

OFFERING CIRCULAR



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). This Offering Circular supersedes the offering circular dated 20th November, 2001. Any Notes issued under the Programme on or after the date of this Offering Circular are issued subject to the provisions herein. This does not affect any Notes already issued.

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 Deutsche Trustee Company Limited (formerly called 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

UBS Warburg

The date of this Offering Circular is 19th December, 2002

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 and The Netherlands (see "*Subscription and Sale*").

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. The exchange rate between the U.S. dollar and the new Israeli shekel on 31st December, 2001 was U.S.\$1=4.416 NIS and on 30th September, 2002 was U.S.\$1=4.871 NIS.

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In connection with the 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 with a view to supporting the market price of the Notes of the Series (as defined below) of which such Tranche forms part at a level higher than that which might otherwise prevail for a limited period. However there may be no obligation on the stabilising manager or any agent of his to do this. Such stabilising, if commenced, may be discontinued at any time and must be brought to an end after a limited period.

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>Notes with a maturity of less than one year</p> <p>Notes having a maturity of less than one year will, if the proceeds of the issue are accepted in the United Kingdom, constitute deposits for the purposes of the prohibition on accepting deposits contained in section 19 of the FSMA unless they are issued to a limited class of professional investors and have a denomination of at least £100,000 or its equivalent, see "<i>Subscription and Sale</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</p>

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

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.

Trustee	Deutsche Trustee Company Limited (formerly called Bankers Trustee Company Limited)
Agent	Deutsche Bank AG London
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	The applicable Pricing Supplement may provide that certain Notes may be redenominated in 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 2000 ISDA Definitions 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.

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.

Index Linked Notes

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.

Index Linked Notes which are issued or sold as a public offer (*appel public à l'épargne*) in France must be issued in compliance with the *Principes Généraux* from time to time set by the *Commission des Opérations de Bourse* and the *Conseil des Bourses de Valeurs* or any successor body thereto.

Other provisions in relation to Floating Rate Notes and Index Linked Interest Notes

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.

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.

Dual Currency Notes

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.

Zero Coupon Notes

Zero Coupon Notes will be offered and sold at a discount to their nominal amount and will not bear interest.

Redemption

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.

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.

Notes having a maturity of less than one year may be subject to restrictions on their denomination and distribution, see "*Certain Restrictions — Notes with a maturity of less than one year*" above.

Denomination of Notes	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 (or equivalent body) or any laws or regulations applicable to the relevant Specified Currency, see “ <i>Certain Restrictions — Notes with a maturity of less than one year</i> ” above.
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 <i>pari passu</i> 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.
Listing	<p>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.</p> <p>Unlisted Notes may also be issued.</p> <p>The applicable Pricing Supplement will state whether or not the relevant Notes are to be listed and, if so, on which stock exchange(s).</p>
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 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 “ <i>Subscription and Sale</i> ”).
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, in either case, will be delivered on or prior to the original issue date of the Tranche to a common depositary (the "**Common Depositary**") for Euroclear Bank S.A./N.V., 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 a 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 BEZEQ — The Israel Telecommunication Corp., Limited (the "**Issuer**") constituted by a Trust Deed dated 7th August, 2000, as modified and restated on 19th December, 2002 (such Trust Deed as further modified and/or supplemented and/or restated from time to time, the "**Trust Deed**") made between the Issuer and Deutsche Trustee Company Limited (formerly called 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 amended and restated Agency Agreement dated 19th December, 2002, (such Agency Agreement as further amended and/or supplemented and/or restated from time to time, the "**Agency Agreement**") 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 19th December, 2002 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 upon 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 Euroclear Bank S.A./N.V., 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 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 (including, where either the Interest Commencement Date or the final Interest Payment Date is not a Determination Date, the period commencing on the first Determination Date prior to, and ending on the first Determination Date falling after, such 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, 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.

ment 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 open.

(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 2000 ISDA Definitions 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 (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 in accordance with this condition 4(b):

- (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 14 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 general 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 paragraph. 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 open.

(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, an Index Linked Interest Note nor a Dual Interest Currency Note) or on any Interest Payment Date (if this Note is either a Floating Rate Note, an Index Linked Interest Note or a Dual Interest Currency 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 and not more than the Maximum 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 outstanding, 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.

To exercise the right to require redemption of this Note the holder of this Note must deliver, at the specified office of any Paying Agent at any time during normal business hours of such Paying Agent falling within the notice period, 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 accompanied by, if this Note is in definitive form, this Note or evidence satisfactory to the Paying Agent concerned that this Note will, following delivery of the Put Notice, be held to its order or under its control.

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 its 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 (expressed as a decimal); 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:

- (a) presented for payment in the State of Israel; or
- (b) presented for payment 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) where such withholding or deduction is imposed on a payment to an individual and is required to be made pursuant to any European Union Directive on the taxation of savings implementing the conclusions of the ECOFIN Council meeting of 26th-27th November, 2000 or any law implementing or complying with, or introduced in order to conform to, such Directive; or
- (d) presented for payment by or on behalf of a holder who would be able to avoid such withholding or deduction by presenting the relevant Note, Receipt or Coupon to another Paying Agent in a Member State of the European Union; or
- (e) presented for payment 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 accounting principles 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) if any European Union Directive on the taxation of savings implementing the conclusions of the ECOFIN Council meeting of 26th-27th November, 2000 or any law implementing or complying with, or introduced in order to conform to such Directive is introduced, there will at all times be a Paying Agent in a Member State of the European Union that will not be obliged to withhold or deduct tax pursuant to any such Directive.

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 or by which they have been admitted to listing. 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 or admitted to listing by any other relevant authority and the rules of that stock exchange or other relevant authority so require, such notice will be published in a daily newspaper of general circulation in the place or places required by those rules. 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 14 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 irrevocably 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

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 19th December, 2002. 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.]

[If the Notes have a maturity of less than one year, the minimum denomination [must/may need to] be £100,000 or its equivalent in any other currency.]

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. (i) Issue Price of Tranche: [] per cent. of the Aggregate Nominal Amount plus accrued interest from [insert date] *(in the case of fungible issues only, if applicable)*
(ii) Net proceeds: [] *(Required only for listed issues)*
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]]*

- 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*]
- (vi) Determination Date(s): [] in each year
*[Insert regular interest payment dates,
 ignoring issue date or maturity date in
 the case of long or short first or last
 coupon]*
*(NB: This will need to be amended in the
 case of regular interest payment dates
 which are not of equal duration)*
*(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 Page 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] <i>(If not applicable, delete the remaining sub-paragraphs of this paragraph)</i>
(i) Accrual Yield:	[] per cent. per annum
(ii) Reference Price:	[]
(iii) Any other formula/basis of determining amount payable:	[] <i>(Consider applicable day count fraction if not U.S. dollar denominated)</i>
(iv) Day Count Fraction in relation to Early Redemption Amounts and late payment:	[Conditions 6(e)(iii) and 6(j) <i>apply/specify other</i>]
18. Index Linked Interest Note Provisions	[Applicable/Not Applicable] <i>(If not applicable, delete the remaining subparagraphs of this paragraph)</i>
(i) Index/Formula:	<i>[give or annex details]</i>
(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/ <i>specify other</i>]
(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] <i>(If not applicable, delete the remaining sub-paragraphs of this paragraph)</i>
(i) Rate of Exchange/method of calculating Rate of Exchange:	<i>[give details]</i>
(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 of each Note and method, if any, of calculation of such amount(s): []
- (iii) If redeemable in part:
- (a) Minimum Redemption Amount: []
- (b) Maximum 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 of each Note 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 of each Note [Nominal Amount/specify other/see Appendix]

23. Early Redemption Amount of each Note 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:** 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: [Not Applicable/give details. NB: a new form of Temporary Global Note and/or Permanent Global Note may be required for Partly Paid issues]
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 €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.

CAPITALISATION

The table below sets forth the consolidated capitalisation of Bezeq at 30th September 2002:

	As at 30th September 2002
	<i>(in NIS⁽¹⁾ thousands)</i>
Long-Term Debt	5,113,587
Short-Term Debt	1,210,528
Shareholders' Equity	7,537,338
Share capital	
— authorised: 2,565,000,000 ordinary shares of NIS 1 each	
— issued: 2,411,657,538 ordinary shares of NIS 1 each	
Total capitalisation and indebtedness	<u>13,861,453</u>

Note:

(1) NIS of September, 2002.

Save as disclosed herein, there has been no material change in the consolidated capitalisation of Bezeq since 30th September 2002.

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 currently owned in equal shares by Bezeq and Pelephone Holdings L.L.C. ("**PHL**"), a subsidiary of Shamrock Holdings, 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's wholly-owned subsidiary, BezeqCall Communications Ltd. ("**BezeqCall**"), provides installation and maintenance services for telecommunications equipment on customers' premises. Another wholly-owned subsidiary of Bezeq, Bezeq On-Line Ltd. ("**Bezeq On-Line**"), provides call center outsourcing services. Bezeq is currently not allowed to offer the above-mentioned services, other than through its subsidiaries. Since 1994, telecommunications services have been gradually opened 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. However, certain difficulties delayed the issuance of licences to competitors and Bezeq continues to be the predominant operator of domestic fixed line telecommunications services in Israel. (see "*Activities — Competition in Domestic Services*"). Bezeq also holds 44.9 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 (see "*Group Structure*").

The State of Israel currently holds approximately 54.6 per cent. of Bezeq's ordinary shares 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 the 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 taken measures to introduce competition in the Israeli telecommunications market and the Group's statutory exclusive rights in all markets have 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 and in February 2001, the MoC granted a licence to provide cellular services to MIRS Communications Ltd. ("**MIRS**") which had already provided cellular services to closed user groups. 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 fierce competition in both the cellular telecommunications market and the international telecommunications market may have an adverse effect on the Group's financial position. The Telecommunications Law (Telecommunications and Broadcasting), 1982 (the "**Telecommunications Law**") enables compe-

tion from the cable television operators in the domestic fixed line telecommunications services market. Bezeq expects that its primary competitors in the domestic telecommunications market will be Cellcom and the cable television operators (see *"Competition in Domestic Services"*). In the broadcasting sector, three cable television operators (currently preparing to merge) provide multi-channel broadcasting services in Israel, covering separate geographical areas. DBS is currently the only multi-channel broadcast provider to compete 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 the Minister of Communications (the **"Minister"**). The provision of telecommunications services and the operation of telecommunications facilities require a licence, which is granted by the Minister under the Telecommunications Law. Bezeq has a licence to provide fixed line domestic telephony, infrastructure and related services in Israel, Bezeq International has licences 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, BezeqCall and Bezeq On-Line, 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 was gradually limited and competition was 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 has declined. Hence, Bezeq International and Pelephone, which face fierce competition in international telecommunications and Internet services (Bezeq International) and cellular services (Pelephone), have benefited from a less extensive regulatory regime than Bezeq. Although the MoC has enabled competition in the market for domestic fixed line services, such competition has not yet been introduced and at present Bezeq continues to be subject to extensive regulation. Bezeq believes 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 to replace its existing licence in connection with the opening of the domestic fixed line services market to competition. In September 2002 the Minister adopted, with certain changes, the recommendations of a committee that he appointed to form a policy to increase competition in the domestic services market (the **"Kroll Committee"**). Subsequently, in November 2002, the Minister expanded the licenses of Cellcom and Med-1 permitting them to provide data communication services. (see *"Domestic Fixed Line Services — Competition in Domestic Services"*).

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 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 other services, only through its subsidiaries, Bezeq International, Pelephone, BezeqCall and Bezeq On-Line. Bezeq's licence requires both a

strict structural and operational separation between Bezeq and its subsidiaries. In general, transactions regarding telecommunications services 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 must be 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 2003 and Bezeq employees with access to sensitive market information concerning a subsidiary's competitors cannot be appointed to such subsidiary's board of directors.

Tariffs

The major tariffs for Bezeq's telecommunications services are regulated and require the approval of the Minister and of the Minister of Finance. Until August 2003, the tariffs for services which generate a substantial part of Bezeq's revenues will 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 an efficiency factor, based on a price cap regulatory regime that is usually recommended once every five years by a public tariffs committee. The committee was requested to make recommendations on Bezeq's tariff regime one year earlier in order to provide participants in the privatisation process of the company with a clear indication of its future tariffs. The committee is expected to submit its recommendations in the near future. The efficiency factor for each of the years 2001 to 2002 was set at minus 3.5 per cent. and the public tariffs committee is currently discussing the efficiency factor for subsequent years. Bezeq's tariffs are also updated according to the rise in the Israeli consumer price index (CPI). Therefore, the nominal change in Bezeq's tariffs is calculated by subtracting the efficiency factor from the cumulative CPI change. With effect from 14th May, 2002, Bezeq's call tariff regime was changed. The most substantial change was the enactment of a single charge throughout Israel, which eliminated differences in charges between local and domestic long-distance calls.

Bezeq may offer alternative tariff baskets for service packages, subject to approval by the Minister and the Minister of Finance. Currently Bezeq offers basket rates for a limited number of services including Internet connectivity and reduced tariffs under promotional tariff schemes limited in time such as off-peak and youth packages.

Royalties and Transactions with Government

Bezeq pays the Government a royalty of 4 per cent. of most of its revenues. In 2004 such royalty will be reduced to 3.5 per cent.. Bezeq International (in common with the other international operators) pays the Government a royalty of 4 per cent. and such royalty will be reduced to 3.5 per cent. in 2004. Pelephone (in common with the other cellular telecommunications providers) pays a royalty of 4.5 per cent. of most of its revenues and such royalty will be reduced to 4 per cent. in 2003 and to 3.5 per cent. in 2004.

Bezeq transacts a large volume of business with government ministries. Such Government business accounted for approximately 4 per cent. of revenues in 2001 and represents Bezeq's largest customer. In July 2002, Bezeq and the Ministry of Defense signed an agreement under which Bezeq will provide during a four year period commencing 1st April, 2001 telecommunication services at certain discounts to the Israeli Defense Forces and the Ministry of Defense undertook to purchase certain services from Bezeq. The above agreement also ended most of the disputes between Bezeq and the Ministry of Defense. (see note 10 to the *"Interim Consolidated 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, namely Bezeq International, BezeqCall and Bezeq On-Line, are considered 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"). As a Government Company and as Subsidiary Government Companies, respectively, Bezeq and its Subsidiary Government Companies are generally required to tender their contracts for goods and services (subject to certain exemptions). In addition, while historically wages and benefits have not been tied to civil servant pay scales, changes at variance with such scales require approval by the Minister of Finance. In January 2001, the Ministerial Committee for Privatization resolved that certain investments by Bezeq in other companies shall be deemed approved within 10 business days of submission of a report on such investment, unless one of the relevant Government agencies decides to examine the investment (see "Investments in Israel").

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 connection with an offering initiated by the Government in 1999 that did not complete, Bezeq's shareholders amended 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 per cent. 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. On 13th November, 2001, the Government Companies Authority published an announcement of the commencement of the process to sell 50.01 per cent. of Bezeq's shares. The Government Companies Authority, pursuant to its authority under the GCL, instructed Bezeq to prepare a "data room" to enable the participants in the sale process to conduct due diligence on the company, and informed Bezeq that the participants will be entitled to enter the data room from 15th November, 2002. However, no review of documents has commenced in the data room. Furthermore, to the best of the company's knowledge, some of the groups which had expressed interest in the privatisation process have given notice of their withdrawal. Subsequently, the Government informed Bezeq that it will continue the privatisation process of Bezeq, however, due to the prevailing circumstances, the commencement of the review of documents in the data room will be delayed. The Government also notified Bezeq that the review will commence in the near future, concurrently with the resolution of certain outstanding issues, including a discussion regarding the size of the controlling stake that the Government intends to sell.

The Government stated that the sale will be completed only following a raising of approximately NIS 890 million by Bezeq through an issuance of shares. Such raising of capital is intended to cover undertakings in connection with early retirement plans for approximately 1,770 of Bezeq's employees (see "Employees"). In a prior resolution, the Ministerial Committee for Privatization resolved that the final price offers to purchase the Government's holdings in Bezeq should only be submitted following the establishment of a mechanism to resolve a dispute between Bezeq and the Government regarding certain properties. The dispute has caused delays in the privatisation process on previous occasions (see "Properties" and note 9B to the financial statements set out in "Audited Annual Financial Statements"). There is no certainty as to the time by which the privatisation will be completed. The privatisation may trigger certain prepayment and event of default provisions in previous loans and debentures entered into by Bezeq (see notes 13(D) and 14(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 “**Order**”), the Minister’s approval is required to hold more than 5 per cent. of the share capital of Bezeq or to gain control of Bezeq. In addition, Bezeq may not, without the prior approval of the Minister, transfer or encumber certain assets, including its holdings in subsidiaries and cable and transmission networks, to third parties. If Bezeq ceases (or is likely to cease) to provide any “essential services” (which includes all basic telecommunications services and a substantial part of all other services provided by Bezeq), the Minister may appoint an external manager to direct Bezeq’s operations. The Order was amended in 2001 to enhance the Government’s regulation of the shareholding of third parties in Bezeq, in preparation for the planned privatisation of Bezeq and following suspicions that the purchase of shares by Ze’evi Communications Holding Ltd. (the “**Ze’evi Group**”) was financed, at least in part, by a third party who did not request or receive an approval under the Order (prior to its recent amendment) in return for rights with respect to such shares. To Bezeq’s knowledge, an indictment has been served against certain of the persons who were involved in the purchase of shares by the Ze’evi Group.

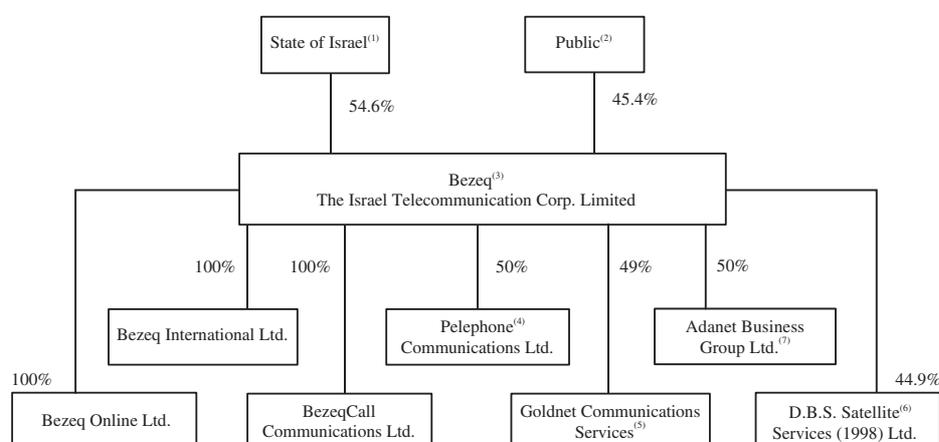
In preparation for Bezeq’s planned privatisation, Bezeq, its employees and the Government entered into a collective labour agreement that extended Bezeq’s former early retirement plans (see “*Employees*”). As to the employees’ position regarding the privatisation process, see “*Employees — Labour Relations*”.

Anti-Trust Regulation

In 1995 the Restrictive Trade Practices Commissioner (the “**Commissioner**”) declared Bezeq to have a monopoly in telecommunications infrastructure, basic telephony services and transmission of broadcasting services to the public and, as a monopoly, Bezeq is subject to certain legal restrictions. A request by Bezeq to repeal its declaration as a monopoly in the field of basic telephony services, on the grounds that Bezeq’s share in the applicable market which includes, in Bezeq’s opinion, both fixed and mobile lines is below 50 per cent., was rejected by the Commissioner in August 2001. In September 2001, Bezeq filed an appeal with the Restrictive Trade Practices Court. In December 2000, the Commissioner declared Bezeq to have a monopoly in the field of telecommunications infrastructure to provide broadband access. In January 2001, Bezeq appealed such declaration at the Restrictive Trade Practices Court. In 1997 the Commissioner determined that Bezeq International, which at such time was declared as a monopoly, 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. By 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 20A(5) and 20A(6) 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 to 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) On 12th November, 2002, the district court appointed a receiver to the Ze'evi Group which at such time owned approximately 19.17 per cent. of Bezeq's share capital. The receiver is authorized to enforce the terms of the debenture issued by the Ze'evi Group to the banks that financed the purchase of Bezeq's shares by the Ze'evi Group. Any disposition of the shares by the receiver is subject to the court's approval, as well as to the Order (see "*Relationship with Government — Government Control and Privatisation*").
- (3) At 30th September, 2002 Bezeq's share capital consisted of 2,565,000,000 ordinary shares of NIS 1 each, of which 2,411,657,538 were issued and fully paid up. The shares are listed on the TASE.
- (4) The remaining 50 per cent. of the shares of Pelephone are held by Pelephone Holdings L.L.C. ("PHL") (see "*Group Structure — Pelephone*").
- (5) Goldnet Communications Services ("**Goldnet**") is a partnership among Bezeq, Malam Systems Ltd. ("**Malam**") and AT&T Middle East Ltd. ("**AT&T**"). In September 2002, AT&T informed Bezeq that it was exercising its option to sell to Bezeq, its remaining 5 per cent. interest in Goldnet for approximately US\$ 1.5 million. Following such sale, Bezeq will hold a 54 per cent. interest in Goldnet. The MoC has approved the transfer of AT&T's interest to Bezeq, but has requested the Government Companies Authority to examine Goldnet's status following such transfer. In the event that the Government Companies Authority will assert that Goldnet should be deemed a Government Company, it may attempt to impose certain limitations on Goldnet's management and business (see "*Relationship with Government — Government Control and Privatisation*"). Bezeq also has an option to acquire from Malam, and Malam has the option to sell to Bezeq, a 20.9 per cent. interest in Goldnet. Such purchase of Malam's interest is subject to the approval of the MoC. The MoC has required that Goldnet, which is currently a partnership, shall be incorporated as a company by the end of 2003. Bezeq requested the MoC to withdraw this requirement, due, *inter alia*, to tax considerations.
- (6) Bezeq's holdings in DBS do not reflect its capital contributions to DBS, which were not matched by some of the other shareholders in DBS. Therefore, Bezeq expects to increase its ownership in DBS, at no additional cost, to approximately 49 per cent..
- (7) Adanet Business Group Ltd. ("**Adanet**") provides data networking services, as well as data security consulting and integration, sales of network equipment and data base administrator services. The remaining shares of Adanet are held by Clal Technologies (44 per cent.) and the founders of Adanet (6 per cent.). Bezeq has an option to acquire from Clal Technologies and the founders, and Clal Technologies and the founders have the option, with effect from February 2004, to sell to Bezeq the remaining 50 per cent. of the shares of Adanet. Such purchase of shares by Bezeq is subject to the approval of the Ministerial Committee for Privatisation, the MoC and the Commissioner.

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 provides a wide range of data communications services. Bezeq On-Line provides call center outsourcing services.

Holdings in Pelephone

Until February 2001, Pelephone was owned in equal shares by Bezeq and Motorola Israel, Ltd. ("Motorola"). Motorola's shares were subsequently transferred to Pelephone Holdings, L.L.C. ("PHL"), a subsidiary of Shamrock Holdings, Inc., a company controlled by the Disney family ("Shamrock"). Bezeq holds an option to purchase all (but not part) of PHL's stock and become the sole shareholder of Pelephone. The option is exercisable at any time between 27th February, 2003 and 27th February, 2005, however if Bezeq is privatised, the option is exercisable until 9 months thereafter (but no later than 27th February, 2005). The purchase of Motorola's shares in Pelephone by PHL was financed with: (i) a US\$ 240 million loan made by Bezeq, which is convertible into PHL shares; (ii) a bank loan of US\$ 300 million; and (iii) US\$ 60 million by way of capital contribution from PHL. If Bezeq exercises its option to purchase PHL, in addition to converting its US\$ 240 million loan, Bezeq will be required to pay to Shamrock an exercise price equal to the higher of (a) 10 per cent. of Pelephone's fair market value at the time of exercise; or (b) a cost value which is expected to be approximately US\$ 60 million. In addition, each of Bezeq and PHL has contributed US\$ 50 million to Pelephone. PHL financed its contribution by increasing the aforementioned bank loan to US\$ 350 million. PHL's shares in Pelephone were pledged under a first ranking lien to secure the payment of the bank loan. This lien has prior claim over a lien that was granted to Bezeq as collateral for the convertible loan. If Bezeq exercises its option prior to privatisation, Pelephone will become a Subsidiary Government Company (see "Government Control and Privatisation").

Following various indications of a decrease in the value of Pelephone, Bezeq commissioned a revised valuation of Pelephone. According to the new valuation, the current value of Pelephone is estimated at between US\$ 1 billion and US\$ 1.2 billion. As mentioned above, PHL's purchase of shares in Pelephone was financed in part by a loan of US\$ 240 million extended by Bezeq, for which Bezeq received convertible debentures for 80% of the shares of PHL, representing 40% of Pelephone's shares. These debentures, plus interest and exchange rate differentials, are presented in Bezeq's balance sheet under the item Long-term investments, deposits and debit balances. In view of the revised valuation and the priority of the PHL's bank financing over the debenture issued to Bezeq, there is doubt as to the collection of approximately US\$ 80 million of the balance of the debentures. Therefore, a provision of approximately NIS 354 million (after deduction of tax savings of NIS 36 million) was made in Bezeq's financial statements. (See note 4(c) in the "Interim Unaudited Financial Statements").

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,									
	1997		1998		1999		2000		2001	
	NIS Millions	%	NIS Millions	%	NIS Millions	%	NIS Millions	%	NIS Millions	%
Domestic fixed-line communications ⁽²⁾ . . .	3,379	35	3,352	35	2,789	30	2,561	30	2,400	30
Cellular telephone ⁽³⁾	2,395	25	2,715	28	2,878	31	2,176	25	2,072	25
Fixed fees ⁽⁴⁾	1,438	15	1,596	16	1,845	20	2,017	24	2,074	25
International communications and Internet services ⁽⁵⁾	1,686	17	1,148	12	917	10	858	10	784	10
Installation and sale of equipment to subscribers ⁽⁶⁾	512	5	513	5	486	5	503	6	426	5
Miscellaneous ⁽⁷⁾	303	3	350	4	369	4	406	5	396	5
Total	<u>9,713</u>	<u>100%</u>	<u>9,674</u>	<u>100%</u>	<u>9,284</u>	<u>100%</u>	<u>8,521</u>	<u>100%</u>	<u>8,152</u>	<u>100%</u>

Notes:

- (1) NIS of December 2001.
- (2) Includes customer charges for domestic calls within Israel (including voice and Internet traffic as well as interconnect charges for calls from a fixed line to a cellular line) and revenues from calling card sales.
- (3) Includes customer airtime charges for calls from a fixed line to a cellular line transferred to the cellular operators (excluded as of 1st March, 2000), 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 (net of adjustments) and fees for various services provided to the cellular operators including rental of transmission equipment.

- (4) 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.
- (5) Includes customer charges for outgoing international calls, gross settlement fees from foreign operators for incoming international calls, access fees, interconnect charges and transit fees from the international operators (other than Bezeq International) for use of Bezeq's network, fees for various services provided to the international operators including rental of transmission facilities and fees for Internet connectivity.
- (6) Includes line and equipment installation charges and equipment sale charges.
- (7) Includes revenues for certain services provided to cable television companies, other telecommunications operators, the Israeli Defense Forces and the Broadcasting Authority (such as billing or network construction) and revenues from the Palestinian telecommunications company, ships at sea and satellite 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 out certain information regarding Bezeq's domestic services and key relevant changes in the Israeli economy for each of the last five years:

	Year ended 31st December,				
	1997	1998	1999	2000	2001
Total number of active subscriber lines (in Thousands) ⁽⁴⁾	2,675	2,807	2,878	2,974	3,033
Lines used by residential customers (in Thousands) ⁽¹⁾	1,752	1,816	1,876	1,937	1,996
Lines used by business customers (in Thousands) ⁽¹⁾⁽²⁾	923	991	1,002	1,037	1,036
Number of subscriber lines per 100 inhabitants	45	46	46	47	47
Annual line growth rate	5%	5%	3%	3%	2%
Percentage of lines connected to digital exchanges ..	100	100	100	100	100
Growth in GDP of Israel ⁽³⁾	3.3%	2.7%	2.6%	6.4%	(0.6)%
Population of Israel (in thousands) ⁽³⁾	5,900	6,041	6,209	6,369	6,509
Annual Growth rate of Israeli population ⁽³⁾	2.5%	2.4%	2.8%	2.6%	2.2%

Notes:

- (1) The split between residential and business customers is based on Bezeq's estimate as subscribers are not required to state if they are business or residential customers.
- (2) Including government authorities and public agencies.
- (3) Data from the Israeli Central Bureau for Statistics.
- (4) Changes in the definition of an active subscriber have led to adjustments in this series since the year 2000.

Domestic services generated revenues of NIS 5,296 million in 2001, representing approximately 65 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, also represented approximately 30 per cent. of such revenues.

In the past few years, Bezeq has made significant investments to meet subscriber demand for lines and to modernise its network. From 1997 to 2001, Bezeq added approximately 358,000 subscriber lines (including ISDN lines), increasing line penetration from approximately 45 to 47 lines per 100 inhabitants during that period. Bezeq has increased its penetration rate by pursuing an aggressive marketing policy and by offering discounts on line installation to encourage residential customers to subscribe for additional lines. Currently, the percentage of households with two or more subscriber lines is approximately 12 per cent.

Domestic Voice Services

Basic Services. As part of its basic switched telephony service package, Bezeq offers subscribers call waiting, call forwarding, repeat dialing, 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 voice mail, conference call, 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 Intelligent Network (IN) services for residential customers and advanced reminder and integrated voice mail services. Various new services will also be offered to business customers, subject to requisite approvals.

Public Payphones. Bezeq currently operates approximately 18,000 public payphones located throughout Israel, representing a penetration rate of approximately three 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. There are currently approximately 17,000 Sifranet lines.

Goldnet Services. Since 1992 Goldnet, a partnership in which Bezeq currently holds a 49 per cent. interest (see note 4 under "*Group Structure*"), provides 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 access to the Israeli Registrar of Companies) and access to international databases. Bezeq has recently introduced new applications through Goldnet, such as e-commerce based on an Ariba platform and secured information services. Goldnet is currently preparing to provide digital signature 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 alterna-

tive 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. As of 30th September, 2002, Bezeq had approximately 12,600 Frame Relay lines.

ISDN Services. Since 1996 Bezeq has offered ISDN, a digital telephone line containing two fast and parallel communications channels over copper access lines. On 30th September, 2002, there were approximately 39,000 ISDN lines installed. The number of ISDN subscribers has decreased during 2002 as subscribers migrated to ADSL (see "*Internet Services — ADSL Service*").

ATM Services. In 2000 Bezeq introduced a data network based on asynchronous transfer mode ("**ATM**") technology. As of 30th September, 2002 there were approximately 250 ATM access lines installed.

IP/VPN Services. As of 2001, Bezeq is conducting a pilot for provision of virtual private network services, such as Intranet VPN and Access VPN over an Internet Protocol MPLS network. Bezeq intends to expand such pilot to a full service, subject to regulatory approval.

Internet Services

ADSL Service. In November 2000, Bezeq launched its ADSL services. ADSL enables high speed transmission of data through ordinary copper telephone lines. Bezeq offers differentiated pricing schemes aimed at increasing market penetration. By 30th September, 2002, approximately 116,000 telephone lines had ADSL service.

Bezeqnet. Since 1997, Bezeq has offered Bezeqnet, a dial-up service which enables subscribers to access various ISPs providing direct access to the Internet on a per call basis. In addition to services aimed at occasional Internet users, Bezeqnet also provides connectivity services between permanent subscribers of ISPs and the ISPs.

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 three largest Israeli ISPs. By 31st December, 2001 Bezeq International had over 300,000 subscribers, most of which were residential customers who represented approximately 76 per cent. of Bezeq International's revenues from Internet activities. Bezeq International's internet subscribers account for approximately 50 per cent of all ADSL subscribers. At 30th September, 2002 Bezeq International held approximately 36.7 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. In addition, as of June 2000, Bezeq International is a web hosting services provider.

GoNext. GoNext, a subsidiary of Pelephone, was established in 2000 to provide cellular Internet services. As of 30th September, 2002, GoNext had approximately 400,000 subscribers. Until recently, Pelephone held 51 per cent. of GoNext. In November 2002, Pelephone purchased the remaining 49 per cent. of GoNext's shares from Suny. Com Ltd. ("**Suny**") in consideration for the par value of such shares. In addition, Pelephone paid to Suny an amount of NIS 42.2 million and Suny assigned to Pelephone all of its rights in the loans extended by it or on its behalf to GoNext, in a similar amount.

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 11 radio stations in Israel. Currently, it also provides certain infrastructure services for two of the three cable television operators in Israel. Bezeq's subsidiary, DBS, (in which Bezeq has a 44.9 per cent. interest) was licensed for satellite television broadcasting in January 1999 and commenced operating in July 2000. DBS competes with three cable television operators in multi-channel services in Israel. In April 2002, the Commissioner approved the

merger of the three cable television operators, subject to certain conditions. In May 2002, DBS filed an objection to the Commissioner's approval at the Restrictive Trade Practices Court and requested, alternatively, to strengthen the conditions to the merger stipulated by the Commissioner. The merger among the three cable television operators, if completed, is expected to reduce their operating costs, thus increasing their competitive advantages, and resulting in an adverse effect on the business of DBS.

As of 30th September, 2002, Bezeq's share in the accumulated losses of DBS amounted to a total of approximately NIS 679 million and Bezeq expects DBS to continue incurring losses during the early years of its operations. (See note 8(f) and Appendix B to the financial statements set out in "Audited Annual Financial Statements" and note 4A to the "Unaudited Interim Financial Statements").

The following table sets out certain information on DBS's business, since its commencement of operations in August 2000:

	2000	2001	Jan-Sept 2002
Number of subscribers (at end of period) . .	80,000	266,000	363,000
Market Share ⁽¹⁾	7%	19%	26%
Average monthly revenue per subscriber ⁽²⁾	\$26	\$35	\$35
Revenues ⁽³⁾	28 million	327 million	491 million
Net loss ⁽³⁾	(590) million	(898) million	(533) million

(1) Market share is determined by the number of subscribers at the end of each period, with respect to the overall number of subscribers in the Israeli multi-channel broadcasting market which includes DBS and the three Cable TV companies.

(2) Excluding VAT.

(3) In NIS of September 2002.

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,				
	1997	1998	1999	2000	2001
Calls (completed connections)⁽¹⁾					
Number of calls (in millions)					
Local ⁽²⁾	4,301	4,374	4,312	4,768	4,862
Domestic long distance ⁽³⁾	3,214	3,561	3,895	3,843	3,600
Total	7,515	7,935	8,207	8,611	8,462
Annual growth rate	4%	6%	3.5%	5%	(2)%
Usage minutes⁽¹⁾					
Number of minutes (in millions)					
Local ⁽²⁾	12,365	13,418	14,619	20,486	26,692
Domestic long distance ⁽³⁾	8,940	9,644	10,303	9,446	8,348
Total	21,305	23,062	24,922	29,932	35,040
Annual growth rate	6%	8%	8%	20%	17%
Average number of usage minutes per Line ⁽⁴⁾ . . .	8,157	8,395	8,785	10,133	11,668

Notes:

(1) As of May 2000, the definition of local calls was changed to include all calls within a single area code and all Internet calls, resulting in a substantial increase in the number of local minutes between 1999 and 2000. With effect from 14th May, 2002, the distinction between local and domestic long distance calls was eliminated and all domestic calls are subject to a single charge.

(2) Local calls included all calls which, according to regulations, were defined as land to land calls at a local tariff and also calls to information services at an additional charge.

(3) Domestic long distance calls included all domestic calls, including land to land calls which were not local, as well as land to mobile calls.

(4) Calculated according to an annual average of connected lines.

From 1997 to 2001, the number of completed domestic calls increased by 13 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 64 per cent. from approximately 21,305 million to 35,040 million. This is due primarily to the increase in Internet traffic. However, Bezeq experienced a decline in the average number of land to land voice 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. In 2001, the total number of completed domestic calls decreased by 2 per cent..

Bezeq estimates that approximately 47 per cent. of traffic within Bezeq's network as at December 2001 (in terms of usage minutes) was attributable to Internet usage.

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 business and residential customers 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 out 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,				
	1997	1998	1999	2000	2001
	(in NIS ⁽¹⁾)				
Standard connection fee	514	532	532	341	331
Standard monthly line rental fee.....	30.0	31.1	36.1	37.5	37.5
Local call of up to five minutes ⁽²⁾⁽³⁾	0.256	0.265	0.208	0.385	0.385
One minute domestic long distance call ⁽²⁾⁽³⁾	0.51	0.53	0.42	0.222	0.222

Notes:

- (1) In current NIS excluding VAT.
- (2) The tariffs for local and domestic long distance calls shown in this table are the highest tariff rates within each category. As of 15th June, 2002, calls are subject to a minimum charge of NIS 0.191. The tariffs for 2000 and 2001 refer to a call for the duration of five minutes.
- (3) With effect from 14th May, 2002, all domestic calls are charged at the same rate, excluding Internet calls, calls to cellular subscribers or to certain numbers (e.g. emergency calls and directory assistance calls).

Competition in Domestic Services

As from 1st June, 1999, Bezeq's statutory exclusive right to provide domestic fixed line services was repealed. In March 2002, the Minister granted licenses to the cable companies to provide broadband access services and subsequently expanded such licenses to include data communication services and transmission services. In November 2002, the Minister expanded the licenses of Cellcom and Med-1 permitting them to provide certain data communication services to organizational customers. Bezeq has filed a petition with the Supreme Court against the expansion of the licenses of Cellcom and Med-1. The Telecommunications Law enables the

Minister to issue to the cable television operators licences to provide a full range of telecommunications services, subject to certain conditions. The Telecommunications Law also authorizes the Minister to instruct operators of public telecommunications networks (including Bezeq) to allow the unbundling and co-location of network services. Bezeq believes that the introduction of competition in the domestic telecommunications sector will adversely impact its financial position.

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. One of the first fields in which Bezeq faces competition is the field of transmission services, where other parties have received licenses and commenced operations.

Government Policy on Competition. In September 2002 the Minister adopted, with certain changes, the recommendations of the Kroll Committee that he appointed to form a policy to increase competition in the domestic services market. The main recommendations that may impact Bezeq, as adopted and modified by the Minister, are as follows: The competition should be facility based and Bezeq will not be required to unbundle its network, unless competition does not develop in which event the unbundling of Bezeq's network will be revisited; Bezeq's tariffs will continue to be subject to regulation which will be alleviated only in areas where effective competition develops; infrastructure, transmission, and data communications (except Internet access services) will be immediately opened for competition with no requirement for minimum geographical coverage and no requirement to provide such services to all persons; starting on a date between September 2003 and August 2005, as shall be determined by the Minister, new telephony and Internet access providers will not be required to cover any predetermined geographical areas, whereas until then such operators must commit to cover certain areas; only Bezeq and the merged cable TV company will be subject to the universal service obligation; the strict structural and operational separation between Bezeq and its subsidiaries will continue and shall be reconsidered following development of competition, whereas the merged cable TV company and the cellular operators will likely be subject to less stringent separation requirements; entities holding fibre optic cable networks such as the Israeli Electric Corp., Israel Railroads and the Cross Israel Highway, will be allowed to lease their infrastructure to telecommunication licensees; the exclusivity of the international operators will be extended until 1 January, 2004. The implementation of the Kroll Committee's major recommendations requires various amendments to legislation and regulations.

Competition from Cellular Operators. Bezeq already faces competition in the domestic telecommunications market from the cellular operators. The rapid growth of cellular usage in Israel has reduced the number of voice minutes in Bezeq's domestic network as subscribers often prefer to use their cellular telephone even when a fixed line alternative is available. Bezeq continues to seek to reverse this trend through focused marketing campaigns aimed at informing customers of the lower cost and higher quality 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. Revenue lost to cellular operators is partially offset by revenues from interconnect fees. The cellular operators are currently gradually connecting their networks to each other, thus reducing their need to pay Bezeq transit fees for calls between two cellular networks.

Competition from Cable TV Companies. The three cable television operators already compete with Bezeq by providing broadband Internet access service, and upon receipt of the requisite approvals, are also expected to compete with Bezeq with respect to the provision of other domestic telecommunications services. Following the recommendations of the Kroll Committee, the Minister expanded the cable television operators' licenses to include data communication services and transmission services. The 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 compete against each other and in April 2002, the Commissioner approved their merger into a single company, subject to certain conditions. In May 2002, DBS filed an objection to the Commissioner's approval at the Restrictive Trade Practices Court and requested, alternatively, to strengthen the conditions to the merger stipulated by the Commissioner. The merger of the three cable television operators, if completed, is expected to increase their market power and to

reduce their operating costs. Hence, the entrance of the merged company into competition with Bezeq is expected to result in an adverse effect on the business of Bezeq.

Under the Telecommunications Law, the Minister is authorised to issue to cable TV operators licences to provide telecommunications services, subject to certain conditions. In April 2002, the Minister granted licenses to the cable companies to provide broadband access services and subsequently expanded such licenses to include data communication services and transmission services. Following the issue of such licences to provide telecommunication services, each cable TV operator lost its exclusive right to provide cable TV services in its geographical area, and others may now request cable TV licences. The Telecommunications Law requires that the telecommunications services licences and the TV broadcasting licences be held separately by affiliated corporations.

Bezeq has taken, and is continuing to implement, various measures to prepare for the increasing competition in the market for domestic telecommunications services. These measures include improving and modernising Bezeq's network infrastructure to accommodate advanced telecommunications services, expanding the services offered to subscribers, such as data communication services, reorganising its operational structure (including cost and workforce reduction initiatives, streamlining internal processes, implementing IT systems, and consolidating customer services divisions) and increasing marketing efforts, including improving Bezeq's price perception.

Universal Service Obligation

Under its licence, Bezeq is required to provide universal service, 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 price of services or the range of services provided. Bezeq submits alternative tariff baskets for service packages to the approval of the Minister and the Minister of Finance, which baskets enable subscribers that choose them to enjoy special rates, but there is no assurance that such baskets shall be approved. The aforesaid obligations, also known as the universal service obligation ("**USO**"), will continue following the introduction of competition in the market for domestic services. Under the policy declared by the Minister, new operators entering the domestic fixed line market other than the Cable TV companies will not be subject to USO and will not be required to cover any predetermined geographical areas. Under the Telecommunications Law, the Minister may set the means to fund the USO subsequent to the advent of effective competition.

Domestic Marketing and Customer Service

In response to the introduction of competition in the domestic telecommunications services market, Bezeq has significantly increased its marketing efforts and decided to implement certain organizational changes. In February 2001, Bezeq started to establish separate units in each of its four geographical districts specializing in marketing and managing the services to business customers. 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. Bezeq intends to adopt bonus payments for its customer representatives in order to provide incentives based on achievement.

Bezeq advertises its services in the press, on television, by 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 implementing a new billing system. In June 2001, Bezeq entered into an agreement with Amdocs Software Systems Ltd. for the provision of a billing system for its business customers. The cost of developing and implementing the new billing system is estimated at approximately US\$ 50 million, with maintenance and support for the first three years estimated at approximately US\$ 8 million. Subject to possible modifications to the project timetable, the billing system is expected to be operational by September 2003, at which time Bezeq intends to commence the migration of its business customers to the new billing system. Such migration process is expected to last several months.

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. Bezeq International estimates that as of 31st December, 2001, it held between 33 and 35 per cent. of the international voice services market, in terms of traffic.

International telecommunications services generated consolidated revenues of NIS 784 million in 2001, 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, 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, as well as fees for services provided to the international operators in their capacity as Internet service providers. In addition, these revenues include Bezeq International's income from Internet connectivity fees, which is expected to make increasing levels of contribution to Bezeq International's overall revenues. 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. Access fees were payable through the end of 2001 at gradually declining rates and ceased to be payable after 1st January 2002. Interconnect charges are paid to Bezeq for all traffic which originates or terminates on its network. 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 and abroad.

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 2001, approximately 37 per cent. of the volume of outgoing traffic consisted of calls to North America and approximately 41 per cent. of the volume of incoming traffic consisted of calls from North America.

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

	Year ended 31st December,				
	1997	1998	1999	2000	2001
Outgoing calls (in millions of minutes)					
North America	145	124	140	142	138
Other	167	216	229	265	237
Total	312	340	369	407	375
Annual growth in outgoing traffic.....	(1)%	9%	8%	10%	(8)%
Incoming calls (in millions of minutes)					
North America	207	110	132	111	96
Other	187	144	128	132	139
Total	394	254	260	243	235
Annual growth in incoming traffic	16%	(34)%	2%	(7)%	(3)%
Ratio of incoming to outgoing traffic.....	1.26	0.75	0.70	0.60	0.63

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. Bezeq International believes that international data traffic has decreased as a result of the downturn in the domestic and international markets, notably in the high-tech and technology sectors.

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 did 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*". Bezeq International's strategy is generally to price particularly competitively in key routes including the United States, Russia and certain western European countries.

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. Bezeq and Bezeq International have raised objections to opening the market to additional competition, on the grounds of market saturation. The Minister adopted the Kroll Committee's recommendation that additional international operators be allowed to enter the market only in 2004, subject to the international operators not raising prices in real terms (see "*Relationship with Government — Regulation*"). 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. In July, 2001, Barak and Golden Lines filed a request for approval of merger with

the Restrictive Trade Practices Authority. Bezeq and Bezeq International have submitted objections to the merger. Bezeq is unable, at this stage, to assess the impact of such a merger, if approved, on the Group's business results.

Cellular Services

The Group provides mobile telephone services through Pelephone, which Bezeq holds in equal shares with PHL (see "Group Structure — Holdings in Pelephone"). In 1994, Bezeq was allotted fifty per cent. of the ownership and control of Pelephone, in exchange for certain infrastructure equipment. Cellular services generated consolidated revenues of NIS 2,072 million in 2001, representing approximately 25 per cent. of Bezeq's consolidated revenues. These revenues consist of 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.

From 1997 to 2001, Pelephone experienced subscriber growth, from approximately 535,000 at 31st December, 1996 to approximately 1,866,000 at 31st December, 2001. Pelephone believes that the cellular penetration rate in Israel at the end of 2001 was approximately 90 per cent., representing some 5,766,000 subscriber lines.

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

	At 31st December,				
	1997	1998	1999	2000	2001
Total subscribers (in thousands) ⁽¹⁾	810	930	1,110	1,505	1,866
Pelephone's cellular subscribers per 100					
Inhabitants	13.8%	15.8%	17.6%	23.5%	25.7%
Average number of subscribers (in Thousands) ⁽²⁾	672	872	1,021	1,308	1,686
Total revenues (in NIS millions of Dec 2001)	2,674	3,054	3,017	3,491	3,569
Average annual revenues per subscriber (in NIS of Dec 2001) ⁽³⁾	3,979	3,501	2,954	2,668	2,110

Notes:

(1) The subscriber numbers relate to registered subscribers, including non-active subscribers. As of January 2002, Pelephone records subscriber data based on active subscribers. At 30th September 2002, Pelephone had approximately 1,713,000 active subscribers.

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

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

Pelephone's results in 2001 (a net loss of approximately NIS 431 million) were affected by the turnaround strategy which included a thorough restructuring process, as well as an accelerated depreciation of the analogue network, the HSPD (High Speed Packet Data) infrastructure and the authentication infrastructure. The subscribers base grew by 361,000 net new additions. At the same time, Pelephone recorded higher operational and marketing costs, which were related to its strategy.

Cellular Services

Pelephone offers a range of voice and value added services throughout Israel, as well as cellular telephone roaming 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 upgrade 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 operate the existing N-AMPS network. By December 2001, Pelephone's CDMA

digital network had approximately 1,194,000 subscribers. Pelephone is upgrading its CDMA network to CDMA 1X, a technology that will provide higher spectrum efficiency (capacity) and will support the data rates required for the emerging usage of Internet access and portal applications. 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 improved performance.

Pelephone offers to both the mass market and the business sector a variety of value-added services in addition to basic cellular voice telephone service. As part of Pelephone's basic service package, subscribers receive services such as caller ID and voice mail, etc. For an extra charge payable to Pelephone and other content providers, subscribers receive premium services such as cellular internet through "GoNext", voice content (information and entertainment), SMS services and location based applications.

Prepaid Market

Pelephone offers a number of pre-paid cellular services, which dispense with monthly fees and commitment to a certain subscription period. Pelephone's pre-paid service is available through both the analogue and digital network.

Around one third of the entire Israeli Cellular market consists of prepaid subscribers. As of December 2001, Pelephone had approximately 528,000 prepaid subscribers which constituted approximately 28 per cent. of the entire prepaid market.

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,				
	1997	1998	1999	2000	2001
Number of usage minutes (in millions).....	2,983	3,342	3,645	4,455	5,543
Annual growth rate	37%	9%	12%	22%	24%
Average number of usage minutes per subscriber	320	300	295	284	274

From 1996 to 2001, the number of cellular calls completed on Pelephone's service increased, mainly due to the increase in the number of Pelephone's subscribers.

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. Pelephone offers its customers a wide variety of pricing plans with varied rates for "friends and family" and other preferred numbers. Pelephone also offers special rates to a wide range of segments: corporate, SME (Small Medium Enterprises), SOHO (Small Office Home Office), soldiers, youth and other segments.

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

	At 31st December,				
	1997	1998	1999 (in NIS)	2000	2001
Monthly service charge (per line)	74.00	36.86	29.68	18.20	17.07
Airtime rate (per minute)	0.4776	0.5366	0.4986	0.4457	0.3848

Pelephone determines its own airtime charges. However, the Minister can, under certain circumstances, regulate such charges. Under regulations, airtime tariffs for incoming calls were limited to NIS 0.54 per minute for October-December 2000, NIS 0.50 per minute for 2001 and 2002, and NIS 0.45 per minute as of 1st January 2003. As a result of such regulations, Pelephone's revenues from incoming calls, net of royalties, decreased by approximately US\$ 9 million between October and December 2000, and by approximately US\$ 62 million for 2001. The

MoC has indicated that it intends to examine the regulation of interconnectivity charges for calls originating on the network of either Bezeq or one of the cellular operators and terminating on another network. Changes to such regulation may further reduce the airtime tariffs for incoming calls. Pelephone is currently discussing with the MoC the inflationary adjustment of airtime tariffs for incoming calls.

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 4.5 per cent. per annum of most of its revenues and such royalty will be reduced to 4 per cent. in 2003 and to 3.5 per cent. in 2004. In December 2000, the State of Israel filed a claim against Pelephone in the amount of approximately NIS 264 million in connection with royalties for the period between January 1994 and February 1996. Pelephone has filed a defense in which it claims, *inter alia*, that amounts previously paid by Bezeq to the State of Israel cover part of such disputed royalties. The parties agreed to enter a mediation procedure to resolve such dispute (see note 20A(20) to the financial statements set out in "*Audited Annual Financial Statements*").

Cellular Competition

In 1993 the Israeli cellular market was opened to competition and in 1994 Cellcom commenced offering cellular services in direct competition with Pelephone. A third cellular operator, Partner, commenced services in 1998. In February 2001, the MoC granted a licence to provide cellular services to MIRS, a company controlled by Motorola specialising in cellular services to closed user groups.

The environment of intensive competition has resulted in reduced air-time tariffs and the erosion of programs containing monthly fees and commitments of customers to a specific operator for a minimum period.

The cellular systems of the four cellular operators are based on different technologies, which means that handsets and telephone numbers must be replaced when switching from operator to operator. As of mid 2002, Cellcom is operating a GSM/GPRS network, similar to that of Partner, which will facilitate movement of subscribers between those two operators. Pelephone believes that this development will not significantly affect the churn rates in the market.

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, value added services, effective 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 90 direct sales persons, 205 dealer points and 43 stores, which together represent 338 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 27 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. Pelephone markets a broad range of handsets made by various manufacturers, and recently launched the first colour display cellular phone in the Israeli market.

Investments in Israel

As part of its strategy to expand its base of income, leverage its technological capabilities and increase its exposure to new technologies, Bezeq has invested and intends to continue to invest in Israeli companies, including start-up companies and companies whose businesses may complement Bezeq's activities. To facilitate certain investments, the Ministerial Committee for Privatization allowed in January 2001 that investments by Bezeq which fulfill certain criteria, shall

be deemed approved, unless one of the relevant Government agencies determines within 10 business days of a report by Bezeq of such investment, to examine such investment.

In addition, Bezeq committed to invest up to US\$ 32 million in venture capital funds, including US\$ 20 million in StageOne Ventures LP, of which it is a sponsor, and which focuses in seed investments in start up companies in the field of telecommunications technology. Bezeq has also established an incubator programme for its employees, under which Bezeq intends to fund the initial stages of the development of technological based business ventures with potential commercial value, in return for part of the equity of the ventures.

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 20A(6) to the financial statements set out in "*Audited Annual Financial Statements*").

Network Infrastructure and Technology

From 1997 to 2001, the Group invested approximately NIS 8,359 million to upgrade and modernise its telecommunications infrastructure, including the development of a modern signaling system for inter-exchange connections throughout the country, the development of advanced transmission systems using fiber optics and the expansion and enhancement 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. In the last three years, Bezeq has substantially invested in the establishment of an ADSL network that enables it to offer its customers fast Internet access and in the future will provide access to other broadband services and applications. During the next three years Bezeq intends to invest in telecommunications infrastructure projects such as expansion of the optical network by using WDM technology, enhancing broadband access capabilities by deploying xDSL technologies and fibre to the curb and deploying an IP based next generation switching network (See — "*Domestic Fixed Line Services — Domestic Data Services and Technologies*"). Bezeq's investment strategy is to remain at the forefront of technological advancement in order to provide advanced and innovative services and to achieve efficiency targets. In recent years, Bezeq's investments in fixed assets have materially decreased, resulting in a steady decline in its depreciation expense. The final depreciation of assets transferred to Bezeq from the Government following Bezeq's establishment and of assets acquired during its first years of activity is expected to cause a further decrease in depreciation. (See note 5 to "*Unaudited Interim Financial Statements*").

Domestic Fixed Line Telecommunications Network

Bezeq's domestic fixed line telecommunications network comprises 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 technology. Bezeq uses TMX-100 exchanges manufactured by Nortel and S.12 exchanges manufactured by Alcatel. Bezeq completed an upgrade of its Nortel TMX-100 exchanges to MMP15 in 2002, and is currently upgrading its Alcatel S.12 exchanges to Word Release.

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, 2001, Bezeq had expanded the use of fibre optic cable to 100 per cent. of its trunk network and at such time the connections of approximately 22 per cent. of Bezeq's subscribers to exchanges utilised fibre optic technologies in its local network, representing approximately 6,000 kilometres of fibre optic cable in its trunk network and approximately 8,600 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 2.68 million lines at the end of 1997 to approximately 3.03 million lines at the end of 2001. 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 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 International uses submarine fibre optic cables providing connections to Palermo, Cyprus and others through which international calls can be routed to over 50 countries. Bezeq International purchased rights of use on additional submarine fibre optic cables that are not directly connected to Israel for communications with Europe, North America and other countries.

Bezeq provides satellite capacity through Intelsat, in which Bezeq is a shareholder, as well as in New Skies Satellites Ltd. (which operates approximately one fifth of Intelsat's satellites). Bezeq owns a land earth station and provides Inmarsat services, pursuant to an operating agreement with Inmarsat. Bezeq's satellite services provide access to Europe, America, Russia and the Far East. Bezeq International has 252 channels through its satellite connections.

Cellular Telecommunications Network

Pelephone has made substantial investments in its cellular telephone network which provides nationwide coverage. Pelephone expects to continue to make substantial investments, including in connection with third generation technologies. Historically, Pelephone 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 is upgrading its CDMA network to CDMA 1X, a technology that will provide higher spectrum efficiency (capacity) and will support the data rates required for the emerging usage of Internet access and portal applications. Pelephone expects to complete the system upgrade to CDMA 1X by the end of 2003.

Pelephone's cellular infrastructure is based on 14 switches, which are scheduled to be upgraded by the end of 2003. System coverage and capacity are based on over 900 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 responsible for the connections between the sites as well as with Bezeq's exchanges.

Pelephone's N-AMPS infrastructure equipment is manufactured by Motorola, Inc. Pelephone plans to operate infrastructure equipment manufactured by Nortel in central urban areas, and Motorola infrastructure equipment in peripheral areas.

Pelephone has encountered difficulties in obtaining permits required for operating cellular sites. Should such difficulties continue, they might delay the planned development of the network. This could have an adverse effect on the range, quality and capacity of the network.

Pelephone recently participated in the third generation frequencies tender held by the MoC and acquired new frequencies at the sum of NIS 225 million, to be paid in several payments until 2006. In addition, Pelephone provided the MoC with a guarantee in the amount of US\$20 million.

Employees

General

At 31st December, 2001 Bezeq had 8,984 employees, approximately 59 per cent. of whom were employed pursuant to permanent collective labour agreements and 29.1 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 one third of Bezeq's employees at 31st December, 2001 were technicians. At that date, 48.5 per cent. of Bezeq's employees performed administrative functions and 6.1 per cent. were engineers.

The table below sets out information regarding Bezeq's positions (FTE) for each of the last five years:

	Year ended 31st December,				
	1997	1998	1999	2000	2001
Number of employees					
Permanent contracts	7,478	6,629	5,989	5,409	5,219
Temporary contracts	312	248	135	61	2,150
Individual contracts	545	607	692	833	1,068
Total	<u>8,335</u>	<u>7,484</u>	<u>6,816</u>	<u>6,303</u>	<u>8,437</u>

Bezeq's employees are divided into three general groups, each subject to different employment terms. The first group of approximately 1,070 employees comprises senior managers and other employees employed under individual employment contracts with Bezeq. The second group of approximately 5,300 permanent employees comprises approximately 1,920 ex-Government employees who were employed by the MoC when Bezeq started its operations in 1984 and were transferred to Bezeq and approximately 3,380 employees hired by Bezeq since it commenced operating. This second group is subject to collective labour agreements. The third group is comprised of temporary employees hired by Bezeq on an "as needed" basis through temporary employment agreements and is also subject to collective labour agreements. Prior to January 2001, Bezeq used temporary workers provided by employment agencies pursuant to agreements between Bezeq and the employment agencies. Legislation which came into effect on 30th June, 2001 determined that a temporary worker provided by an employment agency would become an employee of the actual work place after nine months of work. In view of such legislation, in January 2001 Bezeq entered into a special collective labour agreement under which such temporary workers became employees of Bezeq. At 31st December, 2001, Bezeq employed 2,611 such employees, most of whom occupy administrative, customer service and maintenance positions. Bezeq estimates that the transfer of workers provided by employment agencies to the status of employees will not, in the short term, increase its employment expenses, and may increase such employees' output.

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 under 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. The number of employees who retired within the framework of this plan exceeded Bezeq's forecasts and reached approximately 2,050. In addition, in March 2000, Bezeq further extended the plan to include an additional 530 employees, all of which have already retired as of 31st December 2001. As a result of the extensions, an expense of approximately NIS 398 million was provided for in Bezeq's 1999 financial statements. In September 2000, a special collective labour agreement was signed which effectively extended the retirement plan to the end of 2006 (with an option to extend the final retirement date of certain employees to the end of 2008), and under which up to approximately 1,770 employees may retire. Under the latest extension, approximately 290 employees had retired as of 30th September, 2002. Bezeq intends to implement certain structural changes concurrently with the implementation of the retirement plan (see note 16D of the financial statements set out in "Audited Annual Financial Statements"). In 2000, Bezeq reserved

a total of approximately NIS 1.4 billion in connection with the extension of the early retirement plan.

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 2000, there have been four strikes, most of which were protests against Government policies rather than against Bezeq. 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, 2001 Bezeq owned, leased or used approximately 532,000 developed square metres on approximately 7,002,100 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 certain of its terms, as well as with respect to the validity of those provisions of the 1984 Agreement affording Bezeq lesser rights than those held by the Government prior to the 1984 Agreement. In addition, the Government has transferred to Bezeq significant properties for automatically renewable leases of two years. The 1984 Agreement stipulates that the Government may terminate any renewable lease, by one-year's notice, if the land is required by it for a preferable use. In such event, the Government must offer Bezeq, to Bezeq's satisfaction, an appropriate substitute property within a reasonable distance and cover the costs of transfer to such substitute property. Bezeq views its rights in the properties subject to renewable leases to be tantamount to full rights of ownership. 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. In June 2002, the State of Israel filed a claim against Bezeq requesting the court to declare, *inter alia*, (i) that the State of Israel is the sole owner of the real estate properties transferred to Bezeq pursuant to the 1984 Agreement and that Bezeq has only limited rights of use in such property; (ii) that the Government has a right to immediately repossess properties subject to the renewable leases of two years, provided the Government is of the opinion that there is a preferable use for such properties, and subject to providing to Bezeq alternative property if Bezeq proves that such alternative property is required for provision of its services; (iii) that the Government has the right to repossess, without reimbursement to Bezeq, including giving alternative property, any property not being used for the purposes for which it was leased or if the Government is no longer interested in such purpose; (iv) that Bezeq must immediately transfer to the State of Israel certain properties. Bezeq filed a statement of defence in which it alleges, *inter alia*, that the claim should be struck out or clarified and amended and that in any case the claim should also be dismissed on its merits. Bezeq is unable at this stage to estimate the likelihood of the claim being successful and its overall implications.

Discussions with the Government on this matter have not yet been successfully resolved and there can be no assurance that such dispute will be resolved in the near future. However, recent discussions have led to a proposed settlement, under the principles of which Bezeq would return to the Government certain properties that are subject to renewable leases, and receive long-term lease rights in all other properties. The Government would also lift certain restrictions on the use of the properties held by Bezeq. Any settlement will be subject to a final agreement, the approval of the Government, the Attorney General, the Council of the Israel Land Administration, and of Bezeq's Board of Directors and shareholders. Bezeq does not record the value of the properties subject to the renewable leases in its financial reports, in accordance with generally accepted accounting principles in Israel (see "*Relationship with Government — Government Control and Privatisation*" and note 9B to the financial statements set out in "*Audited Annual Financial Statements*" and note 7A(10) to the "*Unaudited Interim Financial Statements*").

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 it uses are not properly documented or registered. However, Bezeq has taken steps to protect its rights in part of those properties.

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 and 20A) 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 December 2002, Pelephone received a class action claim against Pelephone and another cellular operator in the amount of approximately NIS 4 billion, of which approximately NIS 2.4 billion is against Pelephone. The claim alleges that Pelephone and the other cellular operator collected high and unfair prices for incoming calls to their networks between May 1996 and October 2000. The claim alleges that in doing so, each of Pelephone and the other cellular operator exploited its monopolistic status with respect to incoming calls to its network and violated duties under the Telecommunications Law and under its license. Pelephone is studying the claim and is unable at this stage to estimate the likelihood of such action being successful. On 3rd December, 2002, a class action was filed against DBS, the Cable and Satellite Broadcast Council and the Ministry of Communications. The applicants, who are subscribers of DBS, allege, *inter alia*, that the transfer of content from a non-premium sports channel to a premium sports channel contravenes the terms stipulated by the Cable and Satellite Broadcast Council. The amount of the action is NIS 126 million plus NIS 10.5 million for every month between the date of the claim until judgment. DBS is studying the claim and is unable at this stage to estimate the likelihood of such action being successful. On 16th December, 2002, the Supreme Court dismissed the appeal of two former employees of Bezeq against the ruling of the District Court that had dismissed a class action filed by such former employees against the State of Israel and against Bezeq. The class action alleged that the State of Israel and Bezeq violated various undertakings included in Bezeq's prospectus published in 1991. (see note 20A(9) to the financial statements set out in the "*Audited Annual Financial Statements*"). On 17th December, 2002, the Supreme Court dismissed an appeal against the ruling of the District Court that had dismissed a class action against Bezeq. The class action alleged that Bezeq should have applied certain discounted tariffs offered in a tariff basket for Internet connectivity, also to subscribers who did not elect that basket. (See note 20A(21) to the financial statements set out in the "*Audited Annual Financial Statements*").

Tax Assessments

Bezeq has received final tax assessments up to and including 1998. Pelephone has received final tax assessments up to 1994 and for the years up to 1997 as a result of the statute of

limitations having elapsed. BezeqCall has received final tax assessments up to 1998. Bezeq's other subsidiaries have not yet received any final tax assessments.

Following an assessment review by the income tax authorities for the years 1994 to 1998 inclusive, Bezeq signed an agreement with the income tax authorities. As a result of the above, Bezeq recorded tax expenses in its financial statements as at 31st December 2001 in respect of preceding years, in the amount of NIS 12 million, as well as financing income of approximately NIS 79 million (tax exempt) in connection with the rebate payable to Bezeq. (see note 11E to the financial statements set out in the *"Audited Annual 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.

There are alleged health risks related to base transceiver stations and the use of handsets which could expose Pelephone, as well as other cellular operators, to liability, and lead to reduced usage of mobile phones and increased difficulties in obtaining sites for base stations.

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, 2002 is approximately NIS 1.4 billion.

As at 30th September, 2002, Bezeq had approximately NIS 5.1 billion of long term debt outstanding, approximately NIS 1.8 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. Bezeq expects that some of its lenders will seek repayment of their debt in such circumstances and Bezeq may consider replacing or refinancing a portion of these debts, 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, 2002, it expects sales volumes in the domestic fixed line market to decrease as revenues continue to be impacted by the tariff changes introduced on 1st March 2001 and 14th May 2002. Furthermore, the continued migration of calls from the fixed line to the cellular networks will continue to adversely impact revenues. In addition, beginning January 2002, Bezeq ceased to receive access fees from the three international operators, which adversely impacted revenues.

The anticipated opening of fixed domestic telecommunications services to competition, in addition to the growing competition in the cellular, international, and broadcasting communications sectors, is expected to continue to have a material adverse effect on the Group's business results. During 2002, Bezeq has continued to provide significant financial assistance to the other group companies. Bezeq expects that Pelephone and DBS will continue to make losses through 2002, partly as a consequence of investments in technology and infrastructure to enable them to compete in their highly competitive markets, though Pelephone's losses in 2002 are anticipated to be less than its losses in 2001. (See note 4 to the "*Unaudited Interim Financial Statements*").

In October 2001, the Israeli Institution for Standardization in Accounting published Accounting Standard No. 12, which deals with the termination of inflationary adjustments in financial statements. The standard is scheduled to come into effect as of 1st January, 2004. Until 31st December, 2003, Bezeq will continue to prepare inflation adjusted financial statements, and the adjusted amounts in Bezeq's reports as of 31st December, 2003 will become the basis for the nominal reports starting 1st January, 2004. The standard may have a material adverse effect on the reported results of Bezeq, the extent of which depends on the rate of inflation and on Bezeq's financing structure (see note 2(b) to the "*Unaudited Interim Financial Statements*").

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 consists 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*".

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.

Each director, other than the external directors, is appointed for three years by the Minister and the Prime Minister, but such appointment is subject to such director being elected in each of the following annual general meetings. 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 18 members.

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 (in alphabetical order):

<u>Name</u>	<u>Name</u>
Miriam Mazar ⁽¹⁾	Rachel Kremmerman-Meridor
Yoram Aridor	Amnon Neubach
Amal Assad	Rami Nomkin ⁽²⁾
Yosef Banano ⁽²⁾	Michael Perry ⁽³⁾
Avi Barak	Hava Shechter
Dalit Braun	Aliza Shloss
Ido Dissentshik	Shoshana Weinshal
Shlomit Eytan	
Blanche Kaye ⁽³⁾	
Shimon Levi	
Shiloh Lifschitz	

(1) On 10th December, 2002, Ms. Mazar was appointed as a temporary chairperson until June, 2003. Such appointment is subject to the approval of the Minister and the Prime Minister.

(2) director from among Bezeq's employees.

(3) External director.

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
Paul Weissbach	Deputy Chief Executive Officer and Vice President, Engineering & Planning
Oren Lieder*	Chief Financial Officer
Avi Gabay	Vice President, Economics
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
Shlomo Koppel	Corporate Secretary
Nati Bialistock-Cohen	Anti-Trust Compliance Officer
Yotam Yakir	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
Menachem Avinoam	Head of Jerusalem & South Operating Division

* Mr. Oren Lieder has announced his resignation from Bezeq, effective as of 1st January, 2003. His replacement as Chief Financial Officer has not yet been announced.

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). The summary assumes that the Noteholder is not a resident of Israel. 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, although following 1st January, 2003 it is possible that this rate will be reduced to 15 per cent. in the case of individual Noteholders. Withholding tax may, however, be reduced by (i) an appropriate double taxation treaty to which Israel is a party and the "interest" article of 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 interest income from a Note may be subject to Israeli taxation on the income if the income is received by an Israeli resident.

SUBSCRIPTION AND SALE

The Dealers have, in an amended and restated Programme Agreement dated 19th December, 2002 (the "**Programme Agreement**") 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) in relation to any Notes having a maturity of less than one year, (a) it is a person whose ordinary activities involve it in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of its business and (b) it has not offered

or sold and will not offer or sell any Notes other than to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or as agent) for the purposes of their businesses or who it is reasonable to expect will acquire, hold, manage or dispose of investments (as principal or agent) for the purposes of their businesses where the issue of the Notes would otherwise constitute a contravention of Section 19 of the FSMA by the Issuer;

- (iii) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) received by it in connection with the issue or sale of any Notes in circumstances in which Section 21(1) of the FSMA does not apply to the Issuer; and
- (iv) it has complied and will comply with all applicable provisions of the FSMA 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.

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) or in compliance with any other applicable laws and regulations in The Netherlands.

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 pursu-

ant 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. The first update of the Programme has been duly authorised by a resolution of the Board of Directors of the Issuer dated 23rd October, 2001. The second update of the Programme has been duly authorised by a resolution of the Board of Directors of the Issuer dated 12th December, 2002.

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, 2000 and 2001. 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 30th September, 2002 and there has been no material adverse change in the financial position or prospects of the Group since 31st December, 2001.

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, 2001.

EU Directive on the Taxation of Savings Income

On 13th December, 2001 the Council of the European Union published a revised draft directive regarding the taxation of savings income. It is proposed that, subject to a number of important conditions being met, Member States will be required to provide to the tax authorities of another Member State details of payments of interest (or other similar income) paid by a person within its jurisdiction to an individual resident in that other Member State, except that Belgium, Luxembourg and Austria will instead operate a withholding system for a transitional period in relation to such payments. The proposed directive is not yet final, and may be subject to further amendment.

“BEZEQ” THE ISRAEL TELECOMMUNICATION CORP. LIMITED

FINANCIAL STATEMENTS

DECEMBER 31, 2001

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**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, 2001 and 2000, 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 the last of which ended December 31, 2001. 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, including those consolidated by the proportionate method whose assets constitute approximately 17% and approximately 5% of the total consolidated assets as at December 31, 2001 and 2000 respectively, and whose revenues constitute approximately 28%, 9%, and 7% of the total consolidated revenues for the years ended December 31, 2001, 2000, and 1999, 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 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 provide a reasonable basis for our opinion.

In our opinion, based on our audits and on the reports of the abovementioned 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, 2001 and 2000 and the results of their operations, the changes in the shareholders' equity and their cash flows for each of the three years the last of which ended December 31, 2001, in conformity with generally accepted accounting principles. Furthermore, in our opinion, the financial statements referred to above are prepared in accordance 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 the maximum possible exposure of which is significant:

1. The anticipated opening of the communications sector to competition, changes in the tariffs and their effect on the Company's financial position and operating results, as described in Note 1.
2. A program for a early retirement, as described in Note 16D.
3. Claims made against the Company and against investee companies, as described in Note 20A.

4. The financial condition of an affiliated company, and its non-compliance with the conditions set forth in the financing agreement between the affiliated company and banking corporations. As described in Note 8F the activity of the affiliated company is dependent upon continued execution of the financing agreement, the increase of credit lines approved for the affiliated company by the banking corporations and additional loans to be received from the shareholders. The assessment of the affiliated company's management as to the likelihood of resolution of the required financing is included in the abovementioned note.

KPMG Somekh Chaikin
Certified Public Accountants (Isr.)

March 25, 2002

Balance Sheets

In terms of shekels of December 2001

	Note	Consolidated		Company	
		December 31, 2001	December 31, 2000	December 31, 2001	December 31, 2000
		NIS thousands	NIS thousands	NIS thousands	NIS thousands
Current assets					
Cash and cash equivalents	3	1,303,000	1,554,486	1,270,366	1,543,291
Short-term investments	4	440,654	191,024	424,622	170,749
Trade receivables	5	1,687,212	1,292,129*	1,145,544	738,615
Other receivables and debit balances	6	322,008	482,676	252,739	391,842
Inventory		116,032	136,320	—	—
		<u>3,868,906</u>	<u>3,656,635</u>	<u>3,093,271</u>	<u>2,844,497</u>
Materials and spare parts		<u>151,806</u>	<u>187,794</u>	<u>151,806</u>	<u>187,794</u>
Investments and long-term payables					
Investments, deposits and debit balances	7	1,680,932	293,575	1,619,921	247,450
Investments in investee companies	8	461,067	175,110	1,600,135	1,304,804
		<u>2,141,999</u>	<u>468,685</u>	<u>3,220,056</u>	<u>1,552,254</u>
Fixed assets					
Cost	9	28,165,809	29,451,255	23,977,063	25,654,709
Less — accumulated depreciation		<u>17,927,996</u>	<u>17,680,460</u>	<u>15,425,722</u>	<u>15,693,822</u>
		<u>10,237,813</u>	<u>11,770,795</u>	<u>8,551,341</u>	<u>9,960,887</u>
Other assets					
Deferred charges and other assets	10	340,399	383,418	16,983	15,500
Deferred taxes	11	415,780	642,273	325,205	641,971
		<u>756,179</u>	<u>1,025,691</u>	<u>342,188</u>	<u>657,471</u>
		<u>17,156,703</u>	<u>17,109,600</u>	<u>15,358,662</u>	<u>15,202,903</u>

	Note	Consolidated		Company	
		December 31, 2001	December 31, 2000	December 31, 2001	December 31, 2000
		NIS thousands	NIS thousands	NIS thousands	NIS thousands
Current liabilities					
Short-term bank credit	12	423,566	745,503	—	—
Current maturities of:					
Long-term bank loans	13	556,926	382,909	367,024	321,970
Other debentures	14	186,721	227,755	186,721	227,755
Trade payables	15	1,018,684	961,641*	570,527	472,462
Employee severance benefits	16	262,947	349,639	262,947	349,639
Other current liabilities	17	1,155,097	975,084*	953,879	784,923*
		<u>3,603,941</u>	<u>3,642,531</u>	<u>2,341,098</u>	<u>2,156,749</u>
Long-term liabilities					
Long-term loans	13	2,513,920	2,864,596	1,973,535	2,438,620
Other debentures	14	2,524,266	2,182,406	2,524,266	2,182,406
Employee severance benefits	16	1,275,911	1,275,160*	1,265,078	1,270,826*
Deferred taxes	11	—	14,635	—	—
Deferred revenues	18	58,034	70,785	74,054	94,815
		<u>6,372,131</u>	<u>6,407,582</u>	<u>5,836,933</u>	<u>5,986,667</u>
Convertible debentures	19	—	69,052	—	69,052
Contingent liabilities	20				
Shareholders' equity	21	<u>7,180,631</u>	<u>6,990,435</u>	<u>7,180,631</u>	<u>6,990,435</u>
		<u>17,156,703</u>	<u>17,109,600</u>	<u>15,358,662</u>	<u>15,202,903</u>

* Reclassified

Ido Dissentshik
Chairman of the Board

Ilan Biran
CEO

Oren Lieder
Chief Financial Officer

Date of approval of the financial statements: March 25, 2002

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

Statements of Operation for the Year Ended December 31
In terms of shekels of December 2001

	Note	Consolidated			Company		
		2001	2000	1999	2001	2000	1999
		NIS thousands					
Revenues from							
telecommunications services . . .	22	8,151,848	8,520,659	9,283,746*	5,894,652	6,340,383	7,563,942
Costs and expenses							
Operating and general expenses . .	23	4,467,546	4,344,210	5,203,861*	2,517,342	2,571,924	3,982,755
Depreciation	9	2,596,536	2,738,343	2,759,267	2,151,037	2,277,958	2,325,632
Royalties to the Government of Israel		270,388	318,990	305,605	189,315	203,706	211,141
		<u>7,334,470</u>	<u>7,401,543</u>	<u>8,268,733</u>	<u>4,857,694</u>	<u>5,053,588</u>	<u>6,519,528</u>
Operating income		817,378	1,119,116	1,015,013	1,036,958	1,286,795	1,044,414
Financing expenses, net	24	144,076	348,069	365,147	72,755	298,487	369,829
Earnings after financing expenses		673,302	771,047	649,866	964,203	988,308	674,585
Other expenses, net	25	(100,552)	(1,290,592)	(566,329)	(2,502)	(1,250,233)	(489,574)
Earnings (loss) before income tax		572,750	(519,545)	83,537	961,701	(261,925)	185,011
Tax benefit (income tax)	11	(230,592)	155,484	(60,506)	(346,757)	140,748	(71,371)
Earnings (loss) after income tax . .		342,158	(364,061)	23,031	614,944	(121,177)	113,640
Equity in losses of investee companies	8	(227,257)	(197,910)	(21,854)	(493,823)	(435,832)	(105,340)
Minority share in losses of consolidated company		6,220	4,962	—	—	—	—
Earnings (loss) before cumulative effect of change in accounting method		121,121	(557,009)	1,177	121,121	(557,009)	8,300
Cumulative effect as at beginning of year of the change in accounting method		—	—	7,123	—	—	—
Net earnings (loss)		<u>121,121</u>	<u>(557,009)</u>	<u>8,300</u>	<u>121,121</u>	<u>(557,009)</u>	<u>8,300</u>
Primary and diluted earnings (loss) per NIS 1 par value of common shares (in NIS)	26	<u>0.050</u>	<u>(0.229)</u>	<u>0.008</u>	<u>0.050</u>	<u>(0.229)</u>	<u>0.008</u>

* Reclassified

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

Statements of Changes in Shareholders' Equity
In terms of shekels of December 2001

	Share capital	Capital reserve for distribution of bonus shares	Capital reserve — share premium	Capital reserve in respect of transactions between the Company and a controlling shareholder	Retained earnings	Total
	NIS thousands					
Balance as at January 1, 1999	4,172,962	—	486,303	36,152	2,769,484	7,464,901
Changes in 1999 —						
Net earnings	—	—	—	—	8,300	8,300
Dividend for preceding year	—	—	—	—	(305,815)	(305,815)
Conversion of convertible debentures ⁽¹⁾	18,155	—	174,742	—	—	192,897
Balance as at December 31, 1999	4,191,117	—	661,045	36,152	2,471,969	7,360,283
Changes in 2000 —						
Erosion of dividend declared in a previous year and paid this year...	—	—	—	—	(1,441)	(1,441)
Net loss	—	—	—	—	(557,009)	(557,009)
Tax benefit in respect of shares to employees	—	—	22,066	—	—	22,066
Conversion of convertible debentures ⁽²⁾	14,861	—	151,675	—	—	166,536
Capitalization of undesignated earnings to a reserve fund for the distribution of bonus shares.....	—	1,621,029	—	—	(1,621,029)	—
Balance as at December 31, 2000	4,205,978	1,621,029	834,786	36,152	292,490	6,990,435
Changes in 2001						
Net earnings	—	—	—	—	121,121	121,121
Conversion of convertible debentures ⁽³⁾	6,017	—	63,058	—	—	69,075
Distribution of bonus shares	1,641,704	(1,621,029)	—	—	(20,675)	—
Balance as at December 31, 2001	5,853,699	—	897,844	36,152	392,936	7,180,631

(1) 178,187,698 par value convertible debentures were converted into 17,607,480 ordinary shares with a par value of NIS 1 each.

(2) 147,652,429 par value convertible debentures were converted into 14,590,161 ordinary shares with a par value of NIS 1 each.

(3) 59,754,681 par value convertible debentures were converted into 5,904,612 ordinary shares with a par value of NIS 1 each.

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

Statements of Cash Flows for the Year Ended December 31
In terms of shekels of December 2001

	<u>Consolidated</u>			<u>Company</u>		
	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>
	NIS thousands			NIS thousands		
Cash flows generated by operating activities						
Net earnings (loss)	121,121	(557,009)	8,300	121,121	(557,009)	8,300
Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities (see A below)	<u>3,094,994</u>	<u>3,868,250</u>	<u>2,411,458</u>	<u>2,704,707</u>	<u>3,580,248</u>	<u>2,167,744</u>
Net cash flow generated by operating activities	<u>3,216,115</u>	<u>3,311,241</u>	<u>2,419,758</u>	<u>2,825,828</u>	<u>3,023,239</u>	<u>2,176,044</u>
Cash flows generated by investing activities						
Acquisition of fixed assets	(1,263,949)	(1,749,962)	(1,437,557)	(896,117)	(1,119,800)	(933,559)
Proceeds from disposal of fixed assets	81,997	35,082	20,395	62,747	29,570	16,541
Proceeds from disposal of investment in affiliated company	29,725	173,532	—	29,725	173,532	—
Investment in long-term deposits and investments	(1,102,540)	(60,669)	(16,043)	(1,081,292)	(25,848)	(5,059)
Proceeds from long-term deposits and investments	36,576	60,865	114,295	30,908	23,877	84,367
Decrease (increase) in short-term investments, net	(239,798)	117,334	86,200	(244,985)	129,998	(138,045)
Decrease (increase) in materials and spare parts	48,899	58,776	(81,162)	48,899	58,776	(81,162)
Investment in investee companies	(523,804)	(329,297)	(61,355)	(784,258)	(271,574)	(44,542)
Investments in other assets	<u>(195,862)</u>	<u>(266,708)</u>	<u>(305,653)</u>	<u>(5,589)</u>	<u>—</u>	<u>(132)</u>
Net cash outflow used for investment activities	<u>(3,128,756)</u>	<u>(1,961,047)</u>	<u>(1,680,880)</u>	<u>(2,839,962)</u>	<u>(1,001,469)</u>	<u>(1,101,591)</u>
Cash flows generated by financing activities						
Repayment of debentures issued to the Government of Israel	—	(478,266)	(951,841)	—	(478,266)	(951,841)
Issue of other debentures (after deduction of issue expenses)	510,553	1,109,257	266,963	510,553	1,109,257	266,963
Repayment of other debentures	(226,291)	(229,443)	(209,486)	(226,291)	(229,443)	(209,486)
Receipt of long-term loans	734,117	814,254	730,968	433,540	598,169	567,202
Repayment of long-term loans	(1,035,287)	(1,848,530)	(1,122,137)	(976,593)	(1,663,954)	(1,070,654)
Receipt (repayment) of short-term bank credit	(321,937)	470,677	274,826	—	—	—
Dividend paid	—	(307,256)	—	—	(307,256)	—
Net cash outflow used for financing activities	<u>(338,845)</u>	<u>(469,307)</u>	<u>(1,010,707)</u>	<u>(258,791)</u>	<u>(971,493)</u>	<u>(1,397,816)</u>
Increase (decrease) in cash and cash equivalents	(251,486)	880,887	(271,829)	(272,925)	1,050,277	(323,363)
Cash and cash equivalents at beginning of year	<u>1,554,486</u>	<u>673,599</u>	<u>945,428</u>	<u>1,543,291</u>	<u>493,014</u>	<u>816,377</u>
Cash and cash equivalents at end of year	<u>1,303,000</u>	<u>1,554,486</u>	<u>673,599</u>	<u>1,270,366</u>	<u>1,543,291</u>	<u>493,014</u>

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

Statements of Cash Flows for the Year Ended December 31 (contd.)
In terms of shekels of December 2001

	Consolidated			Company		
	2001	2000	1999	2001	2000	1999
	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	2,596,536	2,738,343	2,759,267	2,151,037	2,277,958	2,325,632
Provision for decrease in value of fixed assets	102,026	11,168	107,879	—	—	107,879
Deferred taxes	(116,925)	(312,537)	81,240	(2,072)	(290,987)	73,911
Company's equity in losses of investee companies, net	227,257	197,910	21,854	493,823	435,832	105,340
Minority share in net losses of a consolidated company	(6,220)	(4,962)	—	—	—	—
Provision for decrease in value of an affiliated company	—	—	(15,129)	—	—	(15,129)
Increase (decrease) in employee severance benefits, net	(85,941)	1,199,014*	(295,159)*	(92,440)	1,187,256*	(297,144)*
Loss (gain) on disposal of fixed assets	(8,705)	(1,360)	(16,622)	2,502	(2,694)	(17,700)
Loss (gain) on disposal of investment in an affiliated company	3,480	(140,692)	—	—	(140,692)	—
Erosion (appreciation) of and interest on long-term deposits and investments	(198,288)	15,642	17,172	(198,288)	15,642	17,172
Appreciation of short-term investments, net	(9,832)	(2,973)	(321)	(8,888)	(2,140)	(321)
Appreciation (erosion) of long-term liabilities:						
Debt issued to the Government of Israel						
Israel	—	674	(2,442)	—	674	(2,442)
Other debentures	16,564	27,319	829	16,564	27,319	829
Long-term loans	128,402	(74,828)	(36,733)	130,883	(72,867)	(35,478)
Convertible debentures	—	—	142	—	—	142
Amortization of deferred expenses and other adjustments	245,534	152,581	68,467	4,253	1,101	7,702
Changes in asset and liability items:						
Decrease (increase) in trade receivables	(403,371)	253,279*	55,573	(415,911)	283,740	87,697
Decrease (increase) in other receivables and debit balances	318,723	(83,750)	(107,083)	287,214	(89,417)	(25,622)
Decrease (increase) in inventory	22,222	(14,921)	(83,098)	—	—	—
Increase (decrease) in trade payables	79,942	(187,917)*	94,192	171,508	(108,594)	68,434
Increase (decrease) in other current liabilities	196,341	105,366*	(232,140)*	185,284	75,241*	(221,197)*
Decrease in deferred revenues	(12,751)	(9,106)	(6,430)	(20,762)	(17,124)	(11,961)
	<u>3,094,994</u>	<u>3,868,250</u>	<u>2,411,458</u>	<u>2,704,707</u>	<u>3,580,248</u>	<u>2,167,744</u>
B — Non-cash transactions						
Acquisition of fixed assets, other assets, materials and spare parts on credit	<u>163,771</u>	<u>305,275</u>	<u>328,730</u>	<u>109,700</u>	<u>184,246</u>	<u>267,038</u>
Sale of fixed assets on credit	<u>—</u>	<u>8,983</u>	<u>23,376</u>	<u>—</u>	<u>8,983</u>	<u>23,376</u>
Transfer of fixed assets in return for an investment in a consolidated company	<u>—</u>	<u>—</u>	<u>—</u>	<u>12,006</u>	<u>—</u>	<u>—</u>
Proposed dividend	<u>—</u>	<u>—</u>	<u>305,815</u>	<u>—</u>	<u>—</u>	<u>305,815</u>

* Reclassified

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

Notes to the Financial Statements as at December 31, 2001

NOTE 1 — GENERAL

- A. "Bezeq" — The Israel Telecommunication Corp. Limited (hereinafter — the Company) is controlled by the State of Israel and as such, is subject to the provisions of the Government Companies Law, 5735-1975. The Company operates under a general license awarded under the Telecommunications Law (telecommunications and broadcasting), 5742-1982, which authorizes it to engage in the telecommunication business and provide telecommunication services. The Company's license, which was granted on March 1, 1994 (and which replaced an earlier license and was subsequently 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, 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.

On March 18, 2002 the Company received a draft amendment to its general license. The Company is studying the proposed amendment and is required to submit its remarks during a hearing which will be scheduled. Preliminary reading of the text of the proposed amendment reveals that it includes the imposition of new provisions and directives on the Company (some of which are reflected in the Telecommunications Law and/or the Telecommunications Order and/or in other laws, and some of which are new provisions/directives), as well as expansion of existing provisions and restrictions on various issues.

- 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.

The Company's tariffs are updated according to the recommendations of the committee for arrangement of the Company's tariffs, which were adopted by the Minister of Communications and Minister of Finance with certain amendments. Those recommendations set the efficiency factor of the Company's tariffs ("the efficiency factor"), which averaged 6% in 1999 and 7% in 2000. Starting from 2001, this factor is 3.5% per year.

In accordance with the above recommendations, the Company's tariffs were lowered on April 1, 1999, May 1, 2000 and March 1, 2001. The March 2001 reduction included lowering of the Company's call tariffs by an average 1.4%, an increase of approximately 33% in interconnect tariffs to cellular communication operators, while other service tariffs were lowered by approximately 2.79%. The update scheduled for March 1, 2002 was postponed, due to the discussions in progress about its percentage and how it should be implemented. The update is now expected to take effect in May 2002.

In March 2002 a new committee was appointed to examine the structure and update mechanism of the Company's tariffs. This committee is supposed to recommend a new tariff arrangement for the Company, one which will be suited to the changing environment of the communications sector. The committee was requested to present its recommendations by the end of October 2002.

- C. The Company and its subsidiary, Bezeq International Ltd. were required to pay royalties, from April 1, 1997 to December 31, 2000, to the Government of Israel at the rate of 5% of their revenues. Until December 31, 2000, Pelephone Communications Ltd. was required to pay royalties at the rate of 8% of its revenues. Since January 2001, the basis of revenues for the matter of payment of royalties has been broadened, with a gradual reduction in the percentage of royalties until a uniform rate is attained for all communications operators. The rate for 2001 is 4% for fixed-line domestic telecommunication services, 4.5% for international telecommunication services, and 5% for cellular services. The above rate for fixed-line domestic telecommunication services will remain in effect until 2003, and in 2004 will fall to 3.5%. The percentage of royalties for international communication services and

Notes to the Financial Statements as at December 31, 2001 (cont'd)

cellular services will be reduced in stages and will be set at 3.5% commencing 2004. The percentage of royalties for DBS Satellite Services (1998) Ltd. in 2001 was 1.5%, and will be 4% in 2002 and 3.5% from 2003 onwards.

- 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 December 2000 the Anti-Trust Commissioner declared the Company a monopoly in the field of telecommunications infrastructure for providing high-speed Internet access services. The Company submitted a petition to the Anti-Trust Tribunal, seeking revocation of the declaration.

The Company's request for revocation of the announcement with regard to basic telephone services, which includes, according to the Company, both fixed-line telephony and mobile telephony, was rejected by the Anti-Trust Commission. The Company filed a protest in the Anti-Trust Tribunal against the dismissal, and the Commissioner filed an application for dismissal in limine of the protest. As proposed by the Tribunal, the application for dismissal in limine was retracted and the discussion in the Tribunal will be held.

In April 2001 the Anti-Trust Commissioner rescinded the notice naming Bezeq International Ltd. a monopoly in the provision of international telephone services.

- E. Below are the significant changes which have occurred in recent years with regard to the exclusivity which the Company enjoyed in providing communications services in Israel.

(1) Cellular services

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

Pursuant to notification from the Company to the Operators, as of 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 then existing arrangement in which the transfer of moneys was made on the basis of customer charges without deduction of a collection fee. The Operators expressed their objection to the change in the arrangement, and one of them also filed a legal claim in the District Court, in which it requested that the Company be instructed to continue to act in accordance with the arrangement which had existed until then. The court denied the claim and confirmed the validity of the new arrangement instituted by the Company. The Operator appealed to the High Court. In its October 30, 2001 session, the High Court decided to summons the Attorney General as respondent to the appeal, in order to hear his position. Concurrently, the Company and the Operators negotiated in an attempt to arrive at an agreed arrangement. During the negotiations, the Company reached an agreement with Pelephone Communications Ltd. (a proportionally consolidated company), defining the relations between the companies with regard to billing from March 1, 2000 to December 31, 2002, and with MIRS Communications Ltd. In November 2001 the Ministry of Communications determined that the Company must pay the Operators (Cellcom and Partner) for airtime according to the volume of actual traffic minutes, irrespective of collection, for the period from October 2, 2000 to January 1, 2003. Pursuant to the decision, the Company will deduct from the payments a certain percentage reflecting "risk sharing" as agreed upon among the parties, and in the absence of such agreement — as the Minister will decide. Pursuant to the Minister's directive, the Company transferred to the Operators an immediate interim payment relating to traffic in the period from October 2000, less 2.5%. The financial statements of the Company include an expense of NIS 78 million deriving from the aforesaid.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

As a result of the change in the billing arrangements, as described above, as of March 1, 2000, the Company's revenues and expenses from mobile wireless telephone do not include airtime. The airtime which was included in the revenues and expenses from mobile wireless telephone in 2000 amounted to approximately NIS 294 million (1999 — approximately NIS 1,521 million).

(2) International communication services

At the beginning of July 1997, two new companies started providing international communication services, as a result of which, international call tariffs were significantly lowered, including those of the consolidated company Bezeq International Ltd. In the current reporting year, those operators filed an application to the Anti-Trust Commissioner for approval of their merger.

At the beginning of July 1997, regulations were promulgated for the purpose of regulating the duty of all the international operators 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", applicable only until December 31, 2001, after their reduction on January 1, 2001 by about 30%.

In July 2001 the Ministry of Communications published a Request for Position in connection with a policy for regulating international telecommunication services. On December 26, 2001 the Ministry of Communications distributed a document setting out the policy for regulation of international telecommunication services, permitting the grant of a general license for providing such services to an applicant who meets the conditions set out in the document, effective from January 1, 2003. Concurrently, holders of special licenses for providing Internet access services will be allowed to purchase transmission services directly from a licensee for the provision of undersea cable services, in addition to the option of purchasing them from the international operators.

(3) Domestic communication services

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 they are awarded a general license by the Ministry of Communications.

In July 2001 the Telecommunications Law was amended. The amendment regulates, *inter alia*, the opening of the domestic communications market and cable broadcasting to competition by means of granting licenses for providing communications services. The amendment includes numerous topics which influence the Company and the Group companies. The law enables the cable companies to switch from franchises to licenses that the cable companies or companies affiliated with the cable companies, will be able to receive a general license for providing telecommunication services. If the license applicant currently owns a franchise, the grant of the license will be contingent upon transfer of the activity involving the provision of the broadcasting services to a company with such an affiliation, and if the license applicant is a company with such an affiliation, the franchisee will transfer to that company the rights in the cable network used for broadcasting.

In September 2001 the Telecommunications order (Determining an essential service provided by Bezeq, The Israel Telecommunication Corp. Ltd.), 5757-1997, was amended following the privatization decisions of August 27, 2000 and June 17, 2001 and following a hearing proceeding arranged for the Company. The Order refers, *inter alia*, to the inclusion of additional services which the Company provides under the

Notes to the Financial Statements as at December 31, 2001 (cont'd)

definition of "Essential Services", and an extension of the limitations on control and holding in the Company.

Following the privatization decisions referred to above, the Company's license was amended in September 2001, *inter alia*, with regard to acquisitions and/or the installation of hardware in the telecommunications installations of the Company in accordance with directives which will be given to the Company pursuant to Section 13 of the Telecommunications Law and with regard to the establishment of a special committee of the Board of Directors of the Company to discuss security issues (on the same subject, the General Meeting of the Company approved, in August 2001, amendment of the Articles of Association of the Company).

In March 2002 the Ministry of Communications commenced granting domestic operator licenses to the cable companies. The license is valid, at this stage, only for providing broadband Internet access services. The application of the cable companies to merge has not yet been approved by the regulatory authorities.

In addition, a cellular company filed a petition in the High Court of Justice against the Company and against the Minister of Communications, for cancellation of the directive it received to disconnect direct connections which bypass the Company's network, which it provides for business customers. On February 11, 2002 the High Court of Justice issued an interim order for preservation of the existing situation. Following the order, directives were issued on February 27, 2002 by the Ministry of Communications to all the cellular companies, forbidding them to make any additional direct connections. Based on the opinion of the legal advisor who is handling the claim on its behalf, the Company is unable to estimate the chances of the defense in this case.

As a result of the various changes in the communications market as described above, a significant deterioration has occurred in the business results of the Group. This is expected to continue with the opening of fixed-line domestic communication services to full competition, and cannot be estimated at this stage.

- F. On August 27, 2000, the Ministerial Committee for Privatization decided to sell the State's holdings in the Company by way of a private sale which would be accompanied by a raising of capital for the Company. The sale will include shares comprising at least 50.01% of the Company's share capital. The Government Companies Authority was authorized to take the actions necessary for implementing the decision, including those actions set out in the decision.

The Ministerial Committee for Privatization later adopted a number of resolutions intended to advance the implementation of the above decision, and the Company's license, its Articles of Association and the Telecommunications Order were amended as aforesaid. On November 13, 2001, the Government of Israel published a notice stating that it was considering the sale of the State's holdings, comprising 50.01% of the share capital of the Company, by way of a private sale. Following the notice, several entities expressed their interest in participating in the sale process. These approaches are still being studied. On January 13, 2002 a framework agreement was signed between the State and the Company, concerning the raising of up to NIS 890 million in capital for the Company in accordance with the decision of the Ministerial Committee for Privatization, while concurrently, the Company will allot shares to the State in the same amount as those sold by the State (see Note 21B).

NOTE 2 — SIGNIFICANT ACCOUNTING PRINCIPLES AND REPORTING POLICIES

A. Definitions

In these financial statements —

- (1) *Subsidiaries* — Companies whose financial statements are fully consolidated, directly or indirectly, with the financial statements of the Company.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

- (2) *Proportionately consolidated companies* — Companies whose financial statements are proportionally consolidated, directly or indirectly, with the financial statements of the Company.
- (3) *Affiliated companies* — Companies, other than subsidiaries or proportionately consolidated companies and including a partnership, the Company's investment in which is stated, directly or indirectly on the equity basis.
- (4) *Investee companies* — Subsidiaries, proportionately consolidated companies or affiliates.
- (5) *Related parties* — As defined in Opinion No. 29 of the Institute of Certified Public Accountants in Israel (hereinafter — "ICPAI").
- (6) *Interested parties* — 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 interest in the financial statements), 5756-1996.
- (8) *CPI* — the Consumer Price Index published by the Central Bureau for Statistics.

B. Financial statements in adjusted values

- (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 (data on the Company in nominal values appear in Note 31).
- (2) The adjusted value of non-monetary assets does not necessarily reflect their market or economic value, but rather, their cost adjusted for the effect of the changes in the general purchasing power of the shekel.
- (3) The terms "cost" as used in the adjusted reports means "adjusted cost".
- (4) All 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 statements of operations have been reclassified 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 the balance sheet month. Monetary assets are stated in the adjusted balance sheet at their nominal value at that 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:

Notes to the Financial Statements as at December 31, 2001 (cont'd)

- (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 as 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 components of the financing item, were adjusted on the basis of the CPI from the date of receipt of payment or making payment, until the index in respect of balance sheet month.
- (c) The Company's equity in operating results of investee companies was included 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 monetary 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 CPI at the time of making each payment, while the amounts payable (or refundable) were not adjusted. Therefore, the current income tax expense includes also the expenses deriving from erosion in the value of the advance tax payments, from the date of payment until the balance sheet date. See Notes 20 and 11D relating to deferred taxes.

(3) **Statement of changes in 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 announced/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 statements 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) Inter-company 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.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

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. Surplus cost of investment over the equity on the date of acquisition was attributed to goodwill and amortized in equal annual installments over 10 years.
- (2) On the financial statements of an affiliate which are adjusted according to changes in the foreign currency exchange rate — see Note 2E(4).

H. Decrease in value of investments in investee and non-investee companies

The Company periodically checks whether a change of a non-temporary nature has occurred in its investments. The review is carried out upon the existence of signs indicating that the value of permanent investments has been impaired, including falling stock-exchange prices, ongoing losses in the investee, the sector in which the investee operates, the goodwill value included in the investment and other parameters. The deductions for adjusting the value of these investments, which management estimates is based on examination of all the relevant aspects and giving them their proper weight, and which are not of a temporary nature, are attributed to the statement of operations.

I. 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 charged to the statement of operations.

J. 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 derives 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.

K. Inventory

Inventory of equipment and user equipment is presented at the lower of cost or value to the business.

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 customer, as well as spare parts which are used by the company for the repair of user equipment in the framework of the insurance it provides for its customers.

L. 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.

M. Fixed assets

- (1) Fixed assets are stated at cost.
- (2) The cost of an asset under self-construction includes materials, sub-contractors, wages and financing expenses in the construction period, but not exceeding their value to the business.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

- (3) Improvements and enhancements are added to the cost of assets, while maintenance and repairs are charged to the statement of operations as incurred.
- (4) In the event of a decrease in the value of assets to the business, a provisions is recorded accordingly for decrease in value.
- (5) Real financing expense for loans and credit used for financing the construction or purchase of fixed assets is attributed, starting on January 1, 2000, to the cost of those assets, in accordance with Accounting Standard No. 3 — Capitalization of Credit Costs. See Note 9A.
- (6) Depreciation is calculated by the straight-line method, based on the estimated useful lives of the assets.

Annual depreciation rates:

	% depreciation	Principal depreciation %	
		Until 2000	As of 2000
Buildings	4	4	4
Digital switching equipment	10	8.3	10
Transmission and power equipment	10-20	20	20
Network equipment	5-25	4.33	5
Subscriber equipment and public telephones	20	20	20
Motor vehicles	15	15	15
Office equipment	10-20	20	10
Computers	33	20	33
Cellular telephone infrastructure 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), which does not exceed the economic life of the asset.

N. Deferred expenses and 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 customers 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 period of the subscribers' undertaking, which is 36 months. The costs of acquiring a subscriber at Bezeq International Ltd. is amortized in a straight line over the term of their use, which is 5 and 10 years.

(3) *Rights of representation of a communications corporation*

The rights of representation of a communications corporation are amortized for the period of financial benefit over 10 years.

(4) *Rights in channels*

Rights in channels are amortized over the period of use, which is 5 and 10 years.

O. 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

Notes to the Financial Statements as at December 31, 2001 (cont'd)

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 tax receivable benefit in respect of timing differences where the likelihood of realizing the benefit is questionable.

P. Income recognition

Income is attributed to the statement of operations upon being generated, on the accrual basis.

Q. Capitalization of credit costs

The Company capitalizes credit costs in accordance with Standard No. 3 — Capitalization of Credit Costs, published in July 1999 by the Institute for Accounting Standardization.

This standard requires the capitalization of specific credit costs and credit costs which are not specific to qualified assets. Non-specific credit costs are capitalized to the investment or part thereof which was not financed by specific credit, at a rate which is the weighted average of the cost in respect of those credit resources whose cost was not specifically capitalized.

The provisions of this standard have been applied since January 1, 2000, and accordingly, credit costs attributed to assets under construction are capitalized until the date on which all activities preparing it for its intended use have been completed. See Note 9A.

R. 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.

S. Foreign currency and linkage

Assets (excluding securities) and liabilities denominated in or linked to a foreign currency are stated at the representative exchange rates published by the Bank of Israel on 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.

Details of the CPI and the U.S. dollar exchange rates:

	December 31 2001	December 31 2000	% of change 2001	% of change 2000	% of change 1999
CPI — index	101.6	100.2	1.397	0.00	1.34
US dollar exchange rate \$1 — in NIS	4.416	4.041	9.279	(2.69)	(0.17)
Euro exchange rate	3.907	3.763	3.827	(9.87)	—

Notes to the Financial Statements as at December 31, 2001 (cont'd)

T. Earnings per share

Earnings per share are calculated in accordance with Opinion No. 55 of the ICPAI. Fully-diluted earnings per share are not presented as the effect of dilution is not significant.

U. Debentures convertible to shares

Debentures convertible to shares are classified by the likelihood of conversion, as laid down in Opinion No. 53 of the ICPAI. Debentures which are not expected to be converted are included as liabilities at their liability value. Debentures which are expected to be converted are included between the long-term liabilities item and the shareholders' equity item, at liability value or capital value, whichever is the higher.

V. Restatement

The Company adjusted its financial statements for the year ended December 31, 1999 by way of restatement, in order to reflect retroactively the accounting treatment in the capitalization of the cost of subscriber acquisition at Pelephone Communications Ltd. — a proportionately consolidated company. Until 1999, in the original reports, Pelephone had attributed customer acquisition costs to profit and loss. Starting with the financial statements for the year ended December 31, 1999, these costs in respect of the years up to 1999 also appear in the balance sheet under other assets and are amortized over 36 months. Amended reports for the year ended December 31, 1999 were published on August 15, 2000.

W. Disclosure of the effect of accounting standards in the period prior to their application

During the reporting period, the Israeli Institute for Accounting Standardization published the following new standards:

1. Accounting Standard No. 8 — Discontinued operations. The standard lays down rules for the separate presentation of information relating to a material business operation which is discontinued by a corporation and information relating to ongoing operations, and determines the minimum disclosure of information concerning a discontinued operation. Accounting Standard No. 8 will apply to financial statements starting from January 1, 2002. The Company does not expect the effects of this standard to be significant.
2. Accounting Standard No. 12 — Termination of adjustment of financial statements. This standard eliminates adjustment for inflation in financial statements, starting from January 1, 2003. Until December 31, 2002, the Company will continue to prepare its adjusted financial statements in accordance with Opinion No. 36 of the ICPAI. The adjusted amounts appearing in the financial statements as at December 31, 2002 will be the starting point for nominal financial reporting starting on January 1, 2003. This standard could have a significant detrimental effect on the reported results of the Company. The extent of that effect will depend on the rate of inflation and the financial structure of the Company.
3. Accounting Standard No. 13 — Effects of changes in foreign currency exchange rates. The standard deals with the translation of foreign currency transactions and the translation of the financial statements of overseas operations for integration in the financial statements of the reporting corporation, and supersedes the provisions of Clarifications 8 and 9 to Opinion No. 36, which will become null and void when Accounting Standard No. 12 — Termination of adjustment of financial statements, takes effect. Standard No. 13 will apply to financial statements for periods starting after December 31, 2002.

X. Initial application of accounting standard

The Company has elected to apply Accounting Standard No. 11 — Sectoral reporting, before it becomes compulsory. The standard requires the inclusion of information about

Notes to the Financial Statements as at December 31, 2001 (cont'd)

business and geographical sectors, and sets out detailed guidelines for identifying such sectors.

This accounting standard will apply to financial statements for the period starting on January 1, 2002 or thereafter.

NOTE 3 — CASH AND CASH EQUIVALENTS

	Consolidated		Company	
	December 31 2001	December 31 2000	December 31 2001	December 31 2000
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Israeli currency	1,261,397	822,399	1,251,301	813,797
Foreign currency	41,603	732,087	19,065	729,494
	<u>1,303,000</u>	<u>1,554,486</u>	<u>1,270,366</u>	<u>1,543,291</u>

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

NOTE 4 — SHORT-TERM INVESTMENTS

	Consolidated		Company	
	December 31 2001	December 31 2000	December 31 2001	December 31 2000
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Marketable securities:				
Government debentures				
Linked to the CPI	127,354	56,290	124,000	54,105
Linked to the U.S. dollar				
exchange rate	16,771	12,150	15,105	10,634
Unlinked	50,912	40,381	46,075	29,872
Debentures convertible to				
shares	15,796	5,237	15,614	4,922
Other debentures	56,288	25,374	56,288	24,636
Mutual fund participation				
certificates	169,914	25,571	167,540	22,242
	<u>437,035</u>	<u>165,003</u>	<u>424,622</u>	<u>146,411</u>
Short-term bank deposits				
Linked to the CPI	3,448	24,596	—	24,338
Unlinked	171	1,425	—	—
	<u>440,654</u>	<u>191,024</u>	<u>424,622</u>	<u>170,749</u>

Notes to the Financial Statements as at December 31, 2001 (cont'd)

NOTE 5 — TRADE RECEIVABLES

	Consolidated		Company	
	December 31, 2001	December 31, 2000	December 31, 2001	December 31, 2000
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
In respect of domestic services:				
On open account	1,543,069	1,171,310	1,014,221	624,293
Income receivable	315,748	282,275	251,353	221,799
Credit cards and checks payable	170,446	128,582	90,031	91,091
Investee companies	1,199	997	1,199	8,137
In respect of international services	37,999	66,354*	8,091	16,908
	<u>2,068,461</u>	<u>1,649,518</u>	<u>1,364,895</u>	<u>962,228</u>
Less provision for doubtful debts	381,249	357,389	219,351	223,613
	<u>1,687,212</u>	<u>1,292,129</u>	<u>1,145,544</u>	<u>738,615</u>

* Reclassified

2001 — Including debts in respect of airtime — See Note 1E(1).

NOTE 6 — OTHER RECEIVABLES AND DEBIT BALANCES

	Consolidated		Company	
	December 31, 2001	December 31, 2000	December 31, 2001	December 31, 2000
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Deferred tax asset (see Note 11D)	181,084	188,785	146,905	164,551
Income tax refundable	5,010	226,530	—	189,981
Prepaid expenses	34,987	20,449	19,742	5,345
Forward exchange contracts	81,210	15,812	78,262	15,812
Other receivables and debit balances	19,717	31,100	7,830	16,153
	<u>322,008</u>	<u>482,676</u>	<u>252,739</u>	<u>391,842</u>

NOTE 7 — INVESTMENTS, DEPOSITS AND DEBIT BALANCES

	Consolidated		Company	
	December 31 2001	December 31 2000	December 31 2001	December 31 2000
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Investment in companies that are not investee companies:				
Investment in convertible debentures ⁽¹⁾	1,106,871	—	1,106,871	—
Investments in shares	58,396	4,454	58,396	4,454
Bank deposit for granting loans to employees ⁽²⁾	223,434	223,644	223,434	223,644
Investment in venture capital funds ..	21,918	19,352	21,918	19,352
Income tax refundable	201,422	—	201,422	—
Forward exchange contracts	7,880	—	7,880	—
Long term trade receivables ⁽³⁾	61,011	46,125	—	—
	<u>1,680,932</u>	<u>293,575</u>	<u>1,619,921</u>	<u>247,450</u>

(1) See Note 8D(2).

(2) The deposit is unlinked and the average weighted monthly interest rate is approximately 0.19%. The Company is responsible for the loans to the employees. Withdrawal of the deposit is contingent upon repayment of the loans.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

- (3) Long-term receivables is calculated less deferred interest income which comprises the difference between the amount of the original debt and its present value on the date of recognition of the income. Present value is calculated at an effective interest rate of 8.5-11% per annum. (2000 — 12%).

NOTE 8 — INVESTMENTS IN AFFILIATED COMPANIES

A. Composition:

	Consolidated		Company	
	December 31 2001	December 31 2000	December 31 2001	December 31 2000
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Affiliated companies				
Investment in shares —				
Cost	111,908	117,893	65,411	63,270
Post-acquisition losses	(394,510)	(212,293)	(371,917)	(196,772)
Amortization of surplus equity over cost attributed to goodwill	<u>(25,638)</u>	<u>(3,213)</u>	<u>(1,111)</u>	<u>(571)</u>
	<u>(308,240)</u>	<u>(97,613)</u>	<u>(307,617)</u>	<u>(134,073)</u>
Other investments —				
Long-term loans ⁽¹⁾	<u>769,307</u>	<u>272,723</u>	<u>765,097</u>	<u>269,748</u>
	<u>461,067</u>	<u>175,110</u>	<u>457,480</u>	<u>135,675</u>
Consolidated companies				
Shares —				
Cost			382,618	359,320
Loans			159,228	—
Post-acquisition losses			<u>(215,217)</u>	<u>(143,500)</u>
			<u>326,629</u>	<u>215,820</u>
Proportionally consolidated company				
Shares —				
Cost			343,755	257,232
Post-acquisition earnings			434,808	658,614
Amortization of surplus equity over cost attributed to fixed assets			<u>37,463</u>	<u>37,463</u>
			<u>816,026</u>	<u>953,309</u>
			<u>1,600,135</u>	<u>1,304,804</u>

(1) Including a loan of NIS 732 million to D.B.S. Satellite Services (1998) Ltd. ("DBS"). At a general meeting of the shareholders of DBS on December 24, 2000, it was resolved that the various loans extended to DBS by the shareholders would bear linkage differentials plus interest at 7% p.a. from the date they were made to the date of their repayment, or their partial repayment, as the case may be, or at other interest rates and linkage differentials, as the general meeting of shareholders decides. These terms will apply also to future loans to DBS by the shareholders, as long as no other resolution is adopted by the general meeting. The same resolution determines that it will take effect on January 24, 2001 unless by that date a certain shareholder gives notice of its objection. If that shareholder does give notice of its objection, the resolution will take effect on the date on which that shareholder withdraws from the venture. As at the date of signing of these financial statements, the shareholder gave notice as aforesaid and accordingly, the resolution has not taken effect and no interest was attributed to the loan. The loans appearing in the financial statements are linked to the CPI.

The date of repayment of the loans has not yet been set, and is subject to limitations set out in a memorandum of terms which was signed between DBS and the banks — see section F below.

The market and book values of an affiliated company listed on the stock exchange as at December 31, 2001, are approximately NIS 8.9 million.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

	Consolidated		Company	
	December 31 2001	December 31 2000	December 31 2001	December 31 2000
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Balance of surplus equity over cost not yet amortized, attributed to goodwill	<u>14,976</u>	<u>37,401</u>	<u>4,294</u>	<u>4,834</u>

A list of the companies in the Group appears in a schedule attached to the financial statements.

B. Investment activity in 2001 was as follows (not including long-term loans):

	Consolidated	Company
	NIS thousands	NIS thousands
Balance as at the beginning of the year	(97,613)	1,035,056
Activity during the year:		
Investment in shares	27,220	141,687
Realization of investment	(29,725)	(29,725)
Equity in losses	(204,642)	(471,208)
Other changes	<u>(3,480)</u>	—
Balance as at the end of the year	<u>(308,240)</u>	<u>675,810</u>

C. Summary of company equity in assets, liabilities, income and expenses of a proportionally consolidated company as included in the consolidated statements

	December 31 2001	December 31 2000
	NIS thousands	NIS thousands
Current assets	<u>521,127</u>	<u>567,273</u>
Other assets	<u>1,687,321</u>	<u>1,812,097</u>
Current liabilities	<u>918,258</u>	<u>1,054,697</u>
Long-term liabilities	<u>515,383</u>	<u>407,316</u>

	For the year ended December 31		
	2001	2000	1999
	NIS thousands	NIS thousands	NIS thousands
Revenues	<u>1,778,608</u>	<u>1,684,233</u>	<u>1,176,202</u>
Costs and expenses	<u>1,825,297</u>	<u>1,782,904</u>	<u>1,351,896</u>

D. Pelephone Communications Ltd. ("Pelephone")

- (1) 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 9, 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 considered the report's findings and concluded, on the basis of explanations and clarification obtained from the Company's management and the Company's legal advisors, that the transactions by which 50% of the ownership and control

Notes to the Financial Statements as at December 31, 2001 (cont'd)

of Pelephone was allotted to the Company, was effected in a professional, economically-sound manner in accordance with the Government decisions referred to above. This position of the Board of Directors was conveyed to the Government Companies Authority. As of the date of publication of these financial statements, the Government Companies Authority has not yet conveyed its position to the Company.

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

On November 5, 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 ministry and of the Ministries of Communications and Justice and of the Government Companies Authority. At the conclusion of the meeting the Minister of Finance decided that the Government would make no claim against the Company in the matter of this transaction and that the Legal Counsel of the Ministry of Finance, in coordination with the Ministry of Communications, would prepare a legal opinion concerning the possibility of the State exercising the Company's rights vis-a-vis Motorola, if such exist, whether directly or through the Company, and that the Ministry of Justice would relate to that legal opinion. As at 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 investigations described above or their likely impact on the Company.

- (2) In September 2000 a notice was received from Motorola Israel Ltd. ("Motorola"), informing the Company of negotiations between Motorola and a third party for the sale of its holdings in Pelephone. Under the Pelephone shareholders' agreement, if one party to the agreement wishes to sell its shares in Pelephone, it must offer them to the other party, and the other party is entitled, *inter alia*, to propose an alternative offeree to buy the shares. At its meeting on November 22, 2000, the Board of Directors of the Company selected Shamrock Holdings of California Inc. as the alternative offeree to purchase the shares of the Pelephone shareholder and sign an option agreement with the Company. The share purchase transaction was subsequently made by a corporation registered in the USA (hereinafter — "the Corporation") indirectly owned by Shamrock.

On February 27, 2001, after approval of the Ministry of Communications and the Anti-Trust Commissioner, the transaction was closed. The main points of the transaction are these:

- a. Motorola's shares in Pelephone were transferred to the Corporation in consideration of approximately \$591 million. The consideration was partially financed by a loan of \$240 million extended by the Company, for which it received debentures linked to the US dollar exchange rate, bearing interest and convertible, for up to four years, for 80% of the shares of the Corporation. These debentures are presented in the balance sheet under the Investments, deposits and long-term debit balances item. Accumulated interest and exchange rate differentials up to December 31, 2001 amount to approximately NIS 98 million.
- b. The Company was given a call option to purchase the remaining 20% of the share capital of the Corporation together with conversion of the debentures to shares as aforesaid ("the Options"). In the event of conversion of the debentures to shares, the Company must exercise the option.
- c. The Company can exercise the Options within six months of the date of purchase of the shares ("the Short Option"), or starting from the end of 24 months from the date of purchase of the shares until the elapse of four years from the date of the purchase ("the Long Option"). As at the report date, the Company had not exercised the Short Option and it expired.
- d. The exercise price of the Long Option is the higher of return of the nominal investment or a valuation of the market value of 20% of the Corporation's shares.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

During the year, the Company invested in Pelephone the sum of US \$20 million as a premium on shares that were issued in the past. Shamrock Holdings of California, Inc. invested the same amount. In February 2002 each of the shareholders invested an additional US \$30 million.

E. Emitel Telecommunication Corp. Ltd. — A company registered in Hungary (“Emitel”)

In December 2000, Aphrodite B.V. (“Aphrodite”), which is indirectly held by the Company (66.7%), signed an agreement for the sale of all its holdings in Emitel. Closing of the transaction was made contingent upon receipt of approvals from the Hungarian Minister of Communications and from the Hungarian Anti-Trust Authority. All the requisite approvals were obtained by June 30, 2001, enabling the transaction to be closed. In consideration of the sale, Aphrodite received approximately US \$49 million and recorded a capital gain of approximately \$32 million.

F. D.B.S. Satellite Services (1998) Ltd. (“DBS”)

The Company holds 30% of the shares of D.B.S. Satellite Services (1998) Ltd. 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 foresees considerable losses and negative cash flow from operations in the first years of its activities. Its losses in 2001 amounted to approximately NIS 840 million, and the negative cash flow from ordinary operations amounted to NIS –596 million. These losses have led to an increase in its working capital deficit to approximately NIS 1,345 million (including NIS 883 million in short-term bank credit).

The Company’s investment in DBS as at the balance sheet date was approximately NIS 732 million. The Company’s share in the accumulated losses of DBS was approximately NIS 443 million, of which some NIS 252 million was recorded in the account year.

On May 23, 2001 a financing agreement was signed between DBS and three banks, determining, *inter alia*, preconditions for withdrawing funds from the credit lines, including an undertaking by DBS to meet the cumulative milestones and other stipulations set out in the agreement (“the Conditions”). As at the date of approval of these financial statements, not all the suspending conditions had been met. DBS and the banks are continuing to discuss the actions required for regulating these Conditions, as well as an increase in the credit lines approved for DBS.

According to a decision of the Ministerial Committee for Privatization on January 21, 2001, the maximum cumulative exposure of the Company in connection with this investment shall at no time exceed the rate of the Company’s actual holding in DBS, multiplied by \$400 million (approximately NIS 1.8 billion). The Committee also approved an increase of the Company’s holding in DBS to 50% of DBS’s share capital, the approval being contingent upon amendment of the Telecommunications Regulations (or the Telecommunications Law) in the matter of limitations on a holding of the means of control in DBS by anyone who is a controlling interest in a broadcasting franchise. The Regulations were amended accordingly on May 14, 2001.

The sources of finance for DBS’s activities are shareholders’ loans and bank credit. On March 17, 2002 the Ministerial Committee for Privatization approved the Company’s request to increase its exposure in DBS to the rate of its actual holdings multiplied by \$480 million.

The activity of the affiliated company depends on continued implementation of the financing agreement, an increase in its approved bank credit lines, and the receipt of additional shareholders’ loans. According to the assessment of the affiliated company’s management, the agreements among the shareholders and the existing credit lines should be sufficient to provide most of the financial resources required by the affiliated Company in 2002, and there is a good chance that the further discussions between the affiliated company, the

Notes to the Financial Statements as at December 31, 2001 (cont'd)

shareholders and the banks will lead to an arrangement for the balance of the finances required.

The Company has signed a perpetual guarantee for the banks, for payment of DBS's debts. The guarantee is up to a maximum sum equal to 30% of the value of DBS as derives from disposal of the pledged shares of the other shareholders. If the Company joins the sale as part of disposal of these pledged shares, the amount of the guarantee will not exceed the proceeds which the Company will receive from disposal of its shares in DBS. The deed of guarantee includes numerous restrictions on the Company in disposing of its shares, and sets out violations which, if perpetrated, will enable the banks to realize the guarantee.

In November 2001 an agreement was signed among the shareholders of DBS (except for Gilat DBS Ltd., which holds 15% of the shares of DBS), whereby the holdings of the Company in DBS will grow, initially to 44.9%. Some of the investments of the shareholders are supposed to become loans bearing interest at 5.5% per annum, and on March 31, 2002, the real investments of the shareholders in DBS are supposed to be recalculated together with a further adjustment in the percentages of holdings in DBS. Those of the DBS shareholders who signed the agreement, undertook that if the agreement was not signed by all the shareholders, they would act to implement the provisions of the agreement by means of adopting appropriate decisions in the competent organs of DBS. Furthermore, the Board of Directors of DBS approved the implementation of the provisions of the aforesaid agreement and allotted shares to the shareholders of the company as set forth in the agreement. As a result of the expected increase in the percentage of the Company's holdings in DBS, a surplus cost is expected to be generated, which will be depreciated over the period of expected financial benefit. The allotment has not yet been made, in view of the demand of the banks for certain amendments to the deed of guarantee which was forwarded to the Company, along with a demand from other DBS shareholders to amend the liens given to the banks.

The Anti-Trust Authority notified the Company on May 6, 2001 that in view of the domestic operator's license that a company in the Eurocom Group received, the Company and the Eurocom Group should be viewed as competitors. As a result, the cross-holding of the Company in DBS is liable to reduce the competition between them and as such, it constitutes, on its face, a binding agreement. The parties were requested to act as quickly as possible to approve the joint venture between them in one of the ways provided in the Anti-Trust Law. The Anti-Trust Commissioner gave notice that without derogating from the aforesaid, he was willing to try to find an agreed solution within 60 days. In response, the Company notified the Anti-Trust Commissioner that the fact of the partnership between it and Eurocom in the satellite venture does not constitute a binding agreement, since all its activities in this field were undertaken in accordance with lawful approvals, and that without derogating therefrom, it does not object to discussion and clarification of the matter with the Commissioner.

A first meeting at the Anti-Trust Authority was held soon after the Company's response was sent. In November 2001, the company from the Eurocom Group which received the domestic operator's license as aforesaid, gave notice that it was cutting back its operations and considering its further steps in this field. To the best of the Company's knowledge, the company has now ceased its activities in this field.

G. Walla! Communications Ltd.

Bezeq International Ltd. invested in Walla, an Israeli company whose shares are listed on the Tel Aviv Stock Exchange and which provides Internet services and operates Internet portals. During 2000, Bezeq International acquired approximately 38.5% of the rights in Walla in consideration of approximately NIS 49,312 thousand.

On December 31, 2000, the affiliate Walla entered into a merger agreement with IOL Israel Online (2000) Ltd. ("IOL"). All the approvals required by law for the merger were obtained by June 24, 2001. Following the merger, the percentage of Bezeq International's holding in Walla decreased from 38.5% to 24.8% (as a result of an issue of shares to a third party),

Notes to the Financial Statements as at December 31, 2001 (cont'd)

generating a loss for the Company from disposal of the investment. This loss, of approximately NIS 3,480 thousand, is included under the other expenses item in the financial statements for the year ended December 31, 2001.

As a result of the value ratios determined between IOL and Walla prior to the merger and the amortization of goodwill made at Walla after the merger with IOL, Bezeq International reduced its investment by recording additional amortization in accordance with the value ratios and other components pertinent to the investment. The depreciation, of approximately NIS 7,675 thousand, and Bezeq International's part in depreciation of the investment made by Walla following the merger, in the amount of approximately NIS 6,229 thousand, were included in the financial statements under the Company's equity in the losses of an affiliate.

On March 14, 2002 Walla issued a prospectus for a rights issue. Bezeq International invested approximately NIS 10,726 thousand in exercise of the rights and approximately NIS 3,157 thousand in the acquisition of additional rights from the public and their exercise. After exercise of the rights and the acquisition from the public, Bezeq International's holding in Walla increased from 24.8% to 36.68%.

H. Adanet for Business Group Ltd. ("Adanet")

During the report period, the Company invested approximately NIS 40 million in Adanet, of which about NIS 19 million in exchange for 50% of Adanet's capital and NIS 21 million as a shareholders' loan. Upon fulfillment of certain conditions, the Company, Clal Information Technologies Ltd. and the managers of Adanet have a put option and a call option for the other 50% of Adanet's shares, subject to any approvals required by law.

Adanet is a private company which erects and services networks and computer equipment.

NOTE 9 — FIXED ASSETS

A. Composition and Activity

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, 2001	2,119,595	14,406,691*	10,865,668*	834,960*	328,012	896,329*	29,451,255
Additions	26,751	651,537	183,653	110,406	22,837	240,094	1,235,278
Disposals ⁽²⁾	9,031	2,096,909	14,457	300,741	67,555	32,031	2,520,724
Balance as at							
December 31, 2001	<u>2,137,315</u>	<u>12,961,319</u>	<u>11,034,864</u>	<u>644,625</u>	<u>283,294</u>	<u>1,104,392</u>	<u>28,165,809</u>
Accumulated depreciation							
Balance as at							
January 1, 2001	1,095,231	8,311,545*	7,176,132*	528,312*	172,187	397,053*	17,680,460
Depreciation allocation	92,994	1,493,636	630,757	148,421	42,659	188,069	2,596,536
Cancellation in respect of disposals ⁽²⁾	1,683	2,058,424	14,457	295,278	55,103	26,081	2,451,026
Provision for decrease of value ⁽³⁾	—	102,026	—	—	—	—	102,026
Balance as at							
December 31, 2001	<u>1,186,542</u>	<u>7,848,783</u>	<u>7,792,432</u>	<u>381,455</u>	<u>159,743</u>	<u>559,041</u>	<u>17,927,996</u>
Net book value —							
As at December 31, 2001	<u>950,773</u>	<u>5,112,536</u>	<u>3,242,432</u>	<u>263,170</u>	<u>123,551</u>	<u>545,351</u>	<u>10,237,813</u>
As at December 31, 2000	<u>1,024,364</u>	<u>6,095,146</u>	<u>3,689,536</u>	<u>306,648</u>	<u>155,825</u>	<u>499,276</u>	<u>11,770,795</u>

Notes to the Financial Statements as at December 31, 2001 (cont'd)

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,							
2001	2,059,322	11,156,774*	10,865,668*	800,318*	280,622	492,005*	25,654,709
Additions	11,849	373,103	183,653	96,401	10,303	122,447	797,756
Disposals ⁽²⁾	8,690	2,085,006	14,457	276,666	59,674	30,909	2,475,402
Balance as at December 31, 2001 ...	<u>2,062,481</u>	<u>9,444,871</u>	<u>11,034,864</u>	<u>620,053</u>	<u>231,251</u>	<u>583,543</u>	<u>23,977,063</u>
Accumulated depreciation							
Balance as at January 1,							
2001	1,075,241	6,541,841*	7,176,132*	515,509*	153,913	231,186*	15,693,822
Depreciation allocation	86,585	1,148,477	630,757	132,051	35,138	118,029	2,151,037
Cancellation in respect of disposals ⁽²⁾	1,622	2,051,598	14,457	276,666	49,650	25,144	2,419,137
Balance as at December 31, 2001 ...	<u>1,160,204</u>	<u>5,638,720</u>	<u>7,792,432</u>	<u>370,894</u>	<u>139,401</u>	<u>324,071</u>	<u>15,425,722</u>
Net book value —							
As at December 31,							
2001	<u>902,277</u>	<u>3,806,151</u>	<u>3,242,432</u>	<u>249,159</u>	<u>91,850</u>	<u>259,472</u>	<u>8,551,341</u>
As at December 31,							
2000	<u>984,081</u>	<u>4,614,933</u>	<u>3,689,536</u>	<u>284,809</u>	<u>126,709</u>	<u>260,819</u>	<u>9,960,887</u>

* Reclassified

(1) Including NIS 2,377 thousand advance payments to suppliers on account of telephone exchange equipment ordered in respect of the year 2000.

(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 2001, fully depreciated fixed assets of a cost of approximately NIS 2,296 million (2000 — NIS 1,294 million) were written off the books.

(3) A proportionally consolidated company made a provision for a decrease in value in respect of assets which it will not use in providing its services (see Note 9C).

(4) The cost includes the amount of NIS 10,000 in the Company and NIS 15,300 consolidated, which constitutes real financing expenses in respect of loans and credit during the establishment period, calculated at a real interest rate of approximately 4% per annum (preceding year — 7.4%).

- B.** Most of the real estate assets used by the Company were transferred to it by the State under an agreement dated January 31, 1984. Some of these assets are leased for 49 years with an option for an extension for another 49 years, and some are rented for renewable periods of two years each.

As at the time of the preparation of the financial statements, the Company's rights in a considerable part of its real estate assets are not registered at the Lands Registry Office.

The Accountant General of the Ministry of Finance notified the Company in January 1998 that the State intends to terminate the lease of those assets rented for the renewable two-year periods, and that the Ministry of Finance will examine the use actually made by the Company of each specific asset and will take appropriate action with respect to the matter of making available alternative land and the payment of the relocation expenses. The Company's management opposed implementation of the plan. In May 1999, representatives of the Company and the Israel Lands Administration held a meeting in the presence of representatives of the Government Companies Authority in the office of the Attorney General. In summing up the meeting, the Attorney General said that the Company could not carry out a public offering of its shares before clarification of the factual basis and the questions in dispute, so that the discussions could be held on the best way for settling the dispute. Further to the decision of the Ministerial Committee for Privatization of August 27, 2000 concerning the privatization of the Company, the Attorney General confirmed, in February 2001, the description of the land dispute which was described in an immediate

Notes to the Financial Statements as at December 31, 2001 (cont'd)

report issued by the Company. The description includes the positions of the parties in their own words, to which was attached a list of the properties which are the subject of the dispute. The main points of the Company's position are, *inter alia*, that it is entitled to receive rights of ownership or "quasi-ownership" in those assets which are rented for renewable two-year periods. With regard to the leased part of the assets, the Company also believes that it is entitled to ownership rights or rights of lease for the maximum period that the State could offer. The State does not agree to these claims of the Company, and asserts, *inter alia*, that it is authorized, with notice to the Company, to terminate the renewable rental, and in any case not to renew it. In the opinion of the State, the Company's refusal to accede to the demands of the State has harmed and continues to harm the State's ability to make financially sound and efficient use of the land, and as an example the State mentions the value of two assets which, according to its preliminary estimates, are worth (together) approximately \$440 million. On the leased assets, the State's position is that the Company's rights therein are rights of lease as stipulated in the agreements signed by the parties on this matter. It is noted that the parties negotiated in the past in an attempt to settle the various disputes on this matter, but were unsuccessful in reaching a settlement. At present, the intention is to bring the dispute to court for settlement.

- C. A proportionally consolidated company depreciated assets in the account year which it will not use in providing its services. The net book value of the assets in the books of the proportionally consolidated company, was approximately NIS 204 million. The depreciation of the assets was included under the Other expenses item.
- D. As at the balance sheet date, commitments exist for the purchase of fixed assets (mainly switching equipment) in the amount of approximately NIS 383 million (consolidated) and approximately NIS 260 million for the Company. A proportionally consolidated company has commitments to purchase inventory of subscriber equipment amounting to approximately NIS 131 million.

NOTE 10 — DEFERRED AND OTHER EXPENSES

Consolidated

	<u>Cost</u>	<u>Accumulated depreciation</u>	<u>Balance for depreciation</u>		
				<u>December 31</u>	<u>December 31</u>
			<u>NIS thousands</u>	<u>2001</u>	<u>2000</u>
Capitalized subscriber acquisition costs.....	757,534	450,274	307,260	356,305	
Rights in channels	5,242	1,515	3,727	4,400	
Representation rights in a communications corporation ...	<u>3,600</u>	<u>1,710</u>	<u>1,890</u>	<u>2,250</u>	
	<u>766,376</u>	<u>453,499</u>	<u>312,877</u>	<u>362,955</u>	
Expenses for issue of debentures and raising loans			16,983	15,500	
Minority rights in proportionally consolidated company			<u>10,539</u>	<u>4,963</u>	
			<u>340,399</u>	<u>383,418</u>	

Company

	<u>Balance for depreciation</u>	
	<u>December 31</u>	<u>December 31</u>
	<u>2001</u>	<u>2000</u>
	<u>NIS thousands</u>	<u>NIS thousands</u>
Deferred expenses		
Expenses for issue of debentures and raising loans	<u>16,983</u>	<u>15,500</u>

Notes to the Financial Statements as at December 31, 2001 (cont'd)

NOTE 11 — TAXES ON INCOME

A. General

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

The asset component demanded by the Company as an expense for tax purposes, is allocated directly to shareholders' equity.

Regarding deferred taxes in respect of these differences — see Notes 2O above and 11D below.

B. Income tax (tax benefit) included in the statement of operations

Consolidated

	<u>For the year ended December 31</u>		
	<u>2001</u>	<u>2000</u>	<u>1999</u>
	<u>NIS thousands</u>	<u>NIS thousands</u>	<u>NIS thousands</u>
Current taxes	(339,838)	(178,299)	9,732
Deferred taxes	121,392	327,374	(72,362)
Taxes for prior years, net	<u>(12,146)</u>	<u>6,409</u>	<u>2,124</u>
	<u><u>(230,592)</u></u>	<u><u>155,484</u></u>	<u><u>(60,506)</u></u>

Company

	<u>For the year ended December 31</u>		
	<u>2001</u>	<u>2000</u>	<u>1999</u>
	<u>NIS thousands</u>	<u>NIS thousands</u>	<u>NIS thousands</u>
Current taxes	(336,710)	(171,637)	(1,100)
Deferred taxes	2,072	305,824	(71,128)
Taxes for prior years, net	<u>(12,119)</u>	<u>6,561</u>	<u>857</u>
	<u><u>(346,757)</u></u>	<u><u>140,748</u></u>	<u><u>(71,371)</u></u>

Notes to the Financial Statements as at December 31, 2001 (cont'd)

C. Reconciliation between the theoretical tax computed in respect of the pre-tax inflation-adjusted earnings and the actual tax expenses in the books

Consolidated

	For the year ended December 31		
	2001	2000	1999
	NIS thousands	NIS thousands	NIS thousands
Tax computed at the regular tax rate (*)	(206,190)	187,036	(30,073)
Increase (savings) in tax liability due to:			
Inflationary erosion of advance tax payments	(379)	68	(1,191)
Exempt income and capital gains	25,823	48,689	14,674
Non-deductible expenses	(13,461)	(13,191)	(12,298)
Losses in respect of which a deferred tax asset was not created	(16,872)	(59,941)	(31,420)
Timing differentials for which no tax benefit was created	(5,789)	(11,843)	1,123
Taxes for prior years, net	(12,146)	6,409	2,124
Other	(1,578)	(1,743)	(3,445)
	<u>(230,592)</u>	<u>155,484</u>	<u>(60,506)</u>
(*) Regular tax rate	<u>36</u>	<u>36</u>	<u>36</u>

Company

	For the year ended December 31		
	2001	2000	1999
	NIS thousands	NIS thousands	NIS thousands
Tax computed at the regular tax rate (*)	(346,212)	94,293	(66,604)
Increase (decrease) in tax liability due to:			
Inflationary erosion of advance tax payments	(379)	66	(704)
Exempt income and capital gains	24,996	48,669	8,337
Non-deductible expenses	(10,934)	(9,724)	(9,492)
Taxes for prior years, net	(12,119)	6,561	857
Other	(2,109)	883	(3,765)
	<u>(346,757)</u>	<u>140,748</u>	<u>(71,371)</u>
(*) Regular tax rate	<u>36</u>	<u>36</u>	<u>36</u>

D. Deferred taxes

	Consolidated		Company	
	December 31 2001	December 31 2000	December 31 2001	December 31 2000
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Activity —				
Balance at beginning of year	816,423	458,072	806,522	469,721
Charged to statement of operations for the year	121,392	327,374	2,072	305,824
Charged to income tax refunds for prior years	(336,484)	45,814	(336,484)	45,814
Charged to statement of operations for prior years	(4,467)	(14,837)	—	(14,837)
Balance as at end of year	<u>596,864</u>	<u>816,423</u>	<u>472,110</u>	<u>806,522</u>

Notes to the Financial Statements as at December 31, 2001 (cont'd)

	Consolidated		Company	
	December 31 2001	December 31 2000	December 31 2001	December 31 2000
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Composition of deferred taxes —				
Difference between the adjusted value of fixed assets and their value for income tax purposes	(543,562)	(206,868)	(471,816)	(170,803)
Adjustment of materials and spare parts ..	(348)	(182)	(204)	(73)
Deferred tax due to losses	264,642	142,894	—	—
Differences in the recognition of expenses relating to employee rights, doubtful debts and other	<u>876,132</u>	<u>880,579</u>	<u>944,130</u>	<u>977,398</u>
Total	<u>596,864</u>	<u>816,423</u>	<u>472,110</u>	<u>806,522</u>
Classified as follows:				
As part of current assets	181,084	188,785	146,905	164,551
As part of other assets	415,780	642,273	325,205	641,971
As part of long-term liabilities	—	(14,635)	—	—
Total	<u>596,864</u>	<u>816,423</u>	<u>472,110</u>	<u>806,522</u>

The deferred taxes are computed at the tax rate expected to be in effect at the time (36%). Realization of the tax benefit is contingent upon the existence of adequate taxable income in the future. The tax benefit is included in the financial statements since, according to the Company's business plans, its realization is anticipated. The tax benefit in respect of a loss accumulated at Pelephone was recorded according to the assessment of Pelephone's management that it is virtually certain that these losses will be realized in the foreseeable future.

Losses for tax purposes of subsidiaries which are carried forward to the coming years amounted to approximately NIS 1,007,117 thousand (2000 — NIS 672,272 thousand). The balance of the loss and deduction carry-forwards for which no deferred tax benefit was included because of the uncertainty of their realization, is approximately NIS 296,389 thousand (2000 — NIS 248,444 thousand).

E. Final tax assessments

- (1) In June 2001 an agreement was signed between the Company and the income tax authorities for final assessments for the years 1994 — 1998 inclusive. Under the agreement, the Company's claim to increase the depreciation rate of switching and subscriber equipment was recognized, and several other issues were also agreed upon, principally postponement of the dates of recognition of certain expenses. As a result of the above, the Company recorded tax expenses in its financial statements in respect of preceding years, amounting to approximately NIS 12 million, as well as financing income of approximately NIS 79 million (tax exempt) deriving from the rebate payable to the Company.
- (2) On January 1, 2002, a subsidiary, Bezeq International Ltd., received a tax assessment (outside the agreement) in respect of the years 1996 — 1999. The assessment requires Bezeq International to pay additional taxes of NIS 106 million, most of which derives from adjustment of expenses. Bezeq International objected to the assessment. In the discussions being held between the subsidiary and the income tax authorities in connection with the assessment, the latter proposed a settlement agreement in the amount of NIS 15 million. Bezeq International's counter-proposal is for NIS 2 million. Since the subsidiary believes that it has valid arguments against the authorities' assessments which could lower the claimed tax payments considerably, it allocated a provision for taxes in respect of preceding years in the amount it proposed. The management of the subsidiary and its advisors are unable to estimate, at this stage, the outcome of the proceeding.
- (3) A proportionally consolidated company has received final assessments up to and including 1994, and a final assessment was determined up to 1997 (by prescription). BezeqCall Communications Ltd. has received final assessments up to and including 1998.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

F. Value added tax

- (1) The Company files a consolidated tax return with its subsidiaries for value added tax purposes.
- (2) The Company is in dispute with the value added tax authorities with regard to the Company's right to reimbursement of value added tax it paid which was not collected from customers in that it was a bad debt, and its right to that reimbursement plus interest and linkage differentials from the date on which the debt was generated. A protest filed by the Company was dismissed by the VAT authorities, and the Company intends to submit the matter for a decision in the appropriate proceedings.

NOTE 12 — BANK CREDIT

	Interest rate	Consolidated	
		December 31, 2001	December 31, 2000
		NIS thousands	NIS thousands
	%		
Unlinked loans	4 — 8.2	388,056	726,229
Dollar-linked loans	2.25 — 2.3	<u>35,510</u>	<u>19,274</u>
		<u>423,566</u>	<u>745,503</u>

NOTE 13 — LONG-TERM LOANS

A. Composition

	Consolidated		Company	
	December 31 2001	December 31 2000	December 31 2001	December 31 2000
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Banks	2,986,034	3,153,204	2,273,021	2,675,716
Pension fund	84,877	99,997	84,877	99,997
Others	16,540	7,820	—	—
Supplier credit	1,407	2,289	—	—
	<u>3,088,858</u>	<u>3,263,310</u>	<u>2,357,898</u>	<u>2,775,713</u>
Less —				
Current maturities from banks	556,926	382,909	367,024	321,970
Other current maturities	18,012	15,805	17,339	15,123
	<u>2,513,920</u>	<u>2,864,596</u>	<u>1,973,535</u>	<u>2,438,620</u>

B. Linkage terms and interest

	Interest rate	Consolidated		Company	
		December 31 2001	December 31 2000	December 31 2001	December 31 2000
		NIS thousands	NIS thousands	NIS thousands	NIS thousands
	%				
Loans in foreign currency					
US dollar(*)	LIBOR + 0.42-0.65	1,803,936	2,039,721	1,803,936	2,039,721
Euro		1,366	—	1,366	—
		<u>1,805,302</u>	<u>2,039,721</u>	<u>1,805,302</u>	<u>2,039,721</u>
Loans linked to the CPI	3.6-6.2	812,139	1,085,349	467,719	635,995
	6.1	84,877	99,997	84,877	99,997
		<u>897,016</u>	<u>1,185,346</u>	<u>552,596</u>	<u>735,992</u>
Unlinked loans	6.85-9.45	386,540	38,242	—	—
		<u>3,088,858</u>	<u>3,263,309</u>	<u>2,357,898</u>	<u>2,775,713</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.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

C. Repayment schedule

	<u>Consolidated</u> NIS thousands	<u>Company</u> NIS thousands
December 31		
2003.....	616,140	454,474
2004.....	543,563	412,817
2005.....	672,455	563,486
2006.....	640,816	542,758
2007 and thereafter	<u>40,946</u>	<u>—</u>
	<u>2,513,920</u>	<u>1,973,535</u>

D. Security

- (1) Long-term loan agreements of the Company, aggregating NIS 1,986,493 thousand, 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 the Company's affairs.

— In respect of loans aggregating NIS 1,235,773 thousand, 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 563,040 thousand upon the occurrence of an event which also allows other loans of the Company to be made available for early repayment.

— In respect of the remaining loan balance of NIS 750,720 thousand upon the occurrence of an event which allows early repayment of other loans of the Company and of material subsidiaries to be demanded, or failure to comply with the following financial ratios relating to the Group:

a. Net financial debt to Earnings Before Interest Taxes Depreciation and Amortization (EBITDA) of not more than 3 : 1.

b. Tangible shareholders' equity at least 35% of total tangible assets.

As at the balance sheet date, the Company is in compliance with these financial ratios.

— A change made without the lenders' consent in the character of the Company's business, which would have a materially adverse effect on its business, assets or financial condition.

Regarding the possibility of existence of the above conditions, including a decrease in the voting rights of the State and the possibility of the complete opening of the communications market to competition — see Note 1.

The Company created a negative pledge in favor of the lenders.

- (2) A proportionally consolidated company created a negative pledge and undertook to meet certain financial conditions in respect of bank loans it received, the proportionally consolidated balance of which, as at the balance sheet date, is NIS 650,342 thousand. As at the balance sheet date, that company is complying with those financial conditions.
- (3) A subsidiary created a negative pledge in respect of bank loans, the balance of which as at the balance sheet date is approximately NIS 72 million.

E. Loan-Procurement Expenses

Deferred expenses for raising loans as at December 31, 2001 and December 31, 2000 amounted to NIS 10,480 thousand and NIS 14,520 thousand respectively. The expenses are presented after deduction of accumulated depreciation amounting to NIS 3,816 thousand and NIS 9,663 thousand respectively.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

NOTE 14 — OTHER DEBENTURES

A. Composition and terms

	Interest Rates	Consolidated and Company	
		December 31 2001	December 31 2000
	%	NIS thousands	NIS thousands
CPI-linked debentures issued to the Public:			
Debentures Series 1 ⁽¹⁾	4.5	<u>199,589</u>	<u>266,107</u>
Debentures issued to the public:			
Linked to the euro ⁽²⁾	6.5	<u>1,166,104</u>	<u>1,137,680</u>
Debentures issued:			
Unlinked ⁽³⁾	6.8 — 8.5	<u>500,110</u>	<u>—</u>
Debentures issued to financial institutions and others:			
CPI-linked	3.9 — 6.35	<u>845,184</u>	<u>1,006,374</u>
		2,710,987	2,410,161
Less — current maturities		<u>186,721</u>	<u>227,755</u>
		<u><u>2,524,266</u></u>	<u><u>2,182,406</u></u>

(1) The outstanding balance of the debentures is NIS 59,850,864 par value (2000 — NIS 79,801,157 par value).

(2) The outstanding balance of the debentures is 300,000,000 euros par value.

(3) The outstanding balance of the debentures is NIS 500,656 par value.

B. Repayment schedule

	NIS thousands
2003	197,114
2004	589,068
2005	204,764
2006	154,512
2007 and thereafter	<u>1,378,808</u>
	<u><u>2,524,266</u></u>

C. Security

The debentures are not secured, except for a nominal lien. However, the Company has undertaken that as 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, 2001 amounts to approximately NIS 788,606 thousand, are entitled to demand the immediate repayment of the debentures if the State's holdings in the share capital of the Company falls below 26% (see Note 1).

In addition, for a balance of NIS 1,172,250 thousand of debentures which were issued to the public and are linked to the euro, upon the occurrence of an event enabling demand for immediate repayment of other loans of the Company and of material subsidiaries.

The Company has created a negative pledge in favor of the holders of the euro-linked debentures issued to the public.

D. Issue Expenses

Deferred expenses with respect to the issue of the debentures amounted to NIS 29,929 thousand (2000 — NIS 29,677 thousand), and are stated net of amortization of NIS 21,038 thousand (2000 — NIS 19,034 thousand).

Notes to the Financial Statements as at December 31, 2001 (cont'd)

NOTE 15 — TRADE PAYABLES

	Consolidated		Company	
	December 31 2001	December 31 2000	December 31 2001	December 31 2000
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Suppliers of goods and services(*)	1,018,011	*960,959	570,527	472,462
Current maturities of long-term supplier credit	673	682	—	—
	<u>1,018,684</u>	<u>961,641</u>	<u>570,527</u>	<u>472,462</u>
Including foreign currency balances(*)	286,724	329,079	25,339	16,027
Including subsidiaries	—	—	8,374	2,022
Including a proportionally consolidated company	35,293	16,267	70,586	32,534

* Reclassified

NOTE 16 — LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

A. Composition

	Consolidated		Company	
	December 31 2001	December 31 2000	December 31 2001	December 31 2000
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Provision for early retirement, net (see D below)	1,450,166	1,566,140	1,450,166	1,566,140
Compensation for unutilized sick leave (see E below)	62,582	48,396	62,582	48,396
	<u>1,512,748</u>	<u>1,614,536</u>	<u>1,512,748</u>	<u>1,614,536</u>
Provision for severance pay	62,422	32,352	28,170	15,088
Less — reserve in compensation fund	(36,312)	(22,089)	(12,893)	(9,159)
	<u>26,110</u>	<u>10,263*</u>	<u>15,277</u>	<u>5,929*</u>
	<u>1,538,858</u>	<u>1,624,799</u>	<u>1,528,025</u>	<u>1,620,465</u>
Stated as follows:				
Among current liabilities	262,947	349,639	262,947	349,639
Among long-term liabilities	1,275,911	1,275,160*	1,265,078	1,270,826*
	<u>1,538,858</u>	<u>1,624,799</u>	<u>1,528,025</u>	<u>1,620,465</u>

* Reclassified

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 liabilities. The accumulated amounts 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, are 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.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

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 is covered, in respect of the period from February 1, 1985, by current deposits in pension funds and with insurance companies, as stated in section B above. Severance pay in respect of the period of government service up to January 31, 1985, is paid by the Company, and the 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 the Company before reaching retirement age, are entitled, under certain conditions, if they so choose, 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. The costs of retirement of such employees is included in the provision for early retirement plans, as described below.

D. Early retirement plans

- (1) Under a special collective agreement for retirement, signed on November 23, 1997 between the Company and the workers' representatives, approximately 2,050 employees retired from the Company up to December 31, 1999.
- (2) As part of the plan for organizational change in the Company, which was approved by the Board of Directors in March 2000, about 530 employees retired from the Company between December 31, 1999 and December 31, 2001.
- (3) In the wake of privatization of the Company and the opening of the telecommunications market to competition, additional workforce changes are required at the Company; accordingly, the Company reached agreement with the workers' representatives in September 2000, to extend the early retirement collective agreement from 1997. The new arrangement states that from April 1, 2001 to December 31, 2006 (with an option to extend the final retirement date for certain employees to December 31, 2008), another 1,770 employees will take early retirement. Furthermore, pursuant to the agreement, the Company's management will be able to dismiss employees under a compensation arrangement over and above the number stated in the agreement. The retirement of workers under this plan will start in 2002.

The financial statements for 2000 include an expense of approximately NIS 1,390 million in respect of the expected cost of implementation of this plan. The Company's management estimates that the likelihood of additional employees retiring in the compensation track is slight, and accordingly, no provision was made therefor in the financial statements.

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.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

NOTE 17 — OTHER CURRENT LIABILITIES

	Consolidated		Company	
	December 31 2001	December 31 2000	December 31 2001	December 31 2000
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
The Government of Israel in respect of royalties, interest and other fees	196,913	197,080	148,834	148,369
Wages and salaries ⁽¹⁾⁽²⁾	242,218	196,257*	197,890	152,688*
Provision for vacation pay	95,525	92,798	91,726	84,634
Income tax payable	95,798	—	91,255	—
Governmental agencies	101,994	73,749	86,396	59,440
Accrued interest	103,319	105,042	97,761	101,726
Forward exchange contracts	13,322	34,835	13,322	34,835
Other accrued expenses	148,260	118,554	84,928	65,026
Current maturities in respect of prepaid income	46,368	45,389	30,387	26,825
Provision for claims in respect of salary and pension components	<u>111,380</u>	<u>111,380</u>	<u>111,380</u>	<u>111,380</u>
	<u>1,155,097</u>	<u>975,084</u>	<u>953,879</u>	<u>784,923</u>

(1) Including current maturities of a long-term loan from a pension fund

	<u>17,339</u>	<u>15,123</u>	<u>17,339</u>	<u>15,123</u>
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(2) Including a provision for payment of a bonus to employees at 10% of net earnings. The directives of the Government Companies Authority authorize the Company to pay a bonus at that rate if in the preceding year the Company made a profit. Subject to discussion and approval of the Board of Directors for sum to be paid, the Company intends to discuss with and request the approval of the Government Companies Authority for payment of the provision included in the financial statements. Payment of the bonus is contingent upon a resolution of the Board of Directors and the approval of the Government Companies Authority.

* Reclassified

NOTE 18 — DEFERRED REVENUES

Deferred revenues consists mainly of receipts in respect of making infrastructures available for the use of external entities, and from compensation in respect of a purchase agreement with a proportionally consolidated company.

NOTE 19 — CONVERTIBLE DEBENTURES

Registered debentures were issued pursuant to a prospectus from February 1998. The issued par value of the debentures 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. In addition, under the same prospectus, options were issued which can be exercised for a convertible debenture, where the par value of the debentures converted from the options is NIS 74,992,200. During the report period, 59,754,681 par value of debentures were converted and in exchange, 5,904,612 ordinary shares of a par value of NIS 1 were issued. A balance of 560,735 par value of debentures was repaid on February 28, 2001.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

NOTE 20 — CONTINGENT LIABILITIES

A. Claims

Below are details of the contingent liabilities situation of the Company and investee companies as at December 31, 2001, in which the maximum possible exposure is considerable.

- (1) 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 125 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 held that the extent of the damage of the members of the group should 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 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. On July 2, 2001 the Supreme Court allowed the appeals of the Company and of Bezeq International. On July 17, 2001 the plaintiff filed an application for an additional hearing of the case. On September 12, 2001 the Israeli Consumer Council filed an application to be added as a party to the application for an additional hearing and as a party to that additional hearing, if held. In the Company's opinion, relying on the legal advisor who is handling the claim on its behalf, it is not possible to estimate whether the plaintiff's application for an additional hearing will be allowed, and if so, what the outcome of the proceeding will be. No provision is included in the financial statements in respect of this claim.
- (2) 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 managers 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 appearance 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 146 million. In November 1999 a decision was given rejecting almost all the causes of the action. This decision has been appealed. The arguments stage in the case has been completed and now awaits the decision of the National Court on the appeal. Negotiations are in progress between the Company and the workers' representatives, with the aim of reaching an arrangement which will end the dispute. A provision is made in the financial statements based on a arrangement proposed by the Company's management.
- (3) 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 Anti Trust Law. The plaintiff alleges that the tariffs for international telecommunication services in the period from May 10, 1996 to July 8, 1997 were exorbitant and unreasonable, while exploiting its status as a monop-

Notes to the Financial Statements as at December 31, 2001 (cont'd)

oly, 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 913 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 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 27, 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 18, 1999 the Anti-Trust Commissioner applied to the court requesting to clarify that he does not dispute that the tariffs of Bezeq International 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 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 30, 1999 the Company and Bezeq International filed for leave to appeal this decision. The Supreme Court allowed the appeal of the Company and Bezeq International, and the decision of the District Court approving the action was voided. The class action filed by the plaintiff was stricken, while reserving the right of the plaintiff to file it anew and preserving all the allegations of the litigants. In September 2001 a claim was filed against Bezeq International Ltd. and the State of Israel, with an application for recognition as a class action. In February 2002 Bezeq International filed its response in the court, rejecting the allegations of the plaintiff and alleging that the conditions for approval as a class action had not been met.

In the opinion of Bezeq International Ltd., relying on the legal advisors who are 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.

- (4) 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. Withholding differences are also claimed in respect of these amounts. 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 advisor who is handling the claim on its behalf, it is not possible, at this stage, to estimate the prospects for this claim. No provision is made in the financial statements in respect of this claim.

The State joined as a party to the proceeding and filed a final opinion of the Attorney General, which supports the position of the Companies Authority that no obligation exists to pay senior employees the wage increment. 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 accede to the claim.

- (5) 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 Ltd., the Chairman of the Board of Bezeq International and the then CEO of Bezeq International. The claim alleges, *inter alia*, that the Anti-Trust Commissioner

Notes to the Financial Statements as at December 31, 2001 (cont'd)

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 when it refrained from clarifying to the public that only those who register as Bezeq International subscribers would enjoy the reduced tariffs. The amount of the class action is estimated by the plaintiffs at approximately NIS 50 million. In December 1997, the Company was stricken from the claim. On June 19, 2001 the District Court decided to reject the application for approval as a class action. On September 20, 2001 the decision of the District Court was appealed in the Supreme Court. On October 28, 2001 Bezeq International filed an application to strike the appeal *in limine*. On January 7, 2002 the court rejected the application and ruled that the appeal would be heard on its merits.

The legal advisors of Bezeq International are unable, at this stage, to estimate the chances of the appeal, and therefore no provision is made in the financial statements in respect of this claim.

- (6) 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* suspicion of binding agreements between Koor Industries, Telrad, Tadiran, the Company and BezeqCall Communications, in the supply of large switchboards and in network end points.

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 end points exchange market.

According to the Commissioner, the Authority investigators recommend that indictments be obtained against some of those who were investigated concerning some of the suspicions which 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 end points market was operated until recently.

In the area of public switching, the Authority's investigation raises suspicions of collaboration between Telrad and Tadiran opposite the Company. Among other things, there is *prima facie* suspicion that Telrad and Tadiran coordinated various aspects of the competition between them in relation to 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 binding agreements 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 prearrangement of the competition between the companies in relation to the Company; an undertaking by the Company not to purchase from the two companies equipment in tenders. It is suspected that these undertakings, or some of them, 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

Notes to the Financial Statements as at December 31, 2001 (cont'd)

been blocked by the aforementioned arrangement in relation 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 willful blindness constitutes not only proof that the relevant parties knew they were involved in an offense, but also defines aggravated circumstances for this offense.

The findings of the Authority's investigation in this area appear to indicate a series of binding agreements and attempted offenses in the field of network end points, between Bezeq Call Communications, Telrad and Tadiran. Among other things, 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 end point infrastructures, the type, 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 end point exchanges. It is suspected that these 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 arrangement for dividing the market between the companies, as well as agreements concerning non-marketing of the product of an additional third vendor in the field of network end point exchanges.

In November 2000 a shareholder approached the Company with a demand that the Company take legal action against the suppliers, stating that in his opinion the Company had suffered a loss of about NIS 400 million due to the binding agreement. In his demand, the shareholder reserves the right to file a derivative action pursuant to Section 194 of the Companies Law. The Company replied that it is monitoring developments in the matter and has requested the investigative material from the Anti-Trust Authority, and that it would formulate its stance in accordance with the decision of the Authority and its findings, if any. In November 2001 a similar application was received from another shareholder, to which the Company replied that it was still awaiting the decision of the Anti-Trust Authority.

On March 3, 2002 the Company received a summons to a hearing from the Anti-Trust Authority. The summons (which relates to the investigation of the public switching case only, and not to the case of the network terminal point exchange market, which is still under examination by the legal department of the Authority) states that the Authority is considering committing the Company for trial for offenses against the Anti-Trust law, 5748-1988 ("the Anti-Trust Law"), and has not yet decided whether or not to file an indictment in this matter. It was decided to allow the Company to voice its allegations in a hearing proceeding, and to read the relevant investigation material in respect of which no immunity was granted. According to the summons, the findings of the investigation raise suspicions that that the Company was a party to the cartel arrangements concerning the purchase of equipment and receipt of various services in the field of public switching and the dividing up of the market and the non-entry of a new competitor in the framework agreements for the years 1994-1997 and the years 1997-2000.

The Anti-Trust Law forbids contracting as a party to a binding agreement 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 Company, relying on its legal advisors, is unable at this stage to estimate the significance of the decision of the Anti-Trust Authority or what the final decisions of the Authority will be after the Company's hearing and their implications for the Com-

Notes to the Financial Statements as at December 31, 2001 (cont'd)

pany, including the ability of its shareholders or its customers or any other third party to sue it, or its own ability to sue others.

- (7) In March 1999 a claim was filed against the Company by a group of employees who were employed as temporary workers at 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 filed an application for dismissal of the claim *in limine* due to its prescription. In the hearing of the Company's application to dismiss, the parties reached agreement regarding partial dismissal and a narrowing of the claim in respect of some of its components, following which, exposure decreased in respect of the claim.

The questions raised in this claim are liable to have a lateral effect on the Company. However, in view of the above agreements, exposure has been significantly reduced. The Company, relying on its legal advisors, 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.

- (8) On February 15, 2000 a claim was filed against the Company in the District Court in Jerusalem in the amount of NIS 21 million. The plaintiff alleges in his claim that the Company violated its undertakings 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 good administration, with negligence and while exploiting the status of the Company as a monopoly or monopsony. At this stage of the proceedings, the Company is unable, relying on the legal advisor which is handling the claim on its behalf, to estimate the chances of the claim. Accordingly, no provision is made in the financial statements in respect of this claim.
- (9) 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 violated various undertakings toward them which were included in the prospectus of the Company published in 1991, including undertakings to allot Company shares, pay dividends and make preferential loans available to the plaintiffs. The plaintiffs allege that the allotment of shares to employees in accordance with the Company's prospectus which 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 1998 prospectus contained misleading details and representations, and material documents which ought to have been attached were not attached.

On May 8, 2001 the District Court dismissed the claim, in part for prescription and in part due to absence of cause. The plaintiffs appealed this decision in the Supreme Court.

At this stage of the proceedings the Company is unable, relying on its legal advisors, to estimate the chances of the proceeding, and therefore no provision is made in the financial statements in respect of this claim.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

- (10) In October 1999, 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 12.3 billion.

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

- (11) In July 2000 a class action and application for its approval as a class action were filed against the Company. According to the plaintiffs, the Company collected money unlawfully from its subscribers for certain services which it provides. The claim is for approximately NIS 915 million. On February 18, 2002 the District Court decided to dismiss the application for approval as a class action.
- (12) In April 2000, a company which provides cable television broadcasts filed a claim against the Company in which it petitions for a permanent mandamus for enforcement of the agreement to upgrade its cable network and alternatively, to enable it to carry out the works itself or through a contractor, alleging that as a result of the Company's sanctions, the upgrade works were interrupted, which constitutes breach of contract. On July 25, 2001 a decision was given to strike the claim, following a consensual application filed on behalf of both parties.
- (13) On August 10, 2000 the Company received a letter from the a representative of the Anti-Trust Commissioner, stating that according to information which had reached the Anti-Trust Authority, there was *prima facie* evidence that the Company was taking actions, in connection with its preparations for providing ADSL services, which are liable to constitute violations of provisions in the Restraint of Trade Law, 5748-1988 ("the Law"). The alleged actions relate to agreements between the Company and its dealers (agents) for ADSL services. Accordingly, the Company was required to give its preliminary response to the allegations, and to submit to the Commissioner various items of information and documents. From the Company's initial investigation it transpires that the above-mentioned suspected violation of the Law, taking into consideration that it relates to a trial and to agreements with dealers who are actually agents, is exaggerated and unjustified.

The Company submitted its comments on the allegations, as well as information and documents as requested, and later received, on November 16, 2000, a letter from the representative of the Anti-Trust Commissioner, stating that in their opinion, even after consideration of the Company's response, the suspicion of violation of the Law still exists, and that the Company is required to cancel all the agreements with the dealers and notify them accordingly. The Company is firm in its position that the suspicion is unjustified. Nevertheless, the Company is examining ways to handle the matter, *inter alia*, in view of the final approval of the ADSL service file. It is noted that following that final approval, the agreements with the dealers were changed to bring them into line with the service file.

- (14) In August 2000, a class action together with an application for approval as a class action, was filed against the Company in the amount of approximately NIS 61 million, including VAT. The plaintiff alleges that the Company unlawfully collected payment differentials from its subscribers, for the fixed fee for use of the telephone line. The requested reliefs are two — declaratory, whereby the Court is requested to declare that the Company collected the payment differentials unlawfully, and "operative — financial", for reimbursement of said amounts. The Company rejects the plaintiff's allegations and alleges that its method of charging meets the criteria of the law, reasonableness and justice. On November 20, 2001 the Company filed an application

Notes to the Financial Statements as at December 31, 2001 (cont'd)

for dismissal *in limine* of the application for approval, since there is no legal authority for filing the class action. On December 17, 2001 it was determined that the hearing of the case would be continued for the time being, until the decision of the Supreme Court (in another case, to which the Company is to a party) on the question of whether the regulation which was relied upon in filing the claim, constitutes a source of legal authority for filing class actions. In the Company's opinion, relying on its legal advisors, the chances of the claim's success cannot be estimated at this stage. No provision was made in the financial statements in respect of this claim.

- (15) In September 2000, a declaratory claim was filed against the Company in the Jerusalem Labor Court, by 2,423 pensioners of the Company, former employees who were transferred from the Ministry of Communications to the Company upon its establishment. The plaintiffs are requesting from the Labor Court declaratory relief which will determine that the payments they received for grossing up of tax, clothing allowance and incentive pay are normal pay for work which should be seen as part of their regular wage for calculating their pension and the payments made to them upon retirement. The plaintiffs are also seeking declaratory relief which will determine that their last determining salary for the pension should be calculated according to the last salary which was paid to each of them for the last month of work, and not according to the average rank which each of them held. The Company has filed a preliminary application for dismissal of the claim *in limine*, a response to that application has been filed, and no defense has yet been filed. In the opinion of the Company, relying on the opinion of its legal advisor, the chances of the claim cannot be estimated at this stage. No provision was made in the financial statements in respect of this claim.
- (16) In September 2000, a class action and an application for approval as a class action were filed against the Company in the amount which is estimated at approximately NIS 104 million. According to the plaintiff, the Company unlawfully collected from its subscribers "collection expenses" for Company bills which were not promptly paid, before it had started any collection actions in connection with the plaintiff. The reliefs requested by the plaintiff are mainly two — declaratory, in which the Court is requested to declare that the collection of "collection expenses" by the Company in the instances described in the claim was unlawful, and that the Company may not continue to collect such expenses in the future, and "operative — financial", for reimbursement of said amounts. In January 2001 the Company filed its response to the application for approval of the class action, in which it alleges that the claim does not meet the criteria of the law and states that it rejects the plaintiff's interpretation of the collection regulations, claiming to have acted lawfully. The plaintiff filed his reply to the Company's response. On May 30, 2001 the Court approved the arrangement reached by the parties as to continuation of the hearing, and the parties filed their summations.

On October 18, 2001 another class action was filed on the same matter, in respect of unlawful charging of collection fees on Company bills which were not promptly paid, before it had started any collection actions. The plaintiff alleges that this action constitutes exploitation of the distress of the consumer, in contravention of the Consumer Protection Law, as well as unjust enrichment. The plaintiff estimates amount of this class action at about NIS 20 million. On December 16, 2001 the Court approved a continuance until after a decision on the application for approval of the claim as a class action, due to the similarity in the cases of action in the two cases.

In the opinion of the Company, relying on its legal advisors, the chances of the claims cannot be estimated at this stage. No provision was included in the financial statements in respect of these claims.

- (17) In September 2000 a class action and application for approval as a class action was filed against the Company in an amount estimated at more than NIS 761 million. According to the plaintiffs, the Company unlawfully collected from its subscribers a fixed payment for the lease of telephones which the Company made available to

Notes to the Financial Statements as at December 31, 2001 (cont'd)

them, so they allege, since the telephones were supplied to subscribers without a specific lease agreement being made, without disclosure and proper publication of the fact that the telephones were given in a "lease" agreement unlimited in time, and also concerns the amount of the "lease fee" demanded and the duration of collection of the "lease fee" even after the date on which the Company's subscribers had paid the "lease fees" in an amount equal to the full revalued value of the telephones supplied. The plaintiffs further allege that the Company collected "lease fees" unlawfully in that it did not give its subscribers the choice of whether to "lease" or purchase the telephones and in that it did not inform them of the option to cease payment of the fixed lease fee in exchange for a lump-sum payment which of itself, according to the plaintiffs, is unlawful. The relief requested by the plaintiffs is mainly financial, for reimbursement of the aforesaid amounts.

In addition, on November 21, 2000 the Company received a class action with an application for approval as a class action. The amount of this claim is estimated at about NIS 243 million. It is noted that the action makes allegations which are similar or identical to those in the above action from September 2000.

The plaintiffs filed an application for consolidation of the hearings for the two claims, which was approved on April 25, 2001. On June 10, 2001 the plaintiffs filed an amended statement of claim and amended application for approval as a class action. Additional allegations are made in the amended statement of claims, *inter alia* concerning unlawful charging of "maintenance fees". The amount of the two claims together is now estimated at more than one billion shekels. The Company filed an application for dismissal *in limine* of the amended application for approval as a class action. No decision has yet been made.

The Company, relying on its legal advisors, is unable, at this stage, to estimate the chances of the claim. No provision was made in the financial statements in respect of this claim.

- (18) On May 10, 2001 a claim was served to an affiliate in which the plaintiff alleges that the affiliate is misleading consumers in its advertisements in connection with the possibility for the consumer to purchase certain channels only, and with regard to the number of channels offered. It is also alleged that the affiliate requires its subscribers to consume a maximum channel package even if they do not choose that package. The plaintiff filed the claim as the representative of the subscribers of the affiliate, and together with the claim also filed an application for recognition of the claim as a class action under the Consumer Protection Law. The personal losses of the plaintiff, as alleged by the plaintiff, are negligible, and the sum stated as accumulated loss for all members of the class is approximately NIS 177 million. The legal advisers of the affiliate believe that the affiliate has a good defense against the action as a class action.
- (19) In September 2000 a class action and application for approval as a class action were filed against the Company, Bezeq International Ltd. and the other international communications operators. The amount of the claim, according to the action, cannot be calculated accurately, and is estimated to be in excess of the competence of the Magistrate's Court, which is currently one million shekels.

According to the plaintiffs, starting on October 20, 1998, the Company unlawfully collected 17% VAT for part of collect calls originating outside Israel and received by its subscribers in Israel, in contravention of the VAT law and its regulations and in violation of a legislated duty in a way which breaches existing agreements, acting in bad faith in the fulfillment of such contracts and with negligent conduct. The plaintiffs further allege against the international operators concerning the collection of VAT in respect of calls which were made abroad to Israel using phone cards. The plaintiffs estimate the total loss incurred by the group due to the unlawful collection of VAT for all calls made from abroad to Israel in the relevant period (since October 20, 1998) at millions of shekels per year.

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The reliefs requested by the plaintiffs are mainly two — declaratory, in which each of the defendants violated its obligations under the contractual agreement between it and the members of the group with which it contracted, and financial, for restitution of said amounts, compensation for the loss incurred by the members of the group in the aforesaid amounts. On June 21, 2001 the Attorney General gave notice that he would appear in this proceeding. On January 6, 2002 the Court decided to conjoin the Director General of the VAT authorities as an additional defendant in the action and the application for its approval as a class action, and denied the application of Bezeq International Ltd. for dismissal *in limine*. At the hearing on February 28, 2002, the plaintiffs' legal representative clarified that the plaintiffs are not demanding independent relief from the communications companies, but rather, reimbursement of the VAT which the Director General of the VAT authorities will repay then if the claim is successful. The plaintiffs attorney also proposed that the communications companies be considered formal defendants.

A date was set for filing summations on the matter of approval of the claim as a class action, while excusing the communications companies from filing them. The legal advisors of the Company and of the subsidiary are unable, at this stage, to estimate the chances of the claim. No provision was made in the financial statements in respect of this claim.

- (20) In December 2000 a claim was filed in the District Court against Pelephone Communications Ltd. ("Pelephone") by the State of Israel, for royalties allegedly payable for the period from January 1994 to February 1996. The amounts claimed is approximately NIS 264 million, consisting of principal, linkage differentials and interest.

In the opinion of the management of Pelephone, based on the opinions of its outside legal advisors, Pelephone has a genuine defense against the claim, the amount of which is also deemed to be highly exaggerated.

On March 11, 2001 Pelephone filed a defense and a counter-claim relating to the State's claim for payment of royalties for the period from January 1, 1994 until February 7, 1996. In the counter-claim, Pelephone claims reimbursement of NIS 66 million (including interest and linkage differentials) in respect of an advance payment it made to the State as a goodwill gesture for reaching a settlement in 1996, a payment which was contingent upon the State not suing Pelephone for royalties. Before the case came to court, the parties agreed to transfer the matter for clarification in a mediation proceeding.

It should be noted that the claim includes sums in respect of the period January — October 1994, for which the Company also received a demand to pay royalties, even though in the Company's opinion the royalties for that period were already paid by the Company as part of a compromise arrangement with the State in November 1995.

- (21) In February 2001 a class action and application for its approval as a class action were filed against the Company, as well as an application for a temporary injunction. The amount of the claim is not stated, but according to the action, the accumulated loss for the entire group in whose name the plaintiff has filed suit, is estimated at "millions of shekels".

According to the plaintiff, the "Light Net" track, which is one of the tracks in the alternative basket of payments introduced on May 1, 2000, is actually a "default" from the aspect of the customer, since it is an offer which contains nothing but acquisition of the customer.

The plaintiff alleges that since May 1, 2000, when the new tariffs took effect, until the end of June, the Company charged the calls to the network of subscribers who did not select one of the tracks, according to the Light Net track as if it were the "regular" tariff for connecting to the network, then from July 1, 2000 also the Company should have continued to apply the Light Net tariff to all subscribers who did not choose another track. The plaintiff alleges that the charge in the months May — June 2000 constitutes

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deception, as does the representation of the Company, on the basis of which the subscriber's situation changed for the worse, and therefore, according to the plaintiff, the Company is precluded from shrugging off that representation. In this, according to the plaintiff, the Company violated the provisions of Section 2(a) of the Consumer Protection Law, 5741-1981. On October 24, 2001 the District Court denied the plaintiff's application for recognition of the claim as a class action pursuant to the Consumer Protection Law. The plaintiff appealed the decision in the Supreme Court. The Company, relying on its legal advisors, is unable to estimate the chances of the plaintiff's appeal in this case, and the chances of the defense if the Supreme Court should rule that the action should have been recognized as a class action. No provision is made in the financial statements in respect of this claim.

- (22) In March 2001 a petition was filed in the Supreme Court against the Minister of Communications, the Company and three cellular operators, in which the petitioner requests, *inter alia*, that the court direct the Minister of Communications and the Company to provide a blocking service for every Company subscriber against outgoing calls to cellular phone area codes, as a positive default. The court forwarded the petition to the defendants for their response. The Company gave notice that it does not oppose providing such a service, but emphasized that it would require the approval of the Ministry of Communications. Pelephone Communications Ltd. objected to the provision of the blocking service. The Company filed an application to expedite the hearing of the petition, and it was heard on October 15, 2001. In view of the notice of the Ministry of Communications that it is considering alternatives to blocking and will re-examine its policy, the hearing was postponed to a later date, as yet unspecified.
- (23) In September 2001, an application was filed for approval of a class action against the Company. The plaintiffs allege that in view of the amendments to the Telecommunications Regulations, the maximum payment that can be collected from Bezeq's subscribers for Pelephone subscribers was lower than the amount actually collected. The applicants estimate the amount of the claim at about NIS 42 million. The Company filed a response to the application for approval, and applied to conjoin Pelephone Communications Ltd. as a party to the proceeding. Based on the opinion of its legal advisors, the Company is unable, at this early stage of the proceeding, to estimate the chances of the claim. No provision was made in the financial statements in respect of this claim.
- (24) In July 2001 a claim was filed in the District Court against Pelephone Communications Ltd. ("Pelephone"). The plaintiffs allege that the pre-paid service constitutes infringement of their patent. Among the reliefs claimed are that Pelephone be directed to refrain from infringing the patent, ordered to submit a report on the number of cards, the revenues and profits, etc., received in respect of the sale of the cards, and ordered to pay NIS 100,000 in damages. At this stage, Pelephone is unable to estimate the outcome and the implications of the claim.
- (25) In August 2001 an application for approval of a class action was filed against Pelephone in the Tel Aviv District Court. The applicant, through his attorney, alleges that Pelephone collected from its customers surplus amounts in respect of for reciprocal connection fees, in contravention of the regulations applicable thereto and/or of its license. The amount of the claim, had it been recognized as class action, would have exceeded NIS 32.6 million. The parties arrived at a compromise agreement, and on March 17, 2002 the District Court gave partial approval for the claim as a class action and simultaneously validated the settlement agreement as a decision. The settlement agreement stipulates it will take effect only after the elapse of the period permitted by law for opposition (45 days). The financial statements include a provision which Pelephone believes to be appropriate.
- (26) In September 2001 a claim was filed in the Ramallah District Court by the General Public Palestinian Communications Co. Ltd., against Pelephone Communications Ltd. ("Pelephone") and another company. According to the claim, the plaintiff, which is a

Notes to the Financial Statements as at December 31, 2001 (cont'd)

company registered with the Registrar of Companies in the West Bank, is involved in the setting up, operation, supply, sale and management of services and stations for telephone communication, both landline and mobile, in the West Bank and the Gaza Strip, except for settlement areas and IDF installations. The plaintiff alleges in its statement of claim that despite having been awarded exclusivity for providing cellular services in the West Bank and the Gaza Strip, Pelephone provides, among other things, cellular services to the inhabitants of the West Bank and the Gaza Strip without restriction and without a license, thereby breaking the law. The plaintiff alleges, *inter alia*, that due to these activities of Pelephone, the plaintiff has sustained and is sustaining extensive damages and heavy losses, and petitions for payment of NIS 676 million from Pelephone, while reserving the right to claim additional amounts from July 1, 2001 up to the date on which Pelephone ceases to provide these services. The plaintiff also petitions for an injunction against the provision of the cellular services by Pelephone. Pelephone and its legal advisors are studying the claim and are unable, at this stage, to estimate its chances and implications.

- (27) In October 2001 the Company received a letter of demand in the name of the Moshav Porath Committee in the Sharon region, which contains allegations in connection with direct and indirect damages which were and are being sustained, according to the moshav members, as a result of the erection of the Hillel station near the moshav, and the station's broadcasts. The Company replied to the letter, refuting the allegations and the demand. In the Company's opinion, relying on its legal advisors, the chances of the Company's defense cannot be estimated if a claim is actually filed against it in this matter. No provision is made in respect of this matter in the financial statements.
- (28) A number of individual claims of current and former employees are pending against the Company, mainly concerning the inclusion of wage components, which could have a lateral effect. The Company's management believes, relying on the opinion of the legal advisors who are handling the claims on its behalf, that the amount of money involved cannot be estimated, nor the chances and implications for the Company. No provision is made in respect of these claims in the financial statements.
- (29) In 1995 the Company, together with others through a joint company, submitted bids in tenders of the Government of India for the erection of a basic communications system in India. Letters of intent and draft franchise agreements for development of the basic telephone system in the four regions for which the joint company won the tender, were submitted to the joint company. However, the joint company did not sign the letters and drafts because, *inter alia*, those documents do not correspond to the terms of the tender. At the time of the tender, the joint company gave the Indian Ministry of Communications bank guarantees, in which the Company's part was 273 million rupees (about NIS 24 million). The Indian Ministry of Communications demanded foreclosure of the guarantees at the end of June 1996. On September 19, 1997 the court gave a permanent injunction, preventing the Indian Ministry of Communications from foreclosing on the guarantees. At the end of October 1997 the Indian Ministry of Communications appealed that decision. The Company's management and legal advisors are unable to estimate the chances of the appeal in those proceedings. No provision was made in the financial statements in respect of this matter.
- (30) In January 2002 the Company received a claim for payment of monetary compensation of about NIS 53 million and for writs of mandamus, which was filed in the Tel Aviv District Court by an international communications operator against the Company and a subsidiary, Bezeq International Ltd. The claim makes allegations concerning the customer allocation process to the international communications operators. According to the plaintiff, it is entitled to compensation from the Company and from Bezeq International in respect of postponement of implementation of the customer allocation process, and in respect of diverting those being allocated to Bezeq International by unlawfully including them in the main file and removing them from the customer allocation process, and in respect of losses it suffered due to the method of the voice announcement of the possibility of dialing from card-operated public telephones.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

Alternatively, the plaintiff alleges that it is entitled to reimbursement of access fees which it paid to the Company under a reciprocal connection agreement which was allegedly forced upon it unlawfully. The plaintiff also requests that the court give orders directing investigations and accounts be made in relation to certain actions in the allocation process and for changing the order of the voice announcement in public telephones so as to ensure, in its opinion, equality among the international operators. The Company, Bezeq International and their legal advisors are studying the claim, and are unable, at this stage, to estimate its chances and implications. No provision was made in the financial statements in respect of this claim.

- (31) In October 2000, Bezeq International Ltd., a subsidiary, received a report from the Ministry of Communications expressing doubt as to the credibility of one of the main files which was forwarded to the Ministry of Communications in the customer allocation process. Bezeq International submitted its objection to the report to the Ministry of Communications. Following the report, one of the competing operators approached the Ministry of Communications, demanding that it direct that the dial code "00" be blocked to all telephone lines which were in the aforementioned file. On April 23, 2001, an agreement was signed between the subsidiary and the competing international operators, with the approval of the Ministry of Communications, whereby the allocation process will be redone for the group of customers called "new customers" in the main file, and the subsidiary would pay monetary compensation in respect of the period which had elapsed from the date of allocation of the main file to the date of the renewed allocation for that group, where the compensation formula is two thirds of the contribution generated to the subsidiary in respect of the traffic of those customers in that period. On May 21, 2001 the competing operators sent a letter to the Ministry of Communications giving notice of cancellation of the agreement. On June 7, 2001 the Ministry of Communications gave notice of transfer of the file to the operators for performance of the agreement. Despite this, the competing operators reneged on the matters which had been agreed and accordingly, the subsidiary notified them, on July 15, 2001, that if within seven days they do not give their explicit consent to performance of the agreement, the subsidiary will deem the agreement to have been breached. On July 16 and 18, 2001, the competing operators notified the Ministry of Communications that they do not intend to rescind their decision, and the subsidiary gave notice, on July 29, 2001, that it considers the agreement to have been breached. On October 28, 2001 the Minister of Communications notified the Company and the international operators that a supplementary referendum would be held for all the subscribers included in the "main file", except for those allocated to an international operator in an allocation form, and he requested their response to this proceeding by November 6, 2001. On that date, the subsidiary submitted to the Ministry of Communications its objections to carrying out the supplementary referendum. Following the objections of the Company, the subsidiary and the competing operators, the Ministry of Communications proposed another format for the supplementary referendum on December 11, 2001, and after receiving yet more objections from the Company, and subsidiary and the competing international operators, on February 14, 2002 the Ministry proposed a final text with details of the supplementary referendum, which will start on February 21, 2002 and end during July 2002. On March 12, 2002 the subsidiary petitioned the Supreme Court, sitting as the High Court of Justice, requesting that it direct the Ministry of Communications to refrain from passing the subsidiary's customer file to the competing international operators before the removal of the particulars of those customers who requested allocation to the subsidiary in the form, and that a supplementary referendum be carried out also for the customers of the competing operators who have no allocation form. The subsidiary also requested an interlocutory injunction concerning transfer of the customer file to the competing companies. On March 14, 2002 the Supreme Court decided to give an interlocutory injunction for non-transfer of the customer file to the competing companies until the petition was heard. The management of the subsidiary and its legal advisors are unable, at this stage, to estimate the outcome of the above proceeding.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

- (32) In January 2002 the Company received a letter of demand from a supplier, in which it was alleged that an order issued by the Company to the supplier for a total sum of about NIS 30 million, is valid. According to the Company, the order was made contingent upon suspending conditions which were not fulfilled, and therefore the order is not valid. In the opinion of the Company, relying on the legal advisor who is handling the demand on its behalf, the chances of the Company's defense cannot be estimated if a claim is filed against it in this matter. No provisions was made in the financial statements in respect of this matter.
- (33) In February 2002 a claim and application for recognition as a class action were filed against the Company in the District Court, concerning reimbursement of a commission which the plaintiff alleges was collected unlawfully, for calls in Israel from a public telephone operated by means of a BezeqCard. The amount of the class action is estimated by the plaintiff at about NIS 14 million as at the date of filing the claim. A pre-trial hearing is scheduled for May 13, 2002. No response and/or defense has yet been filed. In the opinion of the Company, relying on the legal advisor who is handling the claim on its behalf, the chances of the claim cannot be estimated at this stage. No provisions was made in the financial statements in respect of this claim.
- (34) On February 24, 2002 the Company received a "Notice of a party to a collective dispute" ("the Notice"), which was filed in the Regional Labor Court in Jerusalem on February 21, 2002 by the New General Federation of Workers ("the Applicant") in the name of Company employees. The Applicant alleges that payments for grossing up of tax, the on call duty benefits component and clothing allowances which were and are paid to Company employees are normal wages constituting part of the employee's regular pay, and that various payments and provisions should be paid in respect thereof, including for pension purposes. The Notice states that the requested reliefs are for all Company employees, including those whom were transferred from government service to the Company who are currently Company employees and also for former employees. In the Company's opinion, relying on its legal advisors, the claim is material and regarding at least part of it there are considerable risks. Nevertheless, it is not possible to assess those risks at this stage. A provision deemed suitable by the Company's management was included in the financial statements.
- (35) On January 3, 2002 the Company received a class action together with an application for its recognition as a class action which were filed in the Tel Aviv District Court against the Company and against two cellular companies.

The amount of the class action against the two cellular companies is estimated at about NIS 94 million. No mention is made in the claim to the amount claimed (if any) from the Company, although the plaintiff alleges that the Company must repay customers the costs of disconnected calls which were collected through it to the coffers of the defendants. The plaintiff, who claims to be a subscriber of the Company and of the two cellular companies, alleges that the defendants collect payments in respect of calls in the cellular network which were disconnected due to a malfunction in the network rather than on the initiative of the caller or the call recipient. The plaintiff alleges that such collection for a product which was not supplied is unlawful, constitutes a violation of the provisions of the Consumer Protection Law and the Contracts Law, and even constitutes unjust enrichment.

In the Company's opinion, relying on the legal advisor who is handling the claim on its behalf, at this early stage the chances of the application for recognition cannot be estimated, and if allowed, the chances of the claim itself. No provisions was included in the financial statements in respect of this claim.

- (36) In the matter of the notice of the Accountant General at the Ministry of Finance on the subject of the end of the period of two-year renewable rental of assets, see Note 9B.
- (37) For the income tax and value added tax assessments, see note 11E.
- (38) For possible demand for early repayment of bank loans, see Notes 13D1 and 14C.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

(39) 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 beyond the amounts included in the financial statements.

The amounts of the claims referred to above are adjusted (without interest) in terms of shekels of December 31, 2001.

B. Forward exchange contracts

Consolidated and Company

	<u>Currency receivable</u>	<u>Currency payable</u>	<u>Repayment date</u>	<u>Amounts receivable</u>	<u>Amounts payable</u>
	NIS millions				
Forward exchange contracts					
Commitment to purchase (including accrued interest)	Dollars	NIS	May 2002	1,009	959
	Euro	NIS	December 2003	666	658
Contracts at predetermined interest rates (excluding premium/discount)					
Commitment to sell: . . .	Dollars	NIS	April 2002	79	77
Commitment to purchase:	Euro	NIS	December 2002	557	546
	Linked NIS	NIS	June 2003	595	601

A subsidiary has entered into forward exchange contracts not for a specific hedging purpose, which amount, as at December 31, 2001, to \$28 million.

C. Contracts

Lease Contract Commitments

<u>For the year ended December 31</u>	<u>Consolidated</u> NIS thousands	<u>Company</u> NIS thousands
2002	114,028	70,480
2003	116,911	63,696
2004	103,133	53,533
2005	92,559	46,679
2006	91,169	46,472
2007 and thereafter	411,466	342,133
	<u>929,266</u>	<u>622,993</u>

A subsidiary has contracted for providing maintenance services in the network terminal point field in the amount of approximately NIS 43 million.

D. Securities and liens

For securities, liens and stipulations in connection with loan covenants given by the Company and investee companies, see Notes 13D and Note 14C.

E. Guarantees

1. The Company has guaranteed third parties in the amount of approximately NIS 531,000.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

2. A proportionally consolidated company has given a guarantee to third parties amounting to approximately NIS 214 million, of which about NIS 88 million is in connection with the third generation frequencies tender for cellular telephones.
3. Subsidiaries have guaranteed third parties for approximately NIS 76 million.
4. After the balance sheet date, a subsidiary, Bezeq International Ltd., gave a bank guarantee for \$2 million for fulfillment of the terms of its license, as demanded by the Ministry of Communications.
5. Affiliated companies guaranteed third parties for approximately NIS 55 million. Regarding guarantees to related parties, see Note 28C.

NOTE 21 — SHARE CAPITAL

- A. The share capital consists of ordinary shares of a par value of NIS 1 each. The registered capital is 2,565,000,000 shares. The issued and paid up capital is 2,411,657,538 shares (2000 — 2,411,657,538 shares — after an issue of bonus shares). All the shares are listed on the Tel Aviv Stock Exchange.

The General Meeting which convened on November 23, 2000 resolved to approve the recommendation of the Board of Directors of the Company to increase the registered capital of the Company by NIS 1.6 billion of ordinary shares and to distribute bonus shares in the amount of 1.6 billion shares, so that in respect of each share of a par value of NIS 1, two bonus shares of a par value of NIS 1 each will be distributed. In January 2001 the Ministerial Committee for privatization approved the increase of the registered capital for the purpose of allotment of the bonus shares. The increase and the allotment were implemented during February 2001.

- B. On January 13, 2002 a framework agreement was signed between the State and the Company, whereby capital would be raised by way of a sale of the Company's shares by the State in a private placement, in accordance with Sections 15A and 15C(b) of the Securities Law. Concurrently, the Company will allot to the State an identical number of shares. The maximum quantity of shares is 148,333,334. The consideration in respect of the allotted shares will be the State's receipts less a distributors' commission and 1% to cover expenses. The Company is designating the proceeds for financing the costs involved in the retirement of Company employees.

The price at which the State will sell the shares will be not less than NIS 6 net per share (i.e. after deduction of commissions). The registered share capital which has not been allotted in the issuance by February 28, 2003 or by another date on which the State holds 51.02% of the Company's share capital (at full dilution), whichever is the earlier, will be cancelled.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

NOTE 22 — REVENUES FROM TELECOMMUNICATION SERVICES

Consolidated

	For the year ended December 31		
	2001	2000	1999*
	NIS thousands	NIS thousands	NIS thousands
Revenues from communications services —			
Domestic fixed-line communications	2,400,232	2,561,297	2,789,258
Fixed fees	2,073,959	2,016,679	1,844,673
Cellular telephone ⁽¹⁾	2,071,833	2,175,778	2,877,581
International communications and Internet services . .	784,421	858,299	916,624
Installation and sale of equipment to subscribers . . .	425,538	503,262	485,923
Other	119,163	142,368	143,435
	<u>7,875,146</u>	<u>8,257,683</u>	<u>9,057,494</u>
Other revenues	<u>276,702</u>	<u>262,976</u>	<u>226,252</u>
	<u><u>8,151,848</u></u>	<u><u>8,520,659</u></u>	<u><u>9,283,746</u></u>

Company

	For the year ended December 31		
	2001	2000	1999
	NIS thousands	NIS thousands	NIS thousands
Revenues from communications services —			
Domestic fixed-line communications	2,427,600	2,582,509	2,804,317
Fixed fees	1,962,541	1,908,893	1,692,643
International communications and Internet services . .	327,573	393,942	450,633
Cellular telephone ⁽¹⁾	668,216	854,366	2,011,519
Installation and sale of equipment to subscribers . . .	139,786	214,261	238,694
Other	126,030	146,152	145,761
	<u>5,651,746</u>	<u>6,100,123</u>	<u>7,343,567</u>
Other revenues	<u>242,906</u>	<u>240,260</u>	<u>220,375</u>
	<u><u>5,894,652</u></u>	<u><u>6,340,383</u></u>	<u><u>7,563,942</u></u>

* Reclassified

(1) See Note 1E(1).

Notes to the Financial Statements as at December 31, 2001 (cont'd)

NOTE 23 — OPERATING AND GENERAL EXPENSES

Consolidated

	For the year ended December 31		
	2001	2000	1999*
	NIS thousands	NIS thousands	NIS thousands
Salaries and related expenses	1,917,845	1,699,806	1,694,683
General expenses	733,106	689,907	740,306
Materials and spare parts	508,468	423,994	289,794
Cellular telephone expenses ⁽¹⁾	436,696	516,913	1,384,163
Building maintenance	381,644	394,138	402,284
Services and maintenance by sub-contractors	323,403	403,715	477,337
International communications expenses	199,890	254,603	268,330
Vehicle maintenance expenses	83,298	73,622	66,380
Collection fees	36,643	39,557	42,707
	<u>4,620,993</u>	<u>4,496,255</u>	<u>5,365,984</u>
Less — salaries charged to investment in fixed assets	153,447	152,045	162,123
	<u>4,467,546</u>	<u>4,344,210</u>	<u>5,203,861</u>

Company

	For the year ended December 31		
	2001	2000	1999*
	NIS thousands	NIS thousands	NIS thousands
Salaries and related expenses	1,517,758	1,331,160	1,412,647
General expenses	284,463	236,942	259,727
Materials and spare parts	63,005	48,898*	76,546*
Cellular telephone expenses ⁽¹⁾	86,429	307,106	1,518,275
Building maintenance	334,060	348,738	359,140
Services and maintenance by sub-contractors	269,762	336,190*	396,700*
International communications expenses	9,693	12,316	19,015
Vehicle maintenance expenses	69,307	63,291	60,780
Collection fees	36,312	39,328	42,048
	<u>2,670,789</u>	<u>2,723,969</u>	<u>4,144,878</u>
Less — salaries charged to investment in fixed assets	153,447	152,045	162,123
	<u>2,517,342</u>	<u>2,571,924</u>	<u>3,982,755</u>

* Reclassified

(1) See Note 1E(1)

Notes to the Financial Statements as at December 31, 2001 (cont'd)

NOTE 24 — FINANCING EXPENSES, NET

Consolidated

	For the year ended December 31		
	2001	2000	1999
	NIS thousands	NIS thousands	NIS thousands
Financing expenses in respect of a debenture issued to the State of Israel	—	4,950	56,850
Expenses in respect of long-term liabilities*			
Debentures	186,232	120,440	83,833
Loans	<u>302,708</u>	<u>174,846</u>	<u>215,986</u>
	488,940	300,236	356,669
Income in respect of deposits and investments ..	(186,110)	(66,930)	(74,643)
Expenses (income) in respect of forward exchange contracts	(116,415)	103,664	112,749
Short-term bank credit	33,651	36,273	15,183
Interest income from income tax	(78,533)	(6,749)	(3,398)
Other expenses (income), net.....	<u>2,543</u>	<u>(18,425)</u>	<u>(41,413)</u>
	<u>144,076</u>	<u>348,069</u>	<u>365,147</u>
(*) Includes appreciation (net of erosion) in respect of liabilities in foreign currency	<u>158,221</u>	<u>(50,711)</u>	<u>(33,745)</u>

Company

	For the year ended December 31		
	2001	2000	1999
	NIS thousands	NIS thousands	NIS thousands
Financing expenses in respect of a debenture issued to the State of Israel	—	4,950	56,850
Expenses in respect of long-term liabilities*			
Debentures	186,232	120,440	83,833
Loans	<u>266,128</u>	<u>155,707</u>	<u>196,547</u>
	452,360	281,097	337,230
Income in respect of deposits and investments ..	(184,597)	(66,930)	(74,643)
Expenses (income) in respect of forward exchange contracts	(110,520)	103,664	112,749
Interest income from income tax	(78,533)	(6,749)	(3,398)
Other expenses (income), net.....	<u>(5,955)</u>	<u>(12,595)</u>	<u>(2,109)</u>
	<u>72,755</u>	<u>298,487</u>	<u>369,829</u>
(*) Includes appreciation (net of erosion) of liabilities in foreign currency	<u>158,221</u>	<u>(47,668)</u>	<u>(35,827)</u>

Notes to the Financial Statements as at December 31, 2001 (cont'd)

NOTE 25 — OTHER EXPENSES, NET

Consolidated

	For the year ended December 31		
	2001	2000	1999
	NIS thousands	NIS thousands	NIS thousands
Provision for employee severance benefits upon early retirement (Note 16D)	—	(1,466,849)	(403,954)
Compensation (provision) in respect of billing system	—	100,528	(128,559)
Provision for claims for salary and pension components	—	(50,705)	—
Provision update for unutilized sick leave	—	—	9,905
Provision and decrease in value of fixed assets	(102,026)	(11,168)	—
Direct expenses for the customer allocation process	(1,478)	(28,080)	(76,626)
Capital gains, net	8,705	1,360	16,622
Capital gain from sale of an affiliated company ⁽¹⁾	—	140,692	—
Cancellation of provision for a guarantee for an affiliated company	—	23,634	15,129
Loss in respect of decrease in holding in an affiliated company	(3,480)	—	—
Others	(2,273)	(4)	1,154
	<u>(100,552)</u>	<u>(1,290,592)</u>	<u>(566,329)</u>

Company

	For the year ended December 31		
	2001	2000	1999
	NIS thousands	NIS thousands	NIS thousands
Provision for employee severance benefits upon early retirement (Note 16D)	—	(1,466,849)	(403,954)
Compensation (provision) for billing system	—	100,528	(128,559)
Provision for claims for salary and pension components	—	(50,705)	—
Provision update for unutilized sick leave	—	—	9,905
Capital gains (losses), net	(2,502)	2,694	17,700
Capital gain from sale of an affiliated company ⁽¹⁾	—	140,692	—
Cancellation of provision for a guarantee for an affiliated company	—	23,634	15,129
Others	—	(227)	205
	<u>(2,502)</u>	<u>(1,250,233)</u>	<u>(489,574)</u>

(1) In 2000, the Company signed an agreement for the sale and transfer of the Company's holdings in an affiliated company. By December 31, 2000, the Company had received the full consideration for the sale of its holdings.

NOTE 26 — EARNINGS PER SHARE (CONSOLIDATED AND COMPANY)

	For the year ended December 31		
	2001	2000	1999
	NIS thousands	NIS thousands	NIS thousands
Primary and diluted earnings (loss)	<u>121,302</u>	<u>(551,999)</u>	<u>20,610</u>
Weighted number of shares in primary earnings and diluted earnings	<u>2,411,658</u>	<u>2,411,658</u>	<u>2,411,658</u>

Notes to the Financial Statements as at December 31, 2001 (cont'd)

NOTE 27 — 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 operations segments of those companies.

Consolidated

	For the year ended December 31, 2001					
	<u>Fixed-line domestic communications</u>	<u>Cellular telephone</u>	<u>International communications</u>	<u>Others</u>	<u>Adjustments</u>	<u>Consolidated</u>
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues						
Revenues from external sources	5,556,959	1,778,608	657,686	158,595	—	8,151,848
Inter-segment revenues ..	337,693	6,051	11,146	21,660	(376,550)	—
Total revenues	<u>5,894,652</u>	<u>1,784,659</u>	<u>668,832</u>	<u>180,255</u>	<u>(376,550)</u>	<u>8,151,848</u>
Segment results	<u>1,036,958</u>	<u>(181,314)</u>	<u>(40,131)</u>	<u>1,248</u>	<u>617</u>	817,378
Financing expenses						<u>144,076</u>
Earnings after financing expenses						673,302
Other expenses, net						<u>(100,552)</u>
Earnings before income tax						572,750
Income tax						<u>(230,592)</u>
Earnings after income tax						342,158
Equity in losses of affiliated companies ...	28,459			(255,716)		(227,257)
Minority equity in losses of a consolidated company	6,220					<u>6,220</u>
Net earnings						<u>121,121</u>
Identified assets	11,144,316	2,082,631	580,965	123,319	(57,183)	13,874,048
Investment by equity method	126,796			334,271		461,067
General assets						<u>2,821,588</u>
Total consolidated assets						<u>17,156,703</u>
Segment liabilities	1,457,284	742,812	292,059	53,474	(56,476)	2,489,153
General liabilities						<u>7,486,919</u>
Total consolidated liabilities						<u>9,976,072</u>
Capital investments	<u>797,756</u>	<u>485,618</u>	<u>118,278</u>	<u>8,231</u>		
Depreciation and amortization	<u>2,151,037</u>	<u>707,206</u>	<u>75,834</u>	<u>5,100</u>		

Notes to the Financial Statements as at December 31, 2001 (cont'd)

Consolidated

For the year ended December 31, 2000						
	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 external sources	5,995,268	1,691,328	676,658	157,405	—	8,520,659
Inter-segment revenues ..	345,115	53,996	4,497	31,272	(434,880)	—
Total revenues	6,340,383	1,745,324	681,155	188,677	(434,880)	8,520,659
Segment results	1,286,795	(29,319)	(150,984)	12,459	165	1,119,116
Financing expenses						348,069
Earnings after financing expenses						771,047
Other expenses, net						(1,290,592)
Loss before income tax ..						(519,545)
Tax benefit						155,484
Loss after income tax						(364,061)
Equity in losses of affiliated companies ...	(12,266)			(185,644)		(197,910)
Minority equity in losses of a consolidated company						4,962
Net loss						(557,009)
Identified assets	12,472,474	2,326,407	543,973*	90,423	(56,219)	15,377,058
Investment by equity method	101,883			73,227		175,110
General assets						1,557,432
Total consolidated assets						17,109,600
Segment liabilities	2,486,467	937,760	408,151*	50,085	(54,353)	3,828,110
General liabilities						6,222,003
Total consolidated liabilities						10,050,113
Capital investments	1,024,945	827,854	131,687	8,272		
Depreciation and amortization	2,277,958	537,436	75,456	4,508		

* Reclassified

Notes to the Financial Statements as at December 31, 2001 (cont'd)

Consolidated

	For the year ended December 31, 1999					
	<u>Fixed-line domestic communications</u>	<u>Cellular telephone</u>	<u>International communications</u>	<u>Others</u>	<u>Adjustments</u>	<u>Consolidated</u>
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues						
Revenues from external sources	7,228,434	1,176,202	719,930	159,180	—	9,283,746*
Inter-segment revenues ..	335,509	332,591	9,550	27,870	(705,520)	—
Total revenues	<u>7,563,943</u>	<u>1,508,793</u>	<u>729,480</u>	<u>187,050</u>	<u>(705,520)</u>	<u>9,283,746</u>
Segment results	<u>1,044,412</u>	<u>64,465</u>	<u>(60,615)</u>	<u>14,855</u>	<u>(48,104)</u>	1,015,013
Financing expenses						<u>(365,147)</u>
Earnings after financing expenses						649,866
Other expenses, net						<u>(566,329)</u>
Earnings before income tax						83,537
Income tax						<u>(60,506)</u>
Earnings after income tax						23,031
Equity in losses of affiliated companies ...	5,458			(27,312)		<u>(21,854)</u>
Earnings before cumulative effect of the change in accounting method						1,177
Cumulative effect, net, of change in accounting method as at beginning of year		7,123				<u>7,123</u>
Net earnings						<u>8,300</u>
Identified assets	13,009,625	1,922,987	740,450	95,423	(61,229)	15,707,256
Investment by equity method	49,313			27,249		76,562
General assets						<u>1,268,307</u>
Total consolidated assets						<u>17,052,125</u>
Segment liabilities	1,453,707	527,760	390,525	53,608	(90,795)	2,334,805
General liabilities						<u>7,120,044</u>
Total consolidated liabilities						<u>9,454,849</u>
Capital investments	<u>1,079,165</u>	<u>782,731</u>	<u>106,832</u>	<u>7,393</u>		
Depreciation and amortization	<u>2,325,632</u>	<u>442,206</u>	<u>48,853</u>	<u>3,766</u>		

* Reclassified

NOTE 28 — 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. (The exemption in respect of 2001 is dated January 2, 2002.)

Notes to the Financial Statements as at December 31, 2001 (cont'd)

- B.** The Company provides services to the Israeli Defense and Security Forces in accordance with terms agreed 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 which arose between the Company and the Ministry of Defense in connection with the terms of the services which 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 these:

- (1) The balance of the accounting between the Company and the Ministry of Defense for the first half of 1996 amounts to approximately NIS 355 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 between the Company and its other customers. 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.

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.

The Company and the Ministry of Defense are negotiating a revised arrangement of their commercial relations.

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 2.6 million.

In connection with guarantees given by the Company in respect of its investments in India, see Note 20A (29).

In connection with an additional guarantee in respect of the Company's investments in D.B.S. Satellite Services (1998) Ltd., see Note 8F.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

D. Transactions with investee companies (Company books)

	For the year ended December 31		
	2001	2000	1999
	NIS thousands	NIS thousands	NIS thousands
Revenues —			
Interconnect and access fees	274,741	301,907	425,247
Services, royalties and commissions	318,264	203,805	70,720
Rent and usage fees for buildings and equipment	40,813	9,920	909
Interest	6,531	—	—
Expenses —			
Purchase of services	34,245	144,879	681,994
Interest	—	—	14,836
Total earnings (losses) from fixed asset transactions	—	(450)	977
Total transaction turnover	—	576	1,612

Transactions with a proportionally consolidated company were presented in full (100%).

For balances with subsidiaries and a proportionally consolidated company, see relevant notes.

E. Benefits for directors and the CEO

	For the year ended December 31		
	2001	2000	1999
	NIS thousands	NIS thousands	NIS thousands
Total cost of compensation of the CEO and the Chairman of the Board	1,443	1,189	1,533
Number of employees	2	2	3
Compensation of members of the Board of Directors who are not Company employees*	1,344	1,401	1,261
Number of directors receiving compensation . . .	19	17	13

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

The Company holds an insurance policy for the directors and officers of the Company. The maximum insurance is \$150 million per event and per period (of 12 months), and up to an additional \$30 million for legal expenses in Israel. In addition, the Company will indemnify directors and officers in an amount not exceeding \$50 million per director and 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 29 — 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 2,063 million, of which the excess of current liabilities over current assets was approximately NIS 406 million. The excess of current liabilities is partially covered by forward exchange contracts, as described in Note 20B. The Group has revenues in foreign currency from international communications.

As at December 31, 2001, the excess of CPI-linked monetary liabilities over CPI-linked monetary assets amounted to approximately NIS 1,728 million, of which the excess of current liabilities over current assets was approximately NIS 435 million. As stated in Note 1B, most of the Company's tariffs are subject to government regulation and are

Notes to the Financial Statements as at December 31, 2001 (cont'd)

revised from time to time in accordance with the increase in the CPI, net of an efficiency factor.

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

Regarding the Company's commitments to execute forward exchange contracts, at December 31, 2001 — see Note 20B.

B. Credit risks

Most of the cash and cash equivalents, at December 31, 2001, as well as bank deposits, are deposited in large Israeli banks. Short-term investments represent, primarily, investments in government debentures and bank deposits, while a small part is invested in debentures of companies trading on the 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, customers, 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 their estimated fair value, as detailed below.

	December 31, 2001	
	Book value	Fair value
	NIS thousands	NIS thousands
Debtentures:		
Issued to the public	1,365,693	1,405,887
Issued to others	1,345,294	1,323,256
CPI-linked loans	812,139	767,195
Unlinked loans	386,540	324,367
Foreign currency loans	1,803,936	2,032,667

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

Notes to the Financial Statements as at December 31, 2001 (cont'd)

NOTE 30 — LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 2001

Consolidated

	In or linked to foreign currency			CPI-linked	Unlinked NIS thousands	Total
	Dollar-linked NIS thousands	Euro-linked NIS thousands	Other			
Assets						
Cash and cash equivalents . . .	40,583	1,020	—	102	1,261,295	1,303,000
Short-term investments	16,983	—	—	151,510	272,161*	440,654
Trade receivables	30,321	—	—	5,291	1,651,600	1,687,212
Other receivables and debit balances	57,890	22,541	—	5,386	18,641	104,458
Long-term deposits and debit balances	<u>1,106,871</u>	<u>7,880</u>	<u>—</u>	<u>215,453</u>	<u>270,414</u>	<u>1,600,618</u>
	<u>1,252,648</u>	<u>31,441</u>	<u>—</u>	<u>377,742</u>	<u>3,474,111</u>	<u>5,135,942</u>
Liabilities						
Short-term bank credit	35,510	—	—	—	388,056	423,566
Current maturities of long- term liabilities	198,720	—	—	414,927	130,000	743,647
Trade payables	279,933	421	6,370	—	731,960	1,018,684
Other current liabilities	17,630	35,838	—	182,107	873,154	1,108,729
Long-term loans	1,605,216	1,366	—	650,598	256,740	2,513,920
Other long-term debentures	—	1,166,104	—	858,052	500,110	2,524,266
Employee severance benefits	—	—	—	—	1,538,858	1,538,858
	<u>2,137,009</u>	<u>1,203,729</u>	<u>6,370</u>	<u>2,105,684</u>	<u>4,418,878</u>	<u>9,871,670</u>

Company

	In or linked to foreign currency			CPI-linked	Unlinked NIS thousands	Total
	Dollar-linked NIS thousands	Euro-linked NIS thousands	Other			
Assets						
Cash and cash equivalents . . .	18,045	1,020	—	—	1,251,301	1,270,366
Short-term investments	15,317	—	—	148,155	261,150*	424,622
Trade receivables	5,413	—	—	—	1,140,131	1,145,544
Other receivables and debit balances	54,942	22,541	—	1,450	5,680	84,613
Long-term deposits and debit balances	<u>1,106,871</u>	<u>7,880</u>	<u>—</u>	<u>201,422</u>	<u>223,434</u>	<u>1,539,607</u>
	<u>1,200,588</u>	<u>31,441</u>	<u>—</u>	<u>351,027</u>	<u>2,881,696</u>	<u>4,464,752</u>
Liabilities						
Current maturities of long- term liabilities	198,720	—	—	355,025	—	553,745
Trade payables	18,548	421	6,370	—	545,188	570,527
Other current liabilities	17,631	35,838	—	137,544	732,479	923,492
Long-term loans	1,605,216	1,366	—	366,953	—	1,973,535
Other long-term debentures	—	1,166,104	—	858,052	500,110	2,524,266
Employee severance benefits	—	—	—	—	1,528,025	1,528,025
	<u>1,840,115</u>	<u>1,203,729</u>	<u>6,370</u>	<u>1,717,574</u>	<u>3,305,802</u>	<u>8,073,590</u>

* Including mutual fund participation certificates of approximately NIS 170,000 consolidated, and NIS 167,000 for the Company.

For details of forward exchange contracts for covering exposure to foreign currency, see Note 20B.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

Consolidated

	In or linked to foreign currency		CPI-linked	Unlinked	Total
	Dollar-linked*	Euro-linked*			
	NIS thousands				
Assets					
Cash and cash equivalents	122,905	609,182	—	822,399	1,554,486
Short-term investments	12,359	—	90,752	87,913	191,024
Trade receivables	46,174	—	4,597	1,241,358	1,292,129*
Other receivables and debit balances	—	18,892	225,963	28,587	273,442
Long-term deposits and debit balances	—	—	9,998	259,771	269,769
	<u>181,438</u>	<u>628,074</u>	<u>331,310</u>	<u>2,440,028</u>	<u>3,580,850</u>
Liabilities					
Short-term bank credit	19,274	—	—	726,229	745,503
Current maturities of long-term liabilities	153,673	—	456,991	—	610,664
Trade payables	329,079	—	—	632,562	961,641*
Other current liabilities	42,309	30,298	79,077	778,011*	929,695*
Long-term loans	1,886,048	—	940,305	38,243	2,864,596
Other long-term debentures	—	1,137,680	1,044,726	—	2,182,406
Employee severance benefits	—	—	—	1,624,799*	1,624,799*
	<u>2,430,383</u>	<u>1,167,978</u>	<u>2,521,099</u>	<u>3,799,844</u>	<u>9,919,304</u>

Company

	In or linked to foreign currency		CPI-linked	Unlinked	Total
	Dollar-linked*	Euro-linked*			
	NIS thousands				
Assets					
Cash and cash equivalents	120,312	609,182	—	813,797	1,543,291
Short-term investments	10,843	—	88,567	71,339	170,749
Trade receivables	1,798	—	—	736,817	738,615
Other receivables and debit balances	—	18,892	189,414	13,640	221,946
Long-term deposits and debit balances	—	—	—	223,644	223,644
	<u>132,953</u>	<u>628,074</u>	<u>277,981</u>	<u>1,859,237</u>	<u>2,898,245</u>
Liabilities					
Current maturities of long-term liabilities	153,673	—	396,052	—	549,725
Trade payables	16,027	—	—	456,435	472,462
Other current liabilities	42,309	30,298	79,077	606,414*	758,098*
Long-term loans	1,886,048	—	552,572	—	2,438,620
Other long-term debentures	—	1,137,680	1,044,726	—	2,182,406
Employee severance benefits	—	—	—	1,620,465*	1,620,465*
	<u>2,098,057</u>	<u>1,167,978</u>	<u>2,072,427</u>	<u>2,683,314</u>	<u>8,021,776</u>

* Reclassified

For details of forward exchange contracts for covering exposure to foreign currency, see Note 20B.

Notes to the Financial Statements as at December 31, 2001 (cont'd)

NOTE 31 — CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN NOMINAL VALUES

A. Balance sheets

	December 31 2001	December 31 2000
	NIS thousands	NIS thousands
Assets		
Current assets	3,093,366	2,804,982
Materials and spare parts	151,239	184,983
Long-term deposits and debit balances	1,619,378	244,027
Investment in investee companies	1,481,849	1,143,339
Fixed assets	6,374,488	7,097,316
Other assets	950,966	1,492,624**
	<u>13,671,286</u>	<u>12,967,271</u>
Liabilities		
Current	2,341,098	2,126,776*
Long-term	5,833,124	5,898,875*
	<u>8,174,222</u>	<u>8,025,651</u>
Convertible debentures	—	68,092
Shareholders' equity	5,497,064	4,873,528**
	<u>13,671,286</u>	<u>12,967,271</u>

* Reclassified

** Restated

B. Statements of operations

	For the year ended December 31		
	2001	2000	1999
	NIS thousands	NIS thousands	NIS thousands
Revenues from telecommunications services ...	5,875,892	6,237,202	7,369,982
Costs and expenses			
Operating and general expenses	2,503,376	2,531,190	3,883,844
Depreciation	1,466,867	1,482,947	1,422,078
Royalties to the Government of Israel	188,853	204,058	205,769
	<u>4,159,096</u>	<u>4,218,195</u>	<u>5,511,691</u>
Operating income	1,716,796	2,019,007	1,858,291
Financing expenses, net	(117,455)	(289,522)	(416,655)
Earnings after financing expenses	1,599,341	1,729,485	1,441,636
Other expenses, net	(18,193)	(1,227,500)	(464,378)
Earnings before income tax	1,581,148	501,985	977,258
Income tax	(577,431)	(77,418)*	(303,260)*
Earnings after income tax	1,003,717	424,567	673,998
Equity in losses of investee companies	(447,964)	(364,188)	(48,562)
Net earnings	<u>555,753</u>	<u>60,379</u>	<u>625,436</u>

* Restated

Notes to the Financial Statements as at December 31, 2001 (cont'd)

C. Statement of Changes in Shareholders' Equity

	Share capital	Capital reserves	Retained earnings (loss)	Total
	NIS thousands			
Balance as at January 1, 1999	765,784	3,030,698	320,181*	4,116,663
Net earnings	—	—	625,436*	625,436
Dividend in respect of preceding year	—	—	(301,565)	(301,565)
Conversion of convertible debentures	17,607	169,820	—	187,427
Balance as at December 31, 1999	783,391	3,200,518	644,052	4,627,961
Net earnings	—	—	60,379*	60,379
Tax benefit for shares to employees	—	21,841	—	21,841
Capitalization of undesignated earnings to a reserve fund for the distribution of bonus shares	—	1,600,000	(1,600,000)	—
Conversion of convertible debentures	14,590	148,757	—	163,347
Balance as at December 31, 2000	797,981	4,971,116	(895,569)	4,873,528
Net earnings	—	—	555,753	555,753
Conversion of convertible debentures	5,905	61,878	—	67,783
Distribution of bonus shares	1,607,772	(1,600,000)	(7,772)	—
Balance as at December 31, 2001	<u>2,411,658</u>	<u>3,432,994</u>	<u>(347,588)</u>	<u>5,497,064</u>

* Restated

D. Restatement

The Company adjusted its nominal financial statements by way of restatement, in order to reflect therein, retroactively, amendment of the accounting treatment in generating deferred tax in respect of fixed assets.

(1) Effect on the balance sheet as at December 31, 2000:

	As previously reported	Effects of restatement	As reported in these financial statements
	NIS thousands	NIS thousands	NIS thousands
Other assets	864,730	627,894	1,492,624
Shareholders' equity	4,245,634	627,894	4,873,528

(2) Effect on net earnings:

	For the year ended December 31	
	2000	1999
	NIS thousands	NIS thousands
Net earnings as previously reported	351,559	973,151
Effect of restatement:		
Increase in income tax	(291,180)	(347,715)
	<u>60,379</u>	<u>625,436</u>

Notes to the Financial Statements as at December 31, 2001 (cont'd)

NOTE 32 — CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND TELEPHONE COMMUNICATIONS LTD. AND ITS SUBSIDIARY

1. *Bezeq International Ltd.*

A. Balance sheets

	December 31 2001	December 31 2000
	NIS thousands	NIS thousands
Current assets	163,734	170,549*
Investments	8,557	38,706
Fixed assets	405,713	364,763
Other assets	<u>15,540</u>	<u>18,457</u>
	<u>593,544</u>	<u>592,475</u>
Current liabilities	324,059	406,450*
Long-term liabilities	193,346	33,203
Quasi-capital receipt	160,712	160,712
Shareholders' deficit	<u>(84,573)</u>	<u>(7,890)</u>
	<u>593,544</u>	<u>592,475</u>

B. Statements of operations

	For the year ended December 31		
	2001	2000	1999
	NIS thousands	NIS thousands	NIS thousands
Revenues from international communications services	668,832	681,174	729,583
Operating expenses	<u>494,288</u>	<u>564,958*</u>	<u>603,125</u>
Gross profit	<u>174,544</u>	<u>116,216</u>	<u>126,458</u>
Marketing expenses	121,850	167,724	112,996
General and administration expenses	<u>92,825</u>	<u>99,481*</u>	<u>74,080</u>
	<u>214,675</u>	<u>267,205</u>	<u>187,076</u>
Operating loss	(40,131)	(150,989)	(60,618)
Financing income (expenses), net	<u>(10,849)</u>	<u>(3,223)</u>	<u>36,585</u>
Loss after financing	(50,980)	(154,212)	(24,033)
Other income (expenses), net	<u>3,984</u>	<u>(40,277)</u>	<u>(78,633)</u>
Loss before income tax	(46,996)	(194,489)	(102,666)
Tax benefit (income tax)	<u>(3,018)</u>	<u>(1,643)</u>	<u>9,130</u>
Loss after income tax	(50,014)	(196,132)	(93,536)
Company's equity in losses of investee company	<u>(26,669)</u>	<u>(10,606)</u>	<u>—</u>
Net loss	<u>(76,683)</u>	<u>(206,738)</u>	<u>(93,536)</u>

* Reclassified

Notes to the Financial Statements as at December 31, 2001 (cont'd)

2. Pelephone Communications Ltd.

A. Balance sheet

	Consolidated	
	December 31 2001	December 31 2000
	NIS thousands	NIS thousands
Current assets	1,098,689	1,145,886
Long-term trade receivables	93,960	72,259
Investment in investee company	—	1,460
Deferred taxes	180,210	—
Fixed assets	2,522,947	2,903,319
Other assets, net	<u>594,674</u>	<u>688,998</u>
	<u>4,490,480</u>	<u>4,811,922</u>
Current liabilities	1,842,310	2,113,047
Provision for losses of investee company	3,725	—
Long-term liabilities	1,009,687	804,724
Shareholders' equity	<u>1,634,758</u>	<u>1,894,151</u>
	<u>4,490,480</u>	<u>4,811,922</u>

B. Statements of Operations for the year ended December 31

	Consolidated		Company
	2001	2000	1999
	NIS thousands	NIS thousands	NIS thousands
Revenues from cellular services, sales and services	3,569,317	3,490,648	3,017,057
Cost of cellular services, sales and services	<u>3,177,273</u>	<u>2,916,869</u>	<u>2,424,124</u>
Gross profit	392,044	573,779	592,933
Sales and marketing expenses	507,889	454,704	289,249
General and administration expenses	221,509	202,946	186,266
	<u>729,398</u>	<u>657,650</u>	<u>475,515</u>
Operating income (loss)	(337,354)	(83,871)	117,418
Financing expenses, net	(123,192)	(99,382)	(66,672)
Other income (expenses), net	<u>(203,710)</u>	<u>1,739</u>	<u>528</u>
Earnings (loss) before income tax	(664,256)	(181,514)	51,274
Tax benefit (income tax)	228,035	52,166	(25,526)
Earnings (loss) after income tax	(436,221)	(129,348)	25,748
Minority equity in losses of a subsidiary	12,440	9,928	—
Company equity in losses of investee companies	<u>(7,658)</u>	<u>(11,077)</u>	<u>(4,034)</u>
Earnings (loss) before cumulative effect of change in accounting method	(431,439)	(130,497)	21,714
Cumulative effect, net, of change in accounting method as at beginning of year	—	—	14,245
Net earnings (loss)	<u>(431,439)</u>	<u>(130,497)</u>	<u>35,959</u>

APPENDIX A—LIST OF GROUP COMPANIES

	Percent of control and ownership as at	
	December 31, 2001 %	December 31, 2000 %
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
Bezeq On Line Ltd. ⁽³⁾	100	100
Proportionally Consolidated Companies		
Telephone Communications Ltd.	50	50
GoNext Ltd. ⁽⁴⁾	26	26
Affiliated Companies		
Stage One Venture Capital Fund (Israel) L.P. (an Israeli Limited Partnership) (hereinafter — the Fund) ⁽⁵⁾	100	—
Stage One Capital Investments L.P. (an Israeli Limited Partnership) (hereinafter — SOCI) ⁽⁵⁾	27	—
The International Company for Underwater Cables Ltd. ⁽⁶⁾	50	50
Goldnet Communications Services — registered partnership ⁽⁷⁾	49	49
Aphrodite B.V. Amsterdam ⁽⁸⁾	67	67
Emitel Telecommunication Corp. Ltd. (Hungary) ⁽⁸⁾	—	33
D.B.S. Satellite Services (1998) Ltd. ⁽⁹⁾	30	30
Infogate Online Ltd. ⁽¹⁰⁾	29	29
Safe Com-Car Communication (hereinafter — Safe-Car) ⁽¹¹⁾	—	—
Eden Telecom Ltd. ⁽¹¹⁾	23	—
Walla! Communications Ltd. ⁽¹²⁾	25	38.5
Adanet for Business Group Ltd. ⁽¹³⁾	50	23
Companies that are not investees		
Comfynet Ltd.	17	—
Xpert Integrated Systems Ltd. ⁽¹⁴⁾	16	—
Personeta Inc.	4	—
Exent Ltd.	6	11
Atrica Inc.	1	—
Venture Capital Funds		
Eurofund 2000 L.P.	14	14
B.R.M. Capital Fund L.P.	3	4

- (1) Commencing July 1, 1997, the operations of both companies were merged and BezeqCall Ltd. ceased operations.
- (2) The company ceased to operate on July 1, 1998. In 2000 the company decided on voluntary liquidation. The liquidation was approved by the Ministerial Committee for Privatization, and a liquidator was appointed.
- (3) The company was founded in December 2000 and started operations in 2001.
- (4) On March 16, 2000, Telephone Communications Ltd. signed an agreement for the establishment of GoNext Ltd. ("GoNext"). The activities of GoNext focus primarily on setting up a mobile Internet portal. Telephone holds 51% of the shares of GoNext. The consolidated financial statements include consolidation of the financial statements of GoNext, in which control is held by Telephone.
- (5) The fund is a venture capital fund managed by SOCI. The Company undertook to invest the sum of \$20 million in the fund, of which approximately \$3 million was invested during the year.
- (6) 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 resolved upon voluntary liquidation as of March 31, 1999.
- (7) Under the agreement between the partners, in 2000 the Company increased its investment in the partnership to 49%. In addition, under the agreement, the Company has an option to increase its share in the partnership by another 5%. Furthermore, the Company has an option to increase its share in the partnership up to an additional 20%, while the other partners have an option to obligate the Company to increase its share as aforesaid. The option is valid until March 31, 2003.
- (8) See Note 8E.

- (9) See Note 8F.
- (10) The company is developing and supplying data communication services under the ASP concept, in which computers are linked in a broadband network to a central server from which various services are received.
- (11) In October 2000 an agreement was signed between Pelephone Communications Ltd. and the other shareholders in Safe-Car Communication Ltd. ("Safe-Car"), and Eden Telecom Ltd. ("Eden") and its shareholders, whereby the operations of Safe-Car were merged with the operations of Eden by a transfer of net assets from Safe-Car to Eden. After the merger, Pelephone holds 22.95% of Eden. The main business of Eden is the locating of vehicles, similar to the business of Safe-Car. Until October 2000, Pelephone held 51% of Safe-Car. The financial statements of Safe-Car were not consolidated since Pelephone did not own a controlling or joint controlling interest, pursuant to the establishment agreement of the company, which stipulates that significant resolutions require a 75% majority.
- (12) See Note 8G.
- (13) See Note 8H.
- (14) In the report period, the Company invested approximately NIS 40 million in Xpert Integrated Systems Ltd. ("Xpert"), in consideration of 16.26% of the capital of that company, as well as options which will enable it to increase its holdings to 20.33% (15.98% at full dilution). Xpert is an Israeli company involved mainly in the construction and integration of IP networks.

APPENDIX B

DBS SATELLITE SERVICES (1998) LTD.

2001 ANNUAL REPORT

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AUDITORS' REPORT

To the shareholders of

DBS SATELLITE SERVICES (1998) LTD.

We have audited the balance sheets of DBS Satellite Services (1998) Ltd. (hereafter — the Company) as of December 31, 2001 and 2000 and the related statements of operations, changes in capital deficiency and cash flows for each of the two years in the period ended December 31, 2001 and for the period from the date of incorporation (December 2, 1998; see note 1a(1)) to December 31, 1999. These financial statements are the responsibility of the Company's board of directors and management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in Israel, including those prescribed by the Israeli Auditors (Mode of Performance) Regulations, 1973. Those standards require that we plan and perform the audit to obtain reasonable assurances about whether 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 significant estimates made by the board of directors and management of the Company, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2001 and 2000 and the results of its operations, the changes in its capital deficiency and its cash flows for each of the two years in the period ended December 31, 2001 and for the period from the date of incorporation (December 2, 1998) to December 31, 1999, in conformity with accounting principles generally accepted in Israel. Furthermore, in our opinion, the financial statements referred to above are prepared in accordance with the Israeli Securities (Preparation of Annual Financial Statements) Regulations, 1993.

As explained in note 1b, the financial statements referred to above are presented in values adjusted for the changes in the general purchasing power of Israeli currency, in accordance with pronouncements of the Institute of Certified Public Accountants in Israel.

Without qualifying our opinion, we draw attention to note 1a(2) regarding the financial position of the Company, the non-compliance with certain terms specified in the financing agreement between the Company and banks. As explained in the abovementioned note, the Company's activity depends on the continued execution of the financing agreement, increase of the credit facilities provided by banks and the receipt of additional loans from shareholders. Management's opinion as to the chances of achieving the required financing arrangements is presented in note 1a(2)d.

Tel Aviv
March 25, 2002

Balance Sheets
In adjusted NIS

	Note	December 31	
		2001	2000
		In thousands	
Assets			
Current assets:	10		
Cash and cash equivalents	9	21	428
Accounts receivable:			
Trade	11a	56,967	4,016
Other		29,831	43,454
Total current assets		86,819	47,898
Broadcasting rights:	1d;11e		
Cost		286,574	218,780
Less — utilized rights		64,300	32,869
		222,274	185,911
Fixed assets:	2		
Cost		1,494,063	952,604
Less — accumulated depreciation		256,659	56,508
		1,237,404	896,096
License fees — advance on account of royalties	3	26,192	30,192
		1,572,689	1,160,097
Liabilities, net of capital deficiency			
Current liabilities:	9		
Bank credit	11b	882,510	499,504
Accounts payable and accruals:	11c		
Trade		519,551	485,131
Other		29,977	36,612
Total current liabilities		1,432,038	1,021,247
Long-term liabilities:			
Shareholders' loans	5	1,568,546	774,435
Liability for employee rights upon retirement — net	4	1,151	
Customer deposits	1h	19,241	189
Other liabilities	11d	27,110	
Total long-term liabilities		1,616,048	774,624
Commitments and contingent liabilities	6		
Total liabilities		3,048,086	1,795,871
Capital deficiency		(1,475,397)	(635,774)
		1,572,689	1,160,097

Date of approval of the financial statements: March 25, 2002

Oren Lider
Member of the Board
of Directors

Shlomo Liran
Chief Executive Officer

David Brodet
Chairman of the Board
of Directors

The accompanying notes are an integral part of the financial statements.

Statements of Operations
In adjusted NIS

	<u>Note</u>	<u>2001</u>	<u>2000</u>	<u>Period from December 2, 1998 (see note 1a(1)), to December 31, 1999</u>
			In thousands	
Revenues		305,717	26,651	
Operating expenses	11f	<u>707,644</u>	<u>*262,945</u>	
Gross loss		401,927	236,294	
Selling, marketing, general and administrative expenses:	11g			
Selling and marketing		189,048	*166,249	19,144
General and administrative		<u>153,757</u>	<u>*125,644</u>	<u>61,295</u>
Loss from ordinary operations		744,732	528,187	80,439
Financial expenses, net	11h	<u>94,891</u>	<u>23,278</u>	<u>3,880</u>
Loss for the period		<u><u>839,623</u></u>	<u><u>551,465</u></u>	<u><u>84,319</u></u>

*Reclassified.

The accompanying notes are an integral part of the financial statements.

Statements of Changes in Capital Deficiency
In Adjusted NIS

	<u>Share capital</u>	<u>Receipts on account of shares</u>	<u>Accumulated deficit</u>	<u>Total</u>
	In thousands			
Changes during the period from December 2, 1998 (see note 1a(1)) to December 31, 1999:				
Issue of share capital	*			*
Receipts on account of shares to be allotted		1		1
Loss			(84,319)	(84,319)
Balance at December 31, 1999	*	1	(84,319)	(84,318)
Changes during 2000:				
Issue of share capital	10	(1)		9
Loss			(551,465)	(551,465)
Balance at December 31, 2000	10	—	(635,784)	(635,774)
Changes during 2001 — loss			(839,623)	(839,623)
Balance at December 31, 2001	<u>10</u>	<u>—</u>	<u>(1,475,407)</u>	<u>(1,475,397)</u>

* Represents an amount of less than adjusted NIS 1,000.

The accompanying notes are an integral part of the financial statements.

Statements of Cash Flows
In adjusted NIS

	2001	2000	Period from December 2, 1998 (see note 1a(1)), to December 31, 1999
	In thousands		
Cash flows from operating activities:			
Loss for the period	(839,623)	(551,465)	(84,319)
Adjustments required to reflect the cash flows from operating activities (a)	243,450	274,467	56,803
Net cash used in operating activities	(596,173)	(276,998)	(27,516)
Cash flows from investing activities:			
Purchase of fixed assets	(510,512)	*(667,123)	(99,207)
Purchase of broadcasting rights	(69,810)	*(126,502)	(45,498)
Advance on account of license fees			(30,668)
Net cash used in investing activities	(580,322)	(793,625)	(175,373)
Cash flows from financing activities:			
Receipt of long-term loans from shareholders	793,082	638,297	136,139
Short-term credit from banks — net	383,006	387,267	112,237
Net cash provided by financing activities	1,176,088	1,025,564	248,376
Increase (decrease) in cash and cash equivalents	(407)	(45,059)	45,487
Balance of cash and cash equivalents at beginning of period	428	45,487	
Balance of cash and cash equivalents at end of period	21	428	45,487

* Reclassified.

Statements of Cash Flows
In adjusted NIS

	2001	2000	Period from December 2, 1998 (see note 1a(1)), to December 31, 1999
	In thousands		
(a) Adjustments required to reflect the cash flows from operating activities:			
Expenses not involving cash flows:			
Depreciation and amortization	279,034	87,663	2,048
Liability for employee rights upon retirement — net ...	1,151		
Linkage differences on principal of long-term shareholders' loans	1,029		
	<u>281,214</u>	<u>87,663</u>	<u>2,048</u>
Changes in operating asset and liability items:			
Increase in accounts receivable	(39,328)	(39,413)	(7,907)
Increase in accounts payables and accruals (including customer deposits)	1,564	*226,217	62,662
	<u>(37,764)</u>	<u>186,804</u>	<u>54,755</u>
	<u>243,450</u>	<u>274,467</u>	<u>56,803</u>
(b) Supplementary information on investing activities not involving cash flows:			
Purchase of fixed assets with suppliers' credit	30,947	136,598	49,663
Purchase of broadcasting rights with suppliers' credit	41,436	30,331	16,448

* Reclassified.

The accompanying notes are an integral part of the financial statements.

Notes to Financial Statements

NOTE 1 — Significant Accounting Policies

The significant accounting policies, applies on a consistent basis, are as follows:

a. General:

1) Activities

DBS Satellite Services (1998) Ltd. (hereafter — the Company) was incorporated in Israel on December 2, 1998. In January 1999, the Company received a license from the Ministry of Communications to broadcast, in Israel, television broadcasts by means of satellite (hereafter — the License). The License is for a period of ten years from the day of its receipt and can be extended for a period of six additional years on certain conditions. The Company paid an advance on account of license fees (royalties) in the amount of approximately adjusted NIS 30 million, and presented a bank guarantee in the same amount in favor of the State of Israel. The Company is subject to the Telecommunications Law, 1982 (hereafter — the Telecommunications Law), the regulations and rules promulgated thereunder and the terms of the License.

In July 2000, the Company completed the development stage and began to provide its customers with multi-channel television broadcasts in accordance with the License granted it under the Telecommunications Law.

2) The Company's financial position

- a) The Company expects significant losses and a negative cash flow from ordinary operations during the first years of its activities. The loss for 2001 amounts to approximately adjusted NIS 840 million and the negative cash flow from ordinary operations aggregated approximately adjusted NIS 596 million. As a result of these losses, the working capital deficiency increased to adjusted NIS 1,345 million (including approximately adjusted NIS 883 million in short-term credit from banks).
- b) On August 1, 2000, the Company signed a memorandum of terms with banks, which indicates the terms and stipulations likely to be included in a financing agreement between them.

On May 23, 2001, the financing agreement between the Company and the banks was signed (hereafter — the financing agreement). The financing agreement specifies, inter alia, prerequisite conditions for the utilization of credit lines within the facility, including undertakings by the Company to meet certain suspending conditions as well as specified cumulative milestones and financial stipulations (hereafter — the terms).

To date of the approval of these financial statements, not all of the said terms had been fulfilled. The Company and the banks are continuing to discuss the steps necessary to achieve the fulfillment of the terms. In addition, discussions are underway regarding the increase of the credit facilities provided to the Company.

- c) The Company's activities are financed by shareholders' loans and credit from banks. The receipt of additional loans from a principal shareholder is, inter alia, conditional upon the approval of the Ministerial Committee for Privatization (hereafter — the Committee). To date of the approval of the financial statements, the Committee has allowed the shareholder to increase his exposure up to the sum of the multiplication of the percentage of his shareholding of the Company's share capital by U.S. dollar 480 million.
- d) The Company's activity depends on the continued execution of the financing agreement, increase of the credit facilities provided by banks and the receipt of additional loans from shareholders. It is the opinion of the Company's management that the agreements between the shareholders and the existing credit facilities should suffice for most of the finance that would be required for the

Company's operations in 2002, and that there are good chances that the ongoing deliberations between the Company, the shareholders and the banks will yield an arrangement for the remaining financing required.

- 3) Interested parties — as defined in the Israeli Securities (Preparation of Annual Financial Statements) Regulations, 1993.
- 4) Use of estimates in the preparation of financial statements

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of expenses during the reporting periods. Actual results could differ from those estimates.

b. Adjusted financial statements:

- 1) The financial statements have been prepared on the basis of historical cost adjusted for the changes in the general purchasing power of Israeli currency, in accordance with pronouncements of the Institute of Certified Public Accountants in Israel (hereafter — the Israeli Institute). All figures in the financial statements are presented in adjusted new Israeli shekels (NIS) which have a uniform purchasing power (December 2001 adjusted NIS) — based upon the changes in the consumer price index (hereafter — the CPI) see also note 9b).

The adjustment of the financial statements is based on the accounts of the Company, maintained in nominal NIS. Condensed nominal Israeli currency data of the Company, on the basis of which its adjusted financial statements were prepared, are presented in note 14.

The components of the statements of operations were, for the most part, adjusted as follows: the components relating to transactions carried out during the year were adjusted on the basis of the index for the month in which the transaction was carried out, while those relating to non-monetary balance sheet items (mainly depreciation and amortization) were adjusted on the same basis as the related balance sheet item. The financing component represents financial income and expenses in real terms and the erosion of balances of monetary items during the period.

- 2) The adjusted amounts of non-monetary assets do not necessarily represent realization value or current economic value, but only the original historical values, adjusted to reflect the changes in the general purchasing power of Israeli currency. In these financial statements, the term "cost" signifies cost in adjusted Israeli currency.
- 3) In October 2001, the IASB issued Israel Accounting Standard No. 12 — Discontinuance of Adjusting Financial Statements for Inflation. Standard 12 provides for the discontinuance of inflation-adjusted financial statements and the return to the nominal-historical financial reporting as is generally practiced in the world, due to the significant decrease in recent years in the inflation rates, and the less common usage of linkage in the Israeli economy.

According to this Standard, the adjustment of financial statements for inflation will be discontinued commencing January 1, 2003. Through December 31, 2002, the Company will continue to draw up financial statements, adjusted to inflation in accordance with Opinion No. 36 of the Israeli Institute. The inflation-adjusted amounts as of December 31, 2002, will be the base for the nominal-historical financial reporting in the following periods.

The implementation of Standard No. 12 will mainly affect the financing expenses item.

c. Cash equivalents

The Company considers all highly liquid investments, which include short-term bank deposits (up to three months from the date of deposit) that are not restricted as to withdrawal or use, to be cash equivalents.

d. Broadcasting rights

The rights are presented at cost, which includes commitments to suppliers of rights for the screening of movies and television programs, plus direct costs incurred for adapting such movies and programs for screening in Israel. The broadcasting rights are partially depreciated on the basis of actual screenings and partially according to the term of the rights agreement.

e. Fixed assets

Fixed assets are stated at cost and depreciated by the straight-line method, based on their estimated useful life. The costs of installation of broadcasting and receiving equipment were allocated to the cost of this equipment.

Annual rates of depreciation are as follows:

	<u>%</u>
Broadcasting and receiving equipment	10-15
Digital satellite decoders	25
Office furniture and equipment	7-15
Computers	33

Leasehold improvements are amortized by the straight-line method over the lease period or the estimated life of the improvements, whichever is shorter.

f. License fees — advance on account of royalties

The license fees, which reflect royalty amounts as stipulated in the terms of the License (see note 1a(1)), are depreciated from the beginning the commercial utilization of the License, in accordance with the Company's obligation to pay royalties and throughout a period not exceeding ten years.

g. Loss per NIS 1 of par value of shares

The financial statements do not include data regarding the loss per NIS 1 of par value of shares, as it would not add any significant information to that already included in the financial statements.

h. Revenue recognition:

- 1) Revenues from subscribers are recognized as services to the subscribers are performed.
- 2) The Company leases digital satellite decoders to its customers, on an operational lease basis. Revenues from the lease fees are recognized ratably over the lease period.
- 3) The Company receives deposits from its subscribers for the digital satellite decoders, in an amount that does not exceed the cost of the decoders. Revenues from the depreciation of the deposits are carried to income over 5 or 10 years, based on the terms of the contract with the subscriber.

i. Advertising expenses

The expenses are carried to the statement of operations as incurred.

j. Concentration of credit risks — allowance for doubtful accounts

The allowance is determined in accordance with delays in collecting debts.

NOTE 2 — Fixed Assets:

- a. **Composition of assets and accumulated depreciation, grouped by major classifications and changes therein in 2001 are as follows:**

	Cost			Accumulated depreciation			Depreciated balance	
	Balance at beginning of year	Additions during the year	Balance at end of year	Balance at beginning of year	Additions during the year	Balance at end of year	December 31	
	Adjusted NIS in thousands						Adjusted NIS in thousands	
Broadcasting and receiving equipment	*141,608	764	142,372	*12,902	19,468	32,370	110,002	128,706
Capitalized installation costs ..	411,363	273,377	684,740	21,697	47,667	69,364	615,376	389,666
Digital satellite decoders	295,349	236,616	531,965	7,382	102,056	109,438	422,527	287,967
Office furniture and equipment (including computers)	*83,474	25,545	109,019	*12,928	28,693	41,621	67,398	70,546
Leasehold improvements	20,810	5,157	25,967	1,599	2,267	3,866	22,101	19,211
	<u>952,604</u>	<u>541,459</u>	<u>1,494,063</u>	<u>56,508</u>	<u>200,151</u>	<u>256,659</u>	<u>1,237,404</u>	<u>896,096</u>

* Reclassified.

- b. As to liens on the assets — see note 10.

NOTE 3 — Payments on Account of License Fees

Payments on account of license fees (royalties) are linked to the index known on balance sheet date (see note 1a(1)). The accumulated amortization as of December 31, 2001 is adjusted NIS 4,361,000.

In accordance with the terms of the License, the Company has undertaken to pay royalties to the Government of Israel which are calculated on the basis of revenues from the provision of broadcasting services as defined in the License. The rate of the royalties was set at 1.5% of the Company's revenues for the first five years starting on January 1, 1999 or until the accumulation of 250,000 subscribers, whichever is the earlier.

Thereafter, royalties will be computed at the following rates:

Year	Percentage of the Company's revenue
2001	5%
2002	4%
2003 and thereafter	3.5%

In November and December 2001, the number of subscribers exceeded 250,000. The license fees — approximately NIS 30 million — are considered as a non-refundable advance on account of the abovementioned royalties.

NOTE 4 — Employee Rights Upon Retirement

- a. Labor laws and agreements require the Company to pay severance pay to employees dismissed or retiring from its employ in certain other circumstances. The Company's severance pay liability to its employees (which is based on the number of years worked and the latest monthly salary) is covered mainly by purchase of insurance policies. The amounts funded as above are not reflected in the balance sheets since they are not under the control and management of the Company.
- b. The amount of liability for severance pay presented in the balance sheets reflects that part of the liability not covered as above, in accordance with labor agreements in force.

NOTE 5 — Shareholders' Loans

At the general meeting of the shareholders of the Company on December 24, 2000, it was decided that the various loans which had been extended by the shareholders to the Company would be linked to the CPI and bear interest at the annual rate of 7%, from the date of their grant to the date of their repayment, or the repayment of any part thereof, as the case may be, or other interest and linkage differences if so decided by a meeting of the shareholders of the Company. These terms will apply also to loans which will be extended to the Company by the shareholders in the future, as long as no decision to the contrary is made by the shareholders' meeting.

In addition, it was resolved that the abovementioned decision would take effect on January 24, 2001 unless, by that date objections had been registered by a particular shareholder. In the event of such objections by the particular shareholder, the decision would take effect on the date the particular shareholder ceases to be a member of the enterprise. As at the date of signing of these financial statements, the shareholder has registered his objections as aforesaid, and the decision, therefore, has not taken effect. Accordingly, no interest has been charged on the shareholders' loans.

The loans, as included in the financial statements, bear interest at the rate of the increase in the known CPI.

The total amount of interest accrued until December 31, 2001, which would have been added to the amount of the loans had the decision taken effect, aggregates approximately adjusted NIS 128 million.

The date of repayment of the loans has not yet been determined, and is subject to the limitations specified in the memorandum of terms which was signed between the Company and the banks (see note 1a(2)).

NOTE 6 — Commitments and Contingent Liabilities:

a. Commitments:

- 1) The Company has entered into agreements for the purchase of fixed assets (mainly digital satellite decoders) and broadcasting rights, as follows:

	<u>December 31,</u> <u>2001</u>
	<u>Adjusted NIS</u> <u>in thousands</u>
Fixed assets:	
Digital satellite decoders*	<u>213,443</u>
Other assets	<u>10,177</u>
Broadcasting rights	<u>371,096</u>

* See note 13b.

- 2) The Company has entered into two main operating lease agreements for buildings it uses. One agreement expires in 2003 with an option to renew for three additional years, and the second agreement expires in 2009 with an option to renew for an additional 10 years. The lease fees are linked to the U.S. dollar (hereafter — the dollar). Furthermore, the Company has entered into numerous additional operating lease agreements for various periods.

The projected annual lease fees for the next five years, calculated according to the rate in effect on December 31, 2001, are approximately adjusted NIS 13 million.

- 3) As to the Company's undertaking to pay royalties to the Government of Israel, see note 3.
- 4) The Company has entered into an agreement for the lease of space segments on the Amos 1 satellite. The agreement is for a period of 8.5 years commencing April 14, 1999, with options to renew for additional six month periods each time. The lease is linked to the dollar.

The projected annual lease fees for the next five years, calculated according to the rate in effect on December 31, 2001, are approximately adjusted NIS 98 million.

In addition, on May 16, 2000, the Company has entered into an agreement for the lease of space segments on the Amos 2 satellite. The agreement expires after 10 years or at the end of the useful life of the satellite, whichever is earlier. The projected annual lease fees are approximately adjusted NIS 18 million, linked to the dollar. The satellite is expected to be launched in the first quarter of 2003.

- 5) The Company has entered into subcontracting agreements for the establishing, management and operation of the installation array. The installation array includes installing equipment in the homes of subscribers' and instructing them as to the operation of the equipment, end equipment maintenance services and other related services. The costs incurred by the Company in respect of these agreements during the period from September 2001 through December 2001 aggregate approximately adjusted NIS 83 million.

b. Contingent liabilities:

- 1) To secure its liabilities, the Company has provided documentary credits and guarantees in the amount of approximately NIS 52 million.

Claims which were filed against the Company are described below.

In the opinion of the Company's management, based on its legal counsel, the outcome of the claims pending against the Company, which are described below, cannot be estimated at this stage. Therefore, no provision was made in the financial statements in respect thereof.

- 2) On November 27, 2001, Reuveni Pridan Advertisers (hereafter — Pridan) filed a claim for NIS 3 million against the Company.

Pridan alleges that the Company has unlawfully cancelled the advertising services agreement between them, thereby, inter alia, preventing Pridan from receiving additional commissions under the agreement and damaging Pridan's reputation.

On February 12, 2002, the parties have reached an agreement, according to which the Company is to make monthly deposits of NIS 100,000, up to an amount of NIS 1 million, with a trust account that would be opened for this purpose by the representatives of the parties and the dispute is to be referred to an arbitrator.

In the opinion of the Company's legal counsel, the outcome of the claim cannot be estimated at this stage.

- 3) In November and December 2001, the Company received demands (including a claim) for damages in an aggregate amount of approximately NIS 1 million in respect of alleged breach of rights. On March 12, 2002, during a pretrial proceeding, the parties have reached a settlement, according to which the Company is to pay the claimant an insignificant amount. The settlement agreement is in its final stages and is expected to be submitted to the Court in the next few days, with an application to give the agreement the force of a judgment.

In the opinion of the Company's legal counsel, it cannot be estimated at this stage whether the applicant would file a claim, nor can the measures that may be required under such claim or the chances thereof be determined at this stage.

- 4) On May 10, 2001, a claim was filed against the Company, alleging that, in its advertisements, the Company misleads consumers as to the possibility of purchasing only specific channels as well as with respect to the number of channels offered to the consumer. In addition, according to the claim, the Company has charged its subscribers for a maximum channel package, although they have not chosen such package.

The claimant has filed the claim as the representative of the Company's subscribers and has concurrently submitted an application to approve the claim as a class action under the Consumer Protection Law.

The claimant's alleged damages are in an insignificant amount. The aggregate amount of damages claimed for all the members in the represented group is approximately NIS 177 million.

On March 18, 2002, the parties signed a compromise agreement, under which a request to reject the claim and the application for the approval thereof as a class action would be submitted to the Court. In return, the Company shall pay the claimant damages of an insignificant amount.

- 5) On September 3, 2001, the general manager of the Consumer Council notified the Company in writing that the delivery fees (NIS 2.90 per month) that the Company charges its subscribers, without their expressed consent, for the delivery of the Yes magazine, is against the law and required that the Company reimburse all the subscribers whose expressed consent had not been received and, that in the future, the Company would avoid charging any amounts without receiving the expressed consent of consumers.

The general manager of the Consumer Council has also filed a complaint in this respect with the Cable and Satellite Broadcast Council. Consequently, on September 30, 2001 the chairwoman of the latter Council notified the Company that the way in which the delivery fees were charged is also contrary to the terms of the license and of the subscriber agreements. the chairwoman demanded that the Company receive the positive consent of all subscribers before charging them for the delivery of the magazine, reimburse all those who does not express their consent thereto and cease immediately charging delivery fees from those who did not give their expressed consent thereto.

On November 7, 2001, the Head of the Supervising and Control Department in the Ministry of Communications notified the Company that the charging of the delivery fees constitutes an alleged breach and required the Company to submit its response, in accordance with the breach procedure set forth by the Cable and Satellite Broadcast Council. In addition, in his letter he requires the Company to cease immediately any breaches, correct them without delay and report these actions upon their completion.

On November 22, 2001, the Company submitted its response to the Head of the Supervising and Control Department, in which it specified all the measures already taken by the Company as well as those that the Company intends to take in order to make certain that each and every one of the subscribers is aware of his option to cancel the delivery of the magazine and the charge of the delivery fees.

On February 24, 2002, the chairwoman of the Cable and Satellite Broadcast Council notified the Company that, according to the Council's policy, the Company continues to act in violation of the terms of the license and the subscriber agreements. On this basis, the chairwoman of the Council determined that the Company's conduct constitutes a breach and notified the Company that she intends to exercise her authority and require the Company to pay a penalty in respect of such breach.

On February 26, 2002, the Company replied that, to the best of its understanding, it acted in accordance with the expressed instructions of the Council regarding this matter and therefore requests that the claim for breach be cancelled.

In the opinion of the Company's legal counsel, whether a claim would be filed, what measures may be required under such claim or the chances thereof cannot be estimated at this stage, nor can it be determined whether the chairwoman of the Council would require the Company to pay a penalty.

- 6) A dispute arose between the Company and its distributor in the Arab sector (hereafter — the distributor) with respect to the termination of the agreement between the parties.

On March 22, 2001, the Company received a liquidation notice from the distributor, in which he requires a payment of approximately NIS 4.8 million in respect of commissions that he alleges are due to him from the Company. The Company rejects the claims of the distributor and claims that the distributor owes the Company approxi-

mately NIS 100,000, before taking into account damages caused to the Company by his breach of the agreement, that have not yet been fully estimated by the Company. The Company and the distributor are currently reviewing various drafts of an agreement regarding the type of proceedings by which their disputes are to be deliberated.

In the opinion of the Company's legal counsel, it cannot be determined at this stage whether a claim would be filed, what measures may be required under such claim or what the chances of such claim may be.

NOTE 7 — Share Capital:

- a. The share capital as of December 31, 2001 and 2000 is composed of ordinary shares of NIS 1 par value, as follows:

	<u>Number of shares</u>
Authorized.....	<u>36,000</u>
Issued and paid.....	<u>10,000</u>

b. Stock options to employees

The employment agreements with certain employees entitle them to participate in an employee stock option plan, should the Company choose to adopt one, under which options would be granted for the purchase of Company shares. The exact number of options to be granted to each employee under such plan will be determined at the sole discretion of the Company's management.

In accordance with the Company's employment agreements with some of its senior employees, each of these employees is to be granted options for the purchase of Company shares, by way of allotment of shares, of NIS 1 par value, at par, so that after the options are exercised, the number of shares held by each of said employees would range between 0.2% and 0.8% of the Company's issued share capital as on the date of the signing of each agreement.

Each employee would be entitled to exercise the options in purchase of the number of shares stipulated in the agreement with such employee. To date of the approval of the financial statements, the Company has not adopted an employee stock option plan.

See also note 13a(3).

NOTE 8 — Taxes on Income:

a. Measurement of results for tax purposes under the Income Tax (Inflationary Adjustments) Law, 1985 (hereafter — the inflationary adjustments law)

Under the inflationary adjustments law, results for tax purposes are measured in real terms, having regard to the changes in the CPI. The Company is taxed under this law.

b. Tax rates applicable to the Company

The income of the Company will be taxed at the regular rate of 36%.

c. Losses for tax purposes carried forward to future years

Carryforward losses as of December 31, 2001, amount to adjusted NIS 1,471 million. Due to the uncertainty of their utilization in the foreseeable future, the Company has not created deferred taxes in its accounts in respect of these losses. Under the inflationary adjustments law, carryforward losses linked to the CPI and can be utilized indefinitely.

d. Tax assessments

The Company has not been assessed for tax purposes since incorporation.

NOTE 9 — Linkage terms of Monetary Balances:

a. As follows:

	December 31, 2001		
	In dollars or linked thereto	CPI linked	Unlinked
	Adjusted NIS in thousands		
Assets — current:			
Cash and cash equivalents	6		15
Accounts receivable:			
Trade			56,967
Other	10,351	738	18,742
	<u>10,357</u>	<u>738</u>	<u>75,724</u>
Liabilities:			
Current liabilities:			
Bank credit			882,510
Accounts payable and accruals:			
Trade	195,347		324,204
Other	29,977		
Long-term liabilities:			
Shareholders' loans		1,568,546	
Other liabilities, including the current portion		46,351	1,151
	<u>225,324</u>	<u>1,614,897</u>	<u>1,207,865</u>

b. Data regarding the exchange rate and the CPI:

	Exchange rate of one U.S. dollar	CPI*
At end of year:		
2001.....	NIS 4.416	170.9 points
2000.....	NIS 4.041	168.5 points
1999.....	NIS 4.153	168.5 points
Increase (decrease) during the year:		
2001.....	9.3%	1.4%
2000.....	(2.7)%	0.0%
1999.....	(0.2)%	1.3%

* Based on the index for the month ending on each balance sheet date, on the basis of 1993 average = 100.

NOTE 10 — Liabilities Secured by Liens and Restrictions Imposed in Connection with Liabilities:

a. Following is the balance of secured liabilities and guarantees of the Company:

	December 31	
	2001	2000
	Adjusted NIS in thousands	
Liabilities — short-term bank credit.....	<u>882,510</u>	<u>499,504</u>
Guarantees	<u>52,315</u>	<u>46,482</u>

b. To secure the abovementioned liabilities and guarantees, the Company registered a lien on all its assets, including share capital and goodwill.

c. See note 1a(2)(b) as to the financing agreement that the Company signed with banks which, inter alia, stipulates prerequisite conditions for the utilization of credit lines within the facility, including undertakings by the Company to meet certain suspending conditions as well as specified cumulative milestones and financial stipulations.

NOTE 11 — Supplementary Financial Statement Information:

Balance sheets:

a. Accounts receivable:

1) Trade

This item net of an allowance for doubtful accounts of adjusted NIS 5,333,000 (December 31, 2000 — approximately adjusted NIS 230,000).

2) Other:

	December 31	
	2001	2000
	Adjusted NIS in thousands	
Institutions (mainly VAT)	18,720	28,607
Advances to suppliers of purchased channels	8,197	14,807
Other	2,914	40
	<u>29,831</u>	<u>43,454</u>

b. Short-term bank credit:

1) Classified by currency, linkage basis and interest rates, the short-term credit is as follows:

	December 31		
	2001	2001	2000
	Interest rates	Amount	
	%	Adjusted NIS in thousands	
In dollars or linked thereto			136,323
Unlinked	7.9	882,510	363,181
		<u>882,510</u>	<u>499,504</u>

2) As to securities — see note 10.

c. Accounts payable and accruals:

	December 31	
	2001	2000
	Adjusted NIS in thousands	
1) Trade:		
Open accounts*	484,649	347,553
Checks and notes payable	34,902	137,578
	<u>519,551</u>	<u>485,131</u>
* Including content suppliers	<u>88,215</u>	<u>46,779</u>
2) Other:		
Employees and employee institutions	16,872	9,105
Provision for vacation pay	6,334	3,025
Customer deposits	6,365	21
Sundries	406	24,461
	<u>29,977</u>	<u>36,612</u>

d. On January 3, 2002, the Company filed a claim against Baran Raviv Telecom Ltd. (hereafter — “Baran Raviv”). The Company claims, inter alia, that Baran Raviv has failed to fulfill its duties according to the agreement between the two, in which Baran Raviv undertakes to establish, manage and operate an array for the installation of user end equipment for the reception of the Company’s broadcasts, as an independent contractor, on behalf of the Company.

The balance of the Company's liabilities to Baran Raviv, according to the settlement reached on February 2002, is NIS 55.5 million, linked to the CPI for January 2002. The balance is payable until 2004.

The Company's liabilities to Baran Raviv under the settlement are presented in the balance sheets as follows:

	<u>Adjusted NIS in thousands</u>
Among current liabilities	28,390
As a long-term liability	<u>27,110</u>
	<u>55,500</u>

e. Broadcasting rights:

	<u>December 31</u>	
	<u>2001</u>	<u>2000</u>
	<u>Adjusted NIS in thousands</u>	
Advances to content suppliers	47,946	68,439
Broadcasting rights	<u>282,080</u>	<u>150,341</u>
	<u>330,026</u>	<u>218,780</u>
Less — fully utilized rights	<u>43,452</u>	<u> </u>
	<u>286,574</u>	<u>218,780</u>

Statements of operations:

	<u>2001</u>	<u>*2000</u>	<u>Period from December 2, 1998, to December 31, 1999</u>
	Adjusted NIS in thousands		
f. Operating expenses:			
Salaries and employee related expenses	77,136	14,022	
External customer service center	36,652	15,564	
Depreciation and amortization ...	182,613	50,702	
Amortization of broadcasting rights utilized	75,711	32,870	
Content costs	220,933	107,315	
Consumption of space segments	66,885	35,320	
Rent	4,621	3,309	
Other	<u>43,093</u>	<u>3,843</u>	
	<u>707,644</u>	<u>**262,945</u>	
g. Selling, marketing, general and administrative expenses:			
Selling and marketing:			
Salaries and employee related expenses	81,323	58,601	2,941
Advertising	65,650	77,030	3,574
Marketing consultation	6,067	16,054	11,406
Rent and maintenance	4,100	3,510	
Depreciation	483	43	
Other	<u>31,425</u>	<u>11,011</u>	<u>1,223</u>
	<u>189,048</u>	<u>166,249</u>	<u>19,144</u>
General and administrative:			
Salaries and employee related expenses	66,531	37,876	14,351
Consultation and professional fees	9,711	42,115	28,245
Office expenses	14,264	9,696	
Rent and maintenance	15,763	8,702	
Depreciation	20,694	11,508	
Allowance for doubtful accounts	5,103	230	
Other	<u>21,691</u>	<u>15,517</u>	<u>18,699</u>
	<u>153,757</u>	<u>125,644</u>	<u>61,295</u>
h. Financial expenses, net:			
In respect of short-term bank credit	71,971	23,978	2,422
Credit agreement stamping fees..	20,207		
Other — net.....	<u>2,713</u>	<u>(700)</u>	<u>1,458</u>
	<u>94,891</u>	<u>23,278</u>	<u>3,880</u>

* Reclassified.

**For the period from July 1, 2000 to December 31, 2000 (see note 1a(1)).

NOTE 12 — Financial Instruments and Risk Management:

a. Concentration of credit risks

The cash and cash equivalents as of December 31, 2001 and 2000 are deposited with Israeli banks. The Company is of the opinion that the credit risk in respect of these balances is remote.

The Company's sales are made in Israel to a large number of customers. Consequently, the balance of the Company's trade receivables does not represent a significant concentration of credit risk as of December 31, 2001.

b. Fair value of financial instruments

The Company's financial instruments as of December 31, 2001 and 2000 are composed mainly of non-derivative assets and liabilities (which include working capital and the current portion of long-term liabilities). In view of their nature, the fair value of the financial instruments included in working capital is usually close or identical to their carrying value. As to shareholders' loans, see note 5.

NOTE 13 — TRANSACTIONS AND BALANCES WITH INTERESTED PARTIES:

a. Transactions with interested parties:

	<u>2001</u>	<u>2000</u>	<u>Period from December 2, 1998, to December 31, 1999</u>
	Adjusted NIS in thousands		
1) Operating expenses	<u>94,508</u>	<u>47,633</u>	
Consultancy	<u>644</u>	<u>578</u>	<u>752</u>
Selling, marketing, general and administrative and expenses	<u>19,544</u>	<u>11,716</u>	
2) Benefits to interested parties — salary to an interested party employed by the Company and a director's fees	<u>3,138</u>	<u>2,782</u>	<u>750</u>

3) Under the employment agreement with the CEO of the Company, the Company is to allot him options exercisable in purchase of ordinary shares of NIS 1 par value of the Company, subject to the adoption of a stock option plan by the Company's board of directors. The options will be granted at no consideration and will be exercisable in purchase of a number of shares representing 0.8% of the Company's issued and paid share capital as of the date of the agreement.

The options shall be granted to the CEO in three annual batches, commencing November 2002. The exercise price of each option shall be the par value of one share.

To date of the approval of the financial statements, the Company has not adopted an employee stock option plan.

4) Under the employment agreement with a former CEO of the Company, he will be entitled to require the Company to purchase from him the shares underlying exercise of the options to which he is entitled on the date he ended his office — 0.25% of the Company's share capital — at a price which will be set according to an estimated Company valuation which will be made within 60 days of the date on which the CEO gave written notice to the Company of his wish to require the Company to purchase the aforesaid shares from him. The CEO's right to require the Company to purchase the shares from him will be valid for a period of two years from the date of his severance, and so long as the Company's shares have not been listed on the stock exchange.

To the date of the approval of the financial statements, former CEO has not notified the Company on his intention to require the Company to purchase the shares from him.

b. Balances with interested parties:

	December 31	
	2001	2000
	Adjusted NIS in thousands	
1) Long-term liabilities — shareholders' loans (see note 5)	(1,568,546)	(774,435)
2) Current liabilities — presented in the balance sheets under "accounts payable and accruals — other"	(67,083)	(79,835)
c. The Company has entered into an agreement with a third party and with an interested party for the import of digital satellite decoders. In the year ended December 31, 2001, the Company purchased decoders in a total amount of adjusted NIS 237 million.		
d. The Company has entered into an agreement for the lease of space segments on the Amos 1 satellite with a third party who is an interested party. See note 6.		

NOTE 14 — Nominal Data of the Company:

a. Balance sheet data

	Nominal NIS in thousands	
	December 31	
	2001	2000
Assets		
Current assets:		
Cash and cash equivalents	21	422
Accounts receivable:		
Trade	56,967	3,960
Other	29,831	42,851
	<u>86,819</u>	<u>47,233</u>
Broadcasting rights:		
Cost	286,574	215,740
Less — utilized rights	64,300	32,413
	<u>222,274</u>	<u>183,327</u>
Fixed assets:		
Cost	1,484,682	938,678
Less — accumulated depreciation	254,135	55,631
	<u>1,230,547</u>	<u>883,047</u>
License fees — advance on account of royalties	26,192	29,772
	<u>1,565,832</u>	<u>1,143,379</u>
Liabilities, net of capital deficiency		
Current liabilities:		
Bank credit	882,510	492,562
Accounts payable and accruals:		
Trade	519,551	478,389
Other	29,977	36,103
	<u>1,432,038</u>	<u>1,007,054</u>
Long-term liabilities:		
Shareholders' loans	1,568,546	763,672
Liability for employee rights upon retirement, net	1,151	
Customer deposits	19,241	186
Another liability, net of the current portion	27,110	
	<u>1,616,048</u>	<u>763,858</u>
Total liabilities	3,048,086	1,770,912
Capital deficiency, see c. below	(1,482,254)	(627,533)
	<u>1,565,832</u>	<u>1,143,379</u>

b. Operating results data

	Nominal NIS in thousands		
	2001	2000	Period from December 2, 1998, to December 31, 1999
Revenues	305,011	26,281	
Operating expenses	703,458	*245,786	
Gross loss	398,447	219,505	
Selling, marketing, general and administrative expenses:			
Selling and marketing	188,146	*183,729	18,788
General and administrative	152,780	*117,553	60,030
Loss from ordinary operations	739,373	520,787	78,818
Financial expenses, net	115,348	23,151	4,787
Loss for the period — nominal	<u>854,721</u>	<u>543,938</u>	<u>83,605</u>

* Reclassified.

c. Changes in capital deficiency:

	Nominal NIS in thousands		
	Share capital	Receipts on account of shares	Accumulated deficit
Changes during the period from December 2, 1998 to December 31, 1999:			
Issuance of share capital	*		*
Receipts on account of shares to be allotted		1	1
Loss			(83,605)
Balance at December 31, 1999	*	1	(83,605)
Changes during 2000:			
Issuance of share capital	10	(1)	9
Loss			(543,938)
Balance at December 31, 2000	10	—	(627,543)
Changes during 2001 — loss			(854,721)
Balance at December 31, 2001	<u>10</u>	<u>—</u>	<u>(1,482,264)</u>

* Represents an amount of less than NIS 1,000.

“BEZEQ” THE ISRAEL TELECOMMUNICATION CORP. LIMITED

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2002

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**The Board of Directors of
"Bezeq" — The Israel Telecommunications Corp. Limited**

Dear Sirs,

**Re: Review of the Unaudited Interim Consolidated Financial Statements
for the Nine Month and Three Month Periods Ended September 30, 2002**

At your request we have reviewed the interim consolidated balance sheet of "Bezeq" — The Israel Telecommunication Corp. Limited and its subsidiaries as at September 30, 2002, as well as the interim consolidated statement of operations, the interim statement of changes in shareholders' equity and the interim consolidated statement of cash flows for the nine month and the three month periods 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 meetings of the shareholders and 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 September 30, 2002, constitute approximately 18.7% of the total assets included in the interim consolidated balance sheet and whose revenues constitute approximately 34.2% and 35% of the total revenues included in the interim consolidated statement of operations for the nine months and the three months, respectively, then ended. Furthermore, the data contained in the interim consolidated financial statements, which relate to the net asset value of the Company's investments in affiliated companies and its equity in their results, is based on interim financial statements which were 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), 5730-1970.

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 program of early retirement, as described in Note 6.
3. Claims made against the Company and against investee companies, as described in Note 7A.
4. The financial position of an affiliated company, the need for additional financing which is significantly higher than the financing needs defined in the financing agreement between the affiliated company and certain banking corporations and agreements in principle reached as at the date of these financial statements between the affiliated company, its shareholders and the banking corporations. As described in Note 4A the continuation of the activities of the affiliated company is dependent upon the execution of the agreements in principle reached with the banking corporations regarding increasing the credit facilities and upon additional loans to be received from the shareholders. The assessment of the affiliated company's management as to the likelihood of resolution of the required financing is included in the aforementioned note. As stated in the aforementioned note, the grant of additional loans by the Company are subject,

among others, to the approval of the Ministerial Committee for Privatization. The Company is taking action to obtain the Committee's approval to increase its exposure.

Somekh Chaikin
Certified Public Accountants (Isr.)
A member firm of KPMG International

November 26, 2002

Interim Consolidated Balance Sheet
In adjusted shekels of September 2002

	September 30 2002 (Unaudited) <u>NIS thousands</u>	September 30 2001 (Unaudited) <u>NIS thousands</u>	December 31 2001 (Audited) <u>NIS thousands</u>
Current assets			
Cash and cash equivalents	1,105,090	1,178,836	1,394,056
Short-term investments	831,600	295,193	471,448
Trade receivables	1,787,388	1,483,361	1,805,118
Other receivables and debit balances	416,768	568,563*	310,104*
Inventory	181,331	141,994	124,141
	<u>4,322,177</u>	<u>3,667,947</u>	<u>4,104,867</u>
Materials and spare parts	<u>161,287</u>	<u>211,299</u>	<u>162,414</u>
Investments and long-term receivables	<u>1,567,269</u>	<u>1,767,826</u>	<u>1,798,399</u>
Investments, deposits and debit balances	434,672	428,963	493,287
Investments in investee companies	<u>2,001,941</u>	<u>2,196,789</u>	<u>2,291,686</u>
Fixed assets			
Cost	30,996,506	32,228,294	30,134,089
Less — accumulated depreciation	<u>20,846,753</u>	<u>20,857,039</u>	<u>19,180,838</u>
	<u>10,149,753</u>	<u>11,371,255</u>	<u>10,953,251</u>
Other assets			
Deferred charges and other assets	286,208	389,811	364,187
Deferred taxes	<u>455,374</u>	<u>340,463*</u>	<u>479,242*</u>
	<u>741,582</u>	<u>730,274</u>	<u>843,429</u>
	<u><u>17,376,740</u></u>	<u><u>18,177,564</u></u>	<u><u>18,355,647</u></u>

	September 30 2002 (Unaudited) NIS thousands	September 30 2001 (Unaudited) NIS thousands	December 31 2001 (Audited) NIS thousands
Current liabilities			
Bank credit	405,614	545,818	453,166
Current maturities of:			
Long-term bank loans	600,623	481,854	595,845
Other debentures	204,291	199,185	199,769
Trade payables	929,622	890,488	1,089,872
Employee severance benefits	238,798	308,823	281,322
Other current liabilities	<u>1,111,325</u>	<u>992,515*</u>	<u>1,235,817</u>
	<u>3,490,273</u>	<u>3,418,683</u>	<u>3,855,791</u>
Long-term liabilities			
Long-term loans	2,368,450	2,838,419	2,689,597
Other debentures	2,745,137	2,735,822	2,700,666
Employee severance benefits	1,186,383	1,390,089*	1,365,074
Deferred revenues	<u>49,159</u>	<u>66,303</u>	<u>62,090</u>
	<u>6,349,129</u>	<u>7,030,633</u>	<u>6,817,427</u>
Contingent liabilities			
Shareholders' equity	<u>7,537,338</u>	<u>7,728,248</u>	<u>7,682,429</u>
	<u>17,376,740</u>	<u>18,177,564</u>	<u>18,355,647</u>

Avi Barak
Member of the Board
and Chairman of the
Finance Committee

Ilan Biran
Chief Executive Officer

Oren Lieder
Chief Financial Officer

* Reclassified

Date of approval of the financial statements: November 26, 2002

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

Interim Consolidated Statement of Operations
In adjusted shekels of September 2002

	For the nine month period ended September 30		For the three month period ended September 30		For the year ended December 31
	2002 (Unaudited)	2001 (Unaudited)	2002 (Unaudited)	2001 (Unaudited)	2001 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from telecommunications services (Note 8)	6,236,830	6,548,066	2,096,521	2,168,939	8,721,515
Costs and expenses					
Operating and general expenses (Note 9)	3,470,500	3,568,207	1,177,444	1,185,154	4,779,747
Depreciation (see also Note 5)	1,749,828	2,072,335	585,210	682,656	2,777,987
Royalties to the Government of Israel	190,665	213,797	57,206	64,925	289,283
	<u>5,410,993</u>	<u>5,854,339</u>	<u>1,819,860</u>	<u>1,932,735</u>	<u>7,847,017</u>
Operating income	<u>825,837</u>	<u>693,727</u>	<u>276,661</u>	<u>236,204</u>	<u>874,498</u>
Financing expenses, net	<u>(154,910)</u>	<u>(105,640)</u>	<u>(82,530)</u>	<u>(50,392)</u>	<u>(154,144)</u>
Earnings after financing expenses, net ...	670,927	588,087	194,131	185,812	720,354
Other expenses, net (Note 4C)	<u>(392,962)</u>	<u>(960)</u>	<u>(398,602)</u>	<u>(25,868)</u>	<u>(107,578)</u>
Earnings (loss) before income tax	277,965	587,127	(204,471)	159,944	612,776
Income tax	<u>(181,765)</u>	<u>(266,136)</u>	<u>(24,819)</u>	<u>(84,438)</u>	<u>(246,706)</u>
Earnings (loss) after income tax	96,200	320,991	(229,290)	75,506	366,070
Equity in losses of affiliates	(243,604)	(150,783)	(116,288)	(69,233)	(243,138)
Minority share in losses of a consolidated company	<u>2,313</u>	<u>5,197</u>	<u>754</u>	<u>1,552</u>	<u>6,654</u>
Net earnings (losses)	<u>(145,091)</u>	<u>175,405</u>	<u>(344,824)</u>	<u>7,825</u>	<u>129,586</u>
Primary and diluted earnings (loss) per NIS 1 par value of common shares (in NIS)	<u>(0.060)</u>	<u>0.073*</u>	<u>(0.143)</u>	<u>0.003</u>	<u>0.054</u>

* Restated as a result of a clerical error.

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

Interim Statement of Changes in Shareholders' Equity
In adjusted shekels of September 2002

	Share capital	Capital reserve for distribution of bonus shares	Capital reserve- share premium	Capital reserve in respect of transactions between the Company and a controlling shareholder	Retained earnings	Total
	NIS thousands					
Nine months ended September 30, 2002						
Balance as at December 31, 2001 (audited) ..	6,262,767	—	960,587	38,678	420,397	7,682,429
Net loss (unaudited)	—	—	—	—	(145,091)	(145,091)
Balance as at September 30, 2002 (unaudited)	<u>6,262,767</u>	<u>—</u>	<u>960,587</u>	<u>38,678</u>	<u>275,306</u>	<u>7,537,338</u>
Three months ended September 30, 2002						
Balance as at July 1, 2002 (unaudited)	6,262,767	—	960,587	38,678	620,130	7,882,162
Net loss (unaudited)	—	—	—	—	(344,824)	(344,824)
Balance as at September 30, 2002 (unaudited)	<u>6,262,767</u>	<u>—</u>	<u>960,587</u>	<u>38,678</u>	<u>275,306</u>	<u>7,537,338</u>
Nine months ended September 30, 2001						
Balance as at December 31, 2000 (audited) ..	4,499,900	1,734,310	893,122	38,678	312,930	7,478,940
Net earnings (unaudited)	—	—	—	—	175,405	175,405
Conversion of convertible debentures (unaudited) ⁽¹⁾	6,438	—	67,465	—	—	73,903
Distribution of bonus shares (unaudited)	1,756,429	(1,734,310)	—	—	(22,119)	—
Balance as at September 30, 2001 (unaudited)	<u>6,262,767</u>	<u>—</u>	<u>960,587</u>	<u>38,678</u>	<u>466,216</u>	<u>7,728,248</u>
Three months ended September 30, 2001						
Balance as at July 1, 2001 (unaudited)	6,262,767	—	960,587	38,678	458,391	7,720,423
Net earnings (unaudited)	—	—	—	—	7,825	7,825
Balance as at September 30, 2001 (unaudited)	<u>6,262,767</u>	<u>—</u>	<u>960,587</u>	<u>38,678</u>	<u>466,216</u>	<u>7,728,248</u>
Year ended December 31, 2001						
Balance as at December 31, 2000 (audited) ..	4,499,900	1,734,310	893,122	38,678	312,930	7,478,940
Net earnings (audited)	—	—	—	—	129,586	129,586
Conversion of convertible debentures (audited) ⁽¹⁾	6,438	—	67,465	—	—	73,903
Distribution of bonus shares (audited)	1,756,429	(1,734,310)	—	—	(22,119)	—
Balance as at December 31, 2001 (audited) ..	<u>6,262,767</u>	<u>—</u>	<u>960,587</u>	<u>38,678</u>	<u>420,397</u>	<u>7,682,429</u>

(1) 59,754,681 par value convertible debentures were converted into 5,904,612 ordinary shares with a par value of NIS 1 each.

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

Interim Consolidated Statement of Cash Flows
In adjusted shekels of September 2002

	For the nine month period ended September 30		For the three month period ended September 30		For the year ended December 31
	2002 (Unaudited)	2001 (Unaudited)	2002 (Unaudited)	2001 (Unaudited)	2001 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Cash flows provided by operating activities					
Net earnings (loss)	(145,091)	175,405	(344,824)	7,825	129,586
Adjustments to reconcile net earnings (loss) to net cash flows provided by operating activities (see A below)	<u>2,041,506</u>	<u>2,354,259</u>	<u>889,560</u>	<u>896,617</u>	<u>3,311,280</u>
Net cash provided by operating activities	<u>1,896,415</u>	<u>2,529,664</u>	<u>544,736</u>	<u>904,442</u>	<u>3,440,866</u>
Cash flows used in investing activities					
Investment in fixed assets	(925,405)	(1,099,610)	(372,009)	(331,963)	(1,352,276)
Proceeds from disposal of fixed assets	13,839	53,393	5,395	8,792	87,727
Proceeds from disposal of investment in affiliated company	112,130	31,803	—	31,803	31,802
Investment in long-term deposits and investments	(182,467)	(1,166,389)	(63,941)	(54,891)	(1,179,588)
Proceeds from long-term deposits and investments	153,703	15,445	25,884	4,193	39,132
Increase in short-term investments, net	(427,772)	(83,942)	(429,342)	(6,441)	(256,556)
Decrease (increase) in materials and spare parts	(19,366)	(22,726)	(20,513)	(53,210)	52,316
Investment in investee companies	(304,576)	(404,295)	(79,522)	(128,945)	(560,408)
Investment in other assets	(100,782)	(171,251)	(13,828)	(56,953)	(209,549)
Net cash used in investing activities	<u>(1,680,696)</u>	<u>(2,847,572)</u>	<u>(947,876)</u>	<u>(587,615)</u>	<u>(3,347,400)</u>
Cash flows used in financing activities					
Issue of other debentures (net of issue expenses)	109,546	546,231	—	—	546,231
Repayment of other debentures	(205,081)	(219,806)	(25,966)	(76,200)	(242,105)
Receipt of long-term loans	197,657	730,082	1,848	564,090	785,418
Repayment of long-term loans	(559,255)	(971,097)	(313,602)	(760,672)	(1,107,635)
Receipt (repayment) of short-term bank credit, net	<u>(47,552)</u>	<u>(251,782)</u>	<u>176,126</u>	<u>(192,200)</u>	<u>(344,435)</u>
Net cash used in financing activities	<u>(504,685)</u>	<u>(166,372)</u>	<u>(161,594)</u>	<u>(464,982)</u>	<u>(362,526)</u>
Decrease in cash and cash equivalents	(288,966)	(484,280)	(564,734)	(148,155)	(269,060)
Balance of cash and cash equivalents at the beginning of the period	<u>1,394,056</u>	<u>1,663,116</u>	<u>1,669,824</u>	<u>1,326,991</u>	<u>1,663,116</u>
Balance of cash and cash equivalents at the end of the period	<u>1,105,090</u>	<u>1,178,836</u>	<u>1,105,090</u>	<u>1,178,836</u>	<u>1,394,056</u>

The notes to the financial statements are integral part thereof.

Interim Consolidated Statement of Cash Flows (Contd.)
In adjusted shekels of September 2002

	For the nine month period ended September 30		For the three month period ended September 30		For the year ended December 31
	2002	2001	2002	2001	2001
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
A — Adjustments to reconcile net earnings (loss) to net cash flows provided by operating activities					
Revenues and expenses not involving cash flows:					
Depreciation (See also Note 5)	1,749,828	2,072,335	585,210	682,656	2,777,987
Provision for impairment of fixed assets	—	22,708	—	22,708	109,156
Provision for impairment of long-term investments ..	400,500	—	400,500	—	—
Deferred taxes	47,154	23,238	(4,052)	33,239	(125,096)
Company's equity in losses of affiliated companies, net	243,604	150,783	116,288	69,233	243,138
Minority share in losses of a consolidated company	(2,313)	(5,197)	(754)	(1,552)	(6,654)
Decrease in employee severance benefits, net	(221,216)	(39,431)*	(119,524)	(37,285)	(91,947)
Gain (loss) on disposal of fixed assets	(7,326)	(29,332)	(1,820)	3,624	(9,313)
Loss on disposal of investment in affiliated company	—	3,723	—	—	3,723
Appreciation and interest on long-term deposits and investments	(204,747)	(152,151)	(26,880)	(133,300)	(212,145)
Erosion (appreciation) of short-term investments, net	67,621	(6,878)	5,005	(2,669)	(10,519)
Appreciation of long-term liabilities:					
Other debentures	144,528	29,994	17,191	132,506	17,722
Long-term loans	20,988	92,678	32,548	56,556	137,375
Amortization of deferred expenses and other adjustments	181,396	197,800	59,784	82,490	262,693
Changes in current assets and liabilities:					
Decrease (increase) in trade receivables	25,420	12,873	(17,561)	(42,018)	(431,559)
Decrease (increase) in receivables and debit balances	(24,031)	51,668	4,469	(98,421)	340,996
Decrease (increase) in inventory	(58,027)	6,375	13,461	28,516	23,775
Increase (decrease) in trade payables	(176,632)	(36,148)	(116,765)	123,292	85,528
Increase (decrease) in other current liabilities	(132,310)	(31,350)*	(53,169)	(18,801)	210,062
Decrease in deferred revenues	(12,931)	(9,429)	(4,371)	(4,157)	(13,642)
	<u>2,041,506</u>	<u>2,354,259</u>	<u>889,560</u>	<u>896,617</u>	<u>3,311,280</u>
B — Non-cash transactions					
Acquisition of fixed assets, other assets, materials and spare parts on credit	<u>156,870</u>	<u>106,515</u>	<u>156,870</u>	<u>106,515</u>	<u>175,216</u>
Sale of fixed assets on credit	<u>5,936</u>	<u>15,642</u>	<u>5,936</u>	<u>15,642</u>	<u>—</u>

* Reclassified

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

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2002 (Unaudited)**

NOTE 1 — GENERAL

- A. The interim statements were prepared according to generally accepted accounting principles, applicable to the preparation of financial statements for interim financial statements. These statements should be read in conjunction with the Company's annual financial statements and accompanying notes as at December 31, 2001 and for the year then ended.
- B. In the notes to the interim financial statements, the Company presents only the significant changes in its business and legal environment that occurred from the date of the latest annual financial statements until the date of these interim financial statements. The full and detailed description, including significant changes and developments which occurred in recent years, particularly in the field of cellular telephone services, international communication services, domestic communication services, the opening of these markets to competition and decisions of the Ministerial Committee for Privatization to reduce the State's holdings in the Company, appear in Note 1 to the Company's annual financial statements as at December 31, 2001. The significant changes that occurred from the date of those annual financial statements to the date of these financial statements, are as follows:

1. Effective as of January 1, 2002, payment of the access fees to the Company by the international telecommunications operators was cancelled in accordance with the licenses of the operators which stated that payment of the access fees would be cancelled at the end of 2001.

As a result of cancellation of payment of the aforementioned access fees, commencing January 1, 2002, the Company's revenues from international telecommunications exclude access fees. The access fees included in the Group's revenues from international communications were approximately NIS 94 million in the nine month period ended September 30, 2001, approximately NIS 32 million in the three month period then ended, and approximately NIS 124 million in the year ended December 31, 2001 (in the Company's revenues — approximately NIS 140 million, NIS 48 million and NIS 186 million, respectively).

2. On March 18, 2002 the Company received a draft amendment to its general license. The draft incorporates new requirements and restrictions on the Company (some of which are reflected in the Telecommunications Law and/or the Telecommunications Order and/or in other laws, and some are new requirements/restrictions), as well as a broadening of existing requirements and restrictions on various matters. The Company submitted its comments and objections to the Ministry of Communications and a number of hearings on the matter took place.
3. On May 14, 2002, the Company's tariffs were changed. As part of the change, tariffs for various services were revised, *inter alia*, the call tariffs, installation fees and other services. The change in the call tariffs included an adjustment of peak and off-peak times and uniformity of the tariff for local calls and domestic long-distance calls at all hours of the day.
4. On August 8, 2002, the committee for formulating rules and policies for opening domestic fixed-line communications to competition submitted its recommendations to the Minister of Communications. The recommendations set out the proposed policy, the principles for opening domestic fixed-line communications to competition and recommendations for the removal of barriers to the entry of new operators. The Company submitted its comments to the Minister of Communications on the committee's recommendations, wherein it expressed, *inter alia*, its position that adoption of the committee's recommendations concerning structural separation, universal service, splitting of transmission services, data communication and infrastructure and an immediate permit for the selective provision of those services and in addition, comments on the supervision of the Company's tariffs, would have a severely adverse effect on the Company, consumers and the economy. The Minister of Communications adopted the committee's recommendations, with certain changes, the main ones being postponement of the date of grant of the permit for access services to

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2002 (Unaudited) (cont'd)**

Internet providers to a date when a permit will be granted for services to the general public and permitted the requirement of corporate separation on a domestic operator. The Company petitioned the High Court of Justice against the decision of the Minister of Communications, insofar as it relates to the separation of data communications and transmission from telephony (which is impractical, in the Company's opinion) and for immediate grant of a permit for the selective provision of data and transmission services without a universal obligation, in which it contends, *inter alia*, that the decision of the Minister is unreasonable and in making it, he had exceeded his authority.

NOTE 2 — ACCOUNTING POLICY

1. The significant accounting policies employed in preparation of these financial statements are the same as those employed in the preparation of the latest annual financial statements, except for the following:
2. In 2001 the Israeli Institute for Accounting Standardization published Accounting Standard No. 12 — Termination of the Adjustment of Financial Statements. Under this Standard, the adjustment of financial statements for the effects of changes in the general purchasing power of the Israeli currency will end on January 1, 2003. On November 10, 2002, a decision of the Professional Committee of the Institute for Accounting Standardization postponed application of the Standard to January 1, 2004 and accordingly the adjustment of the financial statements will end as of January 1, 2004. Through December 31, 2003, the Company will continue to prepare adjusted financial statements in accordance with Opinion 36 of the Institute of Certified Public Accountants in Israel (ICPAI). The application of this Standard is liable to have a materially adverse effect on the reported business results of the Company. The extent of that effect depends on the rate of inflation, on the composition of assets and the financing structure of the Company. In addition, the application of Standard No. 13 — The Effect of Changes in Foreign Currency Exchange Rates, was postponed to January 1, 2004.
3. In August 2002 the Israeli Institute for Accounting Standardization published Accounting Standard No. 14 — Financial Reporting for Interim Periods. The Standard determines the minimum content of financial reports for interim periods, including the disclosure required in the notes and in addition details the accounting principles with respect to recognition and measurement to be applied in financial reports for interim periods. This Standard will apply to financial statements for periods starting on January 1, 2003, or thereafter. The Standard does not require the restatement of comparative information for interim periods prior to the starting date; however, if financial statements include comparative information for interim periods prior to the starting date, which is not presented in accordance with the provisions of the Standard then the notes to the financial statements must include a description of the main differences between the principles detailed in the Standard and the principles under which the comparative information was prepared. In the Company's opinion, the effects of this new standard on the results of its operations, its financial condition and its cash flows is not expected to be significant.

NOTE 3 — FINANCIAL STATEMENTS IN ADJUSTED VALUES

The financial statements were prepared on the basis of historical cost adjusted for changes in the general purchasing power of the Israeli currency. The changes that occurred in the Consumer Price index ("CPI") and foreign currency exchange rates are as follows:

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2002 (Unaudited) (cont'd)**

	<u>Consumer price index</u>	<u>Exchange rate US dollar</u>	<u>Exchange rate of the euro</u>
	%	%	%
In the nine month period ending:			
September 30, 2002	6.988	10.303	22.830
September 30, 2001	1.996	7.770	6.011
In the three month period ended:			
September 30, 2002	0.648	2.139	1.388
September 30, 2001	0.888	4.562	13.060
In the year ended December 31, 2001	1.397	9.279	3.845

NOTE 4 — INVESTMENTS IN INVESTEE COMPANIES

A. D.B.S. Satellite Services (1998) Ltd. ("DBS")

- Further to Note 8(F) to the financial statements as at December 31, 2001, at the beginning of May 2002 additional shares in DBS were issued to the Company, thereby increasing the Company's holding in DBS to approximately 45%. As a result of the increase in the percentage of its holding in DBS a surplus cost in the amount of approximately NIS 269 million was generated to the Company which will be amortized over a period of 10 years.

The Company's investment in DBS at balance sheet date amounts to approximately NIS 1,044 million. The Company's share in the accumulated losses of DBS is approximately NIS 679 million, of which approximately NIS 205 million was recorded in the nine month period ended September 30, 2002, and approximately NIS 100 million was recorded in the three month period then ended. In addition, the balance of the current debt of DBS to the Company and its consolidated companies amounts to approximately NIS 47 million.

- DBS expects considerable losses and negative cash flows from its operating activities during its initial years of operation. The loss arising in the year 2001 amounted to approximately NIS 898 million and the loss in the nine month period ended September 30, 2002, amounted to approximately NIS 533 million. The negative cash flows from operating activities during 2001 amounted to approximately NIS 613 million and during the nine month period ended September 30, 2002, approximately NIS 6 million. As a result of these losses the deficit in working capital as at September 30, 2002 amounted to approximately NIS 1,615 million.
- On May 23, 2001, a financing agreement ("the Financing Agreement") was signed between DBS and certain banks ("the Banks"), stipulating, *inter alia*, undertakings by DBS to meet certain contingent conditions and to achieve cumulative milestones and financial conditions ("the Conditions"). As at the date of approval of these financial statements some of the aforementioned Conditions had not been met.
- In addition, an economic study carried out by the Banks determined that, in order to finance the operations of DBS, additional financing would be required which considerably exceeds the financing requirements defined in the Financing Agreement.
- The Company provided a perpetual guarantee in favor of the banks with respect to payment of the debts of DBS. The guarantee is up to a maximum equal to the percentage of the Company's holding in DBS multiplied by the value of DBS as derived from disposal of the mortgaged shares of the remaining shareholders. If the Company joins the remaining shareholders in their disposal of the mortgaged shares, the amount of the guarantee will not exceed the amount received by the Company from the sale of its shares in DBS. The letter of guarantee includes numerous limitations on the Company relating to the disposal of its shares in DBS and lists events of default that, should they occur, will allow the banks to foreclose on the guarantee.

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2002 (Unaudited) (cont'd)**

6. At the beginning of May 2002, DBS and the Banks signed an addendum to the Financing Agreement. On the same date, DBS signed a debenture in favor of the banks, and some of the shareholders pledged their rights in the shareholders' loans that they have extended or will extend to the company with a first ranking fixed charge. Concurrently, the Company undertook that in the event of realization of the securities provided by the shareholders, it will not be entitled to sue for or to receive from DBS any payment in connection with the shareholders' loans.

The agreements reached with the Banks require that DBS, with the consent of its shareholders and to the satisfaction of the Banks, takes action to find a solution for obtaining the additional financing required for its operations and that it should present a business plan showing that it will be able to meet its undertakings towards the Banks. If no such solution is found by June 30, 2002, the Banks will be entitled to take the necessary steps, at their absolute discretion, for collecting all the amounts payable to them and to act in accordance with their rights under the Financing Agreement in the event of default.

As at the date of approval of these financial statements, DBS, its shareholders and the Banks had formulated an agreement in principle concerning an increase in the credit together with additional investments of the shareholders in an amount which is not less than a sum equal to 150% of the amount to be provided by the Banks. The aforementioned agreement was approved in principle by the parties — see paragraph 7 below. The above mentioned Financing Agreement has not yet been signed, and is subject, *inter alia*, to the preparation of documents and individual agreements. During the period from October 1, 2002 to the date of approval of these financial statements the Banks injected into DBS approximately six million dollars on the basis of the agreement in principle. In addition, discussions were held between the parties regarding a continuing financing plan. Following these discussions, the continuing financing plan was approved in principle by the authorized entities of a bank. In accordance with an agreement with the other Banks, discussions will be held at a later stage, regarding their approval of the continuing financing plan. As at the date of approval of these financial statements and prior to completion of signing the Financing Agreement with the Banks, the shareholders are continuing to make further credit available to the affiliate, beyond the requirements in the agreement in principle that was reached with the Banks, as aforesaid.

7. The grant of loans by the Company to DBS is subject, *inter alia*, to the approval of the Ministerial Committee for Privatization ("the Committee"). The Committee had given its approval for the Company to increase its exposure up to the total of the percentage of its holding in DBS multiplied by 480 million dollars. The Company is taking action to obtain the Committee's approval to increase its exposure.
8. The continuation of the activities of DBS is contingent upon implementation of the agreement in principle which was formulated by the Banks for an increase in the credit facility, as described above, and upon receipt of additional loans from the shareholders, including approval of the Committee as mentioned in Section 7 above.

The Management of DBS believes that there are good chances that discussions between DBS, the shareholders and the Banks will lead to implementation of the agreement in principle formulated with the Banks and the shareholders, including the formulation of a continuing financing plan as mentioned above and the arrangement of the financial resources required by DBS in the coming year.

B. Walla! Communications Ltd. ("Walla")

Bezeq International Ltd. ("Bezeq International") invested in Walla, an Israeli company whose shares are listed on the Tel Aviv Stock Exchange and which provides Internet services and operates Internet portals.

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2002 (Unaudited) (cont'd)**

On March 14, 2002, Walla issued a prospectus for a rights issue. Bezeq International invested approximately NIS 11,238,000 in exercise of the rights and a further NIS 3,308,000 in the acquisition of additional rights from the public and the exercise thereof. Subsequent to exercise of the aforementioned rights, the acquisition from the public, and an additional acquisition of shares from Walla's shareholders during the second quarter, Bezeq International's holding in Walla increased from 24.83% to 36.74%.

Under the investment agreement between Bezeq International and Walla, Bezeq International undertook to invest an additional \$3 million, through itself or through a strategic investor. During 2002, Bezeq International extended loans amounting to approximately NIS 11,237,000 to Walla, of which NIS 1,770,000 was subsequent to the balance sheet date. The loans are linked to the CPI and are interest-free. Repayment of the loans will be on a date shortly after the date on which Bezeq International invests in Walla's share capital. During the second quarter Bezeq International recorded reduction in the amount of NIS 7,384,000 in the value of its investment in Walla. The balance of its investment in Walla reflects the fair economic value of Walla to Bezeq International, based on the valuation of Walla which was prepared as part of the merger with IOL.

C. Pelephone Communications Ltd. ("Pelephone")

1. Following various indications of a decrease in the value of the subsidiary Pelephone Communications Ltd. ("Pelephone"), in which 50% of the shares are held by the Company and 50% are held by Pelephone Holdings L.L.C. of Shamrock Holdings of California, Inc ("Shamrock"), the Company commissioned a revised valuation of Pelephone. According to the revised valuation, the current value of Pelephone is estimated at between \$1 billion and \$1.2 billion.

As explained in the Company's financial statements for the year ended December 31, 2001, the consideration in respect of the purchase of Shamrock's share in Pelephone was financed in part by a \$240 million loan extended by the Company to Shamrock, for which the Company received debentures which are convertible over a period of four years (from February 27, 2001) for 80% of the shares of Shamrock (and since Shamrock holds 50% of the shares in Pelephone, conversion of the debentures is equivalent to acquisition of 40% of Pelephone's shares). These debentures, plus interest and exchange rate differences, are presented in the Company's balance sheet under the item Long-term investments, deposits and debit balances.

Part of the financing for acquisition of the Pelephone shares by Shamrock and additional investments which Shamrock made in Pelephone after the acquisition, was by means of bank loans, the balance of which on September 30, 2002 was approximately \$ 375 million (including interest), against which shares of Shamrock and Shamrock's shares in Pelephone were pledged under a first ranking lien in favor of the bank. This lien has prior claim over a lien that was given to the Company against the aforementioned debentures, the balance of which on September 30, 2002, was approximately \$ 254 million (including interest).

In view of the revised valuation, the value of Shamrock's holding in Pelephone is approximately \$550 million (based on the mid-range of the valuation). Since the amount of the bank financing is secured under a first ranking lien, the balance available for repayment of the debentures is only approximately \$ 175 million. Accordingly, there is doubt as to the collection of approximately \$80 million of the balance of the debentures (in shekels — approximately NIS 390 million).

Based on the revised valuation, a provision in the amount of NIS 354 million (after deduction of a tax saving of NIS 36 million) was made in respect of a decrease in value of the Company's holding in the debentures.

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2002 (Unaudited) (cont'd)**

2. During the reporting period, the Company and Shamrock Holdings of California, Inc. each invested approximately NIS 148 million as an investment against the share premium of shares of Pelephone which were issued in the past.
3. On October 29, 2002, Pelephone signed an agreement with Suny.Com Ltd. ("Suny"), for the purchase of all of Suny's shares in GoNext Ltd. (49% of the share capital) at a consideration of their par value; and for the assignment to Pelephone of all Suny's rights in all the loans extended by it and/or on its behalf to GoNext Ltd., in the amount of NIS 42.2 million, which will be transferred to Suny by Pelephone on the date of closing the transaction.

NOTE 5 — FIXED ASSETS

In October 2001, pursuant to the Company's policy of periodically reviewing the useful lives of its assets, a committee was appointed to examine whether there was a need to revise the useful lives of the assets and make recommendations to Management. The review included only fixed assets of the Company and was based on the balance of its fixed assets as at December 31, 2001. On May 28, 2002, the Board of Directors of the Company resolved to adopt Management's recommendations that were based on the report of the committee.

According to the recommendations of the committee, which were based, *inter alia*, on technological changes, changes in the investment plans of the Company (including providing broadband Internet service in ADSL technology on the existing copper infrastructure), and based on customary practices among the world's communications companies, the remainder of the useful lives of certain investments in the Company's copper cable network was extended, effective from January 1, 2002, while conversely, the useful lives of certain switching systems was shortened.

The aforementioned changes reduced the depreciation charge of the Company during the nine month period ended September 30, 2002 by approximately NIS 195 million and in the three month period then ended by approximately NIS 65 million and increased the Company's net earnings in the same periods by approximately NIS 125 million and NIS 42 million, respectively. In addition, earnings per share in the nine month period ending September 30, 2002, increased by approximately NIS 0.052 per NIS 1 par value and in the three month period then ended, earnings per share increased by approximately NIS 0.017 per NIS 1 par value.

Had the new depreciation rates been applied in 2001, the depreciation charges in that year would have been reduced by approximately NIS 229 million (and for the nine month period ended September 30, 2001, by approximately NIS 172 million and for the three month period then ended by approximately NIS 57 million), and the balance of the fixed assets would have increased by the same amounts.

In addition, net earnings in 2001 would have increased by approximately NIS 147 million (during the nine month period ended September 30, 2001, by approximately NIS 110 million and during the three month period then ended by approximately NIS 37 million). Earnings per share would have increased by NIS 0.061 (in the nine month period ended September 30, 2001, by approximately NIS 0.045 and in the three month period then ended by approximately NIS 0.015) per NIS 1 par value.

NOTE 6 — LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

1. Early retirement plan

In September 2000, the Company reached an agreement with workers' representatives to extend the 1997 collective agreement for early retirement. Under the agreement 1,770 additional employees would take early retirement from April 1, 2001, through December 31, 2006 (with an option to extend the final retirement date for certain employees through December 31, 2008).

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2002 (Unaudited) (cont'd)**

The agreement also stated that the Company would be able to terminate the employment of employees in a compensation track, in excess of the aforementioned quota. In the opinion of the Company's Management, the possibility of additional employees retiring under the aforementioned track is low and accordingly no provision was made in the financial statements. Under this plan, approximately 290 employees had taken early retirement by September 30, 2002.

2. The pension fund through which the early retirement plan is implemented ("the Fund") was directed by the Capital Markets Division of the Ministry of Finance to fulfill an undertaking it made in connection with changing the retirement tracks of approximately 600 Company retirees, provided that the Company pay the Fund NIS 50 million. After the Fund undertook that no extra cost would be imposed on the Company, the Company notified the Fund that it should continue to implement the agreement which enabled transfer from one retirement track to another at no additional cost to the Company. As a result, the Fund no longer allowed Company retirees to switch from one retirement track to another and even stopped implementation of the agreement, in whole or in part, in relation to retirement benefits paid in respect of April 2002. In the opinion of the Company's Management, based on consultations with its legal advisers, it is unlikely that the Company will be charged any costs in connection with implementation of the agreement and therefore it will insist on its implementation with no further payment to the Fund. Accordingly, no provision was made in the financial statements in respect of the above.

NOTE 7 — CONTINGENT LIABILITIES

A. Claims

The Company and the 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 20A to the Company's financial statements for the year ended December 31, 2001. There were no significant changes in respect of contingent liabilities through the date of the signing of these financial statements, except for the following:

1. Further to Note 20A(7) to the financial statements as at December 31, 2001 in the matter of a claim of a group of employees who were employed as temporary employees at the Ministry of Communications and were transferred to the Company when it commenced operations, the plaintiffs have withdrawn their consent to narrow the claim. The Labor Court may now rule whether it will approve the withdrawal of consent.
2. Further to Note 20A(11) to the financial statements as at December 31, 2001 in the matter of a class action in which the plaintiffs allege that the Company unlawfully collected money from its customers for certain services which it provides, on October 22, 2002, the Supreme Court decided to convert to an appeal the application for permission to appeal which was filed against the decision of the District Court to dismiss the application for approval of the claim as a class action.
3. Further to Note 20A(18) to the financial statements as at December 31, 2001 in the matter of a claim and an application to approve the claim as a class action, which were submitted to an affiliate, in which it is alleged that the affiliate is misleading consumers in its advertisements in connection with an offer to the consumer for the purchase certain channels only, as well as with regard to the number of channels offered, on March 18, 2002 the parties signed a compromise agreement under which an application will be filed in court to strike the claim and the application for approval of the claim as a class action. In exchange, the affiliate will compensate the plaintiff with an immaterial amount.
4. Further to Note 20A(22) to the financial statements as at December 31, 2001 in the matter of providing a blocking service for all land-line subscribers of the Company

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as at September 30, 2002 (Unaudited) (cont'd)**

against outgoing calls to cellular phone area codes as an automatic default, on November 6, 2002 the case was heard and following the recommendation of the court, the petitioners withdrew their petition, which was stricken.

5. Further to Note 20A(25) to the financial statements as at December 31, 2001 in the matter of a class action against Pelephone Communications Ltd. ("Pelephone") concerning the plaintiff's allegation that Pelephone collected surplus amounts from its subscribers for reciprocal connection fees, in contravention of the applicable regulations and/or its license, the parties reached a compromise arrangement which took effect on May 2, 2002, in which the District Court partially approved the claim as a class action while validating the compromise agreement as a judgment. The amount of the settlement deriving from the agreement is approximately NIS 6.6 million. The financial statements include a provision that the management of Pelephone believes to be appropriate.
6. Further to Note 20A(26) to the financial statements as at December 31, 2001 in the matter of a claim filed in the Ramallah District Court by the General Public Palestinian Communications Co. Ltd. against Pelephone and another company, as at the date of signing these financial statements, the processing of service of this claim was terminated by the Attorney General and it is no longer counted among the claims pending against Pelephone.
7. On May 21, 2002 a statement of claim together with an application for its recognition as a class action were received at the Company's offices. The claim and application were filed in the Tel Aviv District Court against all the cellular companies in Israel, among them Pelephone (a proportionally consolidated company) and against the Company as a formal defendant.

The plaintiffs, who contend that they are subscribers of the Company and of one of the defendant cellular companies, allege in their claim that the defendant cellular companies collected and collect, unlawfully, payments for what are ostensibly cellular calls but which in fact are fixed-line calls in every respect. The reference is to calls initiated by Company subscribers to commercial entities that provide entertainment and information services and which made an agreement with the cellular companies. Even though these calls do not "consume airtime", the cellular companies collected payment for them, in contravention of their licenses and of the law.

The amount of the class action against the cellular companies is estimated at about NIS 600 million. The Company has submitted its response to the application for recognition of the claim as a class action. It should be noted that the Company approached the Ministry of Communications on this matter, requesting its intervention. The Company, relying on its legal advisers, is unable to estimate at this stage the chances and implications of the claim, and accordingly, no provision was made in the financial statements in respect of this claim.

8. Further to Note 20A(31) to the financial statements as at December 31, 2001 in the matter of a report from the Ministry of Communications received at Bezeq International Ltd., a consolidated company, which calls into doubt the reliability of one of the main files which was transferred to the Ministry of Communications during the customer allocation process, at a meeting on June 26, 2002 the Company withdrew its petition upon the recommendation of the court. The customer allocation process with the supplementary questionnaire commenced on July 1, 2002, after postponements, is scheduled for completion at the end of February 2003. The management of the consolidated company and its legal advisers are unable to estimate, at this stage, the outcome of the above proceeding and its effect on the financial position and the results of operations of the consolidated company.
9. On July 28, 2002, a claim together with an application for its recognition as a class action, which were filed in the Tel Aviv District Court against the Company, was

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2002 (Unaudited) (cont'd)**

received at the Company offices. The plaintiffs, who contend that they are Company subscribers or use its services, allege in their claim that the Company unlawfully collects interest in arrears, as defined in a directive from the Accountant General concerning interest rates, in respect of arrears in payment for services provided by other communications service providers, which are included in the invoice issued by the Company to its subscribers. According to the plaintiffs, the Company may collect such interest only in respect of arrears in payment for the telecommunication services provided by the Company itself. The plaintiffs further allege that the Company refrains from transferring the full amount of interest in arrears that it collects to the other communications providers. The plaintiffs are requesting restitution of the interest in arrears that the Company is alleged to have collected unlawfully. If approved as a class action, the total amount of the claim is estimated by the plaintiffs to be in the tens of millions of shekels. The Company, based on consultations with its legal advisers, is unable, at this stage, to estimate the outcome of the action and no provision in respect thereof is included in the financial statements.

10. On June 23, 2002, the Company received at its offices a statement of claim that was filed in the Jerusalem District Court against the Company by the Development Authority, the Jewish National Fund and the State of Israel (Israel Lands Administration, the Ministry of Communications and the Ministry of Finance) (jointly referred to as "the State").

The claim seeks for declaratory relief whereby the interpretation of the "Asset Transfer Agreement" which was signed between the State and the Company in connection with the transfer of real estate ("the Real Estate") to the Company prior to the commencement of its operations in 1984, and the "Umbrella Contract" which was signed in 1993 in connection with some of those assets, requires, *inter alia*, the following conclusions:

- a. The State is the sole and exclusive owner of the Real Estate and the Company has no rights in the ownership of the Real Estate and is not entitled to act as if it were the owner.
- b. At most, the Company has a right to use the Real Estate, such right being limited by conditions and objectives that are defined in the aforementioned agreements, and failing compliance with those conditions and objectives, the Real Estate should be restored to the State immediately and unconditionally.
- c. The State has the right to immediately deny the Company the use of the Real Estate leased to it in the bi-annual contracts referred to in the Asset Transfer Agreement, even where the Company is using the Real Estate for the purpose for which it was transferred, as long as the State believes that there is another preferable use for the Real Estate, and as long as alternative real estate is made available to the Company for continuation of the provision of services by the defendant as defined in the agreements and insofar as the defendant can prove that such real estate is needed.
- d. The Company is required to immediately return to the State certain assets in the Rishpon region (480 dunams), in the Sakia region (1,300 dunams) and parts of parcels in the Givat Mordechai neighborhood and in Ramat Beit Hakerem in Jerusalem.

It is noted that this claim was filed following a broad dispute that arose in recent years between the Company and the State concerning real estate that was transferred from the State to the Company prior to the start of operations in 1984 and is known as "the Real Estate Dispute". See Note 9B to the financial statements as at December 31, 2001.

The Company's position in this dispute is described in general in Note 9B to the financial statements as at December 31, 2001, and in the opinion of its legal advisers,

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2002 (Unaudited) (cont'd)**

the Company has worthy arguments to substantiate its position. The Company filed a statement of defense in which it alleges, *inter alia*, that the claim or part of it should be stricken *in limine* or clarified and amended and that in any case the claim should also be dismissed on its merits. The Company, relying on its legal advisers, is unable, at this stage, to estimate the chances of the claim and its overall implications.

It should be noted that concurrently with the above legal proceeding, the Company is negotiating with representatives of the State and of Israel Lands Administration in relation to the Real Estate Dispute. Although these negotiations are far advanced, no format has yet been agreed upon for the final agreement. Under the principles of the agreement being formulated, which has been approved by the Board of Directors of the Company, several properties defined as "Renewable Lease Properties" out of the Real Estate in the Company's possession will be returned to the State and the rest of the properties will remain in the Company's possession on capitalized lease terms. In addition, the State will lift the restrictions it alleges are applicable to the use and exploitation of the Real Estate that was transferred to the Company with the status of capitalized lease.

To the best of the Company's knowledge, the Economic-Social Cabinet of the Government approved the principles of the arrangement being formulated.

11. Further to Note 20A(1) to the financial statements as at December 31, 2001, in the matter of the claim and application for recognition as a class action by way of a motion 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 on the basis of call time units as promised in its advertisements, on September 29, 2002, the Supreme Court allowed the plaintiff's application for an additional hearing and ruled that the additional hearing would be held before a panel of seven judges. On October 17, 2002, the Supreme Court allowed the application of the Israeli Consumer Council to be added as a party to the additional hearing. If the decision on the appeal of the Company and Bezeq International is reversed in the additional hearing, the main hearing will be resumed in the District Court.
12. Further to Note 20A(34) to the annual financial statements in the matter of "Notice of a party to a collective dispute" which was filed by the New General Federation of Workers ("the Applicant") in the name of Company employees, the Applicant alleges that payment for grossing up of tax, the on-call duty benefit components and the clothing allowance which were and are paid to Company employees, are normal wages constituting part of the employee's regular pay, and that various payments and provisions should be made in respect thereof, including for pension purposes. On October 20, 2002, the Attorney General gave notice that he would be joining the claim. Furthermore, the Attorney General filed his position on the matter, stating that all parts of the application should be dismissed.
13. Further to Note 20A(28) to the annual financial statements in the matter of individual claims of employees and former employees concerning the inclusion of various wage components which could have a lateral effect, it should be noted that a ruling in another case has created a precedent which has adversely affected the Company's position regarding a particular wage component. Nevertheless, in consultation with its legal advisers, the Company is unable at this stage, to estimate the outcome of the proceeding. Accordingly, no provision was made in the financial statements in respect of this claim.
14. In September 2002 an application was filed in the Tel Aviv District Court for approval of a class action against Pelephone Communications Ltd. ("Pelephone"). The plaintiff alleges that Pelephone collected overpayment from users who make calls at peak hours from cellular telephones to Bezeq subscribers and that it does so unlawfully and in contravention of the Telecommunications Regulations (Payments for reciprocal

**Notes to the Interim Consolidated Financial Statements
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connection), 5760-2000. This collection allegedly commenced at the beginning of 2001 and is coordinated with the other cellular companies. According to the plaintiff, even though the collection is ostensibly for Bezeq, Pelephone does not transfer the full payment to Bezeq and retains part of it for itself. Pelephone has not yet filed its response to the petition, but its management estimates, based on the opinion of its legal advisers and on an external legal opinion, that the claim has little chance of success, as a judgment exists on this matter as a result of a compromise agreement which was validated as a judgment, in which the claim was approved as a class action and restitution was made to the plaintiff and Pelephone customers in respect of overpayment, *inter alia* for the same charges in respect of which the present claim was filed. Pelephone's lawyers contacted the plaintiff and referred him to that *judgment*. The plaintiff admitted that he had been unaware of the compromise agreement but has not yet given notice of what he intends to do regarding the claim he filed.

15. In September 2002 an application was filed in the Tel Aviv District Court for approval of a class action against Pelephone Communications Ltd. ("Pelephone") in a total amount of NIS 20 million. The applicant, through his lawyers, alleges that Pelephone compels its customers to subscribe to the "GoNext" service and connects them without their prior consent and without giving them a clear explanation of the nature of the service. Pelephone and its legal advisers are studying the claim documents and are unable, at this stage, to estimate the outcome of the action.
16. Further to Note 20A(10) to the annual financial statements, on November 14, 2002 an application was filed for permission to appeal the decision of the Tel Aviv District Court dated October 1, 2002, to dismiss the applicants' application to approve their claim against Pelephone as a class action.

The claim was based on the applicants' allegation that throughout the years in which Pelephone was a monopoly in the cellular market, it exploited its monopoly status and collected exorbitant prices for all its services. Therefore, the applicants sought to order Pelephone to make restitution to its customers of the excess profits it collected and which allegedly amount to the amount of the claim. The outcome of the application for leave to appeal cannot be estimated at this stage.

17. On November 11, 2002, a petition was filed in the High Court of Justice by Ganei Tikva Local Council against the Minister of Communications, the Company and Golden Channels. The petition is for transfer of the cable network in the jurisdiction of the Council which the Company maintains for Golden Channels to an underground infrastructure (instead of above-ground). The petitioners are requesting that the High Court of Justice direct the Minister of Communications to instruct the Company and Golden Channels to make the transfer immediately and at their own expense since the network in its condition today constitutes a safety hazard. The Company and the cable companies are embroiled in a long-standing dispute on the question of who should bear the costs of transferring the infrastructure, deriving from conflicting interpretations of the contract between the parties. The Company is studying the petition and is unable, based on consultations with its legal advisers, to estimate at this stage the outcome and the implications of the petition. No provision has been made in the financial statements in respect of this action.

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2002 (Unaudited) (cont'd)**

B. Forward Exchange Contracts

1. Hedging Contracts (Forward)

	Currency purchased	Currency payable	Final repayment date	Amounts receivable	Amounts payable
NIS millions					
Contracts at predetermined interest rates					
.....	Dollars	CPI-linked NIS	April 2004	636	648
.....	Euro	CPI-linked NIS	February 2005	1,049	927
Contracts at predetermined exchange rate (excluding premium/discount)					
.....	Dollars	NIS	December 2002	97	98
.....	Euro	NIS	August 2003	394	352
.....	CPI-linked NIS	NIS	June 2003	547	520
Call options purchased	Dollars	NIS	March 2003	39	40

2. Contracts not for hedging purposes

	Currency purchased	Currency payable	Final repayment date	Amounts receivable	Amounts payable
NIS millions					
Forward exchange contracts —	Dollars	NIS	June 2003	(0.5)	58
Put options	NIS	Dollars	December 2002	—	731
Call options	NIS	Dollars	December 2002	(19)	731

NOTE 8 — REVENUES FROM TELECOMMUNICATION SERVICES

	For the nine month period ended September 30		For the three month period ended September 30		For the year ended December 31
	2002 (Unaudited)	2001 (Unaudited)	2002 (Unaudited)	2001 (Unaudited)	2001 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from communication services —					
Domestic fixed-line communications ...	1,747,745	1,937,718	587,951	647,913	2,567,965
Cellular telephone	1,651,860	1,663,402	570,540	558,331	2,216,617
Fixed fees	1,593,105	1,662,370	531,763	550,765	2,218,891
International communications and internet services ⁽¹⁾	511,314	625,685	171,813	212,903	839,238
Installation and sale of equipment to subscribers	411,378	343,729	140,457	108,469	455,275
Other	87,059	104,153	21,853	34,755	127,490
	<u>6,002,461</u>	<u>6,337,057</u>	<u>2,024,377</u>	<u>2,113,136</u>	<u>8,425,476</u>
Other revenues	234,369	211,009	72,144	55,803	296,039
	<u>6,236,830</u>	<u>6,548,066</u>	<u>2,096,521</u>	<u>2,168,939</u>	<u>8,721,515</u>

(1) See Note 1B(1).

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NOTE 9 — OPERATING AND GENERAL EXPENSES

	For the nine month period ended September 30		For the three month period ended September 30		For the year ended December 31
	2002 (Unaudited)	2001 (Unaudited)	2002 (Unaudited)	2001 (Unaudited)	2001 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Salaries and related expenses	1,510,337	1,535,984	489,690	511,587	2,051,868
General expenses	552,785	563,483	188,627	201,969	784,337
Materials and spare parts	445,369	392,178	153,661	130,662	544,001
Cellular telephone expenses	358,088	362,892	127,494	116,552	467,213
Building maintenance	279,653	312,271	91,913	102,346	408,314
Services and maintenance by subcontractors	216,559	250,862	69,143	76,443	346,003
International communications expenses	117,332	168,857	52,737	52,307	213,859
Vehicle maintenance expenses	74,825	64,704	25,923	22,047	89,119
Collection fees	24,963	29,778	7,719	9,412	39,204
	<u>3,579,911</u>	<u>3,681,009</u>	<u>1,206,907</u>	<u>1,223,325</u>	<u>4,943,918</u>
Less — salaries charged to investment in fixed assets	109,411	112,802	29,463	38,171	164,171
	<u>3,470,500</u>	<u>3,568,207</u>	<u>1,177,444</u>	<u>1,185,154</u>	<u>4,779,747</u>

NOTE 10 — TRANSACTIONS WITH INTERESTED AND RELATED PARTIES

Further to Note 28B to the financial statements as at December 31, 2001, the Company reached an agreement with the Ministry of Defense in the name of the State of Israel for the provision of telecommunication services by the Company to the IDF.

The main points of the agreement are as follows:

1. The Company will provide the IDF with telecommunications services at a special inclusive discount of approximately 28% in relation to services that the Company provided to the IDF prior to signing the agreement and of 14% relating to services which did not exist or which the Company did not provide to the IDF prior to signing the agreement. Based on the volume of services that the Company provided to the IDF prior to the effective date of the agreement, the discount in respect of the services under the agreement does not differ significantly from the discount that was given pursuant to the memorandum of understanding under which the parties acted prior to signing the agreement.
2. The Ministry of Defense undertakes to purchase services from the Company for which the consideration will be not less than approximately NIS 81.2 million (excluding VAT) for each year of the contract and to order from the Company cabling and development works of communications infrastructures within IDF bases which are used for providing the Company's services, for which the consideration will be not less than 80% of the overall monetary value of the orders of the Ministry of Defense for such infrastructures in each year of the contract.
3. The agreement ends and exhausts all the disputes between the parties up to April 1, 2001, including the disputes that were brought before a special professional commission ("the Gabai Commission") but excluding a dispute concerning a discount of 18% which the Ministry of Defense deducted from payments collected by the Company for other communications providers.
4. At the end of the term of the agreement, ownership of the infrastructures within the IDF base shall remain that of the Ministry of Defense while ownership of infrastructures outside IDF bases shall remain that of the Company.
5. The term of the contract commences on the date of signing the agreement, July 21, 2002, through March 31, 2005 (under the terms of the agreement, retroactive accounting will be effective as of April 1, 2001, and as a result of the aforementioned the Company expects to receive a rebate in a non-material amount).

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2002 (Unaudited) (cont'd)**

NOTE 11 — CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY

A. Statements of Operations

	For the nine month period ended September 30		For the three month period ended September 30		For the year ended December 31
	2002 (Unaudited)	2001 (Unaudited)	2002 (Unaudited)	2001 (Unaudited)	2001 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from telecommunication services					
(Note 11B)	4,259,470	4,760,020	1,405,109	1,561,686	6,306,581
Costs and expenses					
Operating and general expenses (Note 11C)	1,846,065	2,029,664	603,664	657,761	2,693,259
Depreciation (See also Note 5)	1,455,396	1,715,387	487,791	566,132	2,301,356
Royalties to the Government of Israel	134,644	153,866	39,582	51,028	202,545
	<u>3,436,105</u>	<u>3,898,917</u>	<u>1,131,037</u>	<u>1,274,921</u>	<u>5,197,160</u>
Operating income	823,365	861,103	274,072	286,765	1,109,421
Financing expenses, net	(131,790)	(50,856)	(55,651)	(32,186)	(77,839)
Earnings after financing expenses	691,575	810,247	218,421	254,579	1,031,582
Other expenses, net (Note 4C)	(393,193)	(5,205)	(398,473)	(25,817)	(2,675)
Earnings (loss) before income tax	298,382	805,042	(180,052)	228,762	1,028,907
Income tax	(208,786)	(286,156)	(39,424)	(84,883)	(370,989)
Earnings (loss) after income tax	89,596	518,886	(219,476)	143,879	657,918
Company's equity in losses of investee companies	(234,687)	(343,481)	(125,348)	(136,054)	(528,332)
Net earnings (loss)	<u>(145,091)</u>	<u>175,405</u>	<u>(344,824)</u>	<u>7,825</u>	<u>129,586</u>

B. Revenues from telecommunications services

	For the nine month period ended September 30		For the three month period ended September 30		For the year ended December 31
	2002 (Unaudited)	2001 (Unaudited)	2002 (Unaudited)	2001 (Unaudited)	2001 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from communications services					
Domestic fixed-line communications	1,766,916	1,956,828	594,374	655,208	2,597,245
Cellular telephone	478,839	548,552	161,785	176,168	714,912
Fixed fees	1,498,362	1,574,394	488,089	517,282	2,099,687
International communications ⁽¹⁾	112,967	262,028	38,875	87,175	350,464
Installation and sale of equipment to subscribers	121,035	117,954	39,655	41,525	149,555
Other	91,450	104,289	22,749	34,955	134,837
	<u>4,069,569</u>	<u>4,564,045</u>	<u>1,345,527</u>	<u>1,512,313</u>	<u>6,046,700</u>
Other revenues	189,901	195,975	59,582	49,373	259,881
	<u>4,259,470</u>	<u>4,760,020</u>	<u>1,405,109</u>	<u>1,561,686</u>	<u>6,306,581</u>

(1) See Note 1B(1).

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2002 (Unaudited) (cont'd)**

C. Operating and general expenses

	For the nine month period ended September 30		For the three month period ended September 30		For the year ended December 31
	2002 (Unaudited)	2001 (Unaudited)	2002 (Unaudited)	2001 (Unaudited)	2001 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Salaries and related expenses	1,168,343	1,218,502	376,540	411,077	1,623,823
General expenses	216,668	203,987	68,094	71,197	304,342
Materials and spare parts	38,190	53,973	14,310	15,577	67,408
Cellular telephone expenses	22,635	91,164	4,919	15,732	92,469
Building maintenance	243,578	271,502	81,120	86,564	357,405
Services and maintenance by subcontractors	173,136	212,455	57,398	65,685	288,613
International communications expenses	4,316	7,686	1,099	2,303	10,370
Vehicle maintenance expenses	62,483	53,608	20,703	18,391	74,150
Collection fees	26,127	29,589	8,944	9,406	38,850
	<u>1,955,476</u>	<u>2,142,466</u>	<u>633,127</u>	<u>695,932</u>	<u>2,857,430</u>
Less — salaries charged to investments in fixed assets	<u>109,411</u>	<u>112,802</u>	<u>29,463</u>	<u>38,171</u>	<u>164,171</u>
	<u>1,846,065</u>	<u>2,029,664</u>	<u>603,664</u>	<u>657,761</u>	<u>2,693,259</u>

**NOTE 12 — CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND
PELEPHONE COMMUNICATIONS LTD.**

1. Bezeq International Ltd.

A. Balance sheet

	September 30 2002 (Unaudited)	September 30 2001 (Unaudited)	December 31 2001 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	184,122	224,203	175,172
Investments	20,065	12,060	9,155
Fixed assets	426,961	398,286	434,057
Other assets	9,991	19,480	16,626
	<u>641,139</u>	<u>654,029</u>	<u>635,010</u>
Current liabilities	326,140	361,730	346,698
Long-term liabilities	173,719	206,136	206,854
Quasi capital receipt	—	171,939	171,939
Shareholders' equity (deficit)	141,280	(85,776)	(90,481)
	<u>641,139</u>	<u>654,029</u>	<u>635,010</u>

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2002 (Unaudited) (cont'd)**

B. Statement of Operations

	For the nine month period ended September 30		For the three month period ended September 30		For the year ended December 31
	2002 (Unaudited)	2001 (Unaudited)	2002 (Unaudited)	2001 (Unaudited)	2001 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from international telecommunications services	519,797	533,124	173,338	183,926	715,558
Operating expenses	301,449	402,495*	110,382	129,869*	528,820
Gross profit	218,348	130,629	62,956	54,057	186,738
Marketing expenses	108,322	97,145	38,474	34,646	130,363
General and administrative expenses:					
In respect of the reporting period	50,405	78,495*	17,668	26,083*	99,310
In respect of cost differences in communication services in previous periods	(7,576)	—	(14,329)	—	—
	151,151	175,640	41,813	60,729	229,673
Operating income (loss)	67,197	(45,011)	21,143	(6,672)	(42,935)
Financing income (expenses), net	7,238	(11,118)	(3,022)	(4,501)	(11,607)
Earnings (loss) after financing, net	74,435	(56,129)	18,121	(11,173)	(54,542)
Other income (expenses), net	13	4,420	5	(216)	4,262
Earnings (loss) before income tax	74,448	(51,709)	18,126	(11,389)	(50,280)
Income tax	(1,051)	—	(409)	—	(3,229)
Earnings (loss) after income tax	73,397	(51,709)	17,717	(11,389)	(53,509)
Company's equity in losses of an affiliated company	(13,575)	(25,627)	(2,060)	(3,591)	(28,532)
Net earnings (loss)	59,822	(77,336)	15,657	(14,980)	(82,041)

* Reclassified

NOTE 12 — CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD. (CONTD.)

2. Pelephone Communications Ltd.

A. Balance sheet

	September 30 2002 (Unaudited)	September 30 2001 (Unaudited)	December 31 2001 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	1,348,889	1,084,088*	1,106,663*
Long-term trade receivables, net	164,406	95,729	100,526
Deferred income tax	319,457	47,890*	261,605*
Fixed assets, net	2,753,074	2,970,951	2,699,256
Other assets	493,283	683,979	636,231
	5,079,109	4,882,637	4,804,281
Current liabilities	1,943,298	1,815,515	1,971,053
Provision for losses of investee company	4,051	204	3,985
Long-term liabilities	1,191,671	1,205,184*	1,067,405
Minority rights	11,842	12,881	12,841
Shareholders' equity	1,928,247	1,848,853	1,748,997
	5,079,109	4,882,637	4,804,281

* Reclassified

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2002 (Unaudited) (cont'd)**

B. Statement of Operations

	For the nine month period ended September 30		For the three month period ended September 30		For the year ended December 31
	2002	2001	2002	2001	2001
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from cellular services, sales and services	3,015,583	2,834,582	1,037,478	936,616	3,818,747
Cost of cellular services, sales and services	2,582,303	2,500,092	886,209	845,352	3,399,307
Gross profit	433,280	334,490	151,269	91,264	419,440
Sales and marketing expenses	393,808	383,214	134,903	124,222	543,381
General and administrative expenses	164,864	174,956	54,026	54,650	236,988
	558,672	558,170	188,929	178,872	780,369
Operating loss	(125,392)	(223,680)	(37,660)	(87,608)	(360,929)
Financing expenses, net	54,355	85,214	46,861	25,960	131,801
Other income (expenses), net	892	2,080	79	363	(217,946)
Loss before income tax	(178,855)	(306,814)	(84,442)	(113,205)	(710,676)
Tax benefit	57,851	30,254	30,170	1,532	243,971
Loss after income tax	(121,004)	(276,560)	(54,272)	(111,673)	(466,705)
Minority equity in losses of a consolidated company	4,627	10,394	1,508	3,104	13,309
Company's equity in losses of an affiliate	(332)	(4,167)	(351)	(530)	(8,193)
Net loss	(116,709)	(270,333)	(53,115)	(109,099)	(461,589)

APPENDIX A

DBS SATELLITE SERVICES (1998) LTD.

**CONDENSED INTERIM FINANCIAL STATEMENTS
AS OF SEPTEMBER 30, 2002
(Unaudited)**

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November 26, 2002

The Board of Directors of
DBS Satellite Services (1998) Ltd.
6 Hayozma Street
Kfar Saba Industrial Zone

Dear Sirs,

Re: Review of unaudited condensed interim financial statements for the periods ended
September 30, 2002

At your request, we have reviewed the condensed interim balance sheet of DBS Satellite Services (1998) Ltd. (hereafter — the Company) as of September 30, 2002 and the condensed interim statements of operations, changes in capital deficiency and cash flows for the nine and three month periods then ended. Our review was performed in accordance with the procedures prescribed by the Institute of Certified Public Accountants in Israel. Inter alia, these procedures include: reading of the aforementioned financial statements, reading of minutes of meetings of shareholders and of the board of directors and its committees, and making inquiries of officers responsible for financial and accounting matters.

Since our review was limited in scope and did not constitute an audit in accordance with generally accepted auditing standards, we do not express an opinion on the abovementioned condensed interim financial statements.

During our review, nothing came to our attention to indicate that significant adjustments should be made in the aforementioned interim financial statements in order for them to be considered as having been prepared in conformity with generally accepted accounting principles and the Israeli Securities Regulations (Periodic and Immediate Reports), 1970.

We draw attention to Note 3 to the condensed financial statements regarding the financial position of the Company, the need for additional funding in substantially larger amounts than those defined in the financing agreement between the Company and certain banks and the agreements in principle, formulated to the date of these financial statements, between the Company, its shareholders and the banks.

As explained in the abovementioned note, the Company's continued activity depends on the execution of the agreements in principle with the banks regarding the increase of credit facilities and on the receipt of additional loans from shareholders. Management's opinion as to the chances of achieving the required financing arrangements is presented in note 3d. As mentioned in note 3c, the receipt of additional loans from a principal shareholder is subject, inter alia, to the approval of the Ministerial Committee for Privatization. The principal shareholder is taking steps to obtain the approval of said committee for increasing his exposure.

Sincerely yours,

DBS SATELLITE SERVICES (1998) LTD.

**CONDENSED BALANCE SHEET
AS OF SEPTEMBER 30, 2002
IN SEPTEMBER 2002 ADJUSTED NIS**

	September 30		December 31,
	2002	2001	2001
	(Unaudited)		(Audited)
	In thousands		
Assets			
CURRENT ASSETS:			
Cash and cash equivalents	3,939		22
Accounts receivable:			
Trade	113,582	15,085	60,947
Other	9,198	14,527	31,915
Total current assets	<u>126,719</u>	<u>29,612</u>	<u>92,884</u>
BROADCASTING RIGHTS, see note 4:			
Cost	316,200	325,651	306,594
Less — utilized rights	117,566	83,132	68,792
	<u>198,634</u>	<u>242,519</u>	<u>237,802</u>
FIXED ASSETS:			
Cost	1,897,859	1,418,293	1,598,440
Less — accumulated depreciation	523,610	200,851	274,590
	<u>1,374,249</u>	<u>1,217,442</u>	<u>1,323,850</u>
LICENSE FEES — ADVANCE ON ACCOUNT OF ROYALTIES			
	13,025	29,106	28,022
	<u>1,712,627</u>	<u>1,518,679</u>	<u>1,682,558</u>
Liabilities, net of capital deficiency			
CURRENT LIABILITIES:			
Bank credit	1,076,527	816,423	944,162
Accounts payables and accruals:			
Trade	603,266	433,756	555,848
Other	61,724	*19,053	32,071
Total current liabilities	<u>1,741,517</u>	<u>1,269,232</u>	<u>1,532,081</u>
LONG-TERM LIABILITIES:			
Shareholders' loans	2,016,361	1,559,276	1,678,127
Liability for employee rights upon retirement, net	2,620		1,231
Customer deposits, net	43,040	*11,456	20,585
Other liabilities	20,792		29,004
Total long-term liabilities	<u>2,082,813</u>	<u>1,570,732</u>	<u>1,728,947</u>
Total liabilities	<u>3,824,330</u>	<u>2,839,964</u>	<u>3,261,028</u>
CAPITAL DEFICIENCY	<u>(2,111,703)</u>	<u>(1,321,285)</u>	<u>(1,578,470)</u>
	<u>1,712,627</u>	<u>1,518,679</u>	<u>1,682,558</u>

* Reclassified.

Joshua Harel
Deputy Financial Officer

Shlomo Liran
Chief Executive Officer

David Brodet
Chairman of the
Board of Directors

Date of approval of the financial statements: November 26, 2002.

The accompanying notes are an integral part of these condensed financial statements.

DBS SATELLITE SERVICES (1998) LTD.

**CONDENSED STATEMENTS OF OPERATIONS
FOR THE 9 AND 3 MONTH PERIODS ENDED SEPTEMBER 30, 2002
IN SEPTEMBER 2002 ADJUSTED NIS**

	9 months ended September 30		3 months ended September 30		Year ended December 31,
	2002	2001	2002	2001	2001
	(Unaudited)		(Unaudited)		(Audited)
	In thousands				
REVENUES	490,571	205,215	190,447	89,821	327,075
OPERATING EXPENSES	818,653	512,108*	280,816	194,695*	757,081
GROSS LOSS	328,082	306,893	90,369	104,874	430,006
SELLING, MARKETING, GENERAL AND ADMINISTRATIVE EXPENSES:					
Selling and marketing	98,517	151,632	28,485	50,968	202,255
General and administrative	87,981	119,396*	26,474	44,109*	164,499
LOSS FROM ORDINARY OPERATIONS	514,580	577,921	145,328	199,951	796,760
FINANCIAL EXPENSES (INCOME), net	(2,492)	63,174	55,845	18,681	101,520
OTHER EXPENSES, see note 5	21,145		21,145		
LOSS FOR THE PERIOD	533,233	641,095	222,318	218,632	898,280

* Reclassified.

The accompanying notes are an integral part of these condensed financial statements.

DBS SATELLITE SERVICES (1998) LTD.

**CONDENSED STATEMENTS OF CHANGES IN CAPITAL DEFICIENCY
FOR THE 9 AND 3 MONTH PERIODS ENDED SEPTEMBER 30, 2002
IN SEPTEMBER 2002 ADJUSTED NIS**

	<u>Share capital and premium</u>	<u>Accumulated deficit</u> In thousands	<u>Total</u>
BALANCE AT JANUARY 1, 2002 (audited)	11	(1,578,481)	(1,578,470)
CHANGES DURING THE 9 MONTHS ENDED			
SEPTEMBER 30, 2002 (unaudited) — loss	<u> </u>	<u>(533,233)</u>	<u>(533,233)</u>
BALANCE AT SEPTEMBER 30, 2002 (unaudited)	<u>11</u>	<u>(2,111,714)</u>	<u>(2,111,703)</u>
BALANCE AT JANUARY 1, 2001 (audited)	11	(680,201)	(680,190)
CHANGES DURING THE 9 MONTHS ENDED			
SEPTEMBER 30, 2001 (unaudited) — loss	<u> </u>	<u>(641,095)</u>	<u>(641,095)</u>
BALANCE AT SEPTEMBER 30, 2001 (unaudited)	<u>11</u>	<u>(1,321,296)</u>	<u>(1,321,285)</u>
BALANCE AT JULY 1, 2002 (unaudited)	11	(1,889,396)	(1,889,385)
CHANGES DURING THE 3 MONTHS ENDED			
SEPTEMBER 30, 2002 (unaudited) — loss	<u> </u>	<u>(222,318)</u>	<u>(222,318)</u>
BALANCE AT SEPTEMBER 30, 2002 (unaudited)	<u>11</u>	<u>(2,111,714)</u>	<u>(2,111,703)</u>
BALANCE AT JULY 1, 2001 (unaudited)	11	(1,102,664)	(1,102,653)
CHANGES DURING THE 3 MONTHS ENDED			
SEPTEMBER 30, 2001 (unaudited) — loss	<u> </u>	<u>(218,632)</u>	<u>(218,632)</u>
BALANCE AT SEPTEMBER 30, 2001 (unaudited)	<u>11</u>	<u>(1,321,296)</u>	<u>(1,321,285)</u>
BALANCE AT JANUARY 1, 2001 (audited)	11	(680,201)	(680,190)
CHANGES DURING THE YEAR ENDED DECEMBER 31,			
2001 (audited) — loss	<u> </u>	<u>(898,280)</u>	<u>(898,280)</u>
BALANCE AT DECEMBER 31, 2001 (audited)	<u>11</u>	<u>(1,578,481)</u>	<u>(1,578,470)</u>

The accompanying notes are an integral part of these condensed financial statements.

DBS SATELLITE SERVICES (1998) LTD.

**CONDENSED STATEMENTS OF CASH FLOWS
FOR THE 9 AND 3 MONTH PERIODS ENDED SEPTEMBER 30, 2002
IN SEPTEMBER 2002 ADJUSTED NIS**

	9 months ended September 30		3 months ended September 30		Year ended December 31,
	2002	2001	2002	2001	2001
	(Unaudited)		(Unaudited)		(Audited)
	In thousands				
CASH FLOWS FROM OPERATING ACTIVITIES:					
Loss for the period	(533,233)	(641,095)	(222,318)	(218,632)	(898,280)
Adjustments required to reflect the cash flows from operating activities (a)	<u>526,847</u>	<u>*81,450</u>	<u>258,300</u>	<u>*78,196</u>	<u>*285,671</u>
Net cash provided by (used in) operating activities	<u>(6,386)</u>	<u>(559,645)</u>	<u>35,982</u>	<u>(140,436)</u>	<u>(612,609)</u>
CASH FLOWS FROM INVESTING ACTIVITIES, see (b) below:					
Purchase of fixed assets	(405,251)	(369,172)	(113,807)	(142,365)	(546,177)
Purchase of broadcasting rights	<u>(58,803)</u>	<u>*(88,079)</u>	<u>(34,569)</u>	<u>*(33,564)</u>	<u>*(99,900)</u>
Net cash used in investing activities	<u>(464,054)</u>	<u>(457,251)</u>	<u>(148,376)</u>	<u>(175,929)</u>	<u>(646,077)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:					
Receipt of long-term loans from shareholders	341,992	734,410	72,283	244,135	848,487
Short-term bank credit — net	<u>132,365</u>	<u>282,028</u>	<u>39,811</u>	<u>72,186</u>	<u>409,763</u>
Net cash provided by financing activities	<u>474,357</u>	<u>1,016,438</u>	<u>112,094</u>	<u>316,321</u>	<u>1,258,250</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	3,917	(458)	(300)	(44)	(436)
BALANCE OF CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	<u>22</u>	<u>458</u>	<u>4,239</u>	<u>44</u>	<u>458</u>
BALANCE OF CASH AND CASH EQUIVALENTS AT END OF PERIOD ..	<u><u>3,939</u></u>	<u><u>-,-</u></u>	<u><u>3,939</u></u>	<u><u>-,-</u></u>	<u><u>22</u></u>

* Reclassified.

DBS SATELLITE SERVICES (1998) LTD.

**CONDENSED STATEMENTS OF CASH FLOWS
FOR THE 9 AND 3 MONTH PERIODS ENDED SEPTEMBER 30, 2002
IN SEPTEMBER 2002 ADJUSTED NIS**

	9 months ended September 30,		3 months ended September 30,		Year ended December 31,
	2002	2001	2002	2001	2001
	(Unaudited)		(Unaudited)		(Audited)
	In thousands				
(a) Adjustments required to reflect the cash flows from operating activities:					
Income and expenses not involving cash flows:					
Utilized rights	101,918	47,966	33,972	21,602	79,602
Depreciation and amortization	242,872	143,588	85,007	56,779	218,926
Impairment provision in respect of installation equipment	21,145		21,145		
Liability for employee rights upon retirement, net	1,389		1,462		1,231
Linkage differences on (erosion of) principal of long-term shareholders' loans	<u>(3,758)</u>	<u>(3,695)</u>	<u>18,457</u>	<u>1,585</u>	<u>1,102</u>
	363,566	187,859	160,043	79,966	300,861
Changes in operating asset and liability items:					
Decrease (increase) in accounts receivable	(29,918)	21,176	(19,350)	8,266	(42,076)
Increase (decrease) in accounts payable and accruals:					
Trade	149,303	(118,721)*	97,042	(15,832)*	(15,402)*
Customer deposits, net	31,805	13,597	6,091	9,606	27,167
Other	<u>12,091</u>	<u>(22,461)</u>	<u>14,474</u>	<u>(3,810)</u>	<u>15,121</u>
	<u>163,281</u>	<u>(106,409)</u>	<u>98,257</u>	<u>(1,770)</u>	<u>(15,190)</u>
	<u>526,847</u>	<u>81,450</u>	<u>258,300</u>	<u>78,196</u>	<u>285,671</u>
(b) Supplementary information on investing activities not involving cash flows —					
Increase (decrease) in suppliers' credit in respect of purchase of fixed assets	<u>(105,832)</u>	<u>29,939</u>	<u>(48,539)</u>	<u>(10,886)</u>	<u>33,109</u>
Increase (decrease) in suppliers' credit in respect of purchase of broadcasting rights	<u>3,947</u>	<u>3,501*</u>	<u>(7,512)</u>	<u>(2,131)*</u>	<u>(19,117)*</u>

* Reclassified.

The accompanying notes are an integral part of these condensed financial statements.

DBS SATELLITE SERVICES (1998) LTD.

NOTES TO CONDENSED FINANCIAL STATEMENTS

(Unaudited)

AS OF SEPTEMBER 30, 2002

1. General

The condensed interim financial statements as of September 30, 2002 and for the nine and three month periods then ended (hereafter — the interim statements) were drawn up in a condensed form, in accordance with accounting principles generally accepted for interim financial statements and with the Securities Regulations (Periodic and immediate reports), 1970. The generally accepted accounting principles applied in preparation of the interim statements are consistent with those applied in the preparation of the annual financial statements. However, the interim statements do not include all the information and notes required for the annual financial statements.

2. Activities

DBS Satellite Services (1998) Ltd. (hereafter — the Company) was incorporated in Israel on December 2, 1998. In January 1999, the Company received a license from the Ministry of Communications to broadcast in Israel television broadcasts by means of satellite (hereafter — the License). The License is for a period of ten years from the date of its receipt, and can be extended for an additional period of six years, subject to certain conditions. The Company is subject to the Telecommunications Law, 1982 (hereafter — the Telecommunications Law), the regulations and rules promulgated thereunder and the terms of the License.

In July 2000, the Company completed the development stage and began to provide its customers with multi-channel television broadcasts in accordance with the License granted to it under the Telecommunications Law.

3. The Company's financial position

- a) The Company expects significant losses and a negative cash flow from operating activities during the first years of activity. The loss for 2001 amounted to approximately adjusted NIS 898 million, and the loss for the nine months ended September 30, 2002 amounted to approximately adjusted NIS 533 million. The negative cash flow from operating activities amounted to approximately adjusted NIS 613 million and approximately adjusted NIS 6 million in 2001 and in the nine month period ended September 30, 2002, respectively. As a result of these losses, the working capital deficiency as of September 30, 2002 aggregated approximately adjusted NIS 1,615 million.
- b) On May 23, 2001, the Company entered into a financing agreement (hereafter — the financing agreement) with certain banks (hereafter — the banks). The financing agreement stipulates, inter alia, undertakings by the Company to meet certain suspending conditions as well as specified cumulative milestones and financial stipulations (hereafter — the terms). To date of the approval of these financial statements, not all of the terms had been fulfilled.

In addition, a financial evaluation performed by the banks shows that the amount of finance required for the Company's activities substantially exceeds the financing requirements defined in the financing agreement.

On May 1, 2002, the Company and the banks signed an addendum to the financing agreement. In addition, on the same date the Company signed a bond in favor of the banks and the shareholders registered a first ranking fixed charge, in favor of the banks, on their rights pertaining to shareholders' loans that have been and that will be granted to the Company by the shareholders. As part of the arrangements reached with the banks, it was determined that the Company is to search for a solution, to be agreed to by its shareholders and to the satisfaction of the banks, for obtaining the additional funds required for financing the Company's activities. The Company should

DBS SATELLITE SERVICES (1998) LTD.

NOTES TO CONDENSED FINANCIAL STATEMENTS — (continued)

(Unaudited)

AS OF SEPTEMBER 30, 2002

also present a business plan that would testify as to its ability to meet its obligations to the banks. In the event that such a solution is not found by June 30, 2002, the banks would be entitled to take, at their sole discretion, the steps necessary to collect all the amounts due to them and act on their rights stipulated in the financing agreement in the event of a breach of the agreement.

To date of the approval of these financial statements, the Company, its shareholders and the banks had formulated an agreement in principle with regard to increasing the credit facilities in parallel with additional investments by the shareholders in an amount not less than 150% of the amount of funds that would be provided by the banks. This agreement in principle has been approved by the parties, see also (c) below. The aforementioned financing agreement has not yet been signed and is conditional upon, among other matters, formulating documents and the pertinent approvals. Between October 1, 2002 and the date of approval of these financial statements, the banks have provided the Company with some \$6 million on the basis of the agreement in principle.

The parties have also been discussing an additional financing program. Further to these discussions, the additional financing program has been approved in principle by the authorized bodies of one of the banks. As agreed with the other banks, discussions are to be held with them in order to obtain their agreement to the additional financing program. As of the date of approval of these financial statements and prior to finalizing the signature of the financing agreement with the banks, the shareholders are continuing to provide the Company with additional credit facilities, over and above those required pursuant to the agreement in principle with the banks, as referred to above.

- c) The receipt of additional loans from a principal shareholder is, inter alia, conditional upon the approval of the Ministerial Committee for Privatization (hereafter — the Committee). The Committee has allowed the shareholder to increase his exposure up to the sum arrived at by multiplying the percentage of his holding in the Company's share capital by U.S. \$480 million. As of September 30, 2002, the balance of the shareholders' loans granted by this shareholder amounted to NIS 1,044 million. The principal shareholder is taking steps to obtain approval from the committee for the increase in his exposure.
- d) The continuation of the Company's activity depends on the execution of the agreement in principle formulated with the banks for the increase of the credit facilities, as referred to above, and the receipt of additional loans from shareholders, including the approval of the Committee referred to in (c) above.

The Company's management believes that the chances are good that the ongoing deliberations between the Company, the shareholders and the banks will result in the execution of the agreement in principle formulated with the banks and shareholders including formulating the additional financing program referred to above, and in an arrangement for the financing required by the Company in the coming year.

DBS SATELLITE SERVICES (1998) LTD.

NOTES TO CONDENSED FINANCIAL STATEMENTS — (continued)

(Unaudited)

AS OF SEPTEMBER 30, 2002

4. Broadcasting rights:

	<u>September 30, 2002</u>	<u>December 31, 2001</u>
	<u>Adjusted NIS in thousands</u>	
Advances to content providers.....	40,647	51,296
Broadcasting rights	<u>375,185</u>	<u>301,786</u>
	415,832	353,082
Less — fully utilized rights.....	<u>99,632</u>	<u>46,488</u>
	<u>316,200</u>	<u>306,594</u>

5. The amount included under "other expenses" in the reporting periods is in respect of an impairment provision made for installation equipment.

6. In October 2001, the Israeli Accounting Standards Board ("IASB") issued Israel Accounting Standard No. 12 — Discontinuance of Adjusting Financial Statements for inflation, which provided for the discontinuance of adjusting financial statements for the effects of inflation, as of January 1, 2003. On November 10, 2002, the professional committee of the IASB resolved to postpone, by one year, the implementation of the above standard. Accordingly, an exposure draft for a new standard (No. 17) was issued on November 17, 2002 that, when approved, will postpone the implementation of Standard No. 12 to January 1, 2004. Until the date of the implementation of Standard No. 12, the company will continue preparing inflation-adjusted financial statements in accordance with the pronouncements of the Institute of Certified Public Accountants in Israel.

7. In August 2002, the Israel Accounting Standards Board issued Israel Accounting Standard No. 14, "Financial Reporting for Interim Periods", which is to supersede Opinion No. 43 of the Institute of Certified Public Accountants in Israel on this issue. Standard 14 is to be applied to interim financial statements commencing in 2003. The Company is to adopt the new standard forthwith. The Company is presently examining what affect, if any, application of the new standard will have on its financial statements.

8. Data regarding the changes in the exchange rate of the U.S. dollar (hereafter — the dollar) and in the consumer price index:

	<u>Exchange rate of the dollar</u>	<u>Consumer price index</u>
Nine months ended September 30:		
2002	10.30%	6.99%
2001	7.77%	2.01%
Three months ended September 30:		
2002	2.14%	0.64%
2001	4.56%	0.89%
Year ended December 31, 2001.....	9.30%	1.40%

THE ISSUER

BEZEQ

The Israel Telecommunication Corp. Limited

15 Hazvi Street
P.O. Box 1088
Jerusalem 91010
Israel

TRUSTEE

Deutsche Trustee Company Limited

Winchester House
1 Great Winchester Street
London EC2N 2DB
England

ISSUING AND PRINCIPAL PAYING AGENT

Deutsche Bank AG London

Winchester House
1 Great Winchester Street
London EC2N 2DB
England

PAYING AGENT

Deutsche Bank Luxembourg S.A.

2 Boulevard Konrad Adenauer
L-1115 Luxembourg

LEGAL ADVISERS

To the Issuer

as to English law

White & Case
7-11 Moorgate
London EC2R 6HH
England

as to Israeli law

**Bosmat Chelouche
General Counsel**
Bezeq
2 Azrieli Center
Bezeq Building
Tel Aviv 61620
Israel

To the Dealers and the Trustee

as to English law

Allen & Overy
One New Change
London EC4M 9QQ
England

Corso Vittorio Emanuele II, 284
00186 Rome
Italy

as to Israeli law

Herzog, Fox & Neeman
Asia House
4 Weizmann Street
Tel Aviv 64239
Israel

AUDITORS

KPMG Somekh Chaikin
KPMG Millennium Tower
17 Ha'arba'a Street
P.O. Box 609
Tel Aviv 61009
Israel

DEALERS

ABN AMRO Bank N.V.
250 Bishopsgate
London EC2M 4AA
England

Deutsche Bank AG London
Winchester House
1 Great Winchester Street
London EC2N 2DB
England

Merrill Lynch International
Merrill Lynch Financial Centre
2 King Edward Street
London EC1A 1HQ
England

Morgan Stanley & Co. International Limited
25 Cabot Square
Canary Wharf
London E14 4QA
England

Salomon Brothers International Limited
Citigroup Centre
Canada Square
Canary Wharf
London E14 5LB
England

UBS AG, acting through its business group
UBS Warburg
100 Liverpool Street
London EC2M 2RH
England

LUXEMBOURG LISTING AGENT

Deutsche Bank Luxembourg S.A.
2 Boulevard Konrad Adenauer
L-1115 Luxembourg

