In 1994 the Company was allotted shares which gave it 50% of the ownership and control of Pelephone, in exchange for the Company's rights to provide cellular services. In accordance with Government decisions of January 9th, 1994 and August 10, 1994, the "market value" of the assets transferred, to be agreed upon between Motorola Israel Ltd. (50%-owner of Pelephone) and the Company, must be examined and will require the approval of the Government Companies Authority.

The Government Companies Authority appointed independent consultants to verify the aforementioned "market value". In the opinion of the consultants, the Company's share in Pelephone should be 60%.

The Company's Board of Directors has considered the reports findings, and has concluded, on the basis of explanations and clarifications obtained from the Company's management and the Company's legal advisors, that the transactions by which 50% of the ownership and control of Pelephone was allotted to the Company, was effected in a subjective, economically sound manner in accordance with the Government decisions referred to above. This position of the Board of Directors has been conveyed to the Government Companies Authority. As of the date of publication of these financial statements, the Government Companies Authority had not yet conveyed its position to the Company.

The Government Companies Authority and the Company have decided to review the validity and the legal and commercial implications of a letter of undertaking in respect of the agreement made between the Company and Motorola Israel Ltd., which the Company submitted to Motorola Israel Ltd. on October 10th, 1994.

On November 5th, 1997, a meeting to discuss the "market value" took place at the office of the Minister of Finance with the participation of representatives of his office and of the Ministries of Communications and Justice and of the Government Companies Authority. At the conclusion of the meeting the Minister of Finance said that the Government would make no claim against the Company in matters of this transaction and that the Legal Advisor of the Ministry of Finance, in coordination with the Ministry of Communications, would prepare a legal opinion concerning the possibility of the State realizing the Company's rights vis-a-vis Motorola, if such exist, either directly or by means of the Company, and that the Ministry of Justice would relate to the said legal opinion. As of the balance sheet date, such opinions have not yet been prepared.

Neither the Company's management nor its legal advisors can predict the outcome of the examination described above or the likely impact thereof on the Company.

G. D.B.S. Satellite Services (1998) Ltd.

Pursuant to the shareholders agreement signed by the Company in December 1998 with additional entrepreneurs, the Company is entitled to hold approximately 30% of the shares of D.B.S. Satellite Services (1998) Ltd. (hereinafter — DBS). In January 1999, DBS received a license from the Ministry of Communications for satellite television broadcasts, in exchange for payment of NIS 30 million and a guarantee in the amount of NIS 30 million (on the deed of guarantee signed by the Company, see Note 29C). DBS is an enterprise under development, and foresees considerable losses and negative cash flow from operations in the first years of its activities. A bank with which DBS

entered into a long-term financing agreement has refused to grant further credit. DBS is negotiating with other banks for long-term credit lines to finance its ongoing activities.

According to a decision of the Ministerial Committee for Privatization, the maximum cumulative exposure of the Company in connection with this investment shall not exceed, at any time, the rate of the company's actual holding in DBS, multiplied by \$ 216 million (approximately NIS 864 million).

NOTE 9 — FIXED ASSETS

A. Composition and Movement

Consolidated

	Land & buildings	Switching, transmission and power equipment ⁽¹⁾	Network equipment	Subscriber equipment and public telephones	Motor Vehicles	Office equipment and computers	Total
	NIS thousands						
Cost —							
Balance as at January 1, 1999	2,047,446	14,235,777	10,436,707	773,636	360,529	811,277	28,665,372
Additions	76,670	976,614	229,609	140,491	42,783	192,190	1,658,357
Disposals ⁽²⁾	(64,462)	(879,347)	(105,359)	(235,341)	(41,707)	(245,844)	(1,572,060)
Balance as at December 31, 1999	<u>2,059,654</u>	<u>14,333,044</u>	<u>10,560,957</u>	<u>678,786</u>	<u>361,605</u>	<u>757,623</u>	<u>28,751,669</u>
Accumulated depreciation							
Balance as at January 1, 1999	956,677	6,847,122	5,978,530	472,042	175,073	321,190	14,750,634
Provision for depreciation	95,081	1,670,484	606,757	145,576	47,282	155,739	2,720,919
Eliminations upon disposal ⁽²⁾	(50,202)	(846,894)	(105,359)	(202,947)	(33,582)	(243,728)	(1,482,712)
Provision for impairment of asset value (see Note 9E)	—	—	—	—	—	106,380	106,380
Balance as at December 31, 1999	<u>1,001,556</u>	<u>7,670,712</u>	<u>6,479,928</u>	<u>414,671</u>	<u>188,773</u>	<u>339,581</u>	<u>16,095,221</u>
Net book value —							
As at December 31, 1999	<u>1,058,098</u>	<u>6,662,332</u>	<u>4,081,029</u>	<u>264,115</u>	<u>172,832</u>	<u>418,042</u>	<u>12,656,448</u>
As at December 31, 1998	<u>1,090,769</u>	<u>7,388,655</u>	<u>4,458,177</u>	<u>301,594</u>	<u>185,456</u>	<u>490,087</u>	<u>13,914,738</u>

Company

	Land & buildings	Switching, transmission and power equipment ⁽¹⁾	Network equipment	Subscriber equipment and public telephones	Motor Vehicles	Office equipment and computers	Total
	NIS thousands						
Cost —							
Balance as at January 1, 1999	2,013,520	11,974,373	10,325,933	740,466	326,904	643,534	26,024,730
Additions	59,608	561,802	229,609	75,684	33,242	104,222	1,064,167
Disposals ⁽²⁾	(64,436)	(799,891)	(105,359)	(193,790)	(39,379)	(242,069)	(1,444,924)
Balance as at December 31, 1999	<u>2,008,692</u>	<u>11,736,284</u>	<u>10,450,183</u>	<u>622,360</u>	<u>320,767</u>	<u>505,687</u>	<u>25,643,973</u>
Accumulated depreciation							
Balance as at January 1, 1999	945,542	5,813,073	5,939,696	469,282	165,949	263,396	13,596,938
Provision for depreciation	90,974	1,314,935	601,028	126,071	41,627	118,676	2,293,311
Eliminations upon disposal ⁽²⁾	(50,184)	(799,690)	(105,359)	(193,136)	(32,578)	(242,069)	(1,423,016)
Provision for impairment of asset value (see Note 9E)	—	—	—	—	—	106,380	106,380
Balance as at December 31, 1999	<u>986,332</u>	<u>6,328,318</u>	<u>6,435,365</u>	<u>402,217</u>	<u>174,998</u>	<u>246,383</u>	<u>14,573,613</u>
Net book value —							
As at December 31, 1999	<u>1,022,360</u>	<u>5,407,966</u>	<u>4,014,818</u>	<u>220,143</u>	<u>145,769</u>	<u>259,304</u>	<u>11,070,360</u>
As at December 31, 1998	<u>1,067,978</u>	<u>6,161,300</u>	<u>4,386,237</u>	<u>271,184</u>	<u>160,955</u>	<u>380,138</u>	<u>12,427,792</u>

(1) Including NIS 7,116,000 (1998 — NIS 745,000) advances to vendors on account of telephone exchange equipment ordered.

(2) Fixed assets are written off the books at the end of the year in which they became fully depreciated, except for land, buildings and vehicles, which are written off the books when sold. In 1999 fully depreciated fixed assets of a cost of approximately NIS 1,337 million (1998 — NIS 1,332 million) were written off the books.

- B.** Most of the real estate assets which were transferred to the Company pursuant to the agreement dated January 31, 1984, are leased (rented) from the State of Israel, for various periods, as follows:
- Some of the assets are leased for a period of 49 years with an option for extension for an additional 49 years, in consideration of a token lease payment.
 - Some of the assets are leased for periods of 2 years renewable for additional two-year periods, in consideration of a token lease payment.
 - Some of the assets are leased under rent-control arrangements.

Up to the time of the preparation of the financial statements, only a small portion of the real estate assets has been registered in the Company's name at the Lands Registry Office. The Company carried out a land survey and measuring of the freehold and leasehold real estate as well as other real estate it rents or uses. It is also in the process of registering its real estate, and of signing agreements with Israel Lands Administration.

The Accountant General of the Ministry of Finance notified the Company that on January 31, 1998, the State intends to terminate the lease of those assets rented for renewable two-year periods. In addition, the Ministry of Finance will review the Company's actual usage of each of the properties and take appropriate action regarding the matter of making available alternative land and the payment of relocation expenses. In the opinion of Management and its legal advisors, this demand is not consistent with the asset transfer agreement. The Company negotiated with the Israel Lands Authority in order to reach an agreement whereby the Company will return to the Authority a portion of the assets and will receive other properties instead. At the date of the preparation of the financial statements, the Company continues to hold the said property. In Management's opinion, if it will be required to vacate the property without alternative land of equal value being made available, as well as the covering of the relocation costs, the Company will suffer significant damage, which cannot be precisely estimated.

On May 13, 1999, discussions were held at the Attorney General's office between representatives of the Company and Israel Lands Authority, in the presence of the Government Companies Authority's representatives. At the end of the discussions, the Attorney General decided that a public offering could not be performed before clarification of the factual basis and the issues in dispute, so that the dispute could be settled in the appropriate manner. The Attorney General also instructed the relevant government entities to prepare a detailed working paper defining which assets are under dispute, their value, and the use being made of them today. In addition, the Attorney General recommended that the parties negotiate in an attempt to settle the dispute or to limit its scope, as practically as possible. The negotiations between the Company and the Israel Lands Authority have not yet resulted in a resolution of the issues.

- C.** At the balance sheet date, commitments exist for the purchase of fixed assets (mainly switching equipment) in the amount of approximately NIS 335 million on a consolidated basis and approximately NIS 261 million for the Company. Furthermore, in December 1999 a proportionately consolidated company signed a letter of intent for the purchase of additional CDMA infrastructure equipment from Motorola in the amount of approximately NIS 244 million (presented at the Company's proportionate share).
- D.** On May 12, 1999 the Board of Directors of the Company resolved to adopt the recommendations of management, which were based on the report of a firm of outside consultants concerning recommendations to change the depreciation policy and depreciation rates of the Company's assets.

The decision, effective from January 1, 1999, changed the depreciation rates of a number of fixed assets recorded in the Company's books. Among these items are the switching systems, for which the depreciation rate was raised to 10% per annum (instead of 8.33%), and the Company's network, for which the depreciation rate was raised to 5% per annum (instead of 4.33%). As a result of implementation of these recommendations, the Company's depreciation expenses increased for the year ended December 31, 1999 by approximately NIS 214 million.

In the Company's opinion, these changes will lead to increased depreciation expenses of the Company of approximately NIS 182 million, in respect of existing investments in the year 2000, and NIS 85 million, NIS 118 million and NIS 76 million in each of the subsequent years, respectively.

Following these changes the Company approached the Ministry of Communications, requesting approval for an increase of the Company's tariffs, which it believes is necessary as a result of the new depreciation policy. The final stance of the Ministry of Communications has not yet been received.

- E.** Following the breakdown of negotiations between the Company and a software supplier who undertook to develop a billing and collection system, and the Company's notice of foreclosure of a bank guarantee in the amount of approximately \$20 million (NIS 80 million) given to it by the supplier, the parties took a number of legal steps, as described below:
- (1) A claim by the Company for payment of approximately \$ 18 million (NIS 76 million as at the date of filing the claim), as compensation in respect of breach of contract, and a counter-claim of the supplier in the amount of approximately \$ 59 million (NIS 239 million as at the date of filing the claim).
 - (2) Application of the supplier for a temporary and permanent injunction against foreclosure of the bank guarantees by the Company. The application for a temporary injunction was dismissed by the District Court and an application was filed for permission to appeal in the Supreme Court.
 - (3) A claim by the supplier for enforcement of the contract between the parties. Application for a temporary injunction forbidding the Company to enter into a similar agreement with a third party — was dismissed.

It is not possible, at this stage, to estimate the outcome of these legal proceedings, but in the opinion of the legal advisers of the Company, it has good substantiation of its position. Furthermore, the Company is not able to estimate the full implications of the dispute on the process of building a software system, timetables for its completion and the losses that these are liable to cause the Company. However, the Company is of the opinion that delays in completing the system by the planned date, if any, could result in material losses.

As at the balance sheet date, the Company's investment in the billing and collection system project amounted to approximately NIS 118 million. A provision is made in the financial statements for decrease in the value of the investment in the amount of NIS 107 million. In addition, an expense of NIS 20 million is recorded in respect of compensation for a sub-contractor due to cessation of the project.

NOTE 10 — DEFERRED AND OTHER EXPENSES

Consolidated

	<u>Costs</u>	<u>Accumulated Depreciation</u>	<u>Balance for Depreciation</u>	
			<u>December 31, 1999</u>	<u>December 31, 1998</u>
			NIS Thousands	
Representation rights in a communications corporation ...	3,550	976	2,574	2,928
Capitalized subscriber acquisition costs	<u>290,300</u>	<u>50,869</u>	<u>239,431</u>	<u>—</u>
	<u>293,850</u>	<u>51,845</u>	<u>242,005</u>	<u>2,928</u>
Expenses for issue of debentures and procurement of loans			<u>13,225</u>	<u>19,853</u>
			<u>255,230</u>	<u>22,781</u>

Company

	<u>December 31, 1999</u>	<u>December 31, 1998</u>
Deferred expenses		
Expenses for issue of debentures and procurement of loans	<u>13,225</u>	<u>19,853</u>

NOTE 11 — TAXES ON INCOME

- A. The Income Tax Law (Adjustments for inflation) — 5745-1985, effective since 1985, provides for a method of measuring operating results for tax purposes on a real (inflation adjusted) basis. The various adjustments required by the said law are intended to bring about taxation on the basis of real income. However, adjustment of the nominal historical profit in accordance with the terms of said law is not always identical with the inflation adjustments prescribed for financial reporting purposes by opinions of the Institute of ICPAI. As a result, differences arise between the inflation-adjusted profit in the financial statements and adjusted taxable income.

Regarding deferred taxes in respect of the aforesaid differences — see Notes 2N above and 11D below.

- B. Income Tax in the Statement of Operations

Consolidated

	<u>For the year ended December 31</u>		
	<u>1999</u>	<u>1998</u>	<u>1997</u>
	<u>NIS thousands</u>	<u>NIS thousands</u>	<u>NIS thousands</u>
Current taxes	(6,466)	302,352	292,118
Deferred taxes	71,356	175,411	(330,075)
Taxes for prior years, net	<u>(2,094)</u>	<u>13,467</u>	<u>—</u>
	<u>62,796</u>	<u>491,230</u>	<u>(37,957)</u>

Company

	<u>For the year ended December 31</u>		
	<u>1999</u>	<u>1998</u>	<u>1997</u>
	<u>NIS thousands</u>	<u>NIS thousands</u>	<u>NIS thousands</u>
Current taxes	1,085	179,147	84,781
Deferred taxes	70,139	185,917	(317,689)
Taxes for prior years, net	<u>(845)</u>	<u>9,233</u>	<u>—</u>
	<u>70,379</u>	<u>374,297</u>	<u>(232,908)</u>

C. Reconciliation Between the Theoretical Tax Computed in Respect of the Pre-Tax Inflation Adjusted Earnings and the Actual Tax Expense

Consolidated

	For the year ended December 31		
	1999	1998	1997
	NIS thousands	NIS thousands	NIS thousands
Tax computed at the regular tax rates (*)	32,787	449,562	(94,010)
Increase (savings) in tax owed, due to:			
Inflationary erosion of advance tax payments	1,174	14,226	6,220
Exempt income and capital gains	(14,470)	(5,404)	(7,808)
Non-deductible expenses	12,127	14,077	13,838
Losses in respect of which a deferred tax asset was not created	30,983	1,056	42,919
Taxes for prior years, net	(2,094)	13,467	—
Other	<u>2,289</u>	<u>4,246</u>	<u>884</u>
	<u>62,796</u>	<u>491,230</u>	<u>(37,957)</u>
	<u>36%</u>	<u>36%</u>	<u>36%</u>

(*) Regular tax rates

Company

	For the year ended December 31		
	1999	1998	1997
	NIS thousands	NIS thousands	NIS thousands
Tax computed at the regular tax rates (*)	65,678	338,022	(274,360)
Increase (savings) in tax owed, due to:			
Inflationary erosion of advance tax payments	694	10,364	2,889
Exempt income and capital gains	(8,221)	(2,470)	(6,371)
Non-deductible expenses	9,360	14,700	11,632
Losses in respect of which a deferred tax asset was not created	—	—	31,348
Taxes for prior years, net	(845)	9,233	—
Other	<u>3,713</u>	<u>4,448</u>	<u>1,954</u>
	<u>70,379</u>	<u>374,297</u>	<u>(232,908)</u>
	<u>36%</u>	<u>36%</u>	<u>36%</u>

(*) Regular tax rates

D. Deferred Taxes

	Consolidated		Company	
	December 31, 1999	December 31, 1998	December 31, 1999	December 31, 1998
	NIS thousands			
Movement —				
Balance at beginning of year	531,817	695,885	536,077	709,075
Charged to statement of operations for the year	(71,356)	(175,411)	(70,139)	(185,917)
Charged to investment in consolidated company	—	—	(2,745)	—
Charged to statement of operations for prior years	(7,934)	11,343	—	12,919
Balance as at end of year	<u>452,527</u>	<u>531,817</u>	<u>463,193</u>	<u>536,077</u>
Composition of deferred taxes —				
Difference between the adjusted value of fixed assets and their value for tax purposes	(138,852)	(47,278)	(108,740)	(31,500)
Adjustment of materials and spare parts	(1,204)	(4,655)	(969)	(4,386)
Differences in the recognition of expenses relating to employee rights and doubtful debts	592,583	583,750	572,902	571,963
Total	<u>452,527</u>	<u>531,817</u>	<u>463,193</u>	<u>536,077</u>
Classified as follows:				
Among current assets:	234,152	221,536	214,377	187,900
Among other assets	237,737	334,837*	248,816	348,177
Among long-term liabilities	(19,362)	(24,556)*	—	—
Total	<u>452,527</u>	<u>531,817</u>	<u>463,193</u>	<u>536,077</u>

* Reclassified

The deferred taxes are computed based on the tax rate expected to be in effect at the time of their utilization (36%). Realization of the tax benefit is contingent upon the existence of adequate taxable income in the future. The said deferred tax asset is included in the financial statements since, according to the Company's business plans, its realization is anticipated.

Losses for tax purposes of subsidiaries which are carried forward to the coming years amounted to NIS 100,195,000 (1998 — NIS 31,334,000). The balance of the loss and deduction carry-forwards for which no deferred tax asset was included because of the uncertainty of their realization, is approximately NIS 100,195,000 (1998 — NIS 31,334,000).

The net book value of the buildings for tax purposes exceeds its net book value in the financial statements (Company) by NIS 64,652,000 (1998 — NIS 62,009,000; 1997 — NIS 58,725,000). No deferred tax asset in respect of these differences was included in the financial statements.

E. Final Tax Assessments

The Company has received final tax assessments (as a result of the statute of limitations having elapsed) up to and including 1993. A proportionately consolidated company has received final tax assessments up to and including 1993. The other investee companies have not yet received final tax assessments since their inception.

The Company is currently undergoing an assessment review by the income tax authorities for the years 1994 — 1997 (inclusive). In December 1999, tax assessments were issued to the Company (not with agreement) by the Large Companies Tax Assessor, in respect of 1994 only. According to the assessment, the Company must pay additional taxes in the amount of approximately NIS 408 million for 1994, including interest and CPI-linkage. Most of the additional tax derives from a liability for capital gain from the sale of equipment to Pelephone Communications Ltd. in exchange for an allotment of 50% of Pelephone's shares to the Company. The Company is disputing the assessment and intends to file an objection to the demand.

In the Company's opinion, based on its legal advisers who are handling the matter on its behalf, the Company has proper substantiation of its position against the main points of the assessment. At this point, the outcome of the objection cannot be estimated, and therefore, no provision is made in the financial statements in respect of the assessment.

F. Value Added Tax

The Company files a consolidated tax return with its subsidiaries for Value Added Tax purposes.

NOTE 12 — BANK CREDIT

	Interest rate p.a. %	Consolidated		Company	
		December 31, 1999	December 31, 1998	December 31, 1999	December 31, 1998
		NIS thousands			
Unlinked loans	10.95	<u>271,006</u>	<u>—</u>	<u>—</u>	<u>—</u>

NOTE 13 — DEBENTURE ISSUED TO THE GOVERNMENT OF ISRAEL (CONSOLIDATED AND COMPANY)

The debenture represents a portion of the consideration to the Government of Israel for assets transferred to the Company based on the agreement dated January 31, 1984. The principal of the debenture is linked to the Consumer Price Index and bears interest at an effective annual rate of 7.3%, payable quarterly. The debenture is repayable in equal quarterly installments of NIS 235,477,000 each, where the last payment will be made on April 1, 2000.

NOTE 14 — LONG-TERM LOANS

A. Composition

	Consolidated		Company	
	December 31, 1999	December 31, 1998	December 31, 1999	December 31, 1998
	NIS thousands			
Banks	4,188,482	4,599,174	3,747,197	4,264,013
Pension fund	111,337	122,374	111,337	122,374
Supplier credit	<u>3,361</u>	<u>118</u>	<u>—</u>	<u>118</u>
	4,303,180	4,721,666	3,858,534	4,386,505
Less —				
Current maturities from banks	1,053,418	1,090,549	983,615	1,043,133
Other current maturities	<u>13,158</u>	<u>11,225</u>	<u>12,822</u>	<u>11,225</u>
	<u>3,236,604</u>	<u>3,619,892</u>	<u>2,862,097</u>	<u>3,332,147</u>

B. Linkage Terms and Interest

	Interest rate %	Consolidated		Company	
		December 31, 1999	December 31, 1998	December 31, 1999	December 31, 1998
		NIS thousands			
Loans in foreign currency US dollar(*)	Libor + 0.25-0.7	<u>2,972,362</u>	<u>3,184,862</u>	<u>2,868,536</u>	<u>3,047,850</u>
Loans linked to the CPI	3.6 - 5.75	<u>1,219,481</u>	<u>1,414,430</u>	<u>878,661</u>	<u>1,216,281</u>
	6.1	<u>111,337</u>	<u>122,374</u>	<u>111,337</u>	<u>122,374</u>
		<u>1,330,818</u>	<u>1,536,804</u>	<u>989,998</u>	<u>1,338,655</u>
		<u>4,303,180</u>	<u>4,721,666</u>	<u>3,858,534</u>	<u>4,386,505</u>

(*) These loans bear interest at the rate of libor plus a margin. The rate shown in the above table is a weighted average rate as at the balance sheet date.

C. Repayment schedule

December 31	Consolidated	Company
	NIS thousands	
2001	805,706	704,276
2002	1,067,103	992,719
2003	492,085	434,433
2004	432,408	394,838
2005 and thereafter	<u>439,302</u>	<u>335,831</u>
	<u>3,236,604</u>	<u>2,862,097</u>

D. Security

(1) The long-term loan agreements of the Company, aggregating NIS 2,960,707, include certain conditions upon the occurrence of which the lender may demand early repayment of the loans, including:

- The intervention of an authority in the administration of Company matters.
- In respect of loans aggregating NIS 1,684,931,000 a decrease in the State's voting rights in the Company to 50% or less, or initiation of a process which is liable to lead to such a decrease, as well as occurrence of an event which allows other loans of the Company to be made available for early repayment.
- In respect of the remaining loan balance of NIS 1,275,776,000 a decrease in the State's voting rights in the Company to 26% or less, of which in respect of a balance of approximately NIS 524,946,000, upon occurrence of an event which also allows other loans of the Company to be made available for early repayment.
- Change of the nature of the Company's business without the agreement of the lenders, which would have a materially adverse effect on the Company's business, assets or financial position.

With respect to the possibility of the occurrence of the aforementioned conditions, including a decline in the rate of the State's voting rights and the possibility of the complete opening of the communications market to competition — see Note 1.

The Company has made a negative pledge in favor of the lenders.

- (2) A proportionately consolidated company made a negative pledge and committed to maintain certain financial conditions in respect of loans it received from banks, whose balance as at the balance sheet date is NIS 433,728,000. As at the balance sheet date, this company is in compliance with the aforementioned conditions.

E. Loan-Procurement Expenses

The deferred expenses in connection with the procurement of loans as at December 31, 1999 and as at December 31, 1998 amounted to NIS 12,878,000 and NIS 9,437,000 respectively. The expenses are stated net of accumulated amortization in the amount of NIS 6,184,000 and NIS 3,263,000 respectively.

NOTE 15 — OTHER DEBENTURES

A. Composition and Terms

	Interest Rates	Consolidated and Company	
		December 31, 1999	December 31, 1998
NIS thousands			
CPI-linked debentures issued to the public:			
Debentures Series 1 (1)	4.5	<u>327,704</u>	<u>392,997</u>
Debentures issued to financial institutions and others:			
CPI-linked	5.0	1,151,433	1,027,336
		1,479,137	1,420,333
Less — current maturities		<u>225,517</u>	<u>206,518</u>
		<u>1,253,620</u>	<u>1,213,815</u>

(1) The outstanding balance of the debentures is NIS 99,751,438 par value (1998 — NIS 119,701,727 par value).

B. Repayment Schedule

	NIS thousands
2001	224,379
2002	183,945
2003	194,183
2004	194,802
2005 and thereafter	<u>456,311</u>
	<u>1,253,620</u>

C. Security

The debentures are not secured, except for a token lien; however, the Company has undertaken that so long as the debentures are outstanding it will refrain from encumbering its property with other liens.

Some of the lenders, the balance of whose loans as at December 31, 1998 amounts to approximately NIS 1,073,401,000, are entitled to demand the immediate repayment of the debentures if the State of Israel's holdings in the share capital of the Company falls below 26% (see Note 1).

D. Issue Expenses

The deferred expenses with respect to the issue of the debentures amounted to NIS 21,581,000, (1998 — 20,269,000) and are stated net of accumulated amortization of NIS 17,416,000 (1998 — NIS 16,318,000).

NOTE 16 — TRADE PAYABLES

	Consolidated		Company	
	December 31, 1999	December 31, 1998	December 31, 1999	December 31, 1998
	NIS thousands			
Suppliers of goods and services(*)	1,156,038	997,351	654,624	527,191
Current maturities of long-term supplier credit....	336	118	—	118
	<u>1,156,374</u>	<u>997,469</u>	<u>654,624</u>	<u>527,309</u>
(*) Includes foreign currency balances	<u>373,568</u>	<u>458,442</u>	<u>14,183</u>	<u>37,817</u>
Includes consolidated companies	—	—	4,470	2,251
Includes a proportionately consolidated company...	<u>46,682</u>	<u>50,145</u>	<u>93,364</u>	<u>100,289</u>

NOTE 17 — LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

A. Composition

	Consolidated		Company	
	December 31, 1999	December 31, 1998	December 31, 1999	December 31, 1998
	NIS thousands		NIS thousands	
Provision for early retirement, net (see D below)	351,185	637,707	351,185	637,707
Compensation for unused sick leave (see E below)	<u>79,375</u>	<u>91,714</u>	<u>79,375</u>	<u>91,714</u>
	<u>430,560</u>	<u>729,421</u>	<u>430,560</u>	<u>729,421</u>
Provision for severance pay	11,447	10,525	—	—
Less — fundings	<u>(12,359)</u>	<u>(9,121)</u>	—	—
Total	<u>(912)</u>	<u>1,404</u>	—	—
	<u>429,648</u>	<u>730,825</u>	<u>430,560</u>	<u>729,421</u>
Stated as follows:				
Among current liabilities	351,185	637,707	351,185	637,707
Among long-term liabilities	<u>78,463</u>	<u>93,118</u>	<u>79,375</u>	<u>91,714</u>
	<u>429,648</u>	<u>730,825</u>	<u>430,560</u>	<u>729,421</u>

B. Eligibility of employees upon reaching retirement age

- (1) The liability of the Company and its investee companies for severance benefits to employees is fully covered by current payments to pension funds and insurance companies and the above provision. The fundings are not under the management or control of the companies and, therefore, are not reflected in the balance sheet.
- (2) The pension rights of the Company's employees with respect to the period of their employment in government service, up to January 31, 1985, is covered by a pension fund ("Keren Makefet") which assumed the Government's liability in accordance with an agreement between the Government, the Company, the New General Federation of Labor (Histadrut) and the Fund.

C. Employee rights before retirement age

The Company's liability to pay severance pay to employees leaving their employment under conditions entitling them to such benefits are covered, in respect of the period from February 1, 1985, by current deposits in pension funds and with insurance companies, as stated in B, above. Severance pay in respect of the period of government service up to January 31, 1985, is paid by the Company, and amounts accumulated with Keren Makefet, with respect to this period, are held in the Fund for use in connection with the employees' rights.

Employees who transferred to the Company from government service and who leave their service prior to reaching retirement age, are entitled, under certain conditions, at their election, to receive early retirement benefits in lieu of severance pay. The cost of the early retirement benefits, except for cases of sickness or disability up to retirement age, are to be borne by the Company. In light of past experience, most of the Company's employees leave their employment upon reaching retirement age and, accordingly, the chances of actualization of the liabilities referred to above, except for the plan for organizational change (see D below), are quite small and, therefore, no provision with respect thereto has been included in the financial statements.

D. Plan for organizational change

- (1) On November 23, 1997, a special collective labor agreement regarding employee separation and a special collective labor agreement regarding change in organizational structure were signed between the Company and the employees' representatives and the New General Federation of Labor (Histadrut).

The main provisions of the special collective labor agreement regarding employee separation include the following:

- Separation of approximately 1,800 employees.
- Separation of the employees will be effected in stages up to December 31, 1999.
- The total cost of implementing the agreement shall not be more than NIS 1.4 billion.

Within the framework of the plan for improvements and organizational changes in the Company, the implementation of this plan is continuing. The number of employees who retired within the framework of this plan has exceeded the Company's forecasts as they were when the plan was formulated, and has reached approximately 2,050 rather than 1,800. An expense of NIS 110 million is included in the financial statements for adjustment of the cost for up-to-date retirement data.

- (2) Following adoption of the recommendations of the committee for arrangement of the Company's tariffs (see Note 1B) by the Ministers of Finance and Communications, the Board of Directors instructed the management of the Company to formulate a plan accordingly.

The Company's management presented a plan to the Board of Directors in March 2000, which is based on a material change in its organizational and functional concept, in a format similar to that already implemented in a number of similar companies in the communications world as they moved into functioning in a competitive environment. The Board of Directors requested further clarification before giving its approval. The plan indicates that the initial estimate made by the Company in 1999 in respect of the number of employees who would need to retire — is valid: it indicates the need for the retirement of 500-600 employees. The Company has included in the report a provision of approximately NIS 288 million, which is the estimated cost of that retirement, which comes by virtue of an agreement that is valid until June 30, 2000. The Company has approached the Companies Authority for its consent to extend the term of the agreement until March 31, 2001.

E. Compensation for unutilized sick leave

The financial statements include a provision for compensation in respect of unutilized sick leave for all employees, in accordance with the conditions fixed in the employment agreement.

NOTE 18 — OTHER CURRENT LIABILITIES

	Consolidated		Company	
	December 31, 1999	December 31, 1998	December 31, 1999	December 31, 1998
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
The Government of Israel in respect of royalties, interest and fees	193,356	223,605	146,553	167,137
Employees and other salary-related liabilities (1)	178,712	295,322	156,834	263,763
Provision for vacation pay	94,987	107,920	87,700	103,075
Institutions	35,133	51,481	29,266	51,481
Accrued interest	80,158	97,903	77,247	93,873
Forward exchange contracts	19,992	—	19,620	—
Other accrued expenses	106,721	83,077	80,406	50,658
Current maturities in respect of deferred income	56,886	44,219	36,900	35,604
Liability in respect of investee company (Note 8)	—	43,594	—	43,594
Provision for claims in respect of salary and pension components	59,832	118,899	59,832	118,899
	<u>825,777</u>	<u>1,066,020</u>	<u>694,358</u>	<u>928,084</u>
(1) Includes current maturities of long-term loan from pension fund	<u>12,822</u>	<u>11,107</u>	<u>12,822</u>	<u>11,107</u>

NOTE 19 — CONVERTIBLE DEBENTURES

The debentures registered in name were issued pursuant to a prospectus from February 1998. The issued par value of the debentures as at the balance sheet date is NIS 313,500,000. The debentures are convertible into ordinary shares of a par value of NIS 1 so that each NIS 10.12 par value of debentures can be converted into one ordinary

share of NIS 1 par value. The debentures bear real annual interest of 3.25% and guarantee an annual nominal yield of at least 12% in their first year of issue. The debentures will mature, if not converted into shares, on February 8th, 2001. During the reporting period, 178,187,698 par value of debentures were converted and in exchange, 17,607,480 ordinary shares of a par value of NIS 1 were issued. Since then, during the period until the preparation of the financial statements, another 132,655,288 par value of debentures were converted and in exchange, 13,108,230 ordinary shares of a par value of NIS 1 were issued.

NOTE 20 — DEFERRED REVENUES

Deferred revenues is comprised mainly of compensation in respect of a purchase agreement with a proportionately consolidated company, and of advance payments on account of service to outside factors.

NOTE 21 — CONTINGENT LIABILITIES

A. Claims

- (1) Following the reduction in the Company's tariffs from April 1st, 1992, an application was filed in the District Court in April 1992 for approval of a class action against the State of Israel and against the Company, alleging a lack of proper disclosure and the presentation of misleading information in the prospectus of May 23rd, 1991. The action alleged that the Company's public shareholders sustained damages estimated at approximately NIS 618 million. In May 1994 the District Court dismissed the application. In the appeal filed by the plaintiffs in the Supreme Court in June 1994, a deliberate arrangement was arrived at (and was validated as a decision in the appeal and in the application for permission to appeal). Under the arrangement, the appeal and the application for permission to appeal were canceled and it was agreed, inter alia, that the plaintiff may sue on its own behalf in the District Court for the same cause as that for which approval of the class action was sought, and that within 30 days of a decision being given in the District Court, the plaintiff would be entitled to file a renewed appeal against the decision of the District Court to reject the application for approval of the class action. The plaintiff has not yet filed such a claim on its own behalf. In the Company's opinion, relying on the legal counsel who is handling the case on its behalf, the prospects for the claim in the aforesaid proceedings cannot be estimated. No provision is included in the financial statements in respect of this claim.
- (2) In August 1996 a claim and an application by way of motion for approval of the claim as a class action were filed against the Company in the District Court. The plaintiff alleges that the Company is misleading the public in that the prices of direct-dial international calls are calculated and collected on the basis of meter pulses rather than call time units as promised in its advertisements. The claimed damage relates to overcharging deriving from rounding-up of fractions of meter pulses to a whole meter pulse. The value of the claim as a class action is approximately NIS 124 million, and it refers to the seven years preceding the filing of the action. In February 1997 the court approved the action as a declaratory class action with regard to the deception only, and determined that the extent of the damage of the members of the group could not be fixed, whether as a whole or as individuals. If the class action is allowed and a declaration made that the advertising was misleading, a subscriber who believes that he sustained damages as a result of the deception will be able to file a personal claim against the Company, in which he will attempt to prove his losses. The plaintiff filed an appeal against the part of the court's decision that rejects the application to recognize the action as a monetary class action. The Company filed a cross-appeal of the decision to recognize the action a declaratory class action. In March 1998 the application of the plaintiff to conjoin Bezeq International Ltd. as an additional defendant in the class action was allowed. Bezeq International Ltd. filed an appeal against this decision in May 1998 in the Supreme Court. On the same occasion, Bezeq International Ltd. requested to be conjoined as an additional appellant in the Company's appeal. In the Company's opinion, relying on the legal counsel who is handling the claim on its behalf, the chances of the appeal and the cross-appeal cannot be estimated. No provision is included in the financial statements in respect of this claim.
- (3) In June 1997 a group of approximately 130 employees filed a claim, through the Histadrut, in the Regional Labor Court, for declaratory relief in respect of the pension rights of those employees of the group who were transferred from the Ministry of Communications, serving as department heads and employed under personal contracts. According to the plaintiffs, they are entitled to pension terms identical to those of all Company employees to whom a collective agreement applies. In September 1997 the Attorney General gave notice of his presence in the proceeding. In May 1998 the Company filed an actuarial opinion in the Regional Labor Court, stating that the cost of the plaintiffs' demand would be approximately NIS 157 million. In November 1999 a decision was given rejecting almost all the causes of the action. This decision has been appealed. No provision appears in the financial statements in respect of this claim.
- (4) In July 1997 a claim and an application by way of motion were filed against the Company and the subsidiary — Bezeq International Ltd. — to recognize an action as a class action under Section 46A of the Restraint of Trade Law. The plaintiff alleges that the tariffs for international telecommunication services in the period from May 10th, 1996 to July 8th, 1997 were inflated and unreasonable, while exploiting its status as a monopoly, against a background of lowering prices as the international calls market was opening up to competition. The amount of the action is estimated by the plaintiff at about NIS 903 million. The plaintiff declared before the court his willingness to reword his claim so that it would stand against the Company only up to the date on which Bezeq International Ltd. would give notice that it has taken upon itself responsibility for international calls. On October 19, 1998 the Attorney General conveyed his position to the court, stating that the action should not be recognized as a class action. On January 27th, 1999 the Anti-Trust Commissioner applied to the court, requesting a hearing in which he would present evidence refuting the allegations of the Company and Bezeq International. On March 18th, 1999 the Anti-Trust Commissioner applied to the court requesting to clarify that he does not dispute that the tariffs of Bezeq International Ltd. and the Company, at the times relevant to the action, were binding prices rather than maximum

prices as alleged by the plaintiff, and that Bezeq International Ltd. and the Company could not have lawfully lowered the international call prices themselves without the approval of the competent authorities. On August 8, 1999, after submission of the summations of the parties, the District Court approved the claim as a class action. On September 20, 1999 the Company and Bezeq International Ltd. filed for permission to appeal this decision.

In the opinion of the Company and Bezeq International Ltd., relying on the legal counsels who are handling the claim on their behalf, it is not possible, at this stage, to estimate the outcome of the legal proceedings. No provision is made in the financial statements in respect of this claim.

- (5) In September 1997 a claim was filed against the Company and the State in the Regional Labor Court. The claim was filed on behalf of 128 senior employees who are employed under personal contracts. The nature of the claim is the plaintiffs' allegation that starting from October 1, 1996, they are entitled to a wage increment of 33%, corresponding to the increment which was given at that time to Members of the Knesset and to senior civil servants whose salaries are linked to those of Members of the Knesset. The total amount of the claim in respect of salary differences is approximately NIS 11 million. Additional amounts are being claimed in respect of delay in payment. The Company alleged that it pays the salaries of the plaintiffs according to the directives of the Government Companies Authority. In the Company's opinion, relying on the legal counsel who is handling the claim on its behalf, it is not possible, at this stage, to estimate the outcome of this claim. No provision is made in the financial statements in respect of this claim.

It should be noted in this regard, that the Government Companies Authority applied to the Attorney General on November 4, 1996, requesting an opinion. According to the draft opinion that was prepared at the Ministry of Justice, no obligation exists to pay the aforementioned increment. The opinion was conveyed to the government companies, and their senior employees were given the opportunity to present their position to the Attorney General. In the hearing held on January 27, 1998, the State's representative announced that the Attorney General had made his decision, which was that the Companies Authority has no obligation to issue an instruction to raise the senior employees' salaries by 33%, and that the Companies Authority had exercised its discretion reasonably on this question in deciding not to respond to the claim.

- (6) In November 1997 a claim was filed in the District Court, together with an application by way of motion to recognize a claim as a class action, against the Company, Bezeq International, the Chairman of the Board of Bezeq International and the CEO of Bezeq International. The claim alleges, inter alia, that the Anti-Trust Commissioner determined that Bezeq International had unfairly exploited its status in the international calls market and had implemented a deliberate policy of misleading the public on the subject of overseas call tariffs and that it had refrained from clarifying to the public that only those who register as Bezeq International subscribers would enjoy the reduced tariffs, while those who did not so register would be charged at the old tariffs, which were higher than those published.

The claim further alleged that the Company is liable for the acts and omissions of Bezeq International in that Bezeq International is its agent or is offending together with it and/or by allowing the use of the goodwill of Bezeq and/or by violating the duty to supervise Bezeq International, and that the Chairman of the Board and the CEO of Bezeq International are personally liable as managers and/or officers in Bezeq International who, in the course of fulfilling their offices, personally instructed the creation of the misrepresentations, the concealing of information, the selective publication of information, etc.

The amount of the claim as a class action is estimated by the plaintiffs at approximately NIS 56 million. In November 1997 Bezeq International filed an application for dismissal of the claim on the basis of lack of local jurisdiction. In December 1997 the Company was stricken from the claim, while the plaintiffs filed a request to conjoin an additional plaintiff. In addition, the Court approved a procedural agreement whereby all proceedings in the case would be deferred until the decision of the District Court in Jerusalem in the objection filed by Bezeq International to the determination of the Anti-Trust Commissioner. The court has not yet decided on the question of whether to approve the claim as a class action. In the opinion of the consolidated company and its legal advisers, the chances of the claim and/or its possible effect on its business cannot be estimated at this stage. No provision is made in the financial statements in respect of this claim.

- (7) In July 1998, the Central Administration Committee of the General Federation of Workers announced a labor dispute, mainly concerning definition of various payments to wage-earning workers and the determination of the value of various components in calculating pension-related wages. In July 1999 the Company reached an arrangement with the workers concerning the leisure component in the pension-related wage calculation. Under this arrangement, which was validated as a decision by the Regional Labor Court, the workers undertook to end the labor dispute immediately.
- (8) A number of claims of former employees are pending against the Company, whose subject matter is mainly the inclusion of various wage components for calculating pensions. These issues are liable to have broad consequences. In the opinion of Company management, based on opinions of its legal advisers who are handling the claims on its behalf, it is not possible, at this stage, to estimate the outcome and possible implications for the Company of these claims. Accordingly, no provision is made in the financial statements in respect of these claims.
- (9) In accordance with the notice of the Anti-Trust Commissioner dated November 10, 1997, at the end of June 1997 the Commissioner opened an investigation against the consolidated company, which focused on two main suspicions: exploitation of market status by setting "predatory prices", and exploitation of market status by misleading the public. The application of the Ministry of Communications referred to above was also added to the investigation material. On November 9, 1997 the Anti-Trust Commissioner determined that the consolidated company exploited its status in the market in contravention of Section 29A of the Restraint of Trade Law by adopting a policy of

deception in connection with the prices it collects, and he decided that there was no incidence of “predatory prices” and that no action need be taken on that front. The Commissioner conveyed his decision to the State Comptroller, the Minister of Communications, the Attorney General, the director of the Government Companies Authority and the CEO of the Company, to allow them to examine, each according to his or her authority and discretion, whether its contents justifies or requires any action on his or her part, against the aforesaid background. On November 16, 1997 the director of the Government Companies Authority addressed the Attorney General, requesting that he notify her whether the determination constitutes suspicion of a shameful offense and whether there is any intention to act by serving indictments. She also addressed the Anti-Trust Commissioner, requesting that he notify her when he has formulated his position in the matter of criminal proceedings. In response, on December 22, 1997, the Commissioner informed her that at that stage, and based on the investigation material in his possession, he does not intend to initiate criminal proceedings against Bezeq International or against its officers. On December 23, 1997 the consolidated company filed an objection in the Anti-Trust Tribunal to the determination of the Commissioner in the matter of exploitation of market status by way of misleading the public.

In July 1998 the Anti-Trust Commissioner submitted his response to the objection, filed by Bezeq International Ltd. in the Anti-Trust Tribunal, to the determination of the Commissioner concerning exploitation of market status by way of misleading the public, in which he disputes the allegations raised by Bezeq International Ltd. concerning tariffs, including the contention that no fair hearing was held.

On September 8, 1998, Bezeq International Ltd. filed an application for dismissal of the response of the Commissioner in limine and cancellation of his determination. On February 3, 2000 the Anti-Trust Tribunal rejected the application of Bezeq International Ltd. On March 5, 2000 Bezeq International Ltd. filed a request for permission to appeal that decision in the Supreme Court. In the opinion of the consolidated company and its legal advisers, it is not possible, at this stage, to estimate the implications of the Commissioner’s determination for the Company if the court or the tribunal does not void it. Accordingly, no provision is made in the financial statements for this matter.

- (10) In December 1998 the Anti-Trust Commissioner published notice that the Investigations Department of the Anti-Trust Commission had completed an investigation it had carried out over the past year, of prima facie suspicions of cartels between Koor Industries, Telrad, Tadiran, the Company and BezeqCall Communications, in the supply of large switching exchanges and in network terminal point exchanges.

Below are the main points of the Commissioner’s notice:

The investigation focused on two main issues: the public switching market, which includes the supply of digital exchange equipment and concomitant services by Tadiran and Telrad to the Company; and the network terminal point exchange market.

According to the Commissioner, the Authority investigators recommend that indictments be filed against some of those who were investigated concerning some of the suspicions that were investigated. The Legal Department at the Anti-Trust Commission will now examine the investigation material and the recommendations of the investigators, in order to determine whether offenses against the Anti-Trust Law were indeed perpetrated, and whether there is sufficient evidentiary basis for trial. This examination is expected to last several months.

The Commissioner added that the findings of the investigation paint a harsh picture of the manner in which the Company purchased exchanges from Koor, and of the manner in which the network terminal point market was operated until recently.

In the area of public switching, the Authority’s investigation raises suspicions of collaboration between Telrad and Tadiran, vis-a-vis the Company. Among other things, there is prima facie suspicion that Telrad and Tadiran coordinated various aspects of the competition between them vis-a-vis the Company, in some cases with the knowledge of the Company and in other cases without its knowledge. The Authority also investigated suspicion of coordination between Telrad and Tadiran relating to telecommunications tenders in 1998 and relating to framework agreements with the Company in 1994 and 1996.

The second area of suspicion which was investigated in connection with large exchanges, concerns suspicion of cartelism between the Company and Koor, Telrad and Tadiran, which includes a commitment by the Company not to purchase exchanges from a third vendor; division of purchases between Telrad and Tadiran according to a predetermined key, i.e. the ostensible pre-arrangement of the competition between the companies vis-a-vis the Company; an undertaking by the Company not to purchase from the two companies by tender. It is suspected that some or all of these undertakings, in the relevant circumstances, constitute violation of the provisions of the Anti-Trust Law. From the findings of the investigation, it appears, ostensibly, that in fact the Company purchased exchanges from one vendor (Koor Industries) — at prices which were seemingly much higher than those the Company would have paid had it not bound itself and had the entire market not been blocked by the aforementioned arrangement to other equipment vendors.

The investigation of the Authority also revealed, ostensibly, that in some of these engagements the Company acted in clear contravention of the legal advice it received. In the opinion of the Authority investigators, this element of acting elusively constitutes not only proof that the relevant parties knew they were involved in an offense, but also defines aggravated circumstances for that offense.

The findings of the Authority’s investigation in this area appear to indicate a series of cartels and attempted offenses in the field of network end points, between Bezeq Call Communications, Telrad and Tadiran. Among others, suspicions are raised of cartels or attempts at such arrangements -in providing maintenance service for private exchanges, in the prices of buying the service, in customer transfer arrangements and in price discrimination arrangements; in the field of providing maintenance services for private exchanges and network terminal point

infrastructures, the composition and price of the service which will be offered to customers for the exchanges in their possession; in ongoing coordination between those entities or some of them; in tenders which were held by final customers for the purchase of network terminal point exchanges. It is suspected that said companies or some of them, in various instances, coordinated the prices of the proposals they would submit in the tenders of final customers. In addition, prima facie evidence was found of market division arrangements between the companies, as well as agreements concerning non-marketing of the product of an additional third vendor in the field of network terminal point exchanges.

The Anti-Trust Law, 5748-1988, forbids engagement as a party to a cartel which was not duly approved or which was not granted exemption or a temporary permit. Commission of such an act is a criminal offense and is also a tortious act and a possible basis for class action proceedings against a party to the arrangement. The findings of the Anti-Trust Authority's investigation have not been conveyed to the Company and the Company is unable to assess their significance for it and for its officers, in the past and present, or what the decisions of the Anti-Trust Commissioner will be on the above matters, and their implications for the Company, including the ability of its shareholders or customers or any other third party to sue it, or its ability to sue others.

- (11) In December 1998 a claim was filed against the Company, together with an application for recognition of the claim as a class action under the Consumer Protection Law, 5741-1981, the Anti-Trust Law, 5748-1988, and alternatively under Regulation 29 of the Civil Procedures Regulations. The claim concerns an advertising campaign of the Company which deals with the advantages of using a fixed-line telephone from the home compared with the use of a cellular telephone. The amount of the class action is estimated by the plaintiff at approximately NIS 57 million. The court partially accepted the application for approval of the class action. Approval of the action as a class action was limited to a declaratory class action by virtue of the Consumer Protection Law, 5741-1981 only, where the cause is "misleading advertising". The parties filed applications for permission to appeal this decision in the Supreme Court. On October 31, 1999, a statement of defense was filed in the class action. In the opinion of the Company, relying on the legal counsel who is handling the claim on its behalf, it is not possible, at this stage, to estimate the chances of the claim. No provision is made in the financial statements in respect of this claim.
- (12) In December 1998, a claim was filed against the Company, Pelephone Communications Ltd. and against another cellular communications company, together with an application for recognition as a class action under the Consumer Protection Law, 5741-1981, and alternatively under Section 29 of the Civil Procedures Regulations. The claim concerns the collection of payment for airtime which is effected, according to the plaintiff, by the Company for the defendant cellular operators in respect of a call which originates in the network of the Company to one of the operators when the call is routed by means of a service of the operator, to voice mail or by "call forwarding" to the network of the Company. The amount of the class action is estimated by the plaintiff at approximately NIS 2 billion. In the opinion of the Company, based on the legal counsel who is handling the claim on its behalf, it is not possible, at this stage, to estimate the outcome of the claim. No provision is made in the financial statements in respect of this claim.
- (13) In March 1999 a claim was filed against the Company by a group of employees who were employed as temporary workers by the Ministry of Communications and were transferred to the Company when it commenced operations. The plaintiffs are requesting that the Labor Court determine that they are entitled to all the benefits which were granted to permanent transferred employees, graduates of Bezeq College and Ministry of Communications pensioners. The Company has filed an application to dismiss the action in limine since it has exceeded the period of limitations.

The questions raised in this claim are liable to have a lateral effect on the Company. The Company is unable, at this stage, to estimate the outcome and the possible implications for the Company. Accordingly, no provision is made in the financial statements in respect of this claim.

- (14) On February 15, 2000 a claim was filed against the Company in the District Court in Jerusalem in the amount of NIS 20 million. The plaintiff alleges in his claim that the Company breached its commitments and representations to him to purchase large quantities of equipment from him. The plaintiff further alleges that the procedure which was used for selecting the equipment which would be purchased by the Company was unlawfully managed, with infringement of the tenders laws and the rules of proper administration, with negligence and while exploiting the status of the Company as a monopoly or monopsony. No statement of defense has yet been filed. At this stage of the proceedings, the Company is unable, relying on the legal counsel which is handling the claim on its behalf, to estimate the outcome of the claim. Accordingly, no provision is made in the financial statements in respect of this claim.
- (15) On February 23, 2000, two former employees of the Company filed a financial claim in the District Court in Jerusalem against the State of Israel and against the Company. An application was attached to the claim, requesting approval as a class action in the names of additional employees and pensioners of the Company. The amount of the personal claim of the two representative plaintiffs is approximately NIS 6,500. The amount of the claim of all the plaintiffs, for whom representation is requested, is not stated in the claim. The groups for whom approval of representation is applied for in the action comprise a total of 8,272 employees.

In their statement of claim, the plaintiffs allege, inter alia, that the defendants breached various commitments toward them which were included in the prospectus of the Company published in 1991, including commitments to allot Company shares, pay dividends and make preferential loans available to the plaintiffs. The plaintiffs allege that the allotment of shares in accordance with the Company's prospectus that was published in 1998 constitutes only partial and inadequate fulfillment of those undertakings. (For example, they allege that the number of shares allotted was insufficient, that inadequate sums were paid in dividends, that no preferential loans were

given, etc.) The plaintiffs further allege that the prospectus that was published in 1998 contained misleading details and representations, and material documents that ought to have been attached were not attached.

The Company has not yet filed a statement of defense, nor a response to the application for approval as a class action.

At this stage of the proceedings, the Company is unable to estimate the outcome of this legal proceeding, and accordingly, no provision is made in the financial statements in respect of this claim.

- (16) A class action was filed against Pelephone Communications Ltd. in the District Court, by virtue of the Consumer Protection Law, 5741-1981 and the Anti-Trust Law 5748-1988. The basis for the claim is an allegation of exploitation of the Company's status as a monopoly and exploitation of distress and misleading consumers. If the action is recognized as a class action, the amount claimed is approximately NIS 16 billion.

The Company has filed an application for dismissal in limine, based on the belief that the claim is unfounded. The management of Pelephone Communications Ltd. estimates, based on the opinion of its in house and outside legal advisers, that the claim is unlikely to succeed. Accordingly, no provision is made in the financial statements in respect of this claim.

- (17) A class action was filed against Pelephone Communications Ltd. for charging value added tax within the borders of the free trade zone in Eilat. The total for which approval is sought as part of the action is approximately NIS 34 million. At this stage, Pelephone Communications Ltd. and its legal advisers are unable to express any opinion in connection with this claim, since they are still studying the matter. Accordingly, no provision is made in the financial statements in respect of this claim.
- (18) For the claim of the Ministry of Communications in India for forfeiture of guarantees, see Note 8D.
- (19) For the claim of the Company from an equipment vendor and his counter-claim, see Note 9E.
- (20) In the matter of the notice of the Accountant General at the Ministry of Finance on the subject of the end of the asset lease period for a two-year renewal period, see Note 9B.
- (21) For the income tax assessment for 1994, see note 11E.
- (22) For possible demand for early repayment of bank loans, see Note 14D1 and 15C.
- (23) Miscellaneous claims — Various claims are pending against the Company in the normal course of business. It is the opinion of the Company's management that the risk inherent in each of these claims will not cause the Company material financial losses in excess of the provisions included in the financial statements.

The amounts of the claims referred to above are adjusted (without interest) in terms of shekels of December 31, 1999.

B. Forward Exchange Contracts

The Company has entered into forward exchange contracts as a hedge against exposure resulting from changes in the exchange rate of the US dollar in relation to changes in the CPI. As at December 31st, 1999, the Company contracted to purchase approximately US \$343 million (approximately NIS 1,425 million) for which it will pay approximately NIS 1,422 million linked to the CPI. The contracts mature on various dates, the last of which is December 2001. The Company also contracted to purchase approximately US \$355 million (NIS 1,474 million) for which it will pay, per agreed interest rates, approximately NIS 1,504 million.

C. Lease Commitments

<u>For the year ended December 31</u>	<u>Consolidated</u> <u>NIS thousands</u>	<u>Company</u> <u>NIS thousands</u>
2000	105,437	69,699
2001	110,463	66,517
2002	106,789	65,039
2003	99,393	59,515
2004	92,104	52,226
2005 and onwards	<u>523,356</u>	<u>420,282</u>
	<u>1,037,542</u>	<u>733,278</u>

D. Securities and Liens

For securities, liens and stipulations in connection with loan covenants given by the Company, see Note 14D and Note 15C.

NOTE 22 — SHARE CAPITAL

The general Meeting which convened on May 12th, 1999 resolved to approve an increase in the authorized share capital of the Company from NIS 835,000,000 to NIS 910,000,000 by the creation of 75,000,000 ordinary shares of a

par value of NIS 1 each, which would be equal in their rights to the existing ordinary shares of the Company. This was done for the purpose of issuing securities as part of a public offering according to a prospectus, pursuant to the decision of the Ministerial Committee for Privatization from August 4, 1998.

The above mentioned capital increase requires the approval of the Ministerial Committee for Privatization pursuant to Section 11 of the Government Companies Law, 5735-1975. Following the determination of the Attorney General that a public offering cannot be made due to the dispute in the matter of land assets (see Note 9B), the above resolution was not transferred to the Ministerial Committee for Privatization for approval.

The share capital consists of ordinary shares of a par value of NIS 1 each. The authorized share capital is 835,000,000 shares, the issued and paid up capital is 783,391,072 shares (1998 — 765,783,592 shares). All the shares are traded on the Tel Aviv Stock Exchange.

NOTE 23 — REVENUES FROM TELECOMMUNICATION SERVICES

Consolidated

	For the year ended December 31		
	1999	1998*	1997*
	NIS thousands	NIS thousands	NIS thousands
Revenues from telephone services —			
Domestic calls	2,750,493	3,305,647	3,331,673
Cellular telephone	2,837,589	2,677,852	2,362,425
Fixed fees	1,819,036	1,573,652	1,418,202
International communications	892,514	1,105,604	1,662,706
Installation and sale of equipment to subscribers	479,170	505,651	504,390
Other	<u>141,440</u>	<u>76,389</u>	<u>47,153</u>
	8,920,242	9,244,795	9,326,549
Other revenues	<u>223,108</u>	<u>269,230</u>	<u>252,027</u>
	<u>9,143,350</u>	<u>9,514,025</u>	<u>9,578,576</u>

Company

	For the year ended December 31		
	1999	1998*	1997*
	NIS thousands	NIS thousands	NIS thousands
Revenues from telephone services —			
Domestic calls	2,765,344	3,315,010	3,344,011
Cellular telephone	1,983,563	1,821,376	1,612,492
Fixed fees	1,669,119	1,405,872	1,257,113
International communications	444,369	540,088	541,104
Installation and sale of equipment to subscribers	235,377	261,013	264,810
Other	<u>143,736</u>	<u>80,324</u>	<u>49,054</u>
	7,241,508	7,423,683	7,068,584
Other revenues	<u>217,312</u>	<u>257,186</u>	<u>246,149</u>
	<u>7,458,820</u>	<u>7,680,869</u>	<u>7,314,733</u>

* Reclassified

NOTE 24 — OPERATING AND GENERAL EXPENSES

Consolidated

	For the year ended December 31		
	1999	1998*	1997*
	NIS thousands	NIS thousands	NIS thousands
Salaries and related expenses	1,671,130	1,878,920	1,806,479
Cellular telephone expenses	1,364,926	1,090,993	888,506
General expenses	716,230	529,904	499,431
Services and maintenance by sub-contractors	470,703	429,486	387,261
Building maintenance	396,693	379,547	415,592
Materials and spare parts	279,484	288,559	341,094
International communications expenses	264,601	456,213	765,514
Vehicle maintenance expenses	65,457	62,980	77,876
Collection fees	42,115	43,075	44,445
	<u>5,271,339</u>	<u>5,159,677</u>	<u>5,226,198</u>
Less — salaries charged to investment in fixed assets	<u>159,870</u>	<u>171,306</u>	<u>169,094</u>
	<u>5,111,469</u>	<u>4,988,371</u>	<u>5,057,104</u>

Company

	For the year ended December 31		
	1999	1998*	1997*
	NIS thousands	NIS thousands	NIS thousands
Salaries and related expenses	1,393,014	1,660,797	1,589,508
Cellular telephone expenses	1,497,174	1,300,636	1,101,943
General expenses	256,117	231,443	251,487
Services and maintenance by sub-contractors	415,237	386,408	335,138
Building maintenance	354,149	342,999	386,677
Materials and spare parts	51,433	59,597	138,948
International communications expenses	18,751	27,993	21,248
Vehicle maintenance expenses	59,936	58,763	69,074
Collection fees	41,464	42,461	41,082
	<u>4,087,275</u>	<u>4,111,097</u>	<u>3,935,105</u>
Less — salaries charged to investment in fixed assets	<u>159,870</u>	<u>171,306</u>	<u>169,094</u>
	<u>3,927,405</u>	<u>3,939,791</u>	<u>3,766,011</u>

* Reclassified

NOTE 25 — FINANCING EXPENSES TO BANKS AND OTHERS, NET

Consolidated

	For the year ended December 31		
	1999	1998	1997
	NIS thousands	NIS thousands	NIS thousands
Expenses in respect of long-term liabilities (*)			
Debentures	82,668	69,876	57,116
Loans	<u>212,984</u>	<u>520,876</u>	<u>373,930</u>
	295,652	590,752	431,046
Income in respect of deposits and investments	(73,606)	(42,230)	(11,009)
Expenses (income) in respect of forward exchange contracts ...	111,182	(181,705)	(12,460)
Other expenses (income), net	<u>(29,216)</u>	<u>(12,698)</u>	<u>13,956</u>
	<u>304,012</u>	<u>354,119</u>	<u>421,533</u>
(*) Includes increase in value (net of erosion) of liabilities in foreign currency	<u>(33,276)</u>	<u>265,994</u>	<u>59,755</u>

Company

	For the year ended December 31		
	1999	1998	1997
	NIS thousands	NIS thousands	NIS thousands
Expenses in respect of long-term liabilities (*)			
Debentures	82,668	69,876	85,470
Loans	<u>193,815</u>	<u>495,804</u>	<u>354,636</u>
	276,483	565,680	440,106
Income in respect of deposits and investments	(73,606)	(3,318)	(17,606)
Expenses (income) in respect of forward exchange contracts ...	111,182	(181,705)	(12,460)
Other expenses (income), net	<u>(5,432)</u>	<u>(4,750)</u>	<u>10,034</u>
	<u>308,627</u>	<u>375,907</u>	<u>420,074</u>
(*) Includes increase in value (net of erosion) of liabilities in foreign currency	<u>(35,329)</u>	<u>242,466</u>	<u>51,737</u>

NOTE 26 — OTHER INCOME (EXPENSES), NET**Consolidated**

	For the year ended December 31		
	1999	1998	1997
	NIS thousands	NIS thousands	NIS thousands
Provision for employee severance benefits upon early retirement (Note 17D)	(398,340)	202,317	(1,155,376)
Provision for billing system (Note 9E)	(126,772)	—	—
Provision for claims for salary and pension components (Note 21A(7))	—	(88,497)	—
Provision for unused sick leave (1)	9,767	(60,805)	—
Provision for decrease in value of fixed assets	—	(14,623)	—
Direct expenses for customer allocation process	(75,561)	—	—
Capital gains (losses), net	16,391	4,686*	(604)*
Loss from curtailment of operations of BezeqCall Ltd.	—	—	(21,690)
Write-off of investment in an affiliate (Note 8E)	—	—	(87,074)
Cancellation of provision for a guarantee for an affiliate (Note 8)	14,919	—	—
Others	<u>1,138</u>	<u>(316)</u>	<u>2,018</u>
	<u>(558,458)</u>	<u>42,762</u>	<u>(1,262,726)</u>

Company

	For the year ended December 31		
	1999	1998	1997
	NIS thousands	NIS thousands	NIS thousands
Provision for employee severance benefits upon early retirement (Note 17D)	(398,340)	202,317	(1,155,376)-
Provision for billing system (Note 9E)	(126,772)	—	—
Provision for claims for salary and pension components (Note 21A(7))	—	(88,497)	—
Provision for unused sick leave (1)	9,767	(60,805)	—
Provision for decrease in value of fixed assets	—	(14,623)	—
Capital gains (losses), net	17,454	13,027*	(6,619)*
Write-off of investment in an affiliate (Note 8E)	—	—	(87,074)
Cancellation of provision for a guarantee for an affiliate (Note 8)	14,919	—	—
Others	202	—	—
	<u>(482,770)</u>	<u>51,419</u>	<u>(1,249,069)</u>

* Reclassified

(1) Constitutes recording of a provision for unused sick leave in respect of employees who have not yet reached the age of 55 (which is the age at which redemption of unused sick pay is permitted). Up to the year of account, this provision was recorded only in respect of employees who had reached the age of 55.

NOTE 27 — EARNINGS PER SHARE (CONSOLIDATED AND COMPANY)

	For the year ended December 31		
	1999	1998	1997
	NIS thousands	NIS thousands	NIS thousands
Primary and diluted earnings (loss)	<u>18,867</u>	<u>766,149</u>	<u>(245,221)</u>
Weighted number of shares in primary earnings and diluted earnings	<u>803,942</u>	<u>769,611</u>	<u>741,904</u>

In order to determine the likelihood of the conversion of the convertible debentures to calculate earnings per share, the present value for 1999 was calculated assuming possible exercise of the convertible debentures at a post-tax shekel interest rate of 6.5%.

NOTE 28 — BUSINESS SEGMENTS

The Company and the investee companies operate in various segments of the communications sector. The data concerning operations by segment are presented according to the segments of operation of those companies.

For the year ended December 31, 1999

	Fixed line domestic communications	Cellular telephone	International communications	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues						
Revenues from outside sources	7,127,974	1,159,855	698,553	156,968	—	9,143,350
Inter-segment revenues	<u>330,846</u>	<u>327,969</u>	<u>9,417</u>	<u>27,482</u>	<u>(695,714)</u>	<u>—</u>
Total revenues	<u>7,458,820</u>	<u>1,487,824</u>	<u>707,970</u>	<u>184,450</u>	<u>(695,714)</u>	<u>9,143,350</u>
Segment results	<u>1,029,897</u>	<u>72,266</u>	<u>(59,773)</u>	<u>14,649</u>	<u>(47,435)</u>	1,009,604
Financing expenses						<u>(360,072)</u>
Earnings after financing expenses						649,532
Other expenses, net						<u>(558,458)</u>
Earnings before income tax						91,074
Income tax						<u>(62,796)</u>
Earnings after income tax						28,278
Equity in earnings (losses) of affiliates	5,382			(26,932)		<u>(21,550)</u>
Net earnings						<u>6,728</u>
Identified assets	12,828,818	1,896,261	730,159	94,097	(60,378)	15,488,957
Investment by equity method ..	48,628	—	—	26,870	—	75,498
General assets						<u>1,248,402</u>
Total consolidated assets						<u>16,812,857</u>
Segment liabilities	1,433,503	520,425	385,098	52,863	(89,533)	2,302,356
General liabilities						<u>7,020,269</u>
Total consolidated liabilities						<u>9,322,625</u>
Capital investments	<u>1,064,167</u>	<u>771,853</u>	<u>105,347</u>	<u>7,290</u>		
Depreciation and deductions	<u>2,293,311</u>	<u>427,362</u>	<u>48,174</u>	<u>3,714</u>		

For the year ended December 31, 1998

	Fixed line domestic communications	Cellular telephone	International communications	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenue						
Revenues from outside sources	7,255,317	1,162,601	931,483	164,624	—	9,514,025
Inter-segment revenues	<u>425,552</u>	<u>346,949</u>	<u>39,347</u>	<u>15,614</u>	<u>(827,462)</u>	<u>—</u>
Total revenues	<u>7,680,869</u>	<u>1,509,550</u>	<u>970,830</u>	<u>180,238</u>	<u>(827,462)</u>	<u>9,514,025</u>
Segment results	<u>1,365,132</u>	<u>234,786</u>	<u>25,290</u>	<u>13,689</u>	<u>22,939</u>	1,661,836
Financing expenses						<u>(455,814)</u>
Earnings after financing expenses						1,206,022
Other expenses, net						<u>42,762</u>
Earnings before income tax						1,248,784
Income tax						<u>(491,230)</u>
Earnings after income tax						757,554
Equity in earnings of affiliates ..	6,468					<u>6,468</u>
Net earnings						<u>764,022</u>
Identified assets	14,552,646	1,510,185	872,641	76,944	(62,826)	16,949,590
Investment by equity method ..	36,546	—	—	—	—	36,546
General assets						<u>1,241,227</u>
Total consolidated assets						<u>18,227,363</u>
Segment liabilities	1,506,726	242,599	421,796	41,827	(137,810)	2,075,138
General liabilities						<u>8,791,071</u>
Total consolidated liabilities						<u>10,866,209</u>
Capital investments	<u>1,192,893</u>	<u>558,226</u>	<u>50,596</u>	<u>3,872</u>		
Depreciation and deductions ...	<u>2,127,913</u>	<u>337,617</u>	<u>40,952</u>	<u>2,992</u>		

For the year ended December 31, 1997

	Fixed line domestic communications	Cellular telephone	International communications	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues						
Revenues from outside sources	6,708,172	1,013,280	1,696,189	160,935	—	9,578,576
Inter-segment revenues ..	<u>606,561</u>	<u>305,228</u>	<u>37,985</u>	<u>24,451</u>	<u>(974,225)</u>	<u>—</u>
Total revenues	<u>7,314,733</u>	<u>1,318,508</u>	<u>1,734,174</u>	<u>185,386</u>	<u>(974,225)</u>	<u>9,578,576</u>
Segment results	<u>1,116,053</u>	<u>256,049</u>	<u>258,320</u>	<u>(10,654)</u>	<u>12,374</u>	1,632,142
Financing expenses						<u>(630,555)</u>
Earnings after financing expenses						1,001,587
Other expenses, net						<u>(1,262,726)</u>
Loss before income tax ..						(261,139)
Income tax						<u>37,957</u>
Loss after income tax						(223,182)
Equity in losses of affiliates	(22,039)					<u>(22,039)</u>
Net loss						<u>(245,221)</u>
Identified assets	15,238,083	1,276,586	1,029,574	79,767	(106,762)	17,517,248
Investment by equity method	30,082	—	—	—	—	30,082
General assets						<u>1,313,621</u>
Total consolidated assets						<u>18,860,951</u>
Segment liabilities	1,412,966	188,279	498,073	40,273	(152,482)	1,987,109
General liabilities						<u>10,622,024</u>
Total consolidated liabilities						<u>12,609,133</u>
Capital investments	<u>1,642,506</u>	<u>324,020</u>	<u>97,488</u>	<u>3,004</u>		
Depreciation and deductions	<u>2,160,359</u>	<u>299,453</u>	<u>39,205</u>	<u>2,220</u>		

NOTE 29 — TRANSACTIONS WITH INTERESTED AND RELATED PARTIES

A. The Company is a government company, which transacts a large volume of business, in the regular course of its operations, with government ministries and agencies and government companies. The business transacted is, primarily, the provision of telecommunications services and the execution of development work, as well as the receipt of various types of services. It is not practicable to determine the identity of the interested parties involved in such transactions nor to make a distinction in the recording thereof. The Securities Authority, pursuant to its authority under the Securities Regulations (Preparation of annual financial statements), 5753-1993, exempted the Company from detailing its transactions with interested parties, other than extraordinary transactions.

B. The Company provides services to the Israeli Defense and Security Forces in accordance with terms decided upon in prior years and which provided, inter alia, that the Ministry of Defense will fund the Company's infrastructure investments in consideration of discounts which the Company will grant in respect of current services.

Due to controversies that arose between the Company and the Ministry of Defense in connection with the terms of the services that the Company provides to the Israeli Defense Forces, a professional committee was established to examine the differences of opinion. In May 1996, the committee submitted recommendations for the resolution of the differences of opinion, of which the main recommendations are as follows:

- (1) The balance of the accounting between the Company and the Ministry of Defense for the first half of 1996 amounts to approximately NIS 350 million as excess investments by the Ministry of Defense.
- (2) For the purpose of completing the accounting mentioned in (1) above, the Company will grant a discount at the rate of 14% on its total services provided to the Israeli Defense Forces, for a period of ten years commencing on July 1, 1996.
- (3) All prior obligations and controversies between the parties, as they appear in the claims and demands submitted by both parties, are canceled.

- (4) Commencing July 1, 1996, the relationship between the Company and the Ministry of Defense shall be similar to that as between the Company and its other customers. The investments in communications infrastructure shall be made and financed by the Company and the Ministry of Defense will be charged based on the Company's tariffs, subject to that stated in (2) above.

The committee's recommendations require approval by the Minister of Defense and the Minister of Communications. The Company announced that notwithstanding the fact that it has reservations about the report and the results and in order to resolve the long outstanding disagreements, it accepts the recommendations of the committee. Since the recommendations were not adopted by the Ministers of Defense and Communications, the arrangements which were hitherto in effect between the Company and the Israeli Defense Forces, and which were the subject of the committee's discussions, continue to govern.

C. Guarantees

The Company has given guarantees to banks in connection with credit granted to subsidiary companies of up to NIS 70 million. As at balance sheet date, the balance of the guaranteed loans, as stated, amounted to approximately NIS 10 million.

The Company signed a deed of guarantee on behalf of an affiliate to a bank in the amount of NIS 10 million. The guarantee is valid until December 31, 2010. See Note 8F.

In connection with guarantees given by the Company in respect of its investments in India, see Notes 8D and 8E.

D. Transactions with Subsidiaries and a Proportionately Consolidated Company (Company Books)

	For the year ended December 31		
	1999	1998	1997
	NIS thousands	NIS thousands	NIS thousands
Revenues —			
Interconnect and access fees	419,337	478,567	454,014
Services, royalties and commissions	59,527	42,265	249,074
Rent and fixed fees for buildings and equipment	896	20,312	14,074
Interest	—	970	1,304
Management fees	—	5,652	12,584
Expenses —			
Purchase of services	672,516	691,112	625,751
Interest	14,630	—	—
Total earnings from fixed asset transactions	963	2,256	3,989
Total transaction turnover	1,590	4,776	13,772

Transactions with a proportionately consolidated company were presented in full (100%).
For balances with subsidiaries and a proportionately consolidated company, see related notes.

E. Benefits to Directors and the CEO

	For the year ended December 31		
	1999	1998	1997
	NIS thousands	NIS thousands	NIS thousands
Total cost of compensation of the CEO and the Chairman of the Board of Directors	1,512	1,251	1,104
Number of employees	3	2	4
Balance of loans to the CEO and the Chairman of the Board of Directors	—	8	—
Compensation of members of the Board of Directors who are not Company employees*	1,243	1,294	825
Number of directors receiving compensation	13	14	15

* The compensation for directors in a proportionately consolidated company is presented at the proportional share of the Company (50%).

The Company holds an insurance policy for the officers of the Company and of the subsidiaries in which the Company holds 50% or more of the share capital. The maximum insurance is \$150 million per event and per period, and an additional \$30 million for legal expenses in Israel. In addition, the Company will indemnify officers in an amount not exceeding \$50 million per officer for a financial obligation imposed upon them in any matter connected with the Company's prospectus from February 27, 1998 and which is not covered by the insurance policy.

NOTE 30 — FINANCIAL INSTRUMENTS

A. Financial derivatives

The Group has an excess of liabilities over assets in or linked to foreign currency, in the amount of approximately NIS 3,209 million, of which the excess of current liabilities is approximately NIS 986 million. The excess of current liabilities is partially covered by forward exchange contracts, as described in Note 21B. The Group has revenues in foreign currency from international communications.

As at December 31, 1999, the excess of CPI-linked monetary liabilities over CPI-linked monetary assets amounted to approximately NIS 3,060 million, of which the excess of current liabilities is approximately NIS 793 million. As stated in Note 1B, most of the Company's tariffs are subject to government regulation and are revised from time to time in accordance with the increase in the CPI, net of an efficiency factor.

The Company has limited commitments in connection with financial derivatives, which are intended solely for purposes of hedging.

Regarding the Company's commitments to execute forward exchange contracts, at December 31, 1999 — see Note 21B.

B. Credit risks

Most of the cash and cash equivalents, at December 31, 1999, as well as bank deposits, are deposited in large Israeli banks. The short-term investments represent, primarily, investments in government debentures and bank deposits, while a small part thereof is invested in debentures of companies traded on the Tel Aviv Stock Exchange in Israel. Accordingly, Management does not expect significant losses deriving from credit risks.

The Group's revenues derive from a large number of customers. Management reviews customer balances on a current basis, and the financial statements include provisions which, in Management's opinion, are adequate for doubtful debts. The exposure to credit risk in connection with customers is limited considering the large number of customers of the Company.

C. Fair value of financial instruments

The book value of the cash and cash equivalents, short-term investments, trade receivables, other current assets, most of the long-term liabilities, the payables and accrued expenses, are equal or are close to their fair values. The fair value of loans from banks is also close to their book value, since they bear interest at roughly the market rate.

Regarding several items, there is a difference between the amount recorded on the books and the estimated fair value thereof, as detailed below.

	December 31, 1999	
	Book value	Fair value
	NIS thousands	NIS thousands
Debenture issued to the Government of Israel	470,954	472,256
Other debentures		
Issued to the public	327,704	311,572
Issued to others	1,151,433	1,038,299
Loans linked to CPI	1,219,481	1,148,362

The fair value of the debentures issued to the public is based on their market value. The fair value of the other liabilities presented above is based on the present value of the cash flows related thereto.

NOTE 31 — LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 1999

Consolidated

	In foreign currency or linked thereto	CPI-linked	Unlinked	Total
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Assets				
Cash and cash equivalents	22,775	—	641,462	664,237
Short-term investments	9,040	67,474	224,626	301,140
Trade receivables	163,138	3,447	1,356,259	1,522,844
Other receivables and debit balances	104	185,768	40,958	226,830
Long-term bank deposits and debit balances	—	11,841	263,902	275,743
	<u>195,057</u>	<u>268,530</u>	<u>2,527,207</u>	<u>2,990,794</u>
Liabilities				
Short-term credit from banks	—	—	271,006	271,006
Current maturities of long-term liabilities	749,173	529,762	—	1,278,935
Trade payables	373,568	—	782,806	1,156,374
Other current liabilities	58,501	60,976	649,414	768,891
Debenture issued to the Government of Israel	—	470,954	—	470,954
Long-term liabilities	2,223,189	1,013,415	—	3,236,604
Other long-term debentures	—	1,253,620	—	1,253,620
Dividend payable	—	—	301,565	301,565
Liabilities for employee severance benefits	—	—	429,648	429,648
	<u>3,404,431</u>	<u>3,328,727</u>	<u>2,434,439</u>	<u>9,167,597</u>

Company

	In foreign currency or linked thereto	CPI-linked	Unlinked	Total
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Assets				
Cash and cash equivalents	2,699	—	483,463	486,162
Short-term investments	9,040	67,474	217,943	294,457
Trade receivables	5,032	—	1,003,114	1,008,146
Other receivables and debit balances	—	139,804	27,665	167,469
Long-term bank deposits and debit balances	—	—	257,492	257,492
	<u>16,771</u>	<u>207,278</u>	<u>1,989,677</u>	<u>2,213,726</u>
Liabilities				
Current maturities of long-term liabilities	731,522	477,610	—	1,209,132
Trade payables	14,183	—	640,441	654,624
Other current liabilities	57,082	60,976	539,400	657,458
Debenture issued to the Government of Israel	—	470,954	—	470,954
Long-term liabilities	2,137,014	725,083	—	2,862,097
Other long-term debentures	—	1,253,620	—	1,253,620
Dividend payable	—	—	301,565	301,565
Liabilities for employee severance benefits	—	—	430,560	430,560
	<u>2,939,801</u>	<u>2,988,243</u>	<u>1,911,966</u>	<u>7,840,010</u>

For details of forward exchange contracts for covering exposure to foreign currency, see Note 21B.

NOTE 31 — LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 1998

Consolidated

	In foreign currency or linked thereto	CPI-linked	Unlinked	Total
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Assets				
Cash and cash equivalents	100,787	—	831,500	932,287
Short-term investments	10,406	149,788	225,631	385,825
Trade receivables	178,802	1,538	1,372,332	1,552,672
Other receivables and debit balances	68,109	112,128	16,218	196,455
Long-term bank deposits and debit balances	22,289	6,912	287,356	316,557
	<u>380,393</u>	<u>270,366</u>	<u>2,733,037</u>	<u>3,383,796</u>
Liabilities				
Short-term credit from banks				
Current maturities of long-term liabilities	736,579	1,501,804	—	2,238,383
Trade payables	458,442	—	539,027	997,469
Other current liabilities	84,942	93,691	843,168	1,021,801
Debenture issued to the Government of Israel	—	470,658	—	470,658
Long-term liabilities	2,448,165	1,171,727	—	3,619,892
Other long-term debentures	—	1,213,815	—	1,213,815
Convertible debentures	—	419,470	—	419,470
Liabilities for employee severance benefits	—	—	730,825	730,825
	<u>3,728,128</u>	<u>4,871,165</u>	<u>2,113,020</u>	<u>10,712,313</u>

Company

	In foreign currency or linked thereto	CPI-linked	Unlinked	Total
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Assets				
Cash and cash equivalents	140	—	804,891	805,031
Short-term investments	10,406	65,568	82,040	158,014
Trade receivables	1,544	—	1,070,028	1,071,572
Other receivables and debit balances	67,860	122,490	26,351	216,701
Bank deposits and debit balances	22,289	—	255,413	277,702
	<u>102,239</u>	<u>188,058</u>	<u>2,238,723</u>	<u>2,529,020</u>
Liabilities				
Current maturities of long-term liabilities	704,961	1,486,006	—	2,190,967
Trade payables	37,817	—	489,492	527,309
Other current liabilities	80,942	92,724	718,814	892,480
Debenture issued to the Government of Israel	—	470,658	—	470,658
Long-term liabilities	2,342,771	989,376	—	3,332,147
Other long-term debentures	—	1,213,815	—	1,213,815
Convertible debentures	—	419,470	—	419,470
Liabilities for employee severance benefits	—	—	729,421	729,421
	<u>3,166,491</u>	<u>4,672,049</u>	<u>1,937,727</u>	<u>9,776,267</u>

For details of forward exchange contracts for covering exposure to foreign currency, see Note 21B.

NOTE 32 — CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN NOMINAL VALUES

A. Balance Sheets

	December 31, 1999	December 31, 1998
	NIS thousands	NIS thousands
Assets		
Current assets	2,177,728	2,417,815
Materials and spare parts	228,557	219,717
Long-term bank deposits and debit balances	257,492	274,027
Investment in investee companies	1,277,590	1,240,913
Fixed assets	7,579,662	8,060,043
Other assets	401,369	390,742
	<u>11,922,398</u>	<u>12,603,257</u>
Liabilities		
Current	3,681,818	4,184,363
Long-term	4,299,349	5,569,020
	<u>7,981,167</u>	<u>9,753,383</u>
Convertible debentures	233,699	—
Shareholders' equity	3,707,532	2,849,874
	<u>11,922,398</u>	<u>12,603,257</u>

B. Statements of Operations

	For the year ended December 31		
	1999	1998	1997
	NIS thousands	NIS thousands	NIS thousands
Revenues from telecommunication services	7,369,982	7,276,454*	6,563,481
Costs and expenses			
Operating and general expenses	3,883,844	3,731,935*	3,383,168*
Depreciation	1,422,078	1,255,005	1,202,581
Royalties to the Government of Israel	205,769	236,244	245,845
	<u>5,511,691</u>	<u>5,223,184</u>	<u>4,831,594</u>
Operating income	1,858,291	2,053,270	1,731,887
Financing expenses			
Debenture issued to the Government of Israel	61,104	230,925	361,380
Banks and others, net	355,551	788,705	683,866
	<u>416,655</u>	<u>1,019,630</u>	<u>1,045,246</u>
Earnings after financing expenses	1,441,636	1,033,640	686,641
Other expenses, net	464,378	25,036*	1,147,427*
Earnings (loss) before income tax	977,258	1,008,604	(460,786)
Income tax (tax benefit)	44,455	(262,346)	220,392
Earnings (loss) after income tax	1,021,713	746,258	(240,394)
Company's equity in earnings (losses) of affiliated companies ...	(49,917)	252,054	300,849
Net earnings	<u>971,796</u>	<u>998,312</u>	<u>60,455</u>

* Reclassified

C. Statement of Shareholders' Equity

	<u>Share capital</u>	<u>Receipts from the issue of warrants</u>	<u>Capital reserves*</u>	<u>Accumulated deficit</u>	<u>Total</u>
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Balance as at January 1, 1997	732,087	—	2,741,260	(1,927,863)	1,545,484
Net earnings	—	—	—	60,455	60,455
Dividend**	—	—	—	(77,512)	(77,512)
Exercise of warrants	—	—	5,000	—	5,000
Balance as at December 31, 1997	732,087	—	2,746,260	(1,944,920)	1,533,427
Net earnings	—	—	—	998,312	998,312
Issue to the public	—	73,257	—	—	73,257
Issue to employees	4,216	—	32,549	—	36,765
Offer to employees	—	—	3,166	—	3,166
Compensation to Company employees from the Government	—	—	24,710	—	24,710
Exercise of warrants	29,250	(73,257)	221,785	—	177,778
Conversion of convertible debentures	231	—	2,228	—	2,459
Balance as at December 31, 1998	765,784	—	3,030,698	(946,608)	2,849,874
Net earnings	—	—	—	971,796	971,796
Dividend for preceding year	—	—	—	(301,565)	(301,565)
Conversion of convertible debentures	17,607	—	169,820	—	187,427
Balance as at December 31, 1999	<u>783,391</u>	<u>—</u>	<u>3,200,518</u>	<u>(276,377)</u>	<u>3,707,532</u>

* After deduction of assigned issuance expenses in the amount of NIS 3,615,000 in respect of 1998.

** Out of earnings adjusted for changes in the general purchasing power of the shekel.

NOTE 33 — CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD.

1. Bezeq International Ltd.

A. Balance sheets

	December 31, 1999	December 31, 1998
	NIS thousands	NIS thousands
Current assets	413,169	602,128
Investments	—	22,936
Fixed assets	314,224	296,600
Other assets	<u>12,258</u>	<u>2,929</u>
	<u>739,651</u>	<u>924,593</u>
Current liabilities	385,098	438,758
Long-term liabilities	—	22,463
Quasi-capital receipt	158,474	158,474
Shareholders' equity	<u>196,079</u>	<u>304,898</u>
	<u>739,651</u>	<u>924,593</u>

B. Statements of Operations

	For the year ended December 31		
	1999	1998	1997
	NIS thousands	NIS thousands	NIS thousands
Revenues from international communications services	696,681	934,173	1,722,855
Operating expenses	<u>594,726</u>	<u>795,289</u>	<u>1,344,806</u>
Gross profit	101,955	138,884	378,049
Marketing expenses	111,422	61,506	62,129
General and administration expenses	<u>50,306</u>	<u>46,331</u>	<u>53,823</u>
Operating income (loss)	(59,773)	31,047	262,097
Financing income, net	<u>36,075</u>	<u>37,072</u>	<u>18,738</u>
Earnings (losses) after financing	(23,698)	68,119	280,835
Other income (expenses), net	<u>(77,538)</u>	<u>(7,534)</u>	<u>3,701</u>
Earnings (losses) before income tax	(101,236)	60,585	284,536
Income tax	<u>9,003</u>	<u>26,660</u>	<u>103,006</u>
Net earnings (losses)	<u>(92,233)</u>	<u>33,925</u>	<u>181,530</u>

2. **Telephone Communications Ltd.**

A. **Balance sheets**

	December 31, 1999	December 31, 1998
	NIS thousands	NIS thousands
Current assets	930,749	696,979
Fixed assets	2,575,434	2,429,260
Long-term receivables	11,352	18,015
Reserve for compensation fund, net	3,482	—
Other assets, net	<u>459,494</u>	<u>—</u>
	<u>3,980,511</u>	<u>3,144,254</u>
Current liabilities	1,186,213	587,501
Provision for losses of investee company	3,978	—
Long-term liabilities	796,705	595,683
Shareholders' equity	<u>1,993,615</u>	<u>1,961,070</u>
	<u>3,980,511</u>	<u>3,144,254</u>

B. **Statements of Operations**

	For the year ended December 31		
	1999	1998	1997
	NIS thousands	NIS thousands	NIS thousands
Income from cellular services, sales and services	2,975,126	3,011,278	2,637,089
Cost of cellular services, sales and services	<u>2,377,871</u>	<u>2,173,625</u>	<u>1,803,810</u>
Gross profit	<u>597,255</u>	<u>837,653</u>	<u>833,279</u>
Sales and marketing expenses	280,398	230,465	198,379
General and administration expenses	<u>183,677</u>	<u>161,577</u>	<u>138,929</u>
	<u>464,075</u>	<u>392,042</u>	<u>337,308</u>
Income from ordinary operations	133,180	445,611	495,971
Financing expenses, net	65,745	29,541	35,168
Capital (gains) losses	<u>(521)</u>	<u>5,156</u>	<u>593</u>
Earnings before income tax	67,956	410,914	460,210
Income tax	<u>31,433</u>	<u>158,973</u>	<u>171,145</u>
Earnings after income tax	36,523	251,941	289,065
Equity in losses of investee companies	<u>3,978</u>	<u>—</u>	<u>—</u>
Net earnings	<u>32,545</u>	<u>251,941</u>	<u>289,065</u>

SCHEDULE A — LIST OF INVESTEE COMPANIES

	Percent of equity and control as at	
	December 31, 1999	December 31, 1998
	%	%
Subsidiaries		
Bezeq International Ltd.....	100	100
BezeqCall Communications Ltd. (formerly Bezeq Bit 1995 Ltd.)(1)	100	100
BezeqCall Ltd. (1).....	100	100
Bezeq Globe Ltd. (2)	100	100
Proportionately Consolidated Company	50	50
Pelephone Communications Ltd.		
Affiliated Companies		
The International Company for Underwater Cables Ltd. (3)	50	50
Goldnet Communications Services — registered partnership	38	38
Emitel Telecommunication Corp. Ltd. (Hungary) (4).....	33	33
Israeli Autostrada for Information Ltd. (5).....	33	33
Fascal Ltd. (India) (6)	16	16
D.B.S. Satellite Services (1998) Ltd. (7)	33	33
Infogate Online Ltd. (8)	29	—
Safe Com-Car Communication (hereinafter — Safe-Car)(9)	25.5	—
Walla! Communications Ltd.(10).....	26	—
Other Companies		
Intelsat (The International Organization for International Communications)	1.06	1.06

(1) Commencing July 1, 1997, the operations of both companies were merged and BezeqCall Ltd. ceased its operations.

(2) The company ceased to operate on July 1, 1998.

(3) The company maintained an underwater cable which it laid. The Company's share of the cost and maintenance of the equipment is charged to fixed assets and maintenance expenses. In February 1997 use of the cable ceased. In January 1999 the Board of Directors adopted a resolution for voluntary liquidation as of March 31, 1999.

(4) Indirect holding.

(5) During 1997 the operations of Israeli Autostrada for Information Ltd. ceased and a decision was made for its voluntary liquidation.

(6) Right to appoint directors — 25% (see Note 8E).

(7) See Note 8G.

(8) The Company is developing and supplying data communication services in ASP concept, in which computers are linked in a broadband network to a central server from which various services are received.

(9) The company is an investee company of Pelephone Communications Ltd. Pelephone holds 51% of Safe-Car Co. The financial statements of Safe-Car were not consolidated since Pelephone Communications Ltd. does not have control or joint control, pursuant to the establishment agreement of Safe-Car, in which material decisions are adopted by a majority of 75%.

(10) On December 30, 1999, Bezeq International Ltd. gave notice of its wish to exercise the option to purchase 26% of the issued share capital of Walla! Communications Ltd. On January 3, 2000, the shares were transferred to the company in consideration of NIS 24.6 million.

**The Board of Directors
Bezeq The Israel Telecommunication Corp. Limited**

Dear Sirs,

Re: Review of the Unaudited Interim Consolidated Financial Statements for the Three Month Period Ended March 31, 2000

At your request we have reviewed the interim consolidated balance sheet of Bezeq The Israel Telecommunication Corp. Limited and its subsidiaries as at March 31, 2000, as well as the interim consolidated statements of operations, changes in shareholders' equity and cash flows for the three month period then ended.

Our review was carried out in accordance with procedures prescribed by the Institute of Certified Public Accountants in Israel. The procedures included, inter alia, reading the said financial statements, reading the minutes of Shareholders Meetings and of meetings of the Board of Directors and its committees, as well as making inquiries of persons responsible for financial and accounting matters.

Reports of other auditors were furnished to us which relate to the review of the interim financial statements of subsidiaries whose assets as at March 31, 2000 constituted approximately 4.68% of total consolidated assets and whose revenues constituted approximately 7.09% of the total consolidated revenues for the three months then ended. Furthermore, the data included in the financial statements relating to the net asset value of the Company's investments in affiliates and its equity in their operating results is based on their interim financial statements reviewed by other auditors.

As the review is limited in scope and does not constitute an audit in accordance with generally accepted auditing standards, we do not express an opinion on the interim consolidated financial statements.

In the course of our review, including reviewing the reports of other auditors as mentioned above, nothing came to our attention which would indicate the necessity of making material changes in the said interim financial statements in order for them to be in conformity with generally accepted accounting principles and in accordance with the provisions of Section 4 of the Securities Regulations (Periodic and immediate reports), 1970.

We draw attention to the uncertainties relating to the following matters, for which the maximum possible exposure is significant:

1. The anticipated opening of the communications sector to competition, changes in tariffs and their effect on the Company's financial position and operating results, as described in Note 1.
2. A plan for organizational change, as described in Note 5.
3. Claims made against the Company and against investee companies, as described in Note 6A.

Yours truly,

KPMG Somekh Chaikin
Certified Public Accountants (Isr.)

May 23, 2000

UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

Interim Consolidated Balance Sheets In terms of shekels of March 2000

	March 31 2000	March 31 1999	December 31 1999
	Unaudited (NIS thousands)		Audited
Current Assets			
Cash and cash equivalents	433,638	717,945	656,137
Short-term investments	135,342	482,124	297,468
Trade receivables	1,373,397	1,574,728	1,504,273
Other receivables and debit balances	591,513	397,071	476,638
Inventory	107,108	110,843	108,866
	<u>2,640,998</u>	<u>3,282,711</u>	<u>3,043,382</u>
Materials and spare parts	<u>191,444</u>	<u>225,538</u>	<u>228,428</u>
Investments and long-term receivables			
Deposits and debit balances	259,649	302,475	272,380
Investee companies	154,690	46,870	74,577
	<u>414,339</u>	<u>349,345</u>	<u>346,957</u>
Fixed assets			
Cost	28,719,258	28,641,558	28,401,039
Less — accumulated depreciation	<u>16,548,922</u>	<u>15,172,174</u>	<u>15,898,938</u>
	<u>12,170,336</u>	<u>13,469,384</u>	<u>12,502,101</u>
Other assets			
Deferred charges and other assets	291,701	49,461	252,117
Deferred taxes	186,800	*429,966	234,838
	<u>478,501</u>	<u>479,427</u>	<u>486,955</u>
	<u>15,895,618</u>	<u>17,806,405</u>	<u>16,607,823</u>
Current liabilities			
Short-term bank credit	446,480	136,931	267,701
Current maturities of:			
Debenture issued to the Government of Israel	233,268	932,214	465,211
Long-term bank loans	1,054,463	925,330	1,040,571
Other debentures	207,098	214,148	222,767
Trade payables	860,371	948,006	1,142,272
Dividend payable	—	—	297,887
Employee severance benefits	232,763	344,764	346,902
Other current liabilities	858,673	1,056,138	815,707
	<u>3,893,116</u>	<u>4,557,531</u>	<u>4,599,018</u>
Long-term liabilities			
Debenture issued to the Government of Israel	—	233,055	—
Long-term loans	3,198,417	3,700,756	3,197,133
Other debentures	1,130,772	1,177,085	1,238,333
Convertible debentures	—	396,879	—
Employee severance benefits	66,820	371,467	77,506
Deferred taxes	21,570	*25,975	19,126
Deferred revenues	75,487	82,898	77,819
	<u>4,493,066</u>	<u>5,988,115</u>	<u>4,609,917</u>
Convertible debentures	<u>82,159</u>	<u>—</u>	<u>230,849</u>
Contingent liabilities			
Shareholders' equity	<u>7,427,277</u>	<u>7,260,759</u>	<u>7,168,039</u>
	<u>15,895,618</u>	<u>17,806,405</u>	<u>16,607,823</u>

* Reclassified

Israel Tapoohi
Chairman of the Board

Iris Stark
Member of the Board

Ilan Biran
CEO

Oren Lieder
Chief Financial Officer

Date of approval of the financial statements: May 23, 2000.

The notes to the financial statements are an integral part thereof.

Interim Consolidated Statements of Operations
In terms of shekels of March 2000

	For the three months ended March 31		For the year ended December 31 1999
	2000 (Unaudited) NIS thousands	1999 (Unaudited) NIS thousands	(Audited) NIS thousands
Revenues from telecommunications services (Note 7)	<u>2,225,566</u>	<u>*2,321,919</u>	<u>9,031,846</u>
Costs and expenses			
Operating and general expenses (Note 8)	1,216,407	*1,203,582	5,049,134
Depreciation	672,744	668,830	2,687,737
Royalties to the Government of Israel	80,891	78,958	297,683
	<u>1,970,042</u>	<u>1,951,370</u>	<u>8,034,554</u>
Operating income	<u>255,524</u>	<u>370,549</u>	<u>997,292</u>
Financing expenses			
On debenture issued to the Government of Israel:	5,943	24,725	55,376
Interest (including erosion)	123,938	103,258	300,305
Banks and others, net (including erosion)	129,881	127,983	355,681
Earnings after financing expenses	125,643	242,566	641,611
Other income (expenses), net	<u>89,248</u>	<u>(274,017)</u>	<u>(551,648)</u>
Earnings (loss) before income tax	214,891	(31,451)	89,963
Tax benefit (income tax)	<u>(95,370)</u>	<u>2,159</u>	<u>(62,030)</u>
	119,521	(29,292)	27,933
Equity in losses of affiliates	<u>(26,121)</u>	<u>(392)</u>	<u>(21,287)</u>
Net earnings (loss)	<u>93,400</u>	<u>(29,684)</u>	<u>6,646</u>
Earnings (loss) per NIS 1 par value of ordinary shares (In NIS)			
Basic and diluted earnings (loss) per share	<u>0.12</u>	<u>(0.04)</u>	<u>0.02</u>

* Reclassified

The notes to the financial statements are an integral part thereof.

**Interim Statement of Changes in Shareholders' Equity
In terms of shekels of March 2000**

	Share capital	Receipt from issue of warrants	Share premium capital reserve	Capital reserve in respect of transactions between the Company and a controlling shareholder	Retained earnings	Total
	NIS thousands					
Three months ended March 31, 2000						
Balance as of December 31, 1999 (audited)	4,082,467	—	643,908	35,215	2,406,449	7,168,039
Net earnings (unaudited)	—	—	—	—	93,400	93,400
Erosion of dividend proposed last year and paid this year (unaudited)	—	—	—	—	(1,404)	(1,404)
Tax benefit in respect of shares to employees (unaudited)	—	—	21,494	—	—	21,494
Conversion of convertible debentures (unaudited)(1)	13,010	—	132,738	—	—	145,748
Balance as at March 31, 2000 (unaudited)	<u>4,095,477</u>	<u>—</u>	<u>798,140</u>	<u>35,215</u>	<u>2,498,445</u>	<u>7,427,277</u>
Three months ended March 31, 1999						
Balance as at December 31, 1998 (audited)	4,064,783	—	473,696	35,215	2,697,690	7,271,384
Net loss (unaudited)	—	—	—	—	(29,684)	(29,684)
Conversion of convertible debentures (unaudited)(2)	1,812	—	17,247	—	—	19,059
Balance as at March 31, 1999 (unaudited)	<u>4,066,595</u>	<u>—</u>	<u>490,943</u>	<u>35,215</u>	<u>2,668,006</u>	<u>7,260,759</u>
Year ended December 31, 1999						
Balance as at December 31, 1998 (audited)	4,064,783	—	473,696	35,215	2,697,690	7,271,384
Net earnings (audited)	—	—	—	—	6,646	6,646
Dividend in respect of previous year (audited)	—	—	—	—	(297,887)	(297,887)
Conversion of convertible debentures (audited)(3)	17,684	—	170,212	—	—	187,896
Balance as at December 31, 1999 (audited)	<u>4,082,467</u>	<u>—</u>	<u>643,908</u>	<u>35,215</u>	<u>2,406,449</u>	<u>7,168,039</u>

Notes:

- (1) 132,655,287 par value convertible debentures were converted to 13,108,230 ordinary shares with a par value of NIS 1 each.
- (2) 17,734,409 par value convertible debentures were converted to 1,752,412 ordinary shares with a par value of NIS 1 each.
- (3) 178,187,698 par value convertible debentures were converted to 17,607,480 ordinary shares with a par value of NIS 1 each.

The notes to the financial statements are an integral part thereof.

Interim Consolidated Statements of Cash Flows
In terms of shekels of March 2000

	For the three months ended March 31		For the year ended December 31 1999
	2000	1999	
	(Unaudited) NIS thousands	(Unaudited) NIS thousands	(Audited) NIS thousands
Cash flows generated by operating activities			
Net earnings (loss)	93,400	(29,684)	6,646
Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities (see A below)	<u>606,594</u>	<u>376,618</u>	<u>2,339,543</u>
Net cash flow generated by operating activities	699,994	346,934	2,346,189
Cash flows generated by investing activities			
Acquisition of fixed assets	(524,061)	(329,929)	(1,400,290)
Proceeds from disposal of fixed assets	4,918	4,109	19,867
Investment in long-term deposits	(15,815)	(11,262)	(15,627)
Realization of long-term deposits and investments	30,627	22,380	111,333
Decrease (increase) in short-term investments, net	165,568	(99,279)	83,965
Decrease (increase) in materials and spare parts ...	14,150	(2,854)	(79,058)
Investments in investee companies	(106,234)	(11,162)	(59,764)
Investment in other assets	<u>(71,091)</u>	<u>(28,682)</u>	<u>(286,888)</u>
Net cash flow used for investing activities	<u>(501,938)</u>	<u>(456,679)</u>	<u>(1,626,462)</u>
Cash flows generated by financing activities			
Repayment of debenture issued to the Government of Israel	(233,702)	(233,543)	(927,166)
Issue of other debentures (after deduction of issue expenses)	—	98,909	260,043
Repayment of other debentures	(126,918)	(117,405)	(204,056)
Receipt of long-term loans	302,550	306,761	712,019
Repayment of long-term loans	(241,973)	(284,880)	(1,093,048)
Receipt of short-term bank credit, net	178,779	136,931	267,701
Dividend paid	<u>(299,291)</u>	—	—
Net cash flow used for financing activities	<u>(420,555)</u>	<u>(93,227)</u>	<u>(984,507)</u>
Decrease in cash and cash equivalents	(222,499)	(202,972)	(264,780)
Cash and cash equivalents at beginning of period ..	<u>656,137</u>	<u>920,917</u>	<u>920,917</u>
Cash and cash equivalents at end of period	<u>433,638</u>	<u>717,945</u>	<u>656,137</u>

The notes to the financial statements are an integral part thereof.

	For the three months ended March 31		For the year ended December 31
	2000	1999	1999
	(Unaudited) NIS thousands	(Unaudited) NIS thousands	(Audited) NIS thousands
A - Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities			
Revenues and expenses not involving cash flows:			
Depreciation	672,744	668,830	2,687,737
Provision for decrease in value of fixed assets . . .	—	—	105,083
Deferred taxes	94,747	(55,113)	78,323
Company's equity in losses of investee companies, net	26,121	392	21,287
Decrease in employee severance benefits, net . . .	(124,825)	(5,704)	(297,504)
Gain on disposal of fixed assets	(491)	(629)	(16,191)
Provision for decrease in value of an affiliated company	—	—	(14,737)
Appreciation of and interest on investment in long-term deposits and futures contracts	28,971	24,948	16,727
Appreciation of short-term investments, net	(3,442)	(1,714)	(313)
Appreciation (erosion) of long-term liabilities:			
Debenture issued to the Government of Israel . .	1,759	4,017	(2,379)
Other debentures	3,688	5,013	807
Long-term loans	(52,713)	(47,212)	(35,780)
Convertible debentures	—	1,219	138
Interest and amortization	28,565	3,554	58,101
Changes in asset and liability items:			
Decrease (increase) in trade receivables	131,523	(40,946)	54,133
Increase in other receivables and debit balances	(137,646)	(31,383)	(104,307)
Decrease (increase) in inventory	5,566	(69,948)	(80,944)
Increase (decrease) in trade payables	(84,288)	(78,894)	91,751
Increase (decrease) in other current liabilities	18,647	1,376	(216,125)
Decrease in deferred revenues	(2,332)	(1,188)	(6,264)
	<u>606,594</u>	<u>376,618</u>	<u>2,339,543</u>
B - Non-cash transactions			
Acquisition of fixed assets, materials and spare parts on credit	<u>122,537</u>	<u>296,786</u>	<u>320,218</u>
Sale of fixed assets on credit	<u>22,770</u>	<u>—</u>	<u>22,770</u>
Dividend proposed for payment	<u>—</u>	<u>—</u>	<u>297,887</u>

The notes to the financial statements are an integral part thereof.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS AS AT MARCH 31, 2000 (UNAUDITED)

NOTE 1 — GENERAL

- A. The interim statements have been prepared in accordance with generally accepted accounting principles applicable to the preparation of interim periodic financial statements. These statements should be read in conjunction with the Company's annual financial statements and accompanying notes as at December 31, 1999 and for the year then ended.
- B. The Company presents in the notes to the interim financial statements only the significant changes in its business and legal environment which occurred between the date of the previous annual financial statements and the date of these interim financial statements. The extensive and detailed description, including significant changes and developments which occurred in recent years, particularly in the fields of cellular services, international communications services, domestic communications services, the opening of these markets to competition, and the decisions of the Ministerial Committee for Privatization to reduce the State's holdings in the Company, appears in Note 1 to the Company's annual financial statements as at December 31, 1999. The significant changes which occurred from the date of the annual financial statements to the date of these financial statements are detailed below:

1. In connection with the opening of the domestic communications market to competition and determination of the Company's tariffs, the following developments occurred:
 - a. Access fees from the international telecommunications operators were reduced as of January 1, 2000 by approximately 30%, in accordance with the licenses of the operators which determined that the access fees would be reduced each year by that percentage.
 - b. The tariff update which was supposed to take effect on January 1, 2000, took effect on May 1, 2000. The update consisted of lowering the Company's tariffs by an average of 2.43%. Furthermore, a number of tariff baskets were offered, mostly for Internet users, the significance of which is lower tariffs. The tariff update was accompanied by a change in the method of charging for calls, principally a change in the method of charging from charging by meter pulses to charging by time (subject to a minimum tariff per call).
 - c. Pursuant to notification from the Company to the cellular communication service operators, (hereinafter - the Operators), starting on March 1, 2000, the billing arrangement which was in effect between them was canceled and a new arrangement commenced, whereby the Company transfers to the operators only the amounts which it actually collected in respect of airtime less a collection fee, in contrast to the existing arrangement in which the transfer of monies was made on the basis of customer charges without deduction of a collection fee.

The Operators expressed their objection to the change in the existing arrangement and one of them also filed a legal claim in which it requested that the Company be instructed to continue to act in accordance with the arrangement which had existed until then. The same Operator also applied for a temporary injunction instructing as aforesaid until a decision would be given in the principal action. In the hearing which was held before the court, it was agreed by the parties that the application for the temporary injunction would be withdrawn, and that the parties reached consensus as to the procedures in the subsequent stages of conducting the action. The results of this proceeding cannot be assessed.

As a result of the change in the billing arrangements, as described above, starting on March 1, 2000, the Company's revenues and expenses from mobile wireless telephone do not include airtime. The airtime which is included in the revenues and expenses from mobile wireless telephone in the reported period are approximately NIS 280 million (March 31, 1999 - approximately NIS 330 million).

- d. At the beginning of April 2000, the Attorney General made a decision in the dispute between the Ministries of Justice and Communications on the question of whether the Minister of Communications may award to cable broadcasting franchisees, a license to provide fixed-line domestic communication services by means of the cable infrastructure which exists today, without a tender, or alternatively, without receipt of special consideration. The main thrust of the Attorney General's decision was that according to the current legal situation, the Minister of Communications is not authorized to award licenses of which the practical significance is unlimited extension of the franchises, and that for implementation of a decision to change the policy for awarding franchises to a policy of awarding licenses, legislative action would be required.

The decision of the Attorney General is likely to have a material effect on the communications market in a way which cannot be assessed by the Company.

NOTE 2 — ACCOUNTING POLICIES

The significant accounting policies used in preparation of the financial statements, are the same as those used in the preparation of the latest annual financial statements, except for the following:

- A. As of January 1, 2000, the provisions of Accounting Standard Number 3 — Capitalization of Credit Costs apply. Pursuant to the standard, credit costs relating to assets in the process of installation are capitalized until the date on which all the essential activities required for preparing them for their designated use are completed. In the reported period, credit costs amounting to NIS 4.4 million were capitalized at an interest rate of 2.3% in the quarter.
- B. The cost of inventory up to December 31, 1999 was determined by the "first in first out" method. As at March 31, 2000, the cost of inventory was determined by the rolling average method. The cumulative effect as at the beginning of the year in respect of the change in the accounting method as aforesaid, is not material.

NOTE 3 — ADJUSTED FINANCIAL STATEMENTS

The financial statements are prepared on the basis of the historical cost convention adjusted for changes in the general purchasing power of the Israeli currency. Below are details of the changes which occurred in the Consumer Price Index and the exchange rate of the US dollar:

	<u>Consumer Price Index</u>	<u>US dollar exchange rate</u>
	%	%
For the three month period ended:		
March 31, 2000	(1.22)	(3.06)
March 31, 1999	(1.44)	(3.03)
For the year ended December 31, 1999	1.34	(0.17)

NOTE 4 — INVESTMENTS IN INVESTEE COMPANIES

A. Emitel Telecommunication Corp. Ltd. (hereinafter: "Emitel")

On April 17, 2000, Aphrodite B.V. (hereinafter: "Aphrodite"), which is held indirectly by the Company (66.7%), signed a memorandum of understanding whereby, subject to receipt of various approvals, including approvals of authorities and its signature on a final agreement, Aphrodite will sell all of its holdings in Emitel. In consideration of the sale, Aphrodite will receive a sum which will be calculated according to a determined formula and which will in any case not be less than the sum of 50 million US dollars. The indirect investment in Emitel is recorded in the Company's books at equity value and amounts to approximately NIS 36 million as at March 31, 2000. If the sale is actually made, and assuming payment of the minimum consideration, the Company expects to include in its financial statements a pre-tax gain of approximately NIS 93 million.

B. Cellular communications project in India

During the report period, the Company increased its investment in the joint venture company in India by approximately NIS 22.3 million, recorded its equity in the joint venture company's losses as well as the liability in its favor in the books of the joint company, in the amount of approximately NIS 23 million, in respect of the guarantees which were called in during 1999.

C. D.B.S. Satellite Services (1998) Ltd.

Under the shareholders' agreement which the Company and other principals signed in December 1998, the Company is entitled to hold approximately 30% of the shares of D.B.S. Satellite Services (1998) Ltd. (hereinafter: "DBS"). In January 1999, DBS received a license from the Ministry of Communications for satellite television broadcasts, in exchange for payment of NIS 30 million and a guarantee in the amount of NIS 30 million. DBS is a venture in the process of development, and foresees considerable losses and negative cash flow from operations in the first years of its activities. A bank with which DBS entered into a long-term financing agreement refused to grant further credit. DBS is negotiating with other banks for long-term credit lines to finance its ongoing activities.

After the report date, the Company increased its investment in DBS by approximately NIS 48 million, so that its investment in that company is now approximately NIS 138 million.

According to a decision of the Ministerial Committee for Privatization, the maximum cumulative exposure of the Company in connection with this investment shall not exceed, at any time, the rate of the company's actual holding in DBS, multiplied by \$216 million (approximately NIS 864 million).

The Company's equity in the cumulative loss of DBS amounts to approximately NIS 40 million, of which approximately NIS 16 million were recorded in the report period.

D. Agreement to establish an investee company

On March 16, 2000, an agreement was signed between a proportionally-consolidated company and Sunycom Ltd., to establish GoNext Ltd. (hereinafter: "GoNext"), which will be involved principally in setting up a portal with links to the cellular medium. The proportionally-consolidated company will hold 51% of the shares of GoNext. As at the date of the financial statements, GoNext was not yet operative.

NOTE 5 — LIABILITIES FOR EMPLOYEE SEVERANCE BENEFITS

Restructuring plan

In March 2000, the Company's management presented to the Board of Directors a plan based on a material change in its organizational and functional concept, in a pattern similar to the change already made in several similar communications companies in other countries, with the transition to operating in a competitive environment. The Board of Directors of the Company approved the plan after receiving clarification from the Company's management. It is estimated that the retirement of some 500 to 600 employees is needed for implementation of the plan. The estimated cost of this retirement plan, which is pursuant to an agreement which remains in effect until June 30, 2000, is approximately NIS 288 million, which were included in the financial statements for 1999. By March 31, 2000, 122 workers had retired as part of the plan. The Company has approached the Companies Authority for its consent to extend the term of the agreement to March 31, 2001. The Companies Authority has not yet approved the

requested extension. The management of the Company remains in contact with the Companies Authority for receipt of its approval. In accordance with an agreement which was validated as a decision of the Labor Tribunal, the term of the agreement has been extended, at this stage, to July 15th, 2000.

NOTE 6 — CONTINGENT LIABILITIES

A. Claims and contingent liabilities

The Company and investee companies have contingent liabilities in respect of which the maximum possible exposure is considerable. A detailed description of these contingent liabilities appears in Note 21A to the annual financial statements of the Company as at December 31, 1999. No material changes occurred in the contingent liabilities up to the date of signing these financial statements, except for the following:

1. In connection with the change of tariffs on May 1, 2000, as described in Note 1, a petition was filed in the High Court of Justice against the Minister of Communications as the principal respondent, and the Minister of Finance, the Chairman of the Knesset Finance Committee and the Company as "formal" respondents. The subject of the petition is faults which allegedly occurred in the process of approval of the Telecommunications Regulations relating to the tariffs and a change in the method of charging. An application for an interim injunction to prevent implementation of the tariff change, was dismissed by the court, and the new tariffs took effect on the designated date. At this stage, the legal advisors of the Company are unable to estimate the chances of the petition.
2. In April 2000, a company for the provision of cable television broadcasts filed a claim against the Company, in which it petitioned for a writ of permanent mandatory order to enforce an agreement to upgrade its cable network, or alternatively, to enable it to carry out the works itself or through a contractor on its behalf. The claim alleged that as a result of Company sanctions, the upgrade works were interrupted and that this constitutes breach of contract. The same company also petitioned the court for a writ of temporary mandatory order against the Company. The court instructed the Company to respond in writing to the petition. The Company has filed a statement of response, and a statement of defense will be filed in the near future.
3. After the date of the financial statement, and further to the contents of Note 9E to the financial statements as at December 31, 1999, the application for leave to appeal which was filed in the Supreme Court by the software supplier, against calling in the bank guarantee by the Company, was dismissed and the temporary injunction which was given in the framework of the request for leave to appeal, was canceled. Consequently, the Company recorded earnings in the amount of the guarantee, approximately NIS 83 million, in the report period, which is included as part of the other earnings item.
4. In connection with the claim of a cellular communications service operator, see Note 1B1c.

B. Forward currency contracts

The Company has entered in forward exchange contracts as a hedge against exposure resulting from changes in the exchange rate of the US dollar in relation to changes in the CPI. As at March 31st, 2000, the Company is contracted to purchase approximately US \$366 million (approximately NIS 1,473 million) for which it will pay approximately NIS 1,501 million linked to the CPI. The contracts mature on various dates, the last of which is March 2002. The Company also contracted to purchase approximately US \$375 million (approximately NIS 1,510 million) for which it will pay, at an agreed rate, approximately NIS 1,517 million.

NOTE 7 — REVENUES FROM TELECOMMUNICATIONS SERVICES

	For the three months ended March 31		For the year ended December 31 1999
	2000 (Unaudited) NIS thousands	1999* (Unaudited) NIS thousands	(Audited) NIS thousands
Revenues from telephone services —			
Domestic calls	662,015	821,443	2,716,950
Cellular telephone	653,716	665,690	2,802,984
Fixed fees	487,068	396,270	1,796,853
International communications	197,894	219,340	881,630
Installation and sale of equipment to subscribers	129,823	139,735	473,326
Other	39,448	28,066	139,715
	<u>2,169,964</u>	<u>2,270,544</u>	<u>8,811,458</u>
Other revenues	<u>55,602</u>	<u>51,375</u>	<u>220,388</u>
	<u><u>2,225,566</u></u>	<u><u>2,321,919</u></u>	<u><u>9,031,846</u></u>

* Reclassified

NOTE 8 — OPERATING AND GENERAL EXPENSES

	For the three months ended March 31		For the year ended December 31 1999
	2000	1999*	
	(Unaudited) NIS thousands	(Unaudited) NIS thousands	(Audited) NIS thousands
Salaries and related expenses	433,577	419,092	1,650,750
Cellular telephone expenses	310,334	290,752	1,348,281
International communications expenses	67,415	62,027	261,374
Materials and spare parts	68,596	109,796	276,076
Building maintenance	94,117	98,945	391,855
Services and maintenance by sub-contractors	97,506	114,941	464,963
General expenses	157,416	135,456	707,495
Vehicle maintenance expenses	16,454	13,942	64,659
Collection fees	9,552	10,651	41,601
	<u>1,254,967</u>	<u>1,255,602</u>	<u>5,207,054</u>
Less - salaries charged to investments in fixed assets	38,560	52,020	157,920
	<u>1,216,407</u>	<u>1,203,582</u>	<u>5,049,134</u>

* Reclassified

NOTE 9 — CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND TELEPHONE COMMUNICATIONS LTD.

1. Bezeq International Ltd.

A. Balance Sheet

	<u>March 31, 2000</u>	<u>March 31, 1999</u>	<u>December 31 1999</u>
	(Unaudited) NIS thousands	(Unaudited) NIS thousands	(Audited) NIS thousands
Current assets	321,553	581,925	408,143
Investments	23,049	19,225	—
Fixed assets	324,430	278,901	310,402
Other assets	16,024	13,270	12,109
	<u>685,056</u>	<u>893,321</u>	<u>730,654</u>
Current liabilities	383,132	425,572	380,414
Long-term liabilities	—	19,674	—
Quasi-capital receipt	156,546	156,546	156,546
Shareholders' equity	145,378	291,529	193,694
	<u>685,056</u>	<u>893,321</u>	<u>730,654</u>

B. Statement of Operations

	<u>For the three months ended March 31</u>		<u>For the year ended December 31 1999</u>
	2000	1999	1999
	(Unaudited) NIS thousands	(Unaudited) NIS thousands	(Audited) NIS thousands
Revenues from international communications services	166,755	182,684	688,207
Operating expenses	<u>150,944</u>	<u>149,303</u>	<u>587,492</u>
Gross profit	15,811	33,381	100,715
Marketing expenses	35,645	21,561	110,067
General and administration expenses	14,191	11,257	49,694
	<u>49,836</u>	<u>32,818</u>	<u>159,761</u>
Operating income (loss)	(34,025)	563	(59,046)
Financing income, net	<u>1,710</u>	<u>9,783</u>	<u>35,637</u>
Earnings (loss) after financing income, net	(32,315)	10,346	(23,409)
Other expenses, net	<u>(14,533)</u>	<u>—</u>	<u>(76,595)</u>
Earnings (loss) before income tax	(46,848)	10,346	(100,004)
Tax benefit (income tax)	<u>—</u>	<u>(3,166)</u>	<u>8,893</u>
Earnings (loss) after income tax	(46,848)	7,180	(91,111)
Company's equity in losses of investee company, net	<u>(1,468)</u>	<u>—</u>	<u>—</u>
Net earnings (loss)	<u>(48,316)</u>	<u>7,180</u>	<u>(91,111)</u>

2. PELEPHONE COMMUNICATION LTD.

A. Balance sheet

	<u>March 31 2000</u>	<u>March 31 1999</u>	<u>December 31 1999</u>
	(Unaudited) NIS thousands	(Unaudited) NIS thousands	(Audited) NIS thousands
Current assets	942,017	877,073	919,399
Fixed assets	2,540,685	2,447,702	2,544,026
Long-term trade receivables	39,425	33,869	11,213
Compensation fund reserve, net	2,510	—	3,440
Other assets	<u>532,550</u>	<u>33,536</u>	<u>453,890</u>
	<u>4,057,187</u>	<u>3,392,180</u>	<u>3,931,968</u>
Current liabilities	1,517,174	870,514	1,171,750
Provision for losses of investee company	6,330	—	3,929
Long-term liabilities	579,539	562,897	786,989
Shareholders' equity	<u>1,954,144</u>	<u>1,958,769</u>	<u>1,969,300</u>
	<u>4,057,187</u>	<u>3,392,180</u>	<u>3,931,968</u>

B. Statement of Operations

	<u>For the three months ended March 31</u>		<u>For the year ended December 31 1999</u>
	<u>2000</u>	<u>1999</u>	<u>(Audited) NIS thousands</u>
	(Unaudited) NIS thousands	(Unaudited) NIS thousands	
Income from cellular services, sales and services	818,619	753,740	2,938,848
Cost of cellular services, sales and services	<u>662,538</u>	<u>615,199</u>	<u>2,348,873</u>
Gross profit	<u>156,081</u>	<u>138,541</u>	<u>589,975</u>
Sales and marketing expenses	88,485	55,326	276,979
General and administration expenses	<u>49,944</u>	<u>38,921</u>	<u>181,435</u>
	<u>138,429</u>	<u>94,247</u>	<u>458,414</u>
Income from ordinary operations	17,652	44,294	131,561
Financing expenses, net	34,529	7,220	64,943
Capital losses (gains)	<u>247</u>	<u>102</u>	<u>(515)</u>
Earnings (loss) before income tax	(17,124)	36,972	67,133
Income tax (tax benefit)	<u>(4,369)</u>	<u>15,351</u>	<u>31,050</u>
Earnings (loss) after income tax	(12,755)	21,621	36,083
Company's equity in losses of investee company	<u>2,401</u>	—	<u>3,929</u>
Net earnings (loss)	<u>(15,156)</u>	<u>21,621</u>	<u>32,154</u>

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