

OFFERING CIRCULAR

BEZEQ

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

€750,000,000

Euro Medium Term Note Programme

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

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

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

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

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

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

Arrangers

Deutsche Bank

Merrill Lynch International

Dealers

ABN AMRO

Merrill Lynch International

Schroder Salomon Smith Barney

Deutsche Bank

Morgan Stanley

UBS Warburg

The date of this Offering Circular is 20th November, 2001

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.

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

DOCUMENTS INCORPORATED BY REFERENCE

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

- (a) the most recently published audited consolidated annual financial statements and, if published later, the most recently published unaudited interim consolidated financial statements of the Issuer (see "*General Information*" for a description of the financial statements currently published by the Issuer); and
- (b) all supplements or amendments to this Offering Circular circulated by the Issuer from time to time,

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

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

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

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

GENERAL DESCRIPTION OF THE PROGRAMME

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

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

- (a) the euro equivalent of Notes denominated in another Specified Currency (as specified in the applicable Pricing Supplement in relation to the relevant Notes, described under "*Form of Pricing Supplement*") shall be determined by Deutsche Bank AG London (the "**Agent**", which expression shall include any successor agent) either, at the discretion of the Issuer, as of the date on which agreement is reached for the issue of Notes or on the preceding day on which commercial banks and foreign exchange markets are open for business in London and in Frankfurt am Main, in each case on the basis of the reference rate for the sale of the euro against the purchase of such Specified Currency published by the electronic information provider Reuters on page ECB 37 or such other screen page on that service or by such other information service provider which may be determined as the successor for the purposes of displaying such information or, if no such rate is available, on the basis of the exchange rate quoted by any leading bank selected by the Agent on the relevant day of calculation;
- (b) the euro equivalent of Dual Currency Notes, Index Linked Notes and Partly Paid Notes (each as specified in the applicable Pricing Supplement in relation to the relevant Notes, described under "*Form of Pricing Supplement*") shall be calculated in the manner specified above by reference to the original nominal amount on issue of such Notes (in the case of Partly Paid Notes regardless of the subscription price paid); and
- (c) the euro equivalent of Zero Coupon Notes (as specified in the applicable Pricing Supplement in relation to the relevant Notes, described under "*Form of Pricing Supplement*") and other Notes issued at a discount or a premium shall be calculated in the manner specified above by reference to the net proceeds received by the Issuer for the relevant Tranche.

SUMMARY OF THE PROGRAMME

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

Issuer	BEZEQ — The Israel Telecommunication Corp., Limited
Description	Euro Medium Term Note Programme
Arrangers	Deutsche Bank AG London Merrill Lynch International
Dealers	ABN AMRO Bank N.V. Deutsche Bank AG London Merrill Lynch International Morgan Stanley & Co International Limited Salomon Brothers International Limited ⁽¹⁾ UBS AG, acting through its business group UBS Warburg and any other Dealers appointed in accordance with the Programme Agreement.
Certain Restrictions	<p>Each issue of Notes denominated in a currency in respect of which particular laws, guidelines, regulations, restrictions or reporting requirements apply will only be issued in circumstances which comply with such laws, guidelines, regulations, restrictions or reporting requirements from time to time (see "<i>Subscription and Sale</i>") including the following restrictions applicable at the date of this Offering Circular.</p> <p>Sterling</p> <p>Issues of Notes denominated in sterling shall comply with all applicable laws and regulations (as amended from time to time) of United Kingdom authorities. See "<i>Banking Act 1987 (Exempt Transactions) Regulations 1997</i>" under "<i>General Information</i>".</p> <p>Notes with a maturity of less than one year</p> <p>After Section 19 of the Financial Services and Markets Act 2000 (the "FSMA") is brought into force, Notes issued on terms that they must be redeemed before their first anniversary 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 con-</p>

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

nection with article 2, paragraph 2 of the Ordinance of the Federal Banking Commission on Stock Exchanges and Securities Trading of 2nd December, 1996. Under the said regulations, the relevant Dealer or, in the case of a syndicated issue, the lead manager (the “**Swiss Dealer**”), must be a bank domiciled in Switzerland (which includes branches or subsidiaries of a foreign bank located in Switzerland) or a securities dealer duly licensed by the Swiss Federal Banking Commission pursuant to the Federal Law on Stock Exchanges and Securities Trading of 24th March, 1995. The Swiss Dealer must report certain details of the relevant transaction to the Swiss National Bank no later than the Issue Date of the relevant Notes.

Trustee	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	If so specified in the applicable Pricing Supplement, the Issuer may redenominate Notes issued in the currency of a country that subsequently participates in the third stage of European economic and monetary union, or otherwise participates in European economic and monetary union in a manner with similar effect to such third stage, into euro. The provisions relating to any such redenomination will be contained in the applicable Pricing Supplement.
Maturities	Such maturities as may be agreed between the Issuer and the relevant Dealer, subject to such minimum or maximum maturities as may be allowed or required from time to time by the relevant central bank (or equivalent body) or any laws or regulations applicable to the Issuer or the relevant Specified Currency.
Issue Price	Notes may be issued on a fully-paid or a partly-paid basis and at an issue price which is at par or at a discount to, or premium over, par.
Form of Notes	The Notes will be in bearer form and will, on issue, be represented by either a temporary global Note or a permanent global Note as specified in the applicable Pricing Supplement. Temporary global Notes will be exchangeable either for (i) interests in a permanent global Note or (ii) for definitive Notes as indicated in the applicable Pricing Supplement. Permanent global Notes will be exchangeable for definitive Notes upon either (i) not less than 60 days’ written notice from Euroclear and/or CBL (acting on the instructions of any holder of an interest in such permanent global Note) to the Agent as described therein or (ii) only upon the occurrence of an Exchange Event as described under “ <i>Form of the Notes</i> ”.
Fixed Rate Notes	Fixed interest will be payable on such date or dates as may be agreed between the Issuer and the relevant Dealer and on redemption, and will be calculated on the basis of such Day Count

Fraction as may be agreed between the Issuer and the relevant Dealer.

Floating Rate Notes

Floating Rate Notes will bear interest at a rate determined:

- (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.

Unless otherwise permitted by then current laws and regulations, Notes (including Notes denominated in sterling) in respect of which the issue proceeds are to be accepted by the Issuer in the United Kingdom, before Section 19 of the FSMA is brought into force, must have a minimum redemption amount of £100,000 (or its equivalent in other currencies), unless such Notes may not be redeemed until the third anniversary of their Issue Date and are to be listed on the stock exchange of a country within the European Economic Area (an “**EEA Exchange**”).

After Section 19 of the FSMA is brought into force, Notes issued on terms that they must be redeemed before their first anniversary 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.

Unless otherwise permitted by then current laws and regulations, Notes (including Notes denominated in sterling) in respect of which the issue proceeds are to be accepted by the Issuer in the United Kingdom, before Section 19 of the FSMA is brought into force, will have a minimum denomination of £100,000 (or its equivalent in other currencies), unless such Notes may not be redeemed until the third anniversary of their Issue Date and are to be listed on an EEA Exchange.

After Section 19 of the FSMA is brought into force, Notes issued on terms that they must be redeemed before their first anniversary may be subject to restrictions on their denomination and distribution, see “*Certain Restrictions — Notes with a maturity of less than one year*” 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 *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.

Listing

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

Unlisted Notes may also be issued.

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

Governing Law

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

Selling Restrictions

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

**United States Selling
Restrictions**

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

FORM OF THE NOTES

Each Tranche of Notes will be in bearer form and will initially be issued in the form of a temporary global note (a "**Temporary Global Note**") or, if so specified in the applicable Pricing Supplement, a permanent global note (a "**Permanent Global Note**") which, 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 supplemented by a Supplemental Trust Deed dated 20th November, 2001, (such Trust Deed as further modified and/or supplemented and/or restated from time to time, the "**Trust Deed**") made between the Issuer and Bankers Trustee Company Limited (the "**Trustee**") which expression shall include any successor as trustee).

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

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

The Notes, the Receipts (as defined below) and the Coupons (as defined below) have the benefit of an Agency Agreement dated 7th August, 2000, as supplemented by a Supplemental Agency Agreement dated 20th November, 2001, (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 20th November, 2001 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 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 auditing standards in Israel in effect on 20th November, 2001.

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

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

This document constitutes the Pricing Supplement relating to the issue of Notes described herein. Terms used herein shall be deemed to be defined as such for the purposes of the Conditions set forth in the Offering Circular dated 20th November, 2001. This Pricing Supplement is supplemental to and must be read in conjunction with such Offering Circular.

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

1. (i) Series Number: []
(ii) Tranche Number: []
(If fungible with an existing Series, details of that Series, including the date on which the Note become fungible)
2. **Specified Currency or Currencies:** []
3. **Aggregate Nominal Amount:**
— Tranche: []
— Series: []
4. (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]]*

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

(2) Unless otherwise permitted, text to be included for all Notes (including Notes denominated in sterling) in respect of which the issue proceeds are accepted by the Issuer in the United Kingdom before section 19 (General Prohibition) of the Financial Services and Markets Act 2000 is brought into force.

- 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 listing of the €750,000,000 Euro Medium Term Note Programme of BEZEQ — The Israel Telecommunication Corp., Limited]

Responsibility

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

Signed on behalf of the Issuer:

BEZEQ — The Israel Telecommunication Corp., Limited

By: _____
Duly authorised

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

USE OF PROCEEDS

The net proceeds from each issue of Notes will be applied by the Issuer for its general corporate purposes.

CAPITALISATION

The table below sets forth the consolidated capitalisation of Bezeq at 30th June, 2001:

	As at 30th June, 2001
	<i>(in NIS⁽¹⁾ thousands)</i>
Long-Term Debt	4,646,304
Short-Term Debt	1,955,311
Shareholders' Equity	7,194,838
Share capital	
— authorised: 2,435,000,000 ordinary shares of NIS 1 each	
— issued: 2,411,657,538 ordinary shares of NIS 1 each	
Total capitalisation and indebtedness	<u>13,796,453</u>

Note:

(1) NIS of June 2001.

Save as disclosed herein, there has been no material change in the consolidated capitalisation of Bezeq since 30th June, 2001.

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, in essence, the sole operator of domestic fixed line telecommunications services in Israel. To date, the Government has issued one licence for these services to Ofek the New World Ltd., which has recently announced that it is ceasing operations. (see "*Activities — Competition in Domestic Services*"). Bezeq also holds 30 per cent. of the share capital of D.B.S. Satellite Services (1998) Ltd. ("**DBS**"), a company licensed to provide direct broadcast satellite services which commenced operations in July 2000 (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 right in all markets has been repealed. By the end of 1994, Cellcom Israel Ltd. ("**Cellcom**") joined Pelephone as a second mobile telephone operator. Partner Communications Company Ltd. ("**Partner**") began operating as a third mobile telephone operator in October 1998 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 growing competition in both the cellular telecommunications market and the international telecommunications

market may have an adverse effect on the Group's financial position. A recent amendment to the Telecommunications Law (Telecommunications and Broadcasting), 1982 (the "**Telecommunications Law**") enables competition 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 seeking 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 has gradually been limited and competition has been introduced into several segments of the telecommunications market. In June 1999 Bezeq's statutory exclusivity for the provision of domestic fixed line services was repealed. The burden of regulation imposed on the Group has generally decreased as segments of the market have opened to competition and the Group's market share in these segments declined. Hence, Bezeq International and Pelephone, which face fierce competition in international telecommunications and cellular services respectively, have benefited from a less rigid regulatory regime than Bezeq. Although the MoC has 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.

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. All 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 2002 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. The tariffs for services which generate a substantial part of Bezeq's revenues also require the approval of the Finance Committee of the Knesset, the Israeli parliament.

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

Under the framework, tariffs for services such as domestic telecommunications are updated periodically by an efficiency factor, based on a price cap regulatory regime, which is usually recommended once every five years by a public tariffs committee. The efficiency factor for each of the years 2001 to 2003 was set at 3.5 per cent.. Bezeq's tariffs are also updated according to the rise in the Israeli consumer price index. With effect from 1st March, 2001, Bezeq's call tariffs were reduced by an average of 1.4 per cent., interconnect fees for calls to the cellular operators were increased by an average of approximately 33 per cent. and tariffs for other services were reduced by approximately 2.79 per cent..

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 a "friends and family" programme.

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 4.5 per cent. and such royalty will be reduced to 4 per cent. in 2002 and to 3.5 per cent. in 2004. Pelephone (in common with the other cellular telecommunications providers) pays a royalty of 5 per cent. of most of its revenues and such royalty will be reduced to 4.5 per cent. in 2002, to 4 per cent. in 2003 and to 3.5 per cent. in 2004.

Bezeq transacts a large volume of business with government ministries and agencies and government companies. Such Government business accounted for approximately 5 per cent. of revenues in 2000 and represents Bezeq's largest customer. Bezeq provides services to the Israeli Defense and Security Forces on terms which provide that the Ministry of Defence funds infrastructure investments in exchange for discounts on services provided by Bezeq (see note 29 to the financial statements set out in "*Audited Annual Financial Statements*").

Government Control and Privatisation

The Government has a 54.6 per cent. shareholding in Bezeq. As a consequence, Bezeq and those of its subsidiaries in which it holds more than 50 per cent. of the share capital, namely Bezeq International, BezeqCall and Bezeq On-Line, are deemed to be a "Government Company" and "Subsidiary Government Companies" respectively and, as such, are heavily regulated by the Government Companies Law, 1975 (the "**GCL**"). Under the GCL, a number of decisions taken by Government Companies are subject to governmental approval, such as the establishment of companies, the purchase of shares in existing companies and the election of a chief executive officer ("**CEO**") and chairperson of the board of directors. The Minister and the Prime Minister also appoint the majority of Bezeq's directors, subject to the vote of the general meeting (see "*Management*"). 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. On 14th November, 2001, the Government Companies Authority distributed a "sale procedure" providing details of the process. According to the announcement, parties interested in participating in the sale must submit their response (in accordance with the terms of the sale procedure) on 13th February, 2002. The announcement also states 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 at which the privatisation will be completed. The privatisation may trigger certain pre-payment and event of default provisions in previous loans and debentures entered into by Bezeq (see notes 14(D) and 15(C) to the financial statements set out in *"Audited Annual Financial Statements"* and *"Liquidity and Capital Resources"*).

Under the Telecommunications Order (determination of essential service provided by Bezeq — The Israeli Telecommunications Corp. Ltd.), 1997 (the **"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 major 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 recently amended 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, such suspicions are currently under investigation.

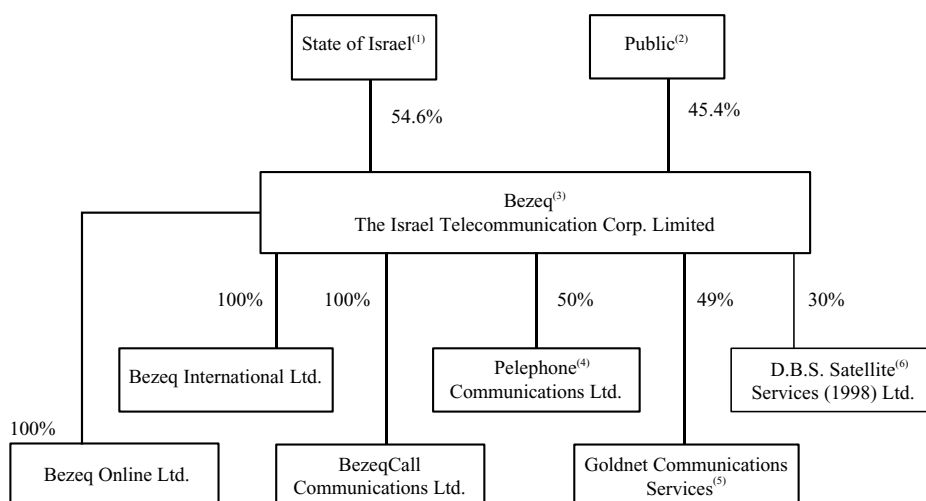
In preparation for Bezeq's planned privatisation, Bezeq, its employees and the Government entered into a collective labour agreement that extended Bezeq's former early retirement plans (see *"Employees"*). As to the employees' position regarding the privatisation process, see *"Employees — Labour Relations"*.

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 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 21A(6) and 21A(9) to the financial statements set out in "Audited Annual Financial Statements").

Group Structure

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



Notes:

- (1) In May 1999 the Shareholders resolved to amend Bezeq's Articles of Association 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, 2001, Zeevi Communications Holding Ltd. (the "Zeevi Group") owned approximately 19.26 per cent. of Bezeq's share capital.
- (3) At 30th June, 2001 Bezeq's share capital consisted of 2,435,000,000 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"). Bezeq has the option to buy from AT&T, and AT&T has the option to sell to Bezeq, AT&T's remaining 5 per cent. interest in Goldnet. Bezeq 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 purchases and options are 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 2001. Bezeq requested an extension of twelve months to fulfill the MoC's requirement, due to certain difficulties in its implementation.

- (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 45 per cent., in accordance with an agreement among the shareholders of DBS (see "Recent Developments and Outlook").

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 27 February, 2003 and 27 February, 2005, however if Bezeq is privatised, the option is exercisable until 9 months thereafter (but no later than 27 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 agreed to contribute US\$ 50 million to Pelephone, and to date Bezeq has contributed US\$ 20 million of such amount. PHL is expected to finance its contribution by increasing the aforementioned bank loan to US\$ 350 million. If Bezeq exercises its option prior to privatisation, Pelephone will become a Subsidiary Government Company (see "Government Control and Privatisation").

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,									
	1996		1997		1998		1999		2000	
	NIS Millions	%	NIS Millions	%	NIS Millions	%	NIS Millions	%	NIS Millions	%
Domestic fixed-line communications ⁽²⁾	3,526	36	3,332	35	3,306	35	2,751	30	2,526	30
Cellular telephone ⁽³⁾	1,584	16	2,362	25	2,678	28	2,838	31	2,146	25
Fixed fees ⁽⁴⁾	1,243	13	1,418	15	1,574	16	1,819	20	1,988	24
International communications and Internet services ⁽⁵⁾	2,492	26	1,663	17	1,132	12	904	10	846	10
Installation and sale of equipment to subscribers ⁽⁶⁾	559	6	505	5	506	5	479	5	496	6
Miscellaneous ⁽⁷⁾	301	3	299	3	345	4	365	4	400	5
Total	<u>9,705</u>	<u>100%</u>	<u>9,579</u>	<u>100%</u>	<u>9,541</u>	<u>100%</u>	<u>9,156</u>	<u>100%</u>	<u>8,402</u>	<u>100%</u>

Notes:

(1) NIS of December 2000.

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

(3) Includes 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 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 and other telecommunications operators (such as billing and network construction) and revenues from the Palestinian telecommunications company, ships at sea, satellite services and telex services. In addition, includes other telecommunications revenues such as collection fees, Bezeqnet Service, detailed billing and Bezeqcard fees.

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

Domestic Fixed Line Services

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

The following table sets 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,				
	1996	1997	1998	1999	2000
Total number of active subscriber lines (in thousands)	2,549	2,675	2,819	2,877	3,021
Lines used by residential customers (in thousands) ⁽¹⁾	1,810	1,872	1,973	2,014	2,084
Lines used by business customers (in Thousands) ⁽¹⁾⁽²⁾	739	803	846	863	937
Number of subscriber lines per 100 inhabitants	44	45	47	46	47
Annual line growth rate	9%	5%	5%	2%	5%
Percentage of lines connected to digital exchanges	100	100	100	100	100
Growth in GDP of Israel ⁽³⁾	5.0%	3.3%	2.4%	2.3%	6.0%
Population of Israel (in thousands) ⁽³⁾	5,758	5,900	6,041	6,209	6,369
Annual Growth rate of Israeli population ⁽³⁾	2.59%	2.47%	2.40%	2.78%	2.58%

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.

Domestic services generated revenues of NIS 5,410 million in 2000, representing approximately 64 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 1996 to 2000, Bezeq added approximately 472,000 subscriber lines (including ISDN lines), increasing line penetration from approximately 44 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 14 per cent..

Domestic Voice Services

Base Services. As part of its basic switched telephony service package, Bezeq offers subscribers call waiting, call forwarding, touch-tone dialing, 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 speed dialing, voice mail and conference call facilities, caller identification, toll-free numbers and calling cards. Bezeq is continuously looking to improve its existing services and add new value-added services to its service offering. Bezeq is currently planning the introduction of new services for residential customers such as a single number facility (assigning the same telephone number for both the customer's fixed line home telephone and his mobile telephone) and advanced reminder and voice mail services. Various new services will also be offered to business customers, subject to requisite approvals.

Public Payphones. Bezeq currently operates approximately 22,000 public payphones located throughout Israel, representing a penetration rate of approximately 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.

Goldnet Services. Since 1992 Goldnet, a partnership in which Bezeq currently holds a 49 per cent. interest (see note 4 under "*Group Structure*"), has provided a wide range of data communications services, primarily for business customers. Goldnet maintains a communications node installed by AT&T in Israel (one of seven installed worldwide) that provides access to 160 countries and 40 communications networks worldwide. These services include local and international electronic mail, Internet access and related services, connections to financial institutions, on-line information services (such as 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.

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

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

ADSL Service. In November 2000, Bezeq received a permit to provide ADSL services from the MoC. ADSL enables high speed transmission of data through ordinary copper telephone lines. By 31st October, 2001, Bezeq had installed approximately 30,000 ADSL modems.

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

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

Internet Services

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

Bezeq International's Internet Services. Since 1999 Bezeq International has provided direct Internet access services as part of its strategic decision to operate Internet-related services. Bezeq International is currently one of the three largest Israeli ISPs. By 30 June, 2001 Bezeq International had over 300,000 subscribers, most of which were residential customers who represented approximately 75 per cent. of Bezeq International's revenues from Internet activities. At 1st August, 2001 Bezeq International held approximately 24.8 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 June 2001, Walla merged with Israel On Line, another Israeli portal. In addition, as of June 2000, Bezeq International is a web hosting services provider.

GoNext. GoNext, a subsidiary of Pelephone (51 per cent.) was established in 2000 to provide cellular Internet services. As of 30 June, 2001, GoNext had 114,000 subscribers.

Broadcasting Services

Bezeq operates and maintains technical transmission services for the public broadcasting system in Israel. Bezeq provides broadcasting services (other than programming) for two television stations and nine radio stations in Israel. Currently, it also provides certain infrastructure services for all three cable television operators in Israel. Bezeq's subsidiary, DBS, (in which Bezeq has a 30 per cent. interest) was licensed for satellite television broadcasting in January 1999 and commenced operating in July 2000. DBS competes with three cable television operators (currently seeking to merge) in multi-channel services in Israel. The merger among the three cable television operators, if approved, is expected to increase their market power as a purchaser of broadcasting content and to reduce their operating costs, thus increasing their competitive advantages, and resulting in an adverse effect on the business of DBS. As of 30 June, 2001, Bezeq's share in the accumulated losses of DBS amounted to a total of approximately NIS 309 million and Bezeq expects DBS to continue incurring losses during the early years of its operations. As Bezeq expects to increase its ownership in DBS (see "*Group Structure*"), its share in the accumulated losses of DBS is also expected to increase. (See note 8(H) and Appendix B to the financial statements set out in "*Audited Annual Financial Statements*").

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,				
	1996	1997	1998	1999	2000
Calls (completed connections)⁽¹⁾					
Number of calls (in millions)					
Local ⁽²⁾	4,376	4,301	4,374	4,312	4,768
Domestic long distance ⁽³⁾	<u>2,865</u>	<u>3,214</u>	<u>3,561</u>	<u>3,895</u>	<u>3,843</u>
Total	<u>7,241</u>	<u>7,515</u>	<u>7,935</u>	<u>8,207</u>	<u>8,611</u>
Annual growth rate	9%	4%	6%	3.5%	5%
Usage minutes⁽¹⁾					
Number of minutes (in millions)					
Local ⁽²⁾	11,933	12,365	13,418	14,619	20,486
Domestic long distance ⁽³⁾	<u>8,248</u>	<u>8,940</u>	<u>9,644</u>	<u>10,303</u>	<u>9,446</u>
Total	<u>20,181</u>	<u>21,305</u>	<u>23,062</u>	<u>24,922</u>	<u>29,932</u>
Annual growth rate	9%	6%	8%	8%	20%
Average number of usage minutes per line ⁽⁴⁾	8,251	8,157	8,395	8,785	10,133

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

From 1996 to 2000, the number of completed domestic calls increased by 19 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 48 per cent. from approximately 20,181 million to 29,932 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.

Bezeq estimates that approximately 40 per cent. of its domestic traffic as at December 2000 (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 types of customer in the fees it charges for line installation, monthly line rental and call charges.

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

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

The following table sets 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,				
	1996	1997	1998 (in NIS ⁽¹⁾)	1999	2000
Standard connection fee	498	514	532	532	341
Standard monthly line rental fee	20.4	30.0	31.1	36.1	37.5
Local call of up to five minutes ⁽²⁾	0.248	0.256	0.265	0.208	0.385
One minute domestic long distance call ⁽²⁾	0.74	0.51	0.53	0.42	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 1st March, 2001, calls are subject to a minimum charge of NIS 0.195. The tariff for 2000 refers to a call for the duration of five minutes.

Competition in Domestic Services

As from 1st June, 1999, Bezeq's statutory exclusive right to provide domestic fixed line services was repealed. It is expected that other operators, including the cable television operators, will be granted licences to operate domestic fixed line services in the near future. A recent amendment to 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 amendment also deals with the Minister's authority to instruct operators of public telecommunications networks (including Bezeq) to allow the unbundling and co-location of network services. In October 2000, the MoC began, but has yet to complete, the tender process for frequencies required to provide wireless technology services such as LMDS. Bezeq believes that the introduction of competition in the domestic telecommunications sector will adversely impact its financial position.

With the introduction of competition in the domestic telecommunications market, other operators will be required to build new domestic network infrastructures (facility-based competition) which will compete with Bezeq's network, unless they are permitted to use other infrastructures (unbundling). 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. Bezeq expects that one of the first fields in which it will face full competition is the field of transmission services, where other parties have received licenses and commenced operations.

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 is seeking to reverse this trend through a focused marketing campaign aimed at informing customers of the lower cost of fixed line calls as compared to cellular calls. However, Bezeq believes that cellular operators may offer more competitive rate packages and thereby increase the competition with the fixed line services offered by Bezeq. It is expected that some of the cellular operators will apply for a licence to provide domestic fixed line telecommunications services. Under regulations, Pelephone is restricted in its holdings in an applicant for a licence to provide domestic fixed line telecommunications services because of Bezeq ownership. Revenue lost to cellular operators is partially offset by increased revenues from interconnect fees. The cellular operators are currently taking steps to connect their networks to each other, thus reducing their need to pay Bezeq interconnect fees for calls between two cellular networks.

Competition from Cable TV Companies. The three cable television operators, upon receipt of the requisite approvals, are also expected to compete with Bezeq with respect to the provision of domestic services. The cable television operators already benefit from an extensive cable

infrastructure throughout Israel that may be modified to carry telecommunications services. The cable television operators, which operate on a regional basis, do not currently compete against each other and have submitted an application for approval of a merger among them. Under a recent amendment to the Telecommunications Law, the Minister is authorised to issue to cable TV operators licences to provide telecommunications services, subject to certain conditions. To Bezeq's knowledge, each of the cable television operators has recently submitted a request for a licence to provide certain telecommunications services, including high speed Internet access. Upon the issue of such a licence, the receiving cable TV operator shall lose its exclusive right to provide cable TV services in its geographical area, and others shall be able to request licences to provide cable TV services in that area. The Telecommunications Law requires that the telecommunications services licences and the TV broadcasting licences be held separately by affiliated companies.

Bezeq has taken, and is continuing to implement, various measures to prepare for 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 internal structure (including cost and workforce reduction initiatives and consolidating customer services divisions) and increasing marketing efforts.

Universal Service Obligation

Under its licence, Bezeq is required to provide universal services, namely services to all persons in all regions of Israel, including installing telephone lines in any location, even if the provision of such services is not profitable. Similarly, Bezeq is generally prohibited from discriminating among subscribers in any manner, including by the cost of services or the range of services provided. Bezeq submits alternative tariff baskets for service packages to the approval of the Minister and the Minister of Finance, 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. It is expected that new operators entering the domestic fixed line market will not be subject to a full USO and will be allowed to eventually limit their operations to specific geographical areas of the country (within which they shall be permitted to differentiate among classes of customers). Under the Telecommunications Law, the Minister may set the means to fund the USO subsequent to the opening of the market to effective competition.

Domestic Marketing and Customer Service

In response to the introduction of competition in the domestic telephone services market, Bezeq has significantly increased its marketing efforts and decided to implement certain organizational changes. In February 2001, Bezeq started to establish separate departments 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. Currently, 24 account managers located in four different regions handle approximately 270 customer accounts. The middle market is currently serviced by approximately 100 marketing representatives. 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 after an unsuccessful project with a billing systems supplier (see note 9E to the financial statements set out in "*Audited Annual Financial Statements*"). In June 2001, Bezeq entered into an agreement with Amdocs Software Systems Ltd. for the provision of a billing system. The cost of constructing 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. The billing system is expected to be fully operational by June 2003.

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, 2000, it held approximately 40 per cent. of the international voice services market, in terms of traffic.

International telecommunications services generated revenues of NIS 846 million in 2000, representing approximately 10 per cent. of Bezeq's consolidated revenues. These revenues consist of customer charges for outgoing international calls, gross settlement fees from foreign operators for incoming international calls, access fees, transit fees and interconnect charges from the international operators (other than Bezeq International) for use of Bezeq's network and fees for various services provided to the international operators, including rental of transmission facilities. 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. The payment obligation consist of interconnect charges and access fees. Interconnect charges are paid to Bezeq for all traffic which originates or terminates on its network. Access fees are paid to Bezeq for traffic transmitted or received through an international operator's system, including traffic which originates or terminates on one of the cellular systems, whether or not such traffic was routed through Bezeq's system. Access fees are payable through the end of 2001 at gradually declining rates and will cease to be payable after 1st January, 2002. Transit fees are paid to Bezeq for traffic transmitted to or from an international operator's system, originating from or, as the case may be, terminating on a cellular operator's system. Bezeq International and the other two international operators also pay Bezeq installation and fixed monthly fees for transmission lines between Bezeq's switches and the switches of the international operators.

International Voice Services

Bezeq International offers various voice services, such as international direct dialling, international toll-free numbers and international directory inquiries. Bezeq International also provides international calling cards such as Globus, Globus Business and a pre-paid calling card, Globus-card, for use in public payphones in Israel 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 2000, approximately 35 per cent. of the volume of outgoing traffic consisted of calls to North America and approximately 46 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,				
	1996 ⁽¹⁾	1997	1998	1999	2000
Outgoing calls (in millions of minutes)					
North America	103	145	124	140	142
Other	<u>212</u>	<u>167</u>	<u>216</u>	<u>229</u>	<u>265</u>
Total	<u>315</u>	<u>312</u>	<u>340</u>	<u>369</u>	<u>407</u>
Annual growth in outgoing traffic	19%	(1)%	9%	7.5%	10%
Incoming calls (in millions of minutes)					
North America	252	207	110	132	111
Other	<u>215</u>	<u>187</u>	<u>144</u>	<u>128</u>	<u>132</u>
Total	<u>467</u>	<u>394</u>	<u>254</u>	<u>260</u>	<u>243</u>
Annual growth in incoming traffic	11%	15.6%	(33.5)%	2%	(6.5)%
Ratio of incoming to outgoing traffic	1.48	1.26	0.75	0.70	0.60

Note:

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

There is currently an imbalance between total outgoing international traffic and total incoming international traffic, with the amount of outgoing traffic being greater than the amount of incoming traffic and Bezeq expects this trend to continue. This is mainly due to the introduction of competition and the resulting decrease in tariffs for calls from Israel to other countries. As a result the Group is a net payer of settlement fees to foreign operators. Bezeq International believes that international data traffic has decreased as a result of the downturn 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 does not exceed 60 per cent. in terms of traffic, Bezeq International was allowed to reduce its rates in order to compete more efficiently and a more flexible price control regime, based on Bezeq International's market share, was introduced. See "*Relationship with Government — Operations*". 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. The MoC has indicated that it intends to enable additional international operators to enter the market in 2002. Bezeq and Bezeq International have voiced objections to opening the market to additional competition, on the grounds of market saturation. The licences of the two new operators require them to price their services through January 2002 at levels that are below those charged by the Group prior to the introduction of competition in

that market. In July 1997, in an effort to retain its market share and remain competitive, Bezeq International reduced its tariffs significantly. Although the entry of these new competitors into the international telecommunications market, particularly with their low tariffs, has resulted in a substantial increase in the size of the market, Bezeq International's market share and revenues and profits from this market have decreased substantially and may continue to decrease. 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 revenues of NIS 2,146 million in 2000, representing approximately 25 per cent. of Bezeq's consolidated revenues. These revenues consist of airtime charges for land to mobile calls 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, transmission charges, Bezeq's proportionate share of Pelephone's revenues (net of adjustments), royalties from Pelephone for use of certain transferred equipment and fees for various services provided to the cellular operators including rental of transmission equipment. Transmission charges for mobile to land calls and land to mobile calls are collected according to rates per minute set in regulations. Pelephone's financial statements are proportionately consolidated with those of Bezeq.

As of March 2000, due to changes in Bezeq's arrangements with the cellular operators and accounting policies, airtime charges for land to mobile calls are no longer recorded in cellular revenues and expenses. (See note 1(B)(3) to the "Unaudited Interim Financial Statements").

From 1996 to 2000, Pelephone experienced subscriber growth, from approximately 230,000 at 31st December, 1995 to approximately 1,505,000 at 31st December, 2000. Pelephone believes that the cellular penetration rate in Israel at the end of 2000 was approximately 65 per cent., representing some 4,190,000 subscriber lines (of which 1,505,000 were Pelephone's subscriber lines).

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

	At 31st December,				
	1996	1997	1998	1999	2000
Total subscribers (in thousands)	535	810	930	1,110	1,505
Pelephone's cellular subscribers per					
100 Inhabitants	8.7%	13.8%	15.8%	17.6%	23.5%
Average number of subscribers (in thousands) ⁽¹⁾ ..	382	672	872	1,021	1,308
Total revenues (in NIS millions)	2,306	2,637	3,011	2,975	3,442
Average annual revenues per subscriber					
(in NIS) ⁽²⁾	6,037	3,924	3,453	2,913	2,631

Notes:

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

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

Pelephone's results in 2000 (a net loss of approximately NIS 129 million) were affected by growing competition in the cellular market, the erosion of its tariffs and the investments relating to the deployment of its digital network. Pelephone's 2000 results also reflected a market-share strategy which the company took during that year. The subscribers base grew by 395,000 net new additions. At the same time, Pelephone recorded higher operational and marketing costs, which were related to its strategy. Pelephone is currently developing a new strategy in response to changes in market conditions and outlook in Israel and abroad.

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 2×12 MHz in the range of 825 MHz to 892 MHz frequencies for its service. To accommodate future growth as well as satisfy the condition in its licence that it upgrades its system, Pelephone began in October 1998 to deploy a digital network using Code Division Multiple Access ("**CDMA**") technology to operate alongside the existing N-AMPS network, while also continuing to operate the existing N-AMPS network. By June 2001, Pelephone's CDMA digital network had approximately 1,100,000 subscribers. Pelephone believes the CDMA technology offers certain advantages over the existing N-AMPS analogue system, such as increased capacity, reduced maintenance and infrastructure costs per subscriber, capability for advanced digital services and handsets with 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 the second quarter of 2001, Pelephone had approximately 480,000 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,				
	1996	1997	1998	1999	2000
Number of usage minutes (in millions).....	2,180	2,983	3,342	3,645	4,455
Annual growth rate	88%	37%	9%	12%	22%
Average number of usage minutes per subscriber	430	320	300	295	284

From 1995 to 2000, 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 peak/off-peak, zone/off zone and "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,				
	1996	1997	1998	1999	2000
Monthly service charge (per line)	74	74	36.86	29.68	18.20
Airtime rate (per minute)	0.5050	0.4776	0.5366	0.4986	0.4457

Pelephone determines its own airtime charges. However, the Minister can, under certain circumstances, regulate such charges. Under regulations which came into force on 1st October 2000, airtime tariffs for incoming calls were limited to NIS 0.54 per minute for October-December 2000, NIS 0.50 per minute for 2001, NIS 0.46 per minute for 2002, and NIS 0.42 per minute as of 1 January 2003. The MoC has agreed to amend the regulations so that airtime tariffs for incoming calls will continue to be limited to NIS 0.50 per minute until 1st January 2003, and as of such date they will be limited to NIS 0.45 per minute. 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 are expected to decrease by approximately US\$ 61 million for 2001 (see "*Legal Proceedings and Tax Assessments — Legal Proceedings*").

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 5 per cent. per annum of most of their revenues. In December 2000, the State of Israel filed a claim against Pelephone in the amount of approximately NIS 260 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 (see note 21A(23) 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. Pelephone believes that this discourages certain subscribers from switching between operators.

Cellular Marketing and Customer Service

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

To increase sales, Pelephone has established a distribution network throughout Israel consisting of approximately 90 direct sales persons, 190 dealer points and 40 stores, which together represent 320 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 26 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.

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\$ 35 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.

Investments Outside of Israel

In December 2000, Bezeq sold its 16 per cent. holdings in Fascel Ltd., a cellular services operator in India for approximately US\$ 36 million and received guarantees it had given previously in the amount of approximately US\$ 6 million, and registered pre-tax gains of approximately NIS 139 million (see note 8E to the financial statements set out in "*Audited Annual Financial Statements*"). In July 2001, Bezeq sold its 33 per cent. holdings in Emitel Telecommunication Corp. Ltd., a fixed-line telecommunications services provider in Hungary, for approximately US\$ 33 million, and registered pre-tax gains of approximately NIS 85 million (see note 4(b) to the financial statements set out in "*Unaudited Interim Financial Statements*"). Bezeq's current strategic position is to refrain from additional investments outside of Israel.

Principal Suppliers

The Group obtains telecommunications-related services and equipment from numerous suppliers. The Group is dependent on several main suppliers. If one of the main suppliers of a service or equipment were to be unwilling or unable to supply such service or equipment, the Group could experience disruptions in the operation of its business (see note 21A(9) to the financial statements set out in "*Audited Annual Financial Statements*").

Network Infrastructure and Technology

From 1996 to 2000, Bezeq invested approximately NIS 10,259 million to upgrade and modernise its telecommunications infrastructure, including the replacement of its analogue exchanges with digital exchanges (completed in 1996), 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 refurbishment of the access network. Bezeq has achieved full digitalisation of its switching network and, as a result, Bezeq is able to provide its customers with numerous value-added services as well as reduce connection intervals and errors. During the next 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 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.

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 fibre optic cables throughout its domestic backbone network. Fibre optic cables provide enhanced service quality in terms of clarity and speed. At 31st December, 2000, Bezeq had expanded the use of fibre optic cable to approximately 100 per cent. of its trunk network and to approximately 25 per cent. of its local network, representing approximately 6,000 kilometres of fibre optic cable in its trunk network and approximately 7,000 kilometres of fibre optic cable in its local network. Bezeq has also modernised and substantially upgraded its local access networks,

increasing the number of access lines in its local network from approximately 2.55 million lines at the end of 1996 to approximately 3.02 million lines at the end of 2000. 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 uses submarine fibre optic cables providing connections to Palermo, Cyprus and Egypt through which international calls can be routed to over 50 countries. Bezeq International purchased user rights on additional submarine fibre optic cables that are not directly connected to Israel for communications with Europe, North America and other countries.

Bezeq 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 is currently constructing a land earth station which will enable it to provide certain Inmarsat services, and is in the process of signing an operating agreement with Inmarsat. In addition, Bezeq is currently negotiating the purchase from the MoC of shares held by the MoC in Inmarsat. Bezeq's satellite services provide access to Europe, America, Russia and the Far East. Bezeq International has 770 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's cellular infrastructure is based primarily on 14 switches connected to approximately 860 radio sites nationwide. Each radio site covers a specific geographical area and includes an antenna for receiving and transmitting and a computerised control system. The sites are connected to a switch which includes a digital exchange responsible for the connection between all the sites and between the sites and Bezeq's exchanges.

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

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.

Employees

General

At 30th June, 2001 Bezeq had 9,090 employees, 59.4 per cent. of whom were employed pursuant to permanent collective labour agreements and 29.2 per cent. of whom were employed pursuant to temporary collective labour agreements. The remaining 11.4 per cent. were employed under individual employment contracts. More than one third of Bezeq's employees at 30th June, 2001 were technicians. At that date, 48.7 per cent. of Bezeq's employees performed administrative functions and 5.8 per cent. were engineers.

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

	Year ended 31st December,				
	1996	1997	1998	1999	2000
Number of employees					
Permanent contracts	7,645	7,478	6,629	5,989	5,409
Temporary contracts	434	312	248	135	61
Individual contracts	542	545	607	692	833
Total	<u>8,621</u>	<u>8,335</u>	<u>7,484</u>	<u>6,816</u>	<u>6,303</u>

Bezeq's employees are divided into three general groups, each subject to different employment terms. The first group of approximately 1,038 employees comprises senior managers and other employees employed under individual employment contracts with Bezeq. The second group of approximately 5,400 permanent employees comprises approximately 2,080 ex-Government employees who were employed by the MoC when Bezeq started its operations in 1984 and were transferred to Bezeq and approximately 3,300 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 30th June, 2001, Bezeq employed 2,631 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 the Company's forecasts and reached approximately 2,050. In addition, in March 2000, the Company further extended the plan to include an additional 530 employees, of which 438 employees have already retired as of 30th June 2001. As a result of the extensions, an expense of approximately NIS 398 million was provided for in the Company'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. Bezeq intends to implement certain structural changes concurrently with the implementation of the plan (see note 17D of the financial statements set out in "*Audited Annual Financial Statements*"). In 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. The last two work disruptions occurred in January and March 2001. Each work disruption lasted several days in reaction to the planned opening of the domestic fixed line market to competition and Bezeq's planned privatisation. 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, 2000 Bezeq owned, leased or used approximately 530,800 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. The Government opposes Bezeq's interpretation of the 1984 Agreement and has stated that the correct interpretation is that it has a right to repossess, without any reimbursement or compensation to Bezeq, including giving alternative property or any other payment, any property that is no longer used for the original needs or purposes for which it was leased or if the Government is no longer interested in such need or purpose. Discussions with the Government on this matter have not yet been successful and there can be no assurance that such dispute, as well as the dispute regarding the 1993 Agreement, will be resolved in the near future. Bezeq does not record the value of the properties subject to the renewable leases in its financial reports, 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*").

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.

Legal Proceedings and Tax Assessments

Legal Proceedings

Bezeq and other members of the Group are party to lawsuits and administrative proceedings incidental to the ordinary course of business. Except for the proceedings referred to elsewhere in this Offering Circular, including the notes to the financial statements set out in "*Audited Annual Financial Statements*" (in particular notes 9B, 9E and 21A) and in "*Unaudited Interim Financial Statements*" (in particular note 6), no member of the Group is a party to any legal proceeding and no such proceeding is known by Bezeq to be contemplated by the Governmental authorities or third parties which, if adversely determined, could have a material adverse effect on Bezeq or the Group. Bezeq believes that adequate provision has been recorded in its financial statements to the extent deemed necessary in respect of such claims. In September 2001, Bezeq received a class action claim in the amount of approximately NIS 41 million in respect of over-collection, on behalf of Pelephone, of airtime fees from calls to Pelephone subscribers. Bezeq is studying the claim and is unable, at this stage, to assess the likelihood of such action being successful. In addition, in September 2001, Bezeq International received a class action claim in an unspecified amount, alleging that it abused its monopolistic power during the period from June 1996 to July 1997 by charging high and unfair tariffs. Bezeq International is studying the claim and is unable, at this stage, to assess the likelihood of such action being successful. In October 2001, the District Court rejected an application for approval as a class action filed against the Company in February 2001 in connection with an Internet access plan known as "Light Net" that was introduced by the Company in May 2000 (see note 21A(24) to the financial statements set out in "*Audited Annual Financial Statements*"). In November 2001, Pelephone received a translation of a claim filed against Pelephone and Cellcom at the district court of Ramallah in the West Bank by the Palestinian General Public Telecommunications Company Ltd. The amount of the claim against Pelephone is approximately NIS 676 million. The plaintiff alleges that Pelephone provides cellular services to residents of the West Bank without a licence and in contradiction to the exclusivity granted to the plaintiff. Pelephone is studying the claim and is unable, at this stage, to assess either the likelihood of such action being successful or the jurisdiction of the district court of Ramallah over the claim.

Tax Assessments

Bezeq has received final tax assessments up to and including 1999. Pelephone has received final tax assessments up to 1994 and for the year 1996 as a result of the statute of limitations having elapsed. 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, the Company recorded tax expenses in its financial statements as at 30th June 2001 in respect of preceding years, in the amount of NIS 12 million, as well as financing income of approximately NIS 73 million (tax exempt) in connection with the rebate payable to the Company. (see note 11E to the financial statements set out in the "*Audited Annual Financial Statements*" and note 6(A)(8) to the "*Unaudited Interim 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, 2001 is approximately NIS 1.9 billion.

As at 30th September, 2001, Bezeq had approximately NIS 5.2 billion of long term debt outstanding, approximately NIS 2.1 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, 2001, it expects sales volumes in the domestic fixed line market to decrease as revenues continue to be impacted by the tariff reductions introduced on 1st May 2000 and on 1st March 2001. Furthermore, the continued migration of calls from the fixed line to the cellular networks and the substitution of data minutes for voice minutes on the fixed line network will adversely impact revenues. Moreover, due to changes in settlement arrangements with the cellular operators, airtime generated from domestic fixed line to cellular telephone connections (which Bezeq collects for, and passes onto all four cellular operators) were no longer recorded in Bezeq's financial statements beginning March 2000. Although this will contribute to the reduction of revenues in 2001 it will not affect operating income as cellular telephone payments were deducted as an operating expense. In addition, beginning January 2002, Bezeq will cease to receive access fees from the three international operators, which will adversely impact 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 have a material adverse effect on the Group's business results. During 2001, Bezeq is expected to continue to provide significant financial assistance to the other group companies. Bezeq suffered a 23 per cent. decline in consolidated net income in the first six months of 2001, largely as a result of continued losses at Pelephone. Bezeq expects that Pelephone, Bezeq International and DBS will continue to make losses through 2001, partly as a consequence of investments in technology and infrastructure to enable them to compete in their highly competitive markets. 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 45 per cent, in accordance with an agreement among the shareholders of DBS. Such increase in ownership will result in an increase in Bezeq's share in the accumulated losses of DBS, and may have a material adverse effect on Bezeq's financial results (See note 4(c) 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, 2003. Until 31st December, 2002, Bezeq will continue to prepare inflation adjusted financial statements, and the adjusted amounts in Bezeq's reports as of 31st December, 2002 will become the basis for the nominal reports starting 1st January, 2003. 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 capital structure (see note 2(c) to the "*Unaudited Interim Financial Statements*"). Following the publication of Accounting Standard No. 12, another governmental company filed a claim at the District Court against the Israeli Institution for Standardization in Accounting, the Israeli Securities Authority and others, requesting the court to declare, *inter alia*, that the aforementioned standard is null and void.

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 elected to a term ending on the date of the annual general meeting following the general meeting in which she or he was elected, except that directors appointed prior to 1st May, 1999 shall continue in their office for the terms provided at the time of their appointment (a period of three years from appointment). A director may be removed either by a resolution of the shareholders of Bezeq at a general meeting, or for reasons such as the director becoming bankrupt, being found guilty of certain offences, or under the GCL (such as for not participating in a certain number of meetings). Bezeq's board of directors currently consists of 17 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:

<u>Name</u>	<u>Name</u>
Ido Dissentshik (Chairman)	Miriam Mazar
Amal Assad	Rachel Kremmerman-Meridor
Yosef Banano ⁽¹⁾	Amnon Neubach
Avi Barak	Azriel Nevo
Moshe Bloomkin	Rami Nomkin ⁽¹⁾
Shlomit Eytan	Michael Perry ⁽²⁾
Yisrael Hasson	Hava Shechter
Blanche Kaye ⁽²⁾	Aliza Shloss
Gabi Last	

Notes:

(1) director from among Bezeq's employees.

(2) 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
Ella Bar-Or	Spokesperson
Abraham Shlomovitz	Head of Tel Aviv & Sharon Operating Division
Rafi Rahat	Head of Central Area Operating Division
Yossi Malka	Head of Haifa & North Operating Division
Menachem Avinoam	Head of Jerusalem & South Operating Division

ISRAELI TAXATION

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

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

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

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

SUBSCRIPTION AND SALE

The Dealers have, in a Programme Agreement dated 7th August, 2000 as supplemented by a Supplemental Programme Agreement dated 20th November, 2001 (together 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) once Section 19 of the Financial Services and Markets Act 2000 (the "FSMA") has come into force, in relation to any Notes which must be redeemed before the first anniversary of the date of their issue, (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 issued or passed on and will only issue or pass on in the United Kingdom, before the repeal of Section 57 of the Financial Services Act 1986 (the "FSA"), any document received by it in connection with the issue of any Notes to a person who is of a kind described in Article 11(3) of the Financial Services Act 1986 (Investment Advertisements) (Exemptions) Order 1996 (as amended) or is a person to whom such document may otherwise lawfully be issued or passed on and, after the repeal of Section 57 of the FSA, it 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 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 FSA and, after they come into force, 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).

General

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

purchase, offer, sale or delivery by it of Notes under the laws and regulations in force in any jurisdiction to which it is subject or in which it makes such purchases, offers, sales or deliveries and neither the Issuer nor any of the other Dealers shall have any responsibility therefor.

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

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

GENERAL INFORMATION

Authorisation

The establishment of the Programme and the issue of Notes have been duly authorised by a resolution of the Public Offering and Privatisation Committee of the Board of Directors of the Issuer dated 31st July, 2000. The update of the Programme has been duly authorised by a resolution of the Board of Directors of the Issuer dated 23rd October, 2001.

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, 1999 and 2000. 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 June, 2001 and there has been no material adverse change in the financial position or prospects of the Group since 31st December, 2000.

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, 2000.

Banking Act 1987 (Exempt Transactions) Regulations 1997

The text below applies until Section 19 of the FSMA is brought into force. This is currently expected to happen on 30th November, 2001 although this date may change. When the FSMA comes into force, the Regulations described below will be repealed.

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

EU Directive on the Taxation of Savings Income

On 18th July, 2001 the EU Commission published a proposal for a new 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 authority 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, subject to the right of certain Member States to opt instead for a withholding system for a transitional period in relation to such payments, and subject to the proposals not being required to be applied, for a limited period of seven years after the new directive comes into force, to tranches of Notes issued before 1st March, 2002 and fungible with Notes issued before 1st March, 2001 or where the original offering document was certified before that date. The proposed directive is not yet final, and may be subject to further amendment and/or clarification.

“BEZEQ” THE ISRAEL TELECOMMUNICATION CORP. LIMITED

FINANCIAL STATEMENTS

DECEMBER 31, 2000

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March 28, 2001

**Auditors' Report to the Shareholders of
"Bezeq" — The Israel Telecommunications Corp. Limited**

We have audited the attached balance sheets of "Bezeq" — The Israel Telecommunication Corp. Limited (hereinafter — the Company) as at December 31, 2000 and 1999 and the consolidated balance sheets as at such dates and the related statements of operations, shareholders' equity and cash flow for each of the three years in the period ended December 31, 2000. These financial statements are the responsibility of the Board of Directors and the management of the Company. Our responsibility is to give our opinion on these financial statements based on our audit.

We did not audit the financial statements of subsidiaries, whose assets constitute approximately 5% and approximately 5% of total consolidated assets as at December 31, 2000 and 1999, respectively, and whose revenues constitutes approximately 9%, approximately 7% and about 8% of total consolidated revenues for the years ended December 31, 2000, 1999 and 1998, respectively. The financial statements of those subsidiaries were audited by other auditors, whose reports 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 audit in accordance with generally accepted accounting 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 assurances 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 assessment of the accounting principles used and significant estimates made by the Board of Directors and the 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 other auditors, the financial statements referred to above present fairly, in all material aspects, the financial position of the Company and its subsidiaries as at December 31, 2000 and 1999 and the results of their operations, the changes in shareholders' equity and their cash flows for each of the three years in the period ended on December 31, 2000, conformity with generally accepted accounting principles. Furthermore, in our opinion, these financial statements referred to above are prepared in conformity with the Securities Regulations (Preparation of Annual Financial Statements), 1993.

As explained in Note 2, the above mentioned financial statements are stated in values adjusted for the changes in the general purchasing power of the Israeli currency, in accordance with opinion 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 to which is significant:

- (1) The anticipated opening of the communications sector to competition, changes in tariffs and their effect on the Company's financial position and operating results, as described in Note 1.
- (2) A program for an additional reorganization, as described in Note 17D.
- (3) Claims made against the Company and against investee companies, as described in Note 21A.
- (4) The financial condition of an affiliated company, the memorandum of terms signed by the affiliated company and banking corporations, the unsigned financing agreement between the affiliated company and the banking corporations, and the affiliated company's assessment as to the agreement signing process, as described in Note 8H.

Somekh Chaikin
Certified Public Accountants

Balance Sheets

In terms of shekels of December 2000

	Note	Consolidated		Company	
		December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999
		NIS thousands	NIS thousands	NIS thousands	NIS thousands
Current assets					
Cash and cash equivalents	3	1,532,882	664,237	1,521,842	486,162
Short-term investments	4	188,369	301,140	168,376	294,457
Trade receivables	5	1,372,781	1,522,844	728,350	1,008,146
Other receivables and debit balances	6	475,968	482,522	386,396	388,048
Inventory		134,425	110,210	—	—
		<u>3,704,425</u>	<u>3,080,953</u>	<u>2,804,964</u>	<u>2,176,813</u>
Materials and spare parts		<u>185,184</u>	<u>231,248</u>	<u>185,184</u>	<u>231,248</u>
Investments and long-term receivables					
Deposits and debit balances	7	289,495	275,743	244,011	257,492
Investments in investee companies	8	172,676	75,498	1,286,670	1,481,028
		<u>462,171</u>	<u>351,241</u>	<u>1,530,681</u>	<u>1,738,520</u>
Fixed assets					
Cost	9	29,041,943	28,751,669	25,298,162	25,643,973
Less — accumulated depreciation		<u>17,434,738</u>	<u>16,095,221</u>	<u>15,475,710</u>	<u>14,573,613</u>
		<u>11,607,205</u>	<u>12,656,448</u>	<u>9,822,452</u>	<u>11,070,360</u>
Other assets					
Deferred charges and other assets	10	378,089	257,508	15,285	13,225
Deferred taxes	11	633,347	237,737	633,049	248,816
		<u>1,011,436</u>	<u>495,245</u>	<u>648,334</u>	<u>262,041</u>
		<u>16,970,421</u>	<u>16,815,135</u>	<u>14,991,615</u>	<u>15,478,982</u>

	Note	Consolidated		Company	
		December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999
		NIS thousands	NIS thousands	NIS thousands	NIS thousands
Current liabilities					
Short-term bank credit	12	735,142	271,006	—	—
Current maturities of:					
Debenture issued to the					
Government of Israel	13	—	470,954	—	470,954
Long-term bank loans	14	377,587	1,053,418	317,495	983,615
Other debentures	15	224,590	225,517	224,590	225,517
Trade payables	16	1,046,886	1,156,374	465,896	654,624
Dividend payable		—	301,565	—	301,565
Employee severance benefits	17	344,780	351,185	344,780	351,185
Other current liabilities	18	967,379	825,777	779,862	694,358
		<u>3,696,364</u>	<u>4,655,796</u>	<u>2,132,623</u>	<u>3,681,818</u>
Long-term liabilities					
Long-term loans	14	2,824,784	3,236,604	2,404,728	2,862,097
Other debentures	15	2,152,075	1,253,620	2,152,075	1,253,620
Employee severance benefits	17	1,251,591	78,463	1,247,318	79,375
Deferred taxes	11	14,432	20,183	—	—
Deferred revenues	19	69,801	78,780	93,497	110,383
		<u>6,312,683</u>	<u>4,667,650</u>	<u>5,897,618</u>	<u>4,305,475</u>
Convertible debentures	20	<u>68,092</u>	<u>233,699</u>	<u>68,092</u>	<u>233,699</u>
Contingent liabilities	21				
Shareholders' equity	22	<u>6,893,282</u>	<u>7,257,990</u>	<u>6,893,282</u>	<u>7,257,990</u>
		<u>16,970,421</u>	<u>16,815,135</u>	<u>14,991,615</u>	<u>15,478,982</u>

Ido Dissentshik
Chairman of the Board

Ilan Biran
CEO

Date of approval of the financial statements: March 15, 2001

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

Statement of Operations for the Year Ended December 31
In terms of shekels of December 2000

	Note	Consolidated			Company		
		2000	1999	1998	2000	1999	1998
		NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues from							
telecommunications services	23	<u>8,402,239</u>	<u>9,154,721*</u>	<u>9,540,512*</u>	<u>6,252,265</u>	<u>7,458,820</u>	<u>7,680,869*</u>
Costs and expenses							
Operating and general expenses	24	4,283,834	5,131,538*	5,014,858*	2,536,180	3,927,405	3,939,791*
Depreciation	9	2,700,286	2,720,919	2,509,146	2,246,299	2,293,311	2,127,913
Royalties to the Government of Israel		314,557	301,358	354,672	200,875	208,207	248,033
		<u>7,298,677</u>	<u>8,153,815</u>	<u>7,878,676</u>	<u>4,983,354</u>	<u>6,428,923</u>	<u>6,315,737</u>
Operating income		1,103,562	1,000,906	1,661,836	1,268,911	1,029,897	1,365,132
Financing expenses, net	25	<u>343,232</u>	<u>360,072</u>	<u>455,814</u>	<u>294,339</u>	<u>364,687</u>	<u>477,602</u>
Earnings after financing expenses		760,330	640,834	1,206,022	974,572	665,210	887,530
Other income (expenses), net	26	<u>(1,272,655)</u>	<u>(558,458)</u>	<u>42,762*</u>	<u>(1,232,857)</u>	<u>(482,770)</u>	<u>51,419*</u>
Earnings (loss) before income tax		(512,325)	82,376	1,248,784	(258,285)	182,440	938,949
Tax benefit (income tax)	11	<u>153,323</u>	<u>(59,665)</u>	<u>(491,230)</u>	<u>138,792</u>	<u>(70,379)</u>	<u>(374,297)</u>
Earnings (loss) after income tax		(359,002)	22,711	757,554	(119,493)	112,061	564,652
Equity in earnings (loss) of investee companies	8	(195,159)	(21,550)	6,468	(429,775)	(103,876)	199,370
Minority share in loss of consolidated company		4,893	—	—	—	—	—
Earnings (loss) before cumulative effect of change in accounting method		(549,268)	1,161	764,022	(549,268)	8,185	764,022
Cumulative effect as at beginning of year of the change in accounting method		—	7,024	—	—	—	—
Net earnings (loss)		<u>(549,268)</u>	<u>8,185</u>	<u>764,022</u>	<u>(549,268)</u>	<u>8,185</u>	<u>764,022</u>
Earnings (loss) per share							
Primary and diluted earnings (loss) per NIS 1 par value of common shares (in NIS)	27	<u>(0.226)</u>	<u>0.008**</u>	<u>0.332**</u>	<u>(0.226)</u>	<u>0.008**</u>	<u>0.332**</u>

* Reclassified

** Restated due to issue of bonus shares which occurred after the balance sheet date.

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

Statement of Changes in Shareholders' Equity
In terms of shekels of December 2000

	Share capital	Receipts from issue of option warrants	Capital reserve for distribution of bonus shares	Capital reserve share premium ⁽⁴⁾	Capital reserve in respect of transactions between the Company and a controlling shareholder	Retained earnings	Total
	NIS thousands						
Balance as at January 1, 1998	4,078,550	—	—	200,741	5,555	1,966,972	6,251,818
Changes in 1998 —							
Net earnings	—	—	—	—	—	764,022	764,022
Public issue	—	80,587	—	—	—	—	80,587
Issue to employees ⁽¹⁾	4,637	—	—	35,806	—	—	40,443
Offer to employees	—	—	—	—	3,482	—	3,482
Compensation to the Company's employees from the State	—	—	—	—	26,613	—	26,613
Exercise of warrants ⁽²⁾	31,542	(80,587)	—	240,721	—	—	191,676
Conversion of convertible debentures ⁽³⁾	237	—	—	2,276	—	—	2,513
Balance as at December 31, 1998	4,114,966	—	—	479,544	35,650	2,730,994	7,361,154
Changes in 1999 —							
Net earnings	—	—	—	—	—	8,185	8,185
Dividend for preceding year	—	—	—	—	—	(301,565)	(301,565)
Conversion of convertible debentures ⁽⁵⁾	17,903	—	—	172,313	—	—	190,216
Balance as at December 31, 1999	4,132,869	—	—	651,857	35,650	2,437,614	7,257,990
Changes in 2000 —							
Erosion of dividend declared in a previous year and paid this year ...	—	—	—	—	—	(1,421)	(1,421)
Net loss	—	—	—	—	—	(549,268)	(549,268)
Tax benefit in respect of shares to employees	—	—	—	21,759	—	—	21,759
Conversion of convertible debentures ⁽⁶⁾	14,654	—	—	149,568	—	—	164,222
Capitalization of undesignated earnings to a reserve fund for the distribution of bonus shares ⁽⁷⁾	—	—	1,598,500	—	—	(1,598,500)	—
Balance as at December 31, 2000	4,147,523	—	1,598,500	823,184	35,650	288,425	6,893,282

(1) 4,215,844 ordinary shares of NIS 1 par value were issued to employees.

(2) Pursuant to a prospectus from February 27, 1998 the Company issued to the public 29,250,000 option warrants exercisable into Company shares (Series C). These options were converted into 29,250,000 ordinary shares with a par value of NIS 1 each.

(3) 2,336,657 par value convertible debentures were converted into 230,895 ordinary shares with a par value of NIS 1 each.

(4) After deduction of assigned issue expenses in the amount of NIS 3,977,000 in respect of 1998.

(5) 178,187,698 par value convertible debentures were converted into 17,607,480 ordinary shares with a par value of NIS 1 each.

(6) 147,652,429 par value convertible debentures were converted into 14,590,161 ordinary shares with a par value of NIS 1 each.

(7) See Note 22.

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

Statement of Cash Flows for the Year Ended December 31
In terms of shekels of December 2000

	Consolidated			Company		
	2000	1999	1998	2000	1999	1998
	NIS thousands			NIS thousands		
Cash flows generated by operating activities						
Net earnings (loss)	(549,268)	8,185	764,022	(549,268)	8,185	764,022
Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities (see A below)	3,814,489	2,377,944	2,254,565	3,530,490	2,137,615	1,730,248
Net cash flow generated by operating activities	<u>3,265,221</u>	<u>2,386,129</u>	<u>3,018,587</u>	<u>2,981,222</u>	<u>2,145,800</u>	<u>2,494,270</u>
Cash flows generated by investing activities						
Acquisition of fixed assets	(1,725,641)	(1,417,578)	(1,862,647)	(1,104,237)	(920,584)	(1,236,799)
Proceeds from disposal of fixed assets	34,594	20,112	65,016	29,159	16,311	51,473
Proceeds from disposal of investment in investee company	171,120	—	4	171,120	—	—
Investment in long-term deposits and investments	(59,826)	(15,820)	(100,035)*	(25,489)	(4,989)	(65,370)*
Proceeds from long-term deposits and investments	60,019	112,707	20,430*	23,545	83,194	18,954*
Decrease (increase) in short-term investments, net	115,703	85,002	(8,222)	128,191	(136,126)	(41,436)
Decrease (increase) in materials and spare parts	57,959	(80,034)	87,749*	57,959	(80,033)	87,748
Investment in investee companies	(324,720)	(60,502)	—	(267,800)	(43,923)	(3,364)
Investments in other assets	(263,001)	(301,405)	—	—	(130)	—
Net cash flow used for investment activities ..	<u>(1,933,793)</u>	<u>(1,657,518)</u>	<u>(1,797,705)</u>	<u>(987,552)</u>	<u>(1,086,280)</u>	<u>(1,188,794)</u>
Cash flows generated by financing activities						
Repayment of debentures issued to the Government of Israel	(471,619)	(938,612)	(928,504)	(471,619)	(938,612)	(928,504)
Issue of other debentures (net of issue expenses)	1,093,841	263,253	69,103	1,093,841	263,253	69,103
Repayment of other debentures	(226,254)	(206,575)	(240,792)	(226,254)	(206,575)	(240,792)
Receipt of long-term loans	802,938	720,809	725,248	589,856	559,319	610,702
Repayment of long-term loans	(1,822,839)	(1,106,542)	(1,270,100)	(1,640,828)	(1,055,774)	(1,185,110)
Receipt (repayment) of short-term bank credit Dividend paid	464,136	271,006	(18,823)	—	—	(7,785)
Proceeds from issue of shares to employees (net of issue expenses)	(302,986)	—	—	(302,986)	—	—
Proceeds from issue of share options (net of issue expenses)	—	—	26,502	—	—	26,502
Proceeds from issue of share options (net of issue expenses)	—	—	80,587	—	—	80,587
Proceeds from convertible debenture and options on them (after deduction of issue expenses)	—	—	407,719	—	—	407,719
Proceeds from exercise of options	—	—	191,676	—	—	191,676
Net cash flow used for financing activities	<u>(462,783)</u>	<u>(996,661)</u>	<u>(957,384)</u>	<u>(957,990)</u>	<u>(1,378,389)</u>	<u>(975,902)</u>
Increase (decrease) in cash and cash equivalents	868,645	(268,050)	263,498	1,035,680	(318,869)	329,574
Cash and cash equivalents at beginning of year	664,237	932,287	668,789	486,162	805,031	475,457
Cash and cash equivalents at end of year	<u>1,532,882</u>	<u>664,237</u>	<u>932,287</u>	<u>1,521,842</u>	<u>486,162</u>	<u>805,031</u>

* Reclassified

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

Statement of Cash Flows for the Year Ended December 31 (contd.)
In terms of shekels of December 2000

	Consolidated			Company		
	2000	1999	1998	2000	1999	1998
	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	2,700,286	2,720,919	2,509,146	2,246,299	2,293,311	2,127,913
Provision for decrease in value of fixed assets	11,013	106,380	14,623	—	106,380	14,623
Deferred taxes	(308,193)	80,111	164,068	(286,943)	72,884	172,998
Company's equity in losses (earnings) of investee companies, net	195,159	21,550	(6,468)	429,775	103,876	(115,400)
Minority share in losses of a consolidated company	(4,893)	—	—	—	—	—
Provision for decrease in value of affiliate	—	(14,919)	—	—	(14,919)	—
Increase (decrease) in employee severance benefits, net	1,166,723	(301,177)	(745,385)	1,161,538	(298,861)	(745,286)
Gain on disposal of fixed assets	(1,341)	(16,391)	(4,686)	(2,657)	(17,454)	(13,027)
Gain on disposal of investment in investee company	(138,737)	—	—	(138,737)	—	—
Imputed salaries expense	—	—	44,036	—	—	44,036
Erosion (appreciation) of and interest on long-term deposits and investments	15,425	16,933	(68,202)*	15,425	16,933	(68,202)*
Erosion (appreciation) of short-term investments, net	(2,932)	(317)	5,272	(2,110)	(317)	5,272
Appreciation (erosion) of long-term liabilities:						
Debt issued to the Government of Israel	665	(2,408)	(21,916)	665	(2,408)	(21,916)
Other debentures	26,939	817	(5,961)	26,939	817	(5,961)
Long-term loans	(73,788)	(36,222)	246,755	(71,854)	(34,985)	233,955
Convertible debentures	—	140	(807)	—	140	(807)
Amortization of deferred expenses and other adjustments	150,460	67,515	8,336	1,086	7,595	7,982
Changes in asset and liability items:						
Decrease (increase) in trade receivables ...	151,149	54,801	(51,630)	279,796	86,477	(60,970)
Decrease (increase) in other receivables and debit balances	(82,586)	(105,595)	117,748	(88,174)	(25,266)	92,430
Increase in inventory	(14,714)	(81,943)	(25,065)*	—	—	—
Increase (decrease) in trade payables	(86,695)	92,884	9,109	(107,085)	67,483	19,206
Increase (decrease) in other current liabilities	119,528	(218,793)	64,156	83,413	(212,276)	41,965
Increase (decrease) in deferred revenues ...	(8,979)	(6,341)	1,436	(16,886)	(11,795)	1,437
	<u>3,814,489</u>	<u>2,377,944</u>	<u>2,254,565</u>	<u>3,530,490</u>	<u>2,137,615</u>	<u>1,730,248</u>
B — Non-cash transactions						
Acquisition of fixed assets, materials and spare parts on credit	181,685	324,161	258,361	301,032	263,327	203,377
Sale of fixed assets on credit	8,858	23,051	—	8,858	23,051	—
Proposed dividend	—	301,565	—	—	301,565	—

* Reclassified

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

Notes to the Financial Statements as at December 31, 2000

NOTE 1 — GENERAL

- A. "Bezeq" — The Israel Telecommunication Corp. Limited (hereinafter — the Company) is controlled by the State of Israel and therefore, is subject to the provisions of the Government Companies Law, 5735-1975. The Company operates under a general license awarded under the Telecommunications Law, 5742-1982, which authorizes it to engage in telecommunication business and provide telecommunication services. The Company's license, which was granted on March 1, 1994 (and which replaced an earlier license and was amended on various dates), sets out the terms under which the Company shall operate, and provides, inter alia, that the Company shall continue to provide telephone and related services, and infrastructure services, and shall operate through subsidiaries which will engage in providing services in areas which were opened to competition. Under the license, the management of the subsidiaries is to be separate from the management of the Company. It was also determined that the provision of new services by the Company is contingent upon receipt of a license from the Ministry of Communications. Limits were also imposed on the extent of the Company's financial exposure with regard to projects undertaken outside Israel.
- 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. Pursuant to the recommendations, the efficiency factor of the Company's tariffs ("the efficiency factor"), was determined to average 6% in 1999 and 7% in 2000. This factor will be updated in 2001 and subsequent years to 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.

In the update of May 2000, the Company's tariffs were lowered by an average of 2.43%, and several tariff baskets were offered, mainly for Internet users, which meant a significant reduction in tariffs. The tariff update was accompanied by a change in the manner of charging for calls, principally a change from charging by call unit to charging by duration (subject to a minimum tariff per call).

- C. As of April 1, 1997, the Company and its subsidiary, Bezeq International Ltd. are required to pay royalties to the Government of Israel at the rate of 5% of their revenues (until then the rate was 8%), Pelephone Communications Ltd. is required to pay royalties at the rate of 8% of its revenues, and an affiliated company — D.B.S. Satellite Services (1998) Ltd. at 5% (with a reduced rate of 1.5% in its first years of operation). The Ministry of Communications announced that it is considering making a change in the payment arrangements, whereby the basis of revenues for the matter of payment of royalties will be broadened and a gradual reduction of their rate will be introduced.
- 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 has submitted a petition to the Anti-Trust Court, seeking revocation of the declaration.
- 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, pursuant to the 1992 amendment of Section 50 of the Telecommunications Law, 5742-1982:

Notes to the Financial Statements as at December 31, 2000 (cont'd)

(1) Cellular services

Cellular services are currently provided by three companies (the Operators), of which one — Pelephone Communications Ltd. — is 50% owned by the Company. At the beginning of 2001, an operating license was awarded to an additional Operator, which had formerly operated in a format somewhat different from that of the other three companies.

According to a notice of the Company to the Operators, starting on March 1, 2000, the arrangement between them for billing was cancelled and a new arrangement was introduced, whereby the Company transfers to the Operators only the amounts it actually collects in respect of airtime, less a collection commission (in the previous arrangement, money was transferred on the basis of customer charges without deducting a collection commission). The Operators opposed the change, and one of them even filed a claim in the District Court, requesting that the Company be ordered to continue the previous arrangement. The Court dismissed the claim and approved the validity of the new arrangement as introduced by the Company. Nevertheless, the disputes between the Company and the Operators have not yet been settled.

As a result of the aforementioned change in the billing arrangements, since March 1, 2000 the cellular revenues and expenses of the Company do not include airtime. Airtime included in revenues and expenses from cellular in 2000 is approximately NIS 290 million (1999 — approximately NIS 1,500 million).

In September 2000 the Ministry of Communications promulgated regulations (effective from October 2, 2000) in connection with the tariffs of incoming calls to the cellular network, whereby the tariffs of the incoming calls to cellular telephones will be gradually reduced, from October 2000 to January 2003. The management of Pelephone Communications Ltd. ("Pelephone") estimates that the effect of the new regulations on its earnings will be material. Pelephone has appealed to the High Court of Justice for cancellation of the regulation.

(2) International communication services

At the beginning of July 1997, two new companies began providing international communication services, as a result of which, international call tariffs were lowered significantly, including those of the consolidated company Bezeq International Ltd.

At the beginning of July 1997, regulations were promulgated for the purpose of anchoring 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" until December 31, 2001, which will be linked to the U.S. dollar, the currency basket and the CPI, and will be reduced by 30% each year.

Pursuant to an amendment to the license of Bezeq International Ltd. relating to the process of allocating subscribers to the various operators, the subscriber allocation process was carried out during the year.

During 2000, Bezeq International allocated NIS 28 million in direct expenses for the allocation process, and in 1999 — NIS 76 million. The Company also incurred costs relating to the technical operation of the allocation. In 2000, Bezeq International expanded its operations as an Internet provider. These activities, added to tariff erosion and a decline in market share, caused it considerable losses.

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

Notes to the Financial Statements as at December 31, 2000 (cont'd)

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

(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.

At the beginning of April 2000, the Attorney General decided on a dispute between the Ministries of Finance and Communications on the question of whether the Minister of Communications is authorized to award the cable services franchisees a license for providing fixed-line domestic communication services using the existing cable infrastructure, without a tender, and alternatively, without receipt of special consideration. The main point in the Attorney General's decision was that in the present legal situation the Minister of Communications may not grant licenses whose practical significance is the unlimited extension of the franchises, and that for implementation of a decision to change the policy of granting franchises to a policy of granting licenses, legislation would be required. It is noted that in an additional opinion, the Attorney General also rejected the possibility of granting a temporary license to the cable companies for providing high-speed Internet access services.

Following the Attorney General's decision, two proposals were submitted to the Knesset for amendment of the Telecommunications Law, both dealing with arrangements for opening the communications market to competition. These proposals include, *inter alia*, a proposal to enable operators to use some or all of the infrastructures of the Company (unbundling). The proposals are at various stages of legislation but have not yet taken shape as a law.

On October 20, 2000, the Ministry of Communications published tenders for the provision of domestic communication services via a wireless network to subscribers' homes (LMDS). In February 2001, the Ministry of Communications awarded a license to an additional company for operating fixed-line domestic communication services.

On November 6, 2000 the Ministry of Communications approved the service file for the provision of broadband communications services in ADSL technology by the Company. The Company has started to provide the service and is working to expand it.

As a result of the various changes in the communications market as described above, a significant decrease 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.

On August 27, 2000 the Ministerial Committee for Privatization decided that the State's holdings in the Company would be sold by way of a private sale, which would be accompanied by raising capital for the Company. The sale will include shares comprising at least 50.01% of the Company's share capital. The Companies Authority was authorized to carry out the actions required for implementation of the decision, including actions listed in the decision. It was further decided that the sale process would end, if possible, within 9 – 12 months from the date of the decision. The above decision of the Ministerial Committee was approved on September 6, 2000 by the Knesset Finance Committee. As at the date of this Report, the capital had not been raised for the Company.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

The Company is unable to estimate whether, when and how the holdings, in whole or in part, of the State in the Company will be reduced.

NOTE 2 — SIGNIFICANT ACCOUNTING PRINCIPLES AND REPORTING POLICIES

A. Definitions

In these financial statements —

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

B. Financial statements adjusted for the effect of inflation

- (1) The financial statements have been prepared on the basis of historical cost adjusted for the effect of the changes in the general purchasing power of the Israeli currency. (Financial statement data on the Company in nominal historical values appears in Note 32.)
- (2) The adjusted value of non-monetary assets does not 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 financial statements have been reclassified and are presented in the order arising from the nature of the Company's business as a communications company.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

E. Principles of adjustment

(1) *Balance sheet*

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

Monetary assets are stated in the adjusted balance sheet at their 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:

- (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 financing item, were adjusted on the basis of the changes in 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 2N and 11D relating to deferred taxes.

(3) *Statement of shareholders' equity*

A dividend that was announced and actually paid in the report year was adjusted on the basis of the CPI at date of payment. A dividend that was 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 statement of the affiliate, adjusted to the changes in the purchasing power of the currency in which they were prepared and translated into NIS according to the representative exchange rate as at balance sheet date.

F. Consolidation of the financial statements

- (1) The consolidated financial statements include the financial statements of those companies over which the Company has control. Jointly controlled companies are consolidated by the proportionate consolidation method.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

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

G. Investments in investee companies

- (1) Investments in affiliates are accounted for by the equity method. In determining the equity of the investments in these companies, the amounts as they are included in the financial statements of the companies are taken into account.
- (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. Marketable securities

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

I. Provision for doubtful debts

In the opinion of management, the provisions for doubtful debts in the financial statements properly reflect the loss inherent in debts, the collection of which is considered doubtful. In determining the propriety of the provisions, management considered, among other things, the risk assessment as 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.

J. Inventory

Inventory of equipment and user equipment is presented at the lower of cost or value to the business. Cost is determined mainly by the moving average method.

As part of its current operations, a proportionately consolidated company upgrades user equipment for its customers. As a result, inventory includes user equipment returned from 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.

The cost of the inventory of a proportionally consolidated company was determined until December 31, 1999 by the First In First out method. Starting in 2000, the cost was determined by the moving average method. The cumulative effect as at the beginning of the year due to the change of accounting method, is not material.

K. Materials and spare parts

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

Notes to the Financial Statements as at December 31, 2000 (cont'd)

L. 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.
- (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.

The annual depreciation rates are:

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

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

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

M. 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 customer of Pelephone (where violation of the undertaking leads to payment of a penalty by the customer and depreciation of the asset). These costs appear in the balance sheet under Other assets, and are amortized throughout the minimum period of the subscribers' undertaking, which is 36 months. The cost of acquiring a subscriber for Internet services at Bezeq International Ltd. is amortized over the term of the subscriber's commitment, which is more than one year.

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

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

Notes to the Financial Statements as at December 31, 2000 (cont'd)

(4) *Rights in channels*

Rights in channels are amortized over the periods of lease, which are 5 and 10 years.

N. Deferred taxes

The companies in the Group allocate taxes for temporary differences. Temporary differences are differences between the value of assets and liabilities for tax purposes and their book value in the balance sheet. Such allocation of taxes is made for differences relating to assets whose consumption or depreciation is deductible for tax purposes. Deferred tax balances (asset or liability) are calculated according to the liability approach using the tax rates which will be in effect at the time of utilization of the deferred taxes, or upon realization of tax benefits, as they are known at the date of approval of the financial statements.

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

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

O. Revenue recognition

Income is recognized on the accrual basis.

P. 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.

Q. 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.

R. Foreign currency and linkage

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

Assets (excluding securities) and liabilities linked to the CPI are stated on the basis of the contractual linkage terms of each balance.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

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

	December 31, 2000	December 31, 1999	% of change 2000	% of change 1999	% of change 1998
CPI — in points	106.6	106.6	0.00	1.34	8.62
US dollar exchange rate					
\$1 — in NIS	4.041	4.153	(2.69)	(0.17)	17.65
Euro exchange rate					
1 Euro — in NIS	3.763	4.175	(9.87)	—	—

S. Restatement

The Company retroactively adjusted its financial statements for the year ended December 31, 1999 by way of restatement, so as to retroactively reflect therein, amendment of the accounting treatment of the capitalization of the costs of subscriber acquisitions in Pelephone Communications Ltd. — a proportionally consolidated company. In the original financial statements until 1999, Pelephone Communications Ltd. charged the costs of subscriber acquisitions to the statement of operations. Commencing with the financial statements for the year ended December 31, 1999 subscriber acquisition costs, including those in respect of years up to 1999, appear in the balance sheet within Other Assets and are depreciated over 36 months. Amended reports for the year ended December 31, 1999 were published on August 15, 2000.

(1) *Effect on the Consolidated Balance Sheet as at December 31, 1999*

	As previously reported*	Effect of restatement	As reported in these financial statements
	NIS thousands	NIS thousands	NIS thousands
Deferred and other expenses	255,230	2,278	257,508
Long-term liabilities — deferred taxes	19,362	821	20,183
Shareholders' Equity	7,256,533	1,457	7,257,990

* Refers to the financial statements for the year ended December 31, 1999, published on March 28, 2000, prior to adjustment of the financial statements by way of restatement.

(2) *Effect on net earnings*

	For the year ended December 31, 1999
	NIS thousands
Net earnings as previously reported	6,728
Effect of restatement:	
Increase in operating and general expenses	(8,698)
Decrease in income taxes	3,131
Cumulative influence of the change in accounting method as at beginning of year, net	7,024
	<u>8,185</u>

(3) *Cumulative effect of the change in the accounting method*

	For the year ended December 31, 1999
	NIS thousands
Cumulative effect of the change in accounting method as at beginning of year, gross	10,975
Less: tax effect	3,951
Net	<u>7,024</u>

Notes to the Financial Statements as at December 31, 2000 (cont'd)

(4) Effect of net earnings per NIS 1 par value

	<u>For the year ended December 31, 1999</u>
	NIS thousands
Net earnings per NIS 1 par value of shares, as previously reported	0.020
Net earnings per NIS 1 par value of shares, as reported in these financial statements	0.025

(5) Effect on the Company Balance Sheet as at December 31, 1999

	<u>As previously reported*</u>	<u>Influence of restatement</u>	<u>As reported in these financial statements</u>
	NIS thousands	NIS thousands	NIS thousands
Investments in investee companies	1,479,571	1,457	1,481,028
Shareholders' Equity	7,256,533	1,457	7,257,990

(6) Effect on net earnings

	<u>For the year ended December 31, 1999</u>
	NIS thousands
Net earnings as previously reported	6,728
Effect of restatement:	
Decrease in the company's share in losses of investee companies	<u>1,457</u>
	<u><u>8,185</u></u>

* Refers to the financial statements for the year ended December 31, 1999, published on March 28, 2000, prior to adjustment of the financial statements by way of restatement.

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 into shares

Debentures convertible into shares are classified according to likelihood of conversion, as determined 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 items Long term liabilities and Shareholders' equity, at liability value or capital value, whichever is the higher.

V. Issue to employees

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

NOTE 3 — CASH AND CASH EQUIVALENTS

	<u>Consolidated</u>		<u>Company</u>	
	<u>December 31, 2000</u>	<u>December 31, 1999</u>	<u>December 31, 2000</u>	<u>December 31, 1999</u>
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Israeli currency	810,969	641,462	802,487	483,463
Foreign currency	721,913	22,775	719,355	2,699
	<u>1,532,882</u>	<u>664,237</u>	<u>1,521,842</u>	<u>486,162</u>

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

Notes to the Financial Statements as at December 31, 2000 (cont'd)

NOTE 4 — SHORT-TERM INVESTMENTS

	Consolidated		Company	
	December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Marketable securities:				
Government debentures				
Linked to the CPI	55,508	56,584	53,353	56,584
Linked to the U.S. dollar exchange rate	11,981	8,604	10,486	8,604
Unlinked	39,820	35,834	29,457	35,834
Debentures convertible to shares	5,164	5,828	4,853	5,828
Other debentures	25,021	14,258	24,294	14,258
Mutual fund participation certificates	25,216	179,704	21,933	173,349
	<u>162,710</u>	<u>300,812</u>	<u>144,376</u>	<u>294,457</u>
Short-term bank deposits				
Linked to the CPI	24,254	—	24,000	—
Unlinked	1,405	328	—	—
	<u>188,369</u>	<u>301,140</u>	<u>168,376</u>	<u>294,457</u>

NOTE 5 — TRADE RECEIVABLES

	Consolidated		Company	
	December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
In respect of domestic services:				
On open account	1,155,031	1,184,220	615,617	791,111
Income receivable	278,352	411,363	218,716	358,162
Credit cards and checks payable	126,795	103,404	89,825	86,159
Investee companies	983	712	8,024	2,419
In respect of international services	164,042	170,032	16,673	20,079
	<u>1,725,203</u>	<u>1,869,731</u>	<u>948,855</u>	<u>1,257,930</u>
Less provision for doubtful debts	352,422	346,887	220,505	249,784
	<u>1,372,781</u>	<u>1,522,844</u>	<u>728,350</u>	<u>1,008,146</u>

NOTE 6 — OTHER RECEIVABLES AND DEBIT BALANCES

	Consolidated		Company	
	December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Deferred tax asset (see Note 11D)	186,161	234,152	162,264	214,377
Income tax refundable	223,382	185,768	187,341	139,804
Prepaid expenses	20,165	21,540	5,271	6,202
Other receivables and debit balances	46,260	41,062	31,520	27,665
	<u>475,968</u>	<u>482,522</u>	<u>386,396</u>	<u>388,048</u>

Notes to the Financial Statements as at December 31, 2000 (cont'd)

NOTE 7 — INVESTMENTS, DEPOSITS AND DEBIT BALANCES

	Consolidated		Company	
	December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Bank deposit for granting loans to Employees ⁽¹⁾	220,536	257,492	220,536	257,492
Investment in venture capital funds	19,083	—	19,083	—
Investment in a company that is not an investee company	4,392	—	4,392	—
Long term receivables ⁽²⁾	45,484	18,251	—	—
	<u>289,495</u>	<u>275,743</u>	<u>244,011</u>	<u>257,492</u>

(1) The deposit is unlinked and the average weighted monthly interest rate is approximately 0.3%. The Company is responsible for the loans to the employees. Withdrawal of the deposit is contingent upon repayment of the loans.

(2) Long-term receivables is calculated less the income of deferred interest 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 approximately 12% per annum.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

NOTE 8 — INVESTMENTS IN INVESTEE COMPANIES

A. Composition:

	Consolidated		Company																				
	December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999																			
	NIS thousands	NIS thousands	NIS thousands	NIS thousands																			
Affiliated companies																							
Investment in shares —																							
Cost	116,255	115,134	62,391	115,134																			
Post-acquisition losses	(209,343)	(49,957)	(194,037)	(49,957)																			
Provision for decrease in value ...	—	(43,480)	—	(43,480)																			
Amortization of surplus equity over cost attributed to goodwill	(3,168)	—	(563)	—																			
	<u>(96,256)</u>	<u>21,697</u>	<u>(132,209)</u>	<u>21,697</u>																			
Other investments —																							
Long-term loans ⁽¹⁾	<u>268,932</u>	<u>53,801</u>	<u>265,998</u>	<u>53,801</u>																			
	<u>172,676</u>	<u>75,498</u>	<u>133,789</u>	<u>75,498</u>																			
Consolidated companies																							
Shares —																							
Cost			354,326	354,326																			
Post-acquisition earnings (losses)			(141,505)	53,258																			
			<u>212,821</u>	<u>407,584</u>																			
Proportionally consolidated company																							
Shares —																							
Cost			253,657	253,657																			
Post-acquisition earnings			649,461	707,347																			
Amortization of surplus equity over cost attributed to fixed assets			36,942	36,942																			
			<u>940,060</u>	<u>997,946</u>																			
			<u>1,286,670</u>	<u>1,481,028</u>																			
<table border="1"> <thead> <tr> <th rowspan="2"></th> <th colspan="2">Consolidated</th> <th colspan="2">Company</th> </tr> <tr> <th>December 31, 2000</th> <th>December 31, 1999</th> <th>December 31, 2000</th> <th>December 31, 1999</th> </tr> <tr> <th></th> <th>NIS thousands</th> <th>NIS thousands</th> <th>NIS thousands</th> <th>NIS thousands</th> </tr> </thead> <tbody> <tr> <td>Balance of surplus equity over cost not yet amortized, attributed to goodwill</td> <td><u>35,484</u></td> <td><u>5,919</u></td> <td><u>4,767</u></td> <td><u>5,919</u></td> </tr> </tbody> </table>						Consolidated		Company		December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999		NIS thousands	NIS thousands	NIS thousands	NIS thousands	Balance of surplus equity over cost not yet amortized, attributed to goodwill	<u>35,484</u>	<u>5,919</u>	<u>4,767</u>	<u>5,919</u>
	Consolidated		Company																				
	December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999																			
	NIS thousands	NIS thousands	NIS thousands	NIS thousands																			
Balance of surplus equity over cost not yet amortized, attributed to goodwill	<u>35,484</u>	<u>5,919</u>	<u>4,767</u>	<u>5,919</u>																			

(1) The loans are linked to the CPI, bear no interest and have no due date.

(2) The market value of an affiliated company traded on the stock exchange as at December 31, 2000 was NIS 25.3 million. The book value of the investment was approximately NIS 38 million.

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

Notes to the Financial Statements as at December 31, 2000 (cont'd)

B. Investment activity in 2000 was as follows (not including long-term loans):

	<u>Consolidated</u>	<u>Company</u>
	NIS thousands	NIS thousands
Balance as at the beginning of the year	21,697	1,427,227
Movement during the year:		
Investment in shares	86,305	32,319
Realization of investment	(32,383)	(32,383)
Equity in losses	(195,159)	(429,775)
Forfeiture of guarantees for an affiliated company	23,284	23,284
Balance as at the end of the year	<u>(96,256)</u>	<u>1,020,672</u>

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

	<u>December 31,</u>	<u>December 31,</u>
	2000	1999
	NIS thousands	NIS thousands
Current assets	<u>559,389</u>	<u>416,046</u>
Other assets	<u>1,786,913</u>	<u>1,490,359</u>
Current liabilities	<u>1,040,039</u>	<u>595,941</u>
Long-term liabilities	<u>401,655</u>	<u>384,497</u>

	<u>For the year ended December 31</u>		
	<u>2000</u>	<u>1999</u>	<u>1998</u>
	NIS thousands	NIS thousands	NIS thousands
Revenues.....	<u>1,660,826</u>	<u>1,159,855</u>	<u>1,162,601*</u>
Costs and expenses	<u>1,758,125</u>	<u>1,333,107</u>	<u>937,516*</u>

* Reclassified

D. Basic telecommunication project in India

The Company submitted a bid, together with others, through a jointly-owned company, in respect of tenders issued by the Indian Government for the establishment of a basic telecommunication system in India. The letter of intent and the draft concession agreements for development of the basic telephone system in four districts, which were awarded to the jointly-owned company in which the Company has an interest, were transferred to the jointly-owned company. The jointly-owned company did not sign the letter of intent or the draft agreements since, inter alia, in its opinion, the draft agreements did not conform with the terms of the tender. When the jointly-owned company submitted its bid for the tender, it provided the Indian Ministry of Communications with bank guarantees, of which Bezeq's share is 273 million Indian rupees (approximately NIS 24 million).

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

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

Notes to the Financial Statements as at December 31, 2000 (cont'd)

E. Cellular communications project in India

On September 5, 2000 the Company signed an agreement for the sale and transfer of its holdings in the joint company in India (16% of the share capital). By December 31, 2000, the Company had received the full consideration for the sale of its holdings. The financial statements include a pre-tax capital gain of approximately NIS 139 million from this sale.

F. 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 reports 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 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 have 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 office and of the Ministries of Communications and Justice and of the Government Companies Authority. At the conclusion of the meeting the Minister of Finance decided that the Government would make no claim against the Company in matters 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 realizing 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 said 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 examination described above or the likely impact thereof on the Company.

- (2) In September 2000 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. On November 22, 2000, the Board of Directors of the Company selected an alternative offeree to buy the shares of the other shareholder, with which an option agreement would be signed.

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 a corporation registered in the USA in consideration of 591 million dollars. The consideration was partially financed by a

Notes to the Financial Statements as at December 31, 2000 (cont'd)

loan of 240 million dollars extended by the Company, for which it received convertible debentures for up to four years, for 80% of the shares of the alternative offeree.

- b. The Company was given a call option to purchase the remaining 20% of the share capital of the alternative offeree together with conversion of the debentures to shares as aforesaid ("the Options").
- 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").
- d. The exercise price of the Short Option is return of the nominal investment plus 8 million US dollars, and of the Long Option is the higher of return of the nominal investment or a valuation of the holdings of the alternative offeree in Pelephone at full dilution.

G. Emitel Telecommunication Corp. Ltd.

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. In consideration, Aphrodite will receive a sum calculated according to a stipulated formula and which will not be less than 46.5 million US dollars. Closing of the transaction is contingent upon receipt of approvals from the Hungarian Minister of Communications (granted in February 2001) and from the Hungarian Anti-Trust Authority, which has not yet been granted. The indirect investment in Emitel is recorded in the Company's books of account at equity value, and amounts to approximately NIS 41 million as at December 31, 2000. If the sale is executed, the Company can expect to include in its financial statements for 2001 a pre-tax capital gain of approximately NIS 84 million.

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

The Company holds 30% of the shares of D.B.S. Satellite Services (1998) Ltd. (hereinafter — DBS). In January 1999, DBS received a license from the Ministry of Communications for satellite television broadcasts, in exchange for payment of NIS 30 million and a guarantee in the amount of NIS 30 million. DBS foresees considerable losses and negative cash flow from operations in the first years of its activities. Its losses in 2000 amounted to NIS 544 million (adjusted), which has led to an increase in its working capital deficit to NIS 960, million (including NIS 493 million in short-term bank credit — see below). The sources of finance for DBS's operations are shareholders' loans and bank credit. On August 1, 2000, DBS signed a memorandum of terms with banks, which indicates the terms and stipulations likely to be included in a financing agreement between them and under which the banks will be willing to consider consenting in principle to participate in the financing of DBS's operations. The memorandum states, inter alia, preconditions for withdrawing funds from the credit line, including an undertaking by DBS to comply with cumulative milestones.

The memorandum also states: "If the financing agreement is not signed by September 30, 2000, this memorandum shall not be valid." In the period from October 1, 2000 to the date of signing the financial statements, the signatory banks to the above memorandum made another NIS 156 million of credit available to DBS. DBS estimates that the delay in signing a financing agreement is technical, and does not harm its continued engagement with the banks in the manner defined in the memorandum.

The Company has presented the banks with a continuing guarantee for payment of the debts of DBS, up to 30% of the value of DBS as derives from disposal of the pledged shares of the other shareholders. If the Company participates in a sale as part of disposal of the pledged shares of the other shareholders, the amount of the guarantee will not exceed the consideration which the Company will receive from the sale of its shares in DBS. The deed of guarantee includes numerous restrictions on the Company in disposing of the shares it holds, and specifies infringing events which enable the banks to foreclose on the guarantee.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

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 1.6 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. This term has not yet been met.

In July 2000, DBS completed the development stage and started to provide its customers with multi-channel satellite broadcasting services. The Company's investment in DBS as at the date of the balance sheet was approximately NIS 260 million. The Company's equity in the cumulative loss of DBS was approximately NIS 188 million, of which approximately NIS 164 million were recorded in the year ended December 31, 2000.

I. Agreement for the establishment of an investee company

On March 16, 2000, a proportionally consolidated company signed an agreement for the establishment of GoNext Ltd. ("GoNext"). The main part of GoNext's activities focuses on setting up a mobile internet portal. The proportionally consolidated company holds 51% of the shares of GoNext. The consolidated financial statements include consolidation of the financial reports of GoNext, in which the proportionally consolidated company is the controlling interest.

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, 2000	2,059,654	14,333,044	10,560,957	678,786	361,605	757,623	28,751,669
Additions	44,003	992,167	248,496	112,931	38,844	265,769	1,702,210
Disposals ⁽²⁾	(13,520)	(922,155)	(40,713)	(218,716)	(76,996)	(139,836)	(1,411,936)
Balance as at							
December 31, 2000	<u>2,090,137</u>	<u>14,403,056</u>	<u>10,768,740</u>	<u>573,001</u>	<u>323,453</u>	<u>883,556</u>	<u>29,041,943</u>
Accumulated depreciation							
Balance as at							
January 1, 2000	1,001,556	7,670,712	6,479,928	414,671	188,773	339,581	16,095,221
Depreciation allocation	89,758	1,635,586	614,848	128,720	51,079	180,295	2,700,286
Elimination upon disposals ⁽²⁾	(11,304)	(916,412)	(32,261)	(201,981)	(70,058)	(139,766)	(1,371,782)
Provision for decrease of value ⁽³⁾	—	—	—	—	—	11,013	11,013
Balance as at							
December 31, 2000	<u>1,080,010</u>	<u>8,389,886</u>	<u>7,062,515</u>	<u>341,410</u>	<u>169,794</u>	<u>391,123</u>	<u>17,434,738</u>
Depreciated value —							
As at December 31, 2000	<u>1,010,127</u>	<u>6,013,170</u>	<u>3,706,225</u>	<u>231,591</u>	<u>153,659</u>	<u>492,433</u>	<u>11,607,205</u>
As at December 31, 1999	<u>1,058,098</u>	<u>6,662,332</u>	<u>4,081,029</u>	<u>264,115</u>	<u>172,832</u>	<u>418,042</u>	<u>12,656,448</u>

Notes to the Financial Statements as at December 31, 2000 (cont'd)

Company

	<u>Land & buildings</u>	<u>Switching, transmission and power equipment⁽¹⁾</u>	<u>Network equipment</u>	<u>Subscriber equipment and public telephones</u>	<u>Motor Vehicles</u>	<u>Office equipment and computers</u>	<u>Total</u>
	NIS thousands						
Cost —							
Balance as at January 1, 2000	2,008,692	11,736,284	10,450,183	622,360	320,767	505,687	25,643,973
Additions	32,891	532,724	193,604	102,177	29,038	120,266	1,010,700
Disposals ⁽²⁾	(10,881)	(910,383)	(35,713)	(185,758)	(73,083)	(140,693)	(1,356,511)
Balance as at December 31, 2000 ...	<u>2,030,702</u>	<u>11,358,625</u>	<u>10,608,074</u>	<u>538,779</u>	<u>276,722</u>	<u>485,260</u>	<u>25,298,162</u>
Accumulated depreciation							
Balance as at January 1, 2000	986,332	6,328,318	6,435,365	402,217	174,998	246,383	14,573,613
Depreciation allocation	84,556	1,276,551	607,722	111,628	44,465	121,377	2,246,299
Elimination upon disposals ⁽²⁾	(10,590)	(906,968)	(34,109)	(185,059)	(67,689)	(139,787)	(1,344,202)
Balance as at December 31, 2000 ...	<u>1,060,298</u>	<u>6,697,901</u>	<u>7,008,978</u>	<u>328,786</u>	<u>151,774</u>	<u>227,973</u>	<u>15,475,710</u>
Depreciated cost —							
As at December 31, 2000	<u>970,404</u>	<u>4,660,724</u>	<u>3,599,096</u>	<u>209,993</u>	<u>124,948</u>	<u>257,287</u>	<u>9,822,452</u>
As at December 31, 1999	<u>1,022,360</u>	<u>5,407,966</u>	<u>4,014,818</u>	<u>220,143</u>	<u>145,769</u>	<u>259,304</u>	<u>11,070,360</u>

(1) Including NIS 2,305,000 (1999 — NIS 7,116,000) advance payments to suppliers on account of telephone exchange equipment ordered.

(2) Fixed assets are written off the books at the end of the year in which they became fully depreciated, except for land, buildings and vehicles, which are written off the books when sold. In 2000, fully depreciated fixed assets of a cost of approximately NIS 1,276 million (1999 — NIS 1,337 million) were written off the books.

(3) A consolidated company made a provision for a decrease in value of computer equipment and software based on a valuation made by professional consultants.

(4) The cost includes the amount of NIS 15,475,000 in the Company and NIS 30,723,000 consolidated, which constitutes real financing expenses in respect of loans and credit during the establishment period calculated at a real interest rate of approximately 7.4% per annum.

- 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 and for the consideration stipulated therein. 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 on January 31, 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 making alternative land available and the payment of the relocation expenses. The Company's management opposed implementation of such demand. 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 at the office of the Attorney General. In summing up the meeting, the Attorney General decided 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 then set forth in an immediate report issued by the Company. The description includes the positions of the parties in their own

Notes to the Financial Statements as at December 31, 2000 (cont'd)

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. As at the balance sheet date, commitments exist for the purchase of fixed assets (mainly switching equipment) in the amount of approximately NIS 439 million on a consolidated basis and approximately NIS 315 million for the Company.
- D. On May 12, 1999 the Board of Directors of the Company resolved to adopt the recommendations of management, which were based on the report of a firm of outside consultants concerning recommendations to change the depreciation policy and depreciation rates of the Company's assets.

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

- E. Following cancellation of the agreement of the Company with a software supplier who undertook to develop a billing system and the Company's notice of foreclosure of bank guarantees given to it by the supplier, the parties took a number of legal steps. As a result, the financial statements as at December 31, 1999 recorded a provision of approximately NIS 107 million for decrease in value of the investment, and an expense of approximately NIS 20 million in respect of compensation which was paid to a sub-contractor in the project due to termination of the project.

On September 21, 2000 the Company signed a settlement agreement with the software supplier, whereby the software supplier paid the Company approximately NIS 3.7 million in addition to the amounts of the guarantees foreclosed by the Company, \$19.8 million. The parties waived all their claims without admitting any liability. The financial statements include revenues of approximately NIS 100 million in respect of the amounts received.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

NOTE 10 — DEFERRED AND OTHER EXPENSES

Consolidated

	Cost	Accumulated depreciation	Balance for depreciation	
			December 31, 2000	December 31, 1999
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Capitalized subscriber acquisition costs.....	559,111	207,758	351,353	241,709
Rights in channels	5,169	830	4,339	—
Representation rights in a communications corporation ...	3,550	1,331	2,219	2,574
	<u>567,830</u>	<u>209,919</u>	<u>357,911</u>	<u>244,283</u>
Expenses for issue of debentures and raising loans			15,285	13,225
Minority rights of proportionately consolidated company			4,893	—
			<u>378,089</u>	<u>257,508</u>

Company

	Balance for depreciation	
	December 31, 2000	December 31, 1999
	NIS thousands	NIS thousands
Deferred expenses		
Expenses for issue of debentures and raising loans	<u>15,285</u>	<u>13,225</u>

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 (inflation adjusted) 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 2N above and 11D below.

B. INCOME TAX (TAX BENEFIT) INCLUDED IN THE STATEMENT OF OPERATIONS

Consolidated

	For the year ended December 31		
	2000	1999	1998
	NIS thousands	NIS thousands	NIS thousands
Current taxes	175,821	(9,597)	302,352
Deferred taxes	(322,824)	71,356	175,411
Taxes for prior years, net	(6,320)	(2,094)	13,467
	<u>(153,323)</u>	<u>59,665</u>	<u>491,230</u>

Notes to the Financial Statements as at December 31, 2000 (cont'd)

Company

	For the year ended December 31		
	2000	1999	1998
	NIS thousands	NIS thousands	NIS thousands
Current taxes	169,252	1,085	179,147
Deferred taxes	(301,574)	70,139	185,917
Taxes for prior years, net	(6,470)	(845)	9,233
	<u>(138,792)</u>	<u>70,379</u>	<u>374,297</u>

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

Consolidated

	For the year ended December 31		
	2000	1999	1998
	NIS thousands	NIS thousands	NIS thousands
Tax computed at the regular tax rates (*)	(184,437)	29,656	449,562
Increase (savings) in tax liability due to:			
Inflationary erosion of advance tax payments	(67)	1,174	14,226
Exempt income and capital gains	(48,012)	(14,470)	(5,404)
Non-deductible expenses	13,008	12,127	14,077
Losses in respect of which a deferred tax asset was not created	59,108	30,983	1,056
Timing differentials for which no tax assets were created	11,678	(1,107)	(1,261)
Taxes for prior years, net	(6,320)	(2,094)	13,467
Other	1,719	3,396	5,507
	<u>(153,323)</u>	<u>59,665</u>	<u>491,230</u>
(*) Regular tax rates	<u>36</u>	<u>36</u>	<u>36</u>

Company

	For the year ended December 31		
	2000	1999	1998
	NIS thousands	NIS thousands	NIS thousands
Tax computed at the regular tax rates (*)	(92,983)	65,678	338,022
Increase (savings) in tax liability due to:			
Inflationary erosion of advance tax payments	(65)	694	10,364
Exempt income and capital gains	(47,993)	(8,221)	(2,470)
Non-deductible expenses	9,589	9,360	14,700
Taxes for prior years, net	(6,470)	(845)	9,233
Other	(870)	3,713	4,448
	<u>(138,792)</u>	<u>70,379</u>	<u>374,297</u>
(*) Regular tax rates	<u>36</u>	<u>36</u>	<u>36</u>

Notes to the Financial Statements as at December 31, 2000 (cont'd)

D. Deferred taxes

	Consolidated		Company	
	December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Activity —				
Balance at beginning of year	451,706	531,817	463,193	536,077
Charged to statement of operations for the year ..	322,824	(72,177)	301,574	(70,139)
Charged to investment in consolidated company	—	—	—	(2,745)
Charged to income tax refund for prior years	45,177	—	45,177	—
Charged to statement of operations for prior years	(14,631)	(7,934)	(14,631)	—
Balance as at end of year	<u>805,076</u>	<u>451,706</u>	<u>795,313</u>	<u>463,193</u>
Composition of deferred taxes —				
Difference between the adjusted value of fixed assets and their value for income tax purposes	(203,993)	(138,852)	(168,429)	(108,740)
Adjustment of materials and spare parts	(179)	(2,025)	(72)	(969)
Deferred tax due to losses	140,908	—	—	—
Differences in the recognition of expenses relating to employee Rights, doubtful debts and other	868,340	592,583	963,814	572,902
Total	<u>805,076</u>	<u>451,706</u>	<u>795,313</u>	<u>463,193</u>
Classified as follows:				
As part of current assets	186,161	234,152	162,264	214,377
As part of other assets	633,347	237,737	633,049	248,816
As part of long-term liabilities	(14,432)	(20,183)	—	—
Total	<u>805,076</u>	<u>451,706</u>	<u>795,313</u>	<u>463,193</u>

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

Losses for tax purposes of subsidiaries which are carried forward to the coming years amounted to approximately NIS 662,929,000 (1999 — NIS 100,195,000). The balance of the loss and deduction carry-forwards for which no deferred tax asset was included because of the uncertainty of their realization, is approximately NIS 244,991,000 (1999 — NIS 100,195,000).

The net book value of the buildings for tax purposes exceeds its net book value in the financial statements (Company) by NIS 65,619,000 (1999 — NIS 64,652,000; 1998 — NIS 62,009,000). No deferred tax asset in respect of these differences was included in the financial statements.

E. Final tax assessments

- (1) The Company has received final tax assessments (prescribed) up to and including the year 1993. A proportionally consolidated company has received final tax assessments up to and including 1994, and a final tax assessment (prescribed) has been agreed up to 1996. The other principal investee companies have not received tax assessments since the dates of their establishment.
- (2) In December 1999, tax assessments were issued to the Company (outside the agreement) by the large companies tax assessor, in respect of 1994. According to that assessment, the Company must pay additional taxes in the amount of approximately NIS 425 million, including interest and CPI-linkage. Most of the additional tax liability derives from a capital gain from the sale of equipment to Pelephone Communications Ltd. in exchange for an allotment of 50% of Pelephone's shares to the Company. The Company is disputing the assessment and has filed an objection to the demand.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

In August 2000 the Company and the tax assessor reached an agreement relating to some of the issues which arose in the audits for 1995-1998, while for the other issues a disputed assessment was issued, to which the Company objected in January 2001. It was also agreed that further to the Company's application and the consent of the Income Tax Authority of August 7, 2000 to increase the depreciation rates which the Company can legitimately claim in respect of subscriber equipment for the years 1995-1998, the tax assessor will examine the amended reports filed by the Company and will reduce the Company's tax liability according to his findings. In the amended reports the Company claims additional depreciation amounts which far exceed the additional tax liabilities in the aforementioned assessments. The agreement is subject to the approval of the tax assessor.

The above proceedings, including the assessment for 1994 and the objection thereto, are still in progress. In the Company's opinion, based on that of its legal advisors who are handling the matter, the Company has good arguments against most of the assessment. At this stage, it is not possible to estimate the outcome of the proceedings. No provision was made in the financial statements in respect of the tax assessments.

- (3) In September 2000, Bezeq Call Ltd. (an inactive company) received an assessment according to best judgment for the year 1997, in which its taxable income was increased to approximately NIS 30 million as a result of determination by the tax assessor of the consideration from the sale of Bezeq Call's business to Bezeq Call Communications Ltd. The Company has filed an objection to the assessment, in which it absolutely rejects the determination. It is not possible, at this stage, to estimate the final outcome of these proceedings. No provision was made in the financial statements in respect of this assessment.

F. Value Added Tax

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

NOTE 12 — BANK CREDIT

	Interest rate	Consolidated		Company	
		December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999
		NIS thousands	NIS thousands	NIS thousands	NIS thousands
	%				
Unlinked loans	8.60 – 8.25	716,136	271,006	—	—
Dollar-linked loans	6.7	19,006	—	—	—
		<u>735,142</u>	<u>271,006</u>	<u>—</u>	<u>—</u>

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

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

Notes to the Financial Statements as at December 31, 2000 (cont'd)

NOTE 14 — LONG-TERM LOANS

A. Composition

	Consolidated		Company	
	December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Banks	3,109,381	4,188,482	2,638,529	3,747,197
Pension fund	98,607	111,337	98,607	111,337
Others	7,711	—	—	—
Supplier credit	2,257	3,361	—	—
	<u>3,217,956</u>	<u>4,303,180</u>	<u>2,737,136</u>	<u>3,858,534</u>
Less —				
Current maturities from banks	377,587	1,053,418	317,495	983,615
Other current maturities	15,585	13,158	14,913	12,822
	<u>2,824,784</u>	<u>3,236,604</u>	<u>2,404,728</u>	<u>2,862,097</u>

B. Linkage terms and interest

	Interest rate	Consolidated		Company	
		December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999
	%	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Loans in foreign currency					
US dollar(*)	LIBOR + 0.35-0.5	2,011,373	2,972,362	2,011,373	2,868,536
Loans linked to the CPI	3.6 – 8.2	1,070,265	1,219,481	627,156	878,661
	6.1	98,607	111,337	98,607	111,337
		<u>1,168,872</u>	<u>1,330,818</u>	<u>725,763</u>	<u>989,998</u>
Unlinked loans	9.45	37,711	—	—	—
		<u>3,217,956</u>	<u>4,303,180</u>	<u>2,737,136</u>	<u>3,858,534</u>

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

C. Repayment schedule

	Consolidated	Company
	NIS thousands	NIS thousands
December 31		
2002	1,172,758	978,088
2003	485,388	427,887
2004	445,474	388,255
2005	563,737	517,704
2006 and thereafter	157,427	92,794
	<u>2,824,784</u>	<u>2,404,728</u>

D. Security

(1) The long-term loan agreements of the Company, aggregating NIS 1,707,156,000 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 606,150,000, a decrease in the State's voting rights in the Company to 50% or less, or initiation of a process which is liable to lead to such a decrease, as well as occurrence of an event which allows other loans of the Company to be made available for early repayment.

— In respect of the remaining loan balance of NIS 1,101,006,000 a decrease in the State's voting rights in the Company to 26% or less, of which in respect of a balance of

Notes to the Financial Statements as at December 31, 2000 (cont'd)

approximately NIS 303,075,000, upon occurrence of an event which also allows other loans of the Company to be made available for early repayment.

- Change of the nature of the Company's business without the agreement of the lenders, which would have a materially adverse effect on the Company's business, assets or financial position.

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

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

- (2) A proportionally consolidated company made a negative pledge and committed to maintain certain financial conditions in respect of loans it received from banks, whose balance as at the balance sheet date is NIS 437,005,000. As at the balance sheet date, this company is in compliance with the aforementioned conditions.

E. Loan-procurement expenses

The deferred expenses in connection with the procurement of loans as at December 31, 2000 and as at December 31, 1999 amounted to NIS 14,318,000 and NIS 12,878,000 respectively. The expenses are stated net of accumulated amortization in the amount of NIS 9,529,000 and NIS 6,183,000 respectively.

NOTE 15 — OTHER DEBENTURES

A. Composition and terms

	Interest Rates	Consolidated and Company	
		December 31, 2000	December 31, 1999
	%	NIS thousands	NIS thousands
CPI-linked debentures issued to the public:			
Debentures Series 1 ⁽¹⁾	4.5	262,409	327,704
Debentures issued to the public:			
Linked to the euro ⁽²⁾	6.5	1,121,869	—
Debentures issued to financial institutions and others:			
CPI-linked	5.1	992,387	1,151,433
		2,376,665	1,479,137
Less — current maturities		224,590	225,517
		<u>2,152,075</u>	<u>1,253,620</u>

(1) The outstanding balance of the debentures is NIS 79,801,157 par value (1999 — NIS 99,751,438 par value).

(2) The outstanding balance of the debenture is 300,000,000 euro par value.

B. Repayment schedule

	NIS thousands
2002	184,117
2003	194,366
2004	194,985
2005	130,038
2006 and thereafter	1,448,569
	<u>2,152,075</u>

Notes to the Financial Statements as at December 31, 2000 (cont'd)

C. Security

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

Some of the lenders, the balance of whose loans as at December 31, 2000 amounts to approximately NIS 925,439,000, 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).

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

D. Issue expenses

The deferred expenses with respect to the issue of the debentures amounted to NIS 29,265,000 (1999 — NIS 21,581,000), and are stated net of amortization of NIS 18,769,000 (1999 — NIS 17,416,000).

NOTE 16 — TRADE PAYABLES

	Consolidated		Company	
	December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Suppliers of goods and services(*)	1,046,214	1,156,038	465,896	654,624
Current maturities of long-term supplier credit	672	336	—	—
	1,046,886	1,156,374	465,896	654,624
(*) Including foreign currency balances	423,116	373,568	15,804	14,183
Including subsidiaries	—	—	1,994	4,470
Including a proportionally consolidated company	16,041	46,682	32,082	93,364

NOTE 17 — LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

A. Composition

	Consolidated		Company	
	December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Provision for early retirement (see D below)	1,544,375	351,185	1,544,375	351,185
Compensation for unutilized sick leave (see E below)	47,723	79,375	47,723	79,375
	1,592,098	430,560	1,592,098	430,560
Provision for severance pay	17,023	11,447	—	—
Less — reserve in compensation fund	(12,750)	(12,359)	—	—
	4,273	(912)	—	—
	1,596,371	429,648	1,592,098	430,560
Stated as follows:				
Among current liabilities	344,780	351,185	344,780	351,185
Among long-term liabilities	1,251,591	78,463	1,247,318	79,375
	1,596,371	429,648	1,592,098	430,560

Notes to the Financial Statements as at December 31, 2000 (cont'd)

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, is covered by a pension fund ("Keren Makefet") which assumed the Government's liability in accordance with an agreement between the Government, the Company, the New General Federation of Labor (Histadrut) and the Fund.

C. Employee rights before retirement age

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

Employees who transferred to the Company from government service and who leave their service prior to reaching retirement age, are entitled, under certain conditions, at their election, to receive early retirement benefits in lieu of severance pay. The cost of the early retirement benefits, except for cases of sickness or disability up to retirement age, are to be borne by the Company. The costs of retirement of such employees is included in the provision to 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, 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, between December 31, 1999 and December 31, 2000, 353 employees retired from the Company, and another 177 are scheduled to retire by March 31, 2001. These financial statements include a provision of approximately NIS 75 million for adjustment of the expected cost of the retirement plan to up-to-date retirement data.
- (3) In the wake of privatization of the Company and the opening of the market to competition, additional workforce changes will become necessary 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 financial statements include an expense of approximately NIS 1,371 million in respect of the expected cost of implementation of this plan. The Company's management estimates that the possibility of additional employees retiring under a compensation arrangement is slight, and accordingly, no provision was made therefore in the financial statements.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

E. Compensation for unutilized sick leave

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

NOTE 18 — OTHER CURRENT LIABILITIES

	Consolidated		Company	
	December 31, 2000	December 31, 1999	December 31, 2000	December 31, 1999
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
The Government of Israel in respect of royalties, interest and fees	194,341	193,356	146,307	146,553
Wages and salaries ⁽¹⁾	199,376	178,712	156,413	156,834
Provision for vacation pay	91,508	94,987	83,458	87,700
Government agencies.....	72,724	35,133	58,614	29,266
Accrued interest	103,583	80,158	100,312	77,247
Forward exchange contracts	34,351	19,992	34,351	19,620
Other accrued expenses	116,906	106,721	64,122	80,406
Current maturities in respect of prepaid income.....	44,758	56,886	26,453	36,900
Provision for claims in respect of Salary and pension components.....	<u>109,832</u>	<u>59,832</u>	<u>109,832</u>	<u>59,832</u>
	<u>967,379</u>	<u>825,777</u>	<u>779,862</u>	<u>694,358</u>
(1) Includes current maturities of a long-term loan from a pension fund	<u>14,913</u>	<u>12,822</u>	<u>14,913</u>	<u>12,822</u>

NOTE 19 — DEFERRED REVENUES

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

NOTE 20 — CONVERTIBLE DEBENTURES

The debentures registered in name 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. The debentures will mature, if not converted into shares, on February 28, 2001. During the reporting period, 147,652,429 par value of debentures were converted and in exchange, 14,590,161 ordinary shares of a par value of NIS 1 were issued. From then, to the last date for conversion, another 59,754,681 par value of debentures were converted and in exchange, 5,904,613 ordinary shares of a par value of NIS 1 were issued. The balance of the debentures, 560,735 par value, have matured.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

NOTE 21 — CONTINGENT LIABILITIES

A. Claims

- (1) Following the reduction in the Company's tariffs from April 1, 1992, an application was filed in the District Court in April 1992 for certification of a class action against the State of Israel and against the Company, alleging the lack of required disclosure and inclusion of misleading information in the prospectus of May 23, 1991. The action alleged that the Company's public shareholders sustained damages estimated at approximately NIS 618 million. In May 1994 the District Court rejected the application. In the appeal filed by the plaintiffs in the Supreme Court in June 1994, a deliberate arrangement was arrived at (and was validated as a decision in the appeal and in the application for permission to appeal). Under the arrangement, the appeal and the application for permission to appeal were stricken and it was agreed, *inter alia*, that the plaintiff may sue on its own behalf in the District Court for the same cause as that for which approval of the class action was sought, and that within 30 days of a decision being given in the District Court, the plaintiff would be entitled to file a renewed appeal against the decision of the District Court to reject the application for approval of the class action. The plaintiff has not yet filed such a claim in his own name. In the Company's opinion, relying on the legal counsel who is handling the case on its behalf, the prospects for the claim in the aforesaid proceedings cannot be estimated. No provision is included in the financial statements in respect of this claim.
- (2) In August 1996 a claim and an application by way of motion for approval of such claim as a class action were filed against the Company in the District Court. The plaintiff alleges that the Company is misleading the public in that the prices of direct-dial international calls are calculated and collected on the basis of meter pulses rather than call time units as promised in its advertisements. The claimed damage relates to overcharging deriving from rounding-up of fractions of meter pulses to a whole meter pulse. The value of the claim as a class action is approximately NIS 124 million, and it refers to the seven years preceding the filing of the action. In February 1997 the court approved the action as a declaratory class action with regard to the deception only, and 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 an appeal of the decision to recognize the action a declaratory class action. In March 1998 the application of the plaintiff to conjoin Bezeq International Ltd. as an additional defendant in the class action was allowed. Bezeq International Ltd. filed an appeal against this decision in May 1998 in the Supreme Court. On the same occasion, Bezeq International Ltd. requested to be conjoined as an additional appellant in the Company's appeal. In the Company's opinion, relying on the legal counsel who is handling the claim on its behalf, the chances of the appeal and the cross-appeal cannot be estimated. No provision is included in the financial statements in respect of this claim.
- (3) In June 1997 a group of approximately 130 employees filed a claim, through the Histadrut, in the Regional Labor Court, for declaratory relief in respect of the pension rights of those employees of the group who were transferred from the Ministry of Communications, serving as 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 1998 the Attorney General gave notice of his involvement in the proceeding. In May 1998 the Company filed an actuarial opinion in the Regional Labor Court, stating that the cost of the plaintiffs' demand would be approximately NIS 157 million. In November 1999 a decision was given rejecting almost all the causes of the action. This decision has been appealed. 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 an arrangement proposed by the Company's management.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

- (4) In July 1997 a claim and an application by way of motion were filed against the Company and the subsidiary — Bezeq International Ltd. — to recognize an action as a class action under Section 46A of the 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 inflated and unreasonable, while exploiting the Company's and Bezeq International's status as a monopoly, against a background of lowering prices as the international calls market was opening up to competition. The amount of the action is estimated by the plaintiff at approximately NIS 900 million. The plaintiff declared before the court his willingness to reword his claim so that it would stand against the Company only up to the date on which Bezeq International Ltd. would give notice that it has taken upon itself responsibility for international calls. On October 19, 1998 the Attorney General conveyed his position to the court, stating that the action should not be recognized as a class action. On January 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 Ltd. and the Company, at the times relevant to the action, were binding prices rather than maximum prices as alleged by the plaintiff, and that Bezeq International Ltd. and the Company could not have lawfully lowered the international call prices themselves without the approval of the competent authorities. On August 8, 1999, after submission of the summations of the parties, the District Court approved the claim as a class action. On September 30, 1999 the Company and Bezeq International Ltd. filed for permission to appeal this decision.

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

- (5) In September 1997 a claim was filed against the Company and the State in the Regional Labor Court. The claim was filed on behalf of 128 senior employees who are employed under personal contracts. The nature of the claim is the plaintiffs' allegation that starting from October 1, 1996, they are entitled to a wage increment of 33%, corresponding to the increment which was given at that time to Members of the Knesset and to senior civil servants whose salaries are linked to those of Members of the Knesset. The total amount of the claim in respect of salary differences is approximately NIS 11 million. Differences are also claimed in respect of holding back of wages for 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 counsel 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 opinion of the Attorney General was filed in the case, and supports the position of the Government 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 Government 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.

- (6) In November 1997 a claim was filed in the District Court, together with an application by way of motion to recognize such claim as a class action, against the Company, Bezeq International, the Chairman of the Board of Bezeq International and the CEO of Bezeq International. The claim alleges, *inter alia*, that the Anti-Trust Commissioner determined that Bezeq International had unfairly exploited its status in the international calls market and had implemented a deliberate policy of misleading the public on the subject of overseas call tariffs and that it had refrained from clarifying to the public that only those who register as Bezeq International subscribers would enjoy its 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.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

Bezeq International and its legal advisers are unable, at this stage, to estimate the chances of the claim and/or its possible effect on the business of Bezeq International, and therefore no provision is made in the financial statements in respect of this claim.

- (7) A number of claims of former employees are pending against the Company, whose subject-matter is mainly the inclusion of various wage components for calculating pensions. These questions are liable to have a broad impact. In the opinion of the Company's management, based on opinions of its legal advisers who are handling the claims on its behalf, it is not possible, at this stage, to estimate the outcome and possible implications of the claims for the Company. Accordingly, no provision is made in the financial statements in respect of these claims.
- (8) Prior to the opening of the market to competition, the subsidiary Bezeq International Ltd. lowered its tariffs to several destinations for registered subscribers. Following that action, the Anti-Trust Commissioner started an investigation which determined, on November 1997, that the subsidiary had unfairly exploited its status by adopting a misleading policy in connection with the tariffs it collects. The Commissioner determined however, that this is not an instance of predatory pricing. On December 22, 1997, following an approach by the Ministry of Communications, the Commissioner announced that at that stage, and based upon the investigation material, he does not intend to initiate criminal proceedings against the subsidiary or its officers. On December 23, 1997 the subsidiary filed an objection to the Commissioner's determination in the Anti-Trust Tribunal, with regard to exploitation of market status by misleading the public. On July 20, 2000, the Tribunal allowed the subsidiary's application to terminate the objection without possibility of renewal.
- (9) In December 1998 the Anti-Trust Commissioner published notice that the Investigations Department of the Anti-Trust Commission had completed an investigation it had carried out over the past year, of prima facie suspicions of cartels between Koor Industries, Telrad, Tadiran, the Company and BezeqCall Communications, in the supply of large switchboards and exchanges for 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 accompanying services by Tadiran and Telrad to the Company; and the network end point exchanges.

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

The second area of suspicion which was investigated in connection with large exchanges, concerns suspicion of cartelism between the Company and Koor, Telrad and Tadiran, which includes a commitment by the Company not to purchase exchanges from a third vendor; division of purchases between Telrad and Tadiran according to a predetermined key, i.e. the

Notes to the Financial Statements as at December 31, 2000 (cont'd)

ostensible pre-arrangement of the competition between the companies vis-a-vis the Company; an undertaking by the Company not to purchase from the two companies 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 been restricted by the aforementioned arrangement from 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, the element of secrecy constitutes not only proof that the relevant parties knew they were involved in an offense, but also indicates aggravated circumstances for this offense.

The findings of the Authority's investigation in this area appear to indicate a series of restrictive business arrangements and attempted offenses in the field of network end point equipment, between Bezeq Call Communications, Telrad and Tadiran. Among others, suspicions are raised of restrictive business arrangements 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 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 said companies or some of them, in various instances, coordinated the prices of the proposals they would submit in the tenders of final customers. In addition, prima facie evidence was found of market division arrangements between the companies, as well as agreements concerning non-marketing of the product of an additional third vendor in the field of network end point exchanges.

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

In November 2000, a communication was received from a Company shareholder, demanding that the Company take legal action against the vendors and stating that in his opinion, the Company had incurred losses of approximately NIS 400 million as a result of the restrictive business arrangement. The shareholder reserves the right to file a derivative claim pursuant to Section 194 of the Companies Law. The Company responded to the communication that it is following the developments in the matter, and that it had requested the investigation material from the Anti-Trust Commission, and that it would formulate its position based on the decision of the Anti-Trust Commission and its findings, if any.

- (10) 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. In the hearing of the Company's application to dismiss the action *in limine*, the parties reached an agreement regarding partial dismissal and a narrowing of the claim in

Notes to the Financial Statements as at December 31, 2000 (cont'd)

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 broad impact on the Company. However, in view of the above agreements, exposure has been materially reduced. The Company is unable, at this stage, to estimate the outcome and the possible implications for the Company. Accordingly, no provision is made in the financial statements in respect of this claim.

- (11) On February 15, 2000 a claim was filed against the Company in the District Court in Jerusalem in the amount of NIS 20 million. The plaintiff alleges in his claim that the Company 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 proper 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 counsel 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.
- (12) On February 23, 2000, two former employees of the Company filed a monetary 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 prospectus which was published in 1998 contained misleading details and representations, and material documents which should have been attached were not attached.

The Company has not yet filed a statement of defense, nor a response to the application for approval as a class action. The Company and the State have filed, separately, preliminary applications for dismissal of the claim *in limine* for no case to answer and expiry under the statute of limitations.

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

- (13) 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 Pelephone's status as a monopoly and exploitation of distress and misleading consumers. If the action shall be recognized as a class action, the amount claimed is estimated at 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 advisers 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.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

- (14) In March 2000, a class action was filed against Pelephone Communications Ltd. for charging value added tax within the borders of the free trade zone in Eilat. The total for which approval is sought as part of the action is approximately NIS 34.5 million. In the opinion of Pelephone's management, based on the opinion of its legal advisers and on an outside opinion, the claim is unlikely to succeed. Accordingly, no provision is made in the financial statements in respect of this claim.
- (15) In July 2000 a class action and application for 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 903 million. In the opinion of the Company's legal advisors, the Company has good arguments against the application and against the claim; nevertheless, the Company is unable to estimate the chances that the application for approval will be allowed. No provision is made for this claim in the financial statements.
- (16) 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 an 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 work disruptions by the Company's employees, the upgrade works were interrupted, which constitutes breach of contract. In the opinion of the Company's legal advisors, the Company has good arguments against the application for the permanent mandamus.
- (17) On August 10, 2000, the Company received a letter from a representative of the Anti-Trust Commissioner, stating that according to information which had reached the Commissioner, 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 Anti-Trust Law, 5748-1988 ("the Law"). The alleged actions relate to agreements between the Company and its dealers (agents) for ADSL services. Accordingly, the Company is required to give its preliminary response to the allegations, and to submit to the Commissioner various 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, which could make the agreements with the dealers irrelevant.
- (18) 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 60 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. 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.
- (19) 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

Notes to the Financial Statements as at December 31, 2000 (cont'd)

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*, to which the plaintiffs have not yet responded. In the opinion of the Company, relying on the opinion of its legal counsel, the chances of the claim cannot be estimated at this stage. No provision was made in the financial statements in respect of this claim.

- (20) In September 2000, a class action and an application for approval as a class action were filed against the Company in an amount which is estimated at approximately NIS 103 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: declarative: — 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 regulations governing collection of bills, claiming to have acted lawfully. The plaintiff has filed his reply to the Company's response and date has been set for hearing the application. The legal advisors of the Company 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.
- (21) 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 750 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 them, so they allege, after 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 of 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. The legal advisors of the Company 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.

In addition, on November 21, 2000 the Company received a class action and application for approval as a class action in an amount estimated at approximately NIS 240 million. This action makes similar allegations to those of the action described above from September 2000. The Company is studying the claim and is unable, at this stage, to assess its chances.

The plaintiffs have filed a request for consolidation of the two actions described above.

- (22) 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 received by its subscribers in Israel originating outside

Notes to the Financial Statements as at December 31, 2000 (cont'd)

Israel, in contravention of the VAT law and its regulations and in violation of a legislated duty in a manner 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 and 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 plaintiffs, as a 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.

The reliefs requested by the plaintiffs are mainly two — declaratory, in which the court is requested to declare that each of the defendants violated its obligations under the agreement between it and each member of the group of plaintiffs, and financial, for restitution of said amounts, compensation for the loss incurred by the members of the group in the aforesaid amounts. The legal advisors of the Company 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.

- (23) 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 amount claimed is approximately NIS 260 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 above period. In the counter-claim, Pelephone claims reimbursement of NIS 66 million 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.

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 settlement arrangement with the State in November 1995.

- (24) In February 2001 a class action and application for 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 a benefit to the customer.

The plaintiff alleges that since May 1, 2000, when the new tariffs took effect, until the end of June, the Company charged subscribers who did not select one of the Internet tracks, for calls to the Internet according to the Light Net track as if it were the "regular" tariff for connecting to the Internet. Therefore, according to the plaintiff, from July 1, 2000 and onwards 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 deception, as well as representation of the Company, on the basis of which the subscriber altered his or her situation for the worse, and therefore, according to the plaintiff, the Company is bound by the alleged representation. In this, according to the plaintiff, the Company violated the provisions of Section 2(a) of the Consumer Protection Law.

The Company is studying the claim and is unable, at this stage, to estimate its chances.

- (25) A claim and application for recognition as a class action which were filed against the Company in the matter of the Company's advertising campaign about the advantages of using a fixed-line telephone rather than a cellular telephone (which was estimated by the

Notes to the Financial Statements as at December 31, 2000 (cont'd)

plaintiff in the amount of approximately NIS 57 million), ended in an arrangement (at nominal cost to the Company) between the parties which was confirmed by the Supreme Court, which stipulated, *inter alia*, that the Company's advertising campaign did not mislead the public. As part of the arrangement, the Company acceded, for its part, to devote part of its sponsorships for humanistic purposes.

In addition, the claim and application for recognition as a class action which were filed against the Company, a proportionally consolidated company and another cellular communications company, concerning the collection of payment for airtime for voice mail services or "call forwarding" services" to the Company's network (estimated by the plaintiff at approximately NIS 2 billion), was dismissed.

- (26) In March 2001, a petition was filed in the Supreme Court against the Minister of Communications, the Company and the three cellular operators, in which the petitioner is requesting, *inter alia*, that the Court order the Minister of Communications and the Company to provide a blocking service for every Company telephone-line subscriber against outgoing calls to the area codes of the mobile telephones as a positive default. The Court has transferred the petition for the response of the respondents. The Company is studying the petition and is unable, at this stage, to estimate its chances and implications.
- (27) For the claim of the Ministry of Communications in India for forfeiture of guarantees, see Note 8D.
- (28) 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.
- (29) For the income tax assessment for 1994, see note 11E.
- (30) For possible demand for early repayment of bank loans, see Note 14D1 and 15C.
- (31) 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, 2000.

B. Forward exchange contracts

The Company has entered into forward exchange contracts as a hedge against exposure resulting from changes in the exchange rate of the US dollar in relation to changes in the CPI. As at December 31, 2000, the Company contracted to purchase approximately US \$302 million (approximately NIS 1,222 million) for which it will pay approximately NIS 1,249 million linked to the CPI, and approximately 40 million euros (approximately NIS 152 million), for which it will pay approximately NIS 144 million linked to the CPI. The contracts mature on various dates, the last of which is May 2002. The Company also contracted to purchase approximately US \$205 million (approximately NIS 828 million), for which it will pay approximately NIS 844 million at predetermined rates, and approximately 70 million euros (NIS 263 million), for which it will pay approximately NIS 258 million at predetermined rates, and approximately NIS 187 million for which it will pay approximately NIS 189 million.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

C. Lease contract commitments

<u>For the year ended December 31</u>	<u>Consolidated</u> <u>NIS thousands</u>	<u>Company</u> <u>NIS thousands</u>
2001.....	113,833	77,441
2002.....	119,445	73,838
2003.....	108,344	64,922
2004.....	95,496	54,636
2005.....	91,314	50,820
2006 onwards.....	<u>460,284</u>	<u>384,187</u>
	<u>988,716</u>	<u>705,844</u>

D. Commitment of a subsidiary for the creation of a joint venture

The subsidiary Bezeq International Ltd. entered into an agreement of principles on January 30, 2001 with TyCom Networks Ltd. ("TyCom"), one of the world's leading international providers, for communications systems and services, including capacity and sub-marine optical fibers.

The agreement of principles addresses the establishment of a joint venture for laying and operating a system of undersea optical fibers in the eastern Mediterranean Basin as part of TyCom's global network ("TGN"), at a total cost of approximately 390 million dollars. The investment of Bezeq International in the project will be approximately 20%. Bezeq International has an option to increase its investment, on certain terms, to 33% of the joint venture.

According to the agreement of principles, the parties are to take steps toward the signing of a detailed agreement within 60 days of the date of signature of the agreement of principles.

E. Securities and liens

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

For guarantees given by the Company for its investments in D.B.S. Satellite Services (1998) Ltd., see Note 8H.

NOTE 22 — SHARE CAPITAL

The share capital consists of ordinary shares of a par value of NIS 1 each. The registered capital — 835,000,000 shares. The issued and paid up capital — 797,981,233 shares (1999 — 783,391,072 shares). All the shares are listed on the Tel Aviv Stock Exchange.

The General Meeting which convened on November 22, 2000 resolved to approve the recommendation of the Board of Directors of the Company to increase the registered capital of the Company by approximately NIS 1.6 billion of ordinary shares and to distribute bonus shares in the amount of approximately 1.6 billion shares, so that in respect of each shares of a par value of NIS 1, two bonus shares of a par value of NIS 1 each will be distributed. For this purpose, it was resolved to capitalize undesignated earnings to a reserve fund which will be earmarked for the distribution of bonus shares, and to authorize the Board of Directors to issue those bonus shares. In January 2001, approval was received from the Ministerial Committee for Privatization for the increase of the registered capital for allotment of the bonus shares. The increase in the registered capital and the allotment of the bonus shares as aforesaid, were implemented in February 2001.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

NOTE 23 — REVENUES FROM TELECOMMUNICATION SERVICES

Consolidated

	For the year ended December 31		
	2000	1999*	1998*
	NIS thousands	NIS thousands	NIS thousands
Revenues from telephone services —			
Domestic fixed-line communications	2,525,700	2,750,493	3,305,647
Cellular telephone ⁽¹⁾	2,145,539	2,837,589	2,677,852
Fixed fees	1,988,651	1,819,036	1,573,652
International communications and Internet services ..	846,370	903,885	1,132,091
Installation and sale of equipment to subscribers	496,269	479,170	505,651
Other	140,389	141,440	76,389
	<u>8,142,918</u>	<u>8,931,613</u>	<u>9,271,282</u>
Other revenues	259,321	223,108	269,230
	<u>8,402,239</u>	<u>9,154,721</u>	<u>9,540,512</u>

Company

	For the year ended December 31		
	2000	1999*	1998*
	NIS thousands	NIS thousands	NIS thousands
Revenues from telephone services —			
Domestic fixed-line communications	2,546,617	2,765,344	3,315,010
Cellular telephone ⁽¹⁾	842,491	1,983,563	1,821,376
Fixed fees	1,882,363	1,669,119	1,405,872
International communications and Internet services ..	388,467	444,369	540,088
Installation and sale of equipment to subscribers	211,283	235,377	261,013
Other	144,122	143,736	80,324
	<u>6,015,343</u>	<u>7,241,508</u>	<u>7,423,683</u>
Other revenues	236,922	217,312	257,186
	<u>6,252,265</u>	<u>7,458,820</u>	<u>7,680,869</u>

(1) See Note 1E(1).

* Reclassified.

NOTE 24 — OPERATING AND GENERAL EXPENSES

Consolidated

	For the year ended December 31		
	2000	1999*	1998*
	NIS thousands	NIS thousands	NIS thousands
Salaries and related expenses	1,676,182	1,671,130	1,878,920
Cellular telephone expenses ⁽¹⁾	509,729	1,364,926	1,090,993
General expenses	680,319	730,017	556,391
Services and maintenance by sub-contractors	398,104	470,703	429,486
Building maintenance	388,660	396,693	379,547
Materials and spare parts	418,101	285,766	288,559
International communications expenses	251,065	264,601	456,213
Vehicle maintenance expenses	72,599	65,457	62,980
Collection fees	39,008	42,115	43,075
	<u>4,433,767</u>	<u>5,291,408</u>	<u>5,186,164</u>
Less — salaries charged to investment in fixed assets	149,933	159,870	171,306
	<u>4,283,834</u>	<u>5,131,538</u>	<u>5,014,858</u>

Notes to the Financial Statements as at December 31, 2000 (cont'd)

Company

	For the year ended December 31		
	2000	1999	1998*
	NIS thousands	NIS thousands	NIS thousands
Salaries and related expenses	1,312,659	1,393,014	1,660,797
Cellular telephone expenses ⁽¹⁾	302,838	1,497,174	1,300,636
General expenses	233,649	256,117	231,443
Services and maintenance by sub-contractors	340,715	415,237	386,408
Building maintenance	343,891	354,149	342,999
Materials and spare parts	39,021	51,433	59,597
International communications expenses	12,145	18,751	27,993
Vehicle maintenance expenses	62,412	59,936	58,763
Collection fees	38,783	41,464	42,461
	<u>2,686,113</u>	<u>4,087,275</u>	<u>4,111,097</u>
Less — salaries charged to investment in fixed assets	149,933	159,870	171,306
	<u>2,536,180</u>	<u>3,927,405</u>	<u>3,939,791</u>

(1) See Note 1E(1)

* Reclassified

NOTE 25 — FINANCING EXPENSES TO BANKS AND OTHERS, NET

Consolidated

	For the year ended December 31		
	2000	1999	1998
	NIS thousands	NIS thousands	NIS thousands
Financing expenses for a debenture issued to the State of Israel	4,881	56,060	101,695
Expenses in respect of long-term liabilities (*)			
Debentures	118,766	82,668	69,876
Loans	172,416	212,984	520,876
	<u>296,063</u>	<u>351,712</u>	<u>692,447</u>
Income in respect of deposits and investments	(66,000)	(73,606)	(42,230)
Expenses (income) in respect of forward exchange contracts	102,223	111,182	(181,705)
Short-term bank credit	35,769	14,972	—
Other income, net	(24,823)	(44,188)	(12,698)
	<u>343,232</u>	<u>360,072</u>	<u>455,814</u>
(*) Includes increase in value (net of erosion) of liabilities in foreign currency	(50,006)	(33,276)	265,994

Notes to the Financial Statements as at December 31, 2000 (cont'd)

Company

	For the year ended December 31		
	2000	1999	1998
	NIS thousands	NIS thousands	NIS thousands
Financing expenses for a debenture issued to the State of Israel	4,881	56,060	101,695
Expenses in respect of long-term liabilities (*)			
Debentures	118,766	82,668	69,876
Loans	153,543	193,815	495,804
	277,190	332,543	667,375
Income in respect of deposits and investments	(66,000)	(73,606)	(3,318)
Expenses (income) in respect of forward exchange contracts	102,223	111,182	(181,705)
Other income, net	(19,074)	(5,432)	(4,750)
	<u>294,339</u>	<u>364,687</u>	<u>477,602</u>
(*) Includes increase in value (net of erosion) of liabilities in foreign currency	(47,006)	(35,329)	242,466

NOTE 26 — OTHER INCOME (EXPENSES), NET

Consolidated

	For the year ended December 31		
	2000	1999	1998
	NIS thousands	NIS thousands	NIS thousands
Provision for employee severance benefits upon early retirement (Note 17D)	(1,446,463)	(398,340)	202,317
Compensation (provision) for the billing system (Note 9E)	99,131	(126,772)	—
Provision for claims for salary and pension components	(50,000)	—	(88,497)
Provision for unutilized sick leave ⁽¹⁾	—	9,767	(60,805)
Provision for decrease in value of fixed assets	(11,013)	—	(14,623)
Direct expenses for the customer allocation process	(27,690)	(75,561)	—
Capital gains (losses), net	1,341	16,391	4,686*
Capital gain from sale of an affiliate (Note 8E)	138,737	—	—
Cancellation of provision for a guarantee for an affiliate	23,306	14,919	—
Others	(4)	1,138	(316)
	<u>(1,272,655)</u>	<u>(558,458)</u>	<u>42,762</u>

Notes to the Financial Statements as at December 31, 2000 (cont'd)

Company

	For the year ended December 31		
	2000	1999	1998
	NIS thousands	NIS thousands	NIS thousands
Provision for employee severance benefits upon early retirement (Note 17D)	(1,446,463)	(398,340)	202,317
Compensation (provision) for the billing system (Note 9E)	99,131	(126,772)	—
Provision for claims for salary and pension components	(50,000)	—	(88,497)
Provision for unutilized sick leave ⁽¹⁾	—	9,767	(60,805)
Provision for decrease in value of fixed assets	—	—	(14,623)
Capital gains, net	2,657	17,454	13,027*
Capital gain from sale of an affiliate (Note 8E)	138,737	—	—
Cancellation of provision for a guarantee for an affiliate	23,306	14,919	—
Others	(225)	202	—
	<u>(1,232,857)</u>	<u>(482,770)</u>	<u>51,419</u>

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

* Reclassified

NOTE 27 — EARNINGS PER SHARE (CONSOLIDATED AND COMPANY)

	For the year ended December 31		
	2000	1999	1998
	NIS thousands	NIS thousands	NIS thousands
Primary and diluted earnings (loss)	<u>(544,327)</u>	<u>20,324</u>	<u>766,149</u>
Weighted number of shares in primary earnings and diluted earnings ⁽¹⁾	<u>2,411,826</u>	<u>2,411,826</u>	<u>2,308,833</u>

In order to determine the likelihood of conversion of the convertible debentures and calculate earnings per share, the present value for 2000 was calculated assuming possible exercise of the convertible debentures at a shekel interest rate after tax of 7%.

(1) Calculation of earnings per share takes into account the bonus share component, as explained in Note 22.

Notes to the Financial Statements as at December 31, 2000 (cont'd)

NOTE 28 — BUSINESS SECTORS

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.

	For the year ended December 31, 2000					
	<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						
Revenue from outside sources	5,911,946	1,667,822	667,254	155,217	—	8,402,239
Inter-segment revenues ...	340,319	53,246	4,434	30,837	(428,836)	—
Total revenues	<u>6,252,265</u>	<u>1,721,068</u>	<u>671,688</u>	<u>186,054</u>	<u>(428,836)</u>	<u>8,402,239</u>
Segment results	<u>1,268,911</u>	<u>(28,912)</u>	<u>(148,886)</u>	<u>12,286</u>	<u>163</u>	<u>1,103,562</u>
Financing expenses						<u>343,232</u>
Earnings after financing expenses						760,330
Other expenses, net						<u>(1,272,655)</u>
Loss before income tax ...						(512,325)
Tax benefit						<u>153,323</u>
Loss after income tax						(359,002)
Equity in earnings (losses) of affiliates	(12,096)			(183,063)		(195,159)
Minority equity in losses of a subsidiary						4,893
Net loss						<u>(549,268)</u>
Identified assets	12,299,132	2,294,075	635,023	89,166	(55,438)	15,261,958
Investment by equity method	100,467			72,209		172,676
General assets						<u>1,535,787</u>
Total consolidated assets						<u>16,970,421</u>
Segment liabilities	2,451,910	924,727	501,089	49,389	(53,598)	3,873,517
General liabilities						<u>6,135,530</u>
Total consolidated liabilities						<u>10,009,047</u>
Capital investments	<u>1,010,700</u>	<u>816,349</u>	<u>129,857</u>	<u>8,157</u>		
Depreciation and amortization	<u>2,246,299</u>	<u>529,967</u>	<u>74,407</u>	<u>4,445</u>		

Notes to the Financial Statements as at December 31, 2000 (cont'd)

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						
Revenue from outside sources	7,127,974	1,159,855	698,553	156,968	—	9,143,350
Inter-segment revenues...	<u>330,846</u>	<u>327,969</u>	<u>9,417</u>	<u>27,482</u>	<u>(695,714)</u>	<u>—</u>
Total revenues	<u>7,458,820</u>	<u>1,487,824</u>	<u>707,970</u>	<u>184,450</u>	<u>(695,714)</u>	<u>9,143,350</u>
Segment results	<u>1,029,897</u>	<u>63,568</u>	<u>(59,773)</u>	<u>14,649</u>	<u>(47,435)</u>	<u>1,000,906</u>
Financing expenses						<u>(360,072)</u>
Earnings after financing expenses						640,834
Other expenses, net						<u>(558,458)</u>
Earnings before income tax						82,376
Income tax						<u>(59,665)</u>
Earnings after income tax						22,711
Equity in earnings (losses) of affiliates	5,382			(26,932)		<u>(21,550)</u>
Earnings before cumulative influence of the change in accounting method						1,161
Cumulative effect as at beginning of year of change in accounting method, net		7,024				<u>7,024</u>
Net earnings						<u>8,185</u>
Identified assets	12,828,818	1,896,261	730,159	94,097	(60,378)	15,488,957
Investment by equity method	48,628			26,870		75,498
General assets						<u>1,250,680</u>
Total consolidated assets						<u>16,815,135</u>
Segment liabilities	1,433,503	520,425	385,098	52,863	(89,533)	2,302,356
General liabilities						<u>7,021,090</u>
Total consolidated liabilities						<u>9,323,446</u>
Capital investments	<u>1,064,167</u>	<u>771,853</u>	<u>105,347</u>	<u>7,290</u>		
Depreciation and amortization	<u>2,293,311</u>	<u>436,060</u>	<u>48,174</u>	<u>3,714</u>		

Notes to the Financial Statements as at December 31, 2000 (cont'd)

For the year ended December 31, 1998

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

Notes to the Financial Statements as at December 31, 2000 (cont'd)

NOTE 29 — TRANSACTIONS WITH INTERESTED AND RELATED PARTIES

- A.** The Company is a government company, which transacts a large volume of business in the regular course of its operations, with government ministries and agencies and government companies. The business transacted is, primarily, the provision of telecommunications services and the execution of development work, as well as the receipt of various types of services. It is not practicable to determine the identity of the interested parties involved in such transactions nor to make a distinction in the recording thereof. The Securities Authority, pursuant to its authority under the Securities Regulations (Preparation of annual financial statements), 5753-1993, (the exemption for the year 2000 is dated February 4, 2001) exempted the Company from detailing its transactions with interested parties, other than extraordinary transactions.
- B.** The Company provides services to the Israeli Defense and Security Forces in accordance with terms decided upon in prior years and which provided, *inter alia*, that the Ministry of Defense will fund the Company's infrastructure investments in consideration of discounts which the Company will grant in respect of current services.

Due to controversies 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 as follows:

- (1) The balance of the accounting between the Company and the Ministry of Defense for the first half of 1996 amounts to approximately NIS 350 million as excess investments by the Ministry of Defense.
- (2) For the purpose of completing the accounting mentioned in (1) above, the Company will grant a discount at the rate of 14% on its total services provided to the Israeli Defense Forces, for a period of ten years commencing on July 1, 1997.
- (3) All prior obligations and controversies between the parties, as they appear in the claims and demands submitted by both parties, are canceled.
- (4) Commencing July 1, 1996, the relationship between the Company and the Ministry of Defense shall be similar to that as between the Company and its other customers. The investments in communications infrastructure shall be made and financed by the Company and the Ministry of Defense will be charged based on the Company's tariffs, subject to that stated in (2) above.

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 53 million.

The Company signed a deed of guarantee in connection with the debts of an affiliate to a bank in the amount of NIS 10 million. The guarantee is valid until December 31, 2010.

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

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

Notes to the Financial Statements as at December 31, 2000 (cont'd)

D. Transactions with investee companies (company)

	For the year ended December 31		
	2000	1999	1998
	NIS thousands	NIS thousands	NIS thousands
Revenues —			
Interconnect and access fees	297,711	419,337	478,567
Services, royalties and commissions	190,732	59,527	42,265
Rent and usage of buildings and equipment ..	9,782	896	20,312
Interest	—	—	970
Management fees	—	—	5,652
Expenses —			
Purchase of services	142,865	672,516	691,112
Interest	—	14,630	—
Total earnings (losses) from fixed asset transactions	(444)	963	2,256
Total transaction turnover	568	1,590	4,776

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		
	2000	1999	1998
	NIS thousands	NIS thousands	NIS thousands
Total cost of compensation of the CEO and the Chairman of the Board	1,172	1,512	1,251
Number of employees	2	3	2
Balance of loans to the CEO and the Chairman of the Board	—	—	8
Compensation of members of the Board of Directors who are not Company employees*	1,382	1,243	1,294
Number of directors receiving compensation ...	17	13	14

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

NOTE 30 — FINANCIAL INSTRUMENTS

A. Financial derivatives

The Group has an excess of liabilities over assets in or linked to foreign currency, in the amount of approximately NIS 2,750,091,000, of which the excess of current liabilities is approximately NIS 231,614,000. The excess of current liabilities is partially covered by forward exchange contracts, as described in Note 21B. The Group has revenues in foreign currency from international communications.

As at December 31, 2000, the excess of CPI-linked monetary liabilities over CPI-linked monetary assets amounted to approximately NIS 2,159,335,000, of which the excess of current liabilities is approximately NIS 211,771,000. As stated in Note 1B, most of the

Notes to the Financial Statements as at December 31, 2000 (cont'd)

Company's tariffs are subject to government regulation and are revised from time to time in accordance with the increase in the CPI, net of an efficiency factor.

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

Regarding the Company's commitments to execute forward exchange contracts, at December 31, 2000 — see Note 21B.

B. Credit risks

Most of the cash and cash equivalents, at December 31, 2000, as well as bank deposits, are deposited in large Israeli banks. The short-term investments represent, primarily, investments in government debentures and bank deposits, while a small part 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 the estimated fair value thereof, as detailed below.

	December 31, 2000	
	Book value	Fair value
	NIS thousands	NIS thousands
Debentures:		
Issued to the public	1,384,278	1,321,329
Issued to others	992,387	744,886
CPI-linked loans	1,168,872	1,128,036

The fair value of the debentures 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, 2000 (cont'd)

NOTE 31 — LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 2000

Consolidated

	In foreign currency or linked thereto NIS thousands	CPI-linked NIS thousands	Unlinked NIS thousands	Total NIS thousands
Assets				
Cash and cash equivalents	721,913	—	810,969	1,532,882
Short-term investments	12,187	89,491	86,691	188,369
Trade receivables	144,142	4,533	1,224,106	1,372,781
Other receivables and debit balances ..	18,629	222,823	28,190	269,642
Long-term deposits and other debit balances	—	9,859	256,161	266,020
	<u>896,871</u>	<u>326,706</u>	<u>2,406,117</u>	<u>3,629,694</u>
Liabilities				
Short-term bank credit	19,006	—	716,136	735,142
Current maturities of long-term liabilities	151,537	450,640	—	602,177
Trade payables	423,116	—	623,770	1,046,886
Other current liabilities	71,598	77,978	773,045	922,621
Long-term loans	1,859,836	927,237	37,711	2,824,784
Other long-term debentures	1,121,869	1,030,206	—	2,152,075
Liabilities for employee severance benefits	—	—	1,596,371	1,596,371
	<u>3,646,962</u>	<u>2,486,061</u>	<u>3,747,033</u>	<u>9,880,056</u>

Company

	In foreign currency or linked thereto NIS thousands	CPI-linked NIS thousands	Unlinked NIS thousands	Total NIS thousands
Assets				
Cash and cash equivalents	719,355	—	802,487	1,521,842
Short-term investments	10,692	87,336	70,348	168,376
Trade receivables	1,773	—	726,577	728,350
Other receivables and debit balances ..	18,629	186,782	13,450	218,861
Long-term bank deposits and debit balances	—	—	220,536	220,536
	<u>750,449</u>	<u>274,118</u>	<u>1,833,398</u>	<u>2,857,965</u>
Liabilities				
Current maturities of long-term liabilities	151,537	390,548	—	542,085
Trade payables	15,804	—	450,092	465,896
Other current liabilities	71,598	77,978	603,833	753,409
Long-term loans	1,859,836	544,892	—	2,404,728
Other long-term debentures	1,121,869	1,030,206	—	2,152,075
Liabilities for employee severance benefits	—	—	1,592,098	1,592,098
	<u>3,220,644</u>	<u>2,043,624</u>	<u>2,646,023</u>	<u>7,910,291</u>

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

Notes to the Financial Statements as at December 31, 2000 (cont'd)

NOTE 31 — Linkage terms of monetary balances as at December 31, 1999

Consolidated

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

Company

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

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

Notes to the Financial Statements as at December 31, 2000 (cont'd)

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

A. Balance sheets

	December 31, 2000	December 31, 1999
	NIS thousands	NIS thousands
Assets		
Current assets	2,804,982	2,177,728
Materials and spare parts	184,983	228,557
Long-term deposits and debit balances	244,027	257,492
Investment in investee companies	1,143,339	1,278,945
Fixed assets	7,097,316	7,579,662
Other assets	864,730	401,369
	<u>12,339,377</u>	<u>11,923,753</u>
Liabilities		
Current	2,132,623	3,681,818
Long-term	5,893,028	4,299,349
	<u>8,025,651</u>	<u>7,981,167</u>
Convertible debentures	68,092	233,699
Shareholders' equity	4,245,634	3,708,887
	<u>12,339,377</u>	<u>11,923,753</u>

B. Statements of operations

	For the year ended December 31		
	2000	1999	1998
	NIS thousands	NIS thousands	NIS thousands
Revenues from telecommunication services	6,237,202	7,369,982	7,276,454*
Costs and expenses			
Operating and general expenses	2,531,190	3,883,844	3,731,935*
Depreciation	1,482,947	1,422,078	1,255,005
Royalties to the Government of Israel	204,058	205,769	236,244
	<u>4,218,195</u>	<u>5,511,691</u>	<u>5,223,184</u>
Operating income	2,019,007	1,858,291	2,053,270
Financing expenses, net	289,522	416,655	1,019,630
Earnings after financing expenses	1,729,485	1,441,636	1,033,640
Other expenses, net	1,227,500	464,378	25,036*
Earnings before taxes on income	501,985	977,258	1,008,604
Tax benefit (income tax)	213,762	44,455	(262,346)
Earnings after income tax	715,747	1,021,713	746,258
Company's equity in earnings (losses) of investee companies	<u>(364,188)</u>	<u>(48,562)</u>	<u>252,054</u>
Net earnings	<u>351,559</u>	<u>973,151</u>	<u>998,312</u>

* Reclassified

Notes to the Financial Statements as at December 31, 2000 (cont'd)

C. Statement of changes in shareholders' equity

	Share capital	Receipts from the issue of option warrants	Capital reserves(*)	Accumulated deficit	Total
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Balance as at January 1, 1998	732,087	—	2,746,260	(1,944,920)	1,533,427
Net earnings	—	—	—	998,312	998,312
Issue to the public	—	73,257	—	—	73,257
Issue to employees	4,216	—	32,549	—	36,765
Offer to employees	—	—	3,166	—	3,166
Compensation to Company employees from the Government	—	—	24,710	—	24,710
Exercise of warrants	29,250	(73,257)	221,785	—	177,778
Conversion of convertible debentures	231	—	2,228	—	2,459
Balance as at December 31, 1998 ...	765,784	—	3,030,698	(946,608)	2,849,874
Net earnings	—	—	—	973,151	973,151
Dividend for 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	(275,022)	3,708,887
Net earnings	—	—	—	351,559	351,559
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	(1,523,463)	4,245,634

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

Notes to the Financial Statements as at December 31, 2000 (cont'd)

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

1. *Bezeq International Ltd.*

A. Balance sheets

	December 31, 2000	December 31, 1999
	NIS thousands	NIS thousands
Current assets	266,781	413,169
Investments	38,167	—
Fixed assets	359,684	314,224
Other assets	18,200	12,258
	<u>682,832</u>	<u>739,651</u>
Current liabilities	499,398	385,098
Long-term liabilities	32,740	—
Quasi-capital receipt	158,474	158,474
Shareholders' equity (deficit)	(7,780)	196,079
	<u>682,832</u>	<u>739,651</u>

B. Statements of operations

	For the year ended December 31		
	2000	1999	1998
	NIS thousands	NIS thousands	NIS thousands
Revenues from international telecommunications services	671,688	719,423*	982,491*
Operating expenses	559,901	594,726	795,289
Gross profit	111,787	124,697	187,202
Marketing expenses	165,388	111,422	61,506
General and administration expenses	95,285	73,048*	94,649*
	<u>260,673</u>	<u>184,470</u>	<u>156,155</u>
Operating income (loss)	(148,886)	(59,773)	31,047
Financing income (expenses), net	(3,179)	36,075	37,072
Earnings (loss) after financing	(152,065)	(23,698)	68,119
Other expenses, net	(39,716)	(77,538)	(7,534)
Earnings (loss) before income tax	(191,781)	(101,236)	60,585
Tax benefit (income tax)	(1,620)	9,003	(26,660)
Earnings (loss) after income tax	(193,401)	(92,233)	33,925
Company's equity in losses of investee company	(10,458)	—	—
Net earnings (loss)	<u>(203,859)</u>	<u>(92,233)</u>	<u>33,925</u>

* Reclassified

Notes to the Financial Statements as at December 31, 2000 (cont'd)

2. Pelephone Communications Ltd. (Consolidated)

A. Balance sheets

	<u>December 31,</u> <u>2000</u>	<u>December 31,</u> <u>1999</u>
	NIS thousands	NIS thousands
Current assets	1,129,961	930,749
Long-term receivables	71,255	11,352
Investment in an investee company	1,440	—
Reserve for compensation fund, net	—	3,482
Fixed assets	2,862,967	2,575,434
Other assets, net	<u>679,422</u>	<u>464,048</u>
	<u>4,745,045</u>	<u>3,985,065</u>
Current liabilities	2,083,658	1,186,213
Provision for losses of investee company	—	3,978
Long-term liabilities	793,541	798,345
Shareholders' equity	<u>1,867,846</u>	<u>1,996,529</u>
	<u>4,745,045</u>	<u>3,985,065</u>

B. Statements of operations

	<u>For the year ended December 31</u>		
	<u>Consolidated</u>	<u>Company</u>	
	<u>2000</u>	<u>1999</u>	<u>1998</u>
	NIS thousands	NIS thousands	NIS thousands
Revenues from cellular services, sales and services	3,442,135	2,975,126	3,011,278
Cost of cellular services, sales and services	<u>2,876,330</u>	<u>2,390,434</u>	<u>2,173,625</u>
Gross profit	565,805	584,692	837,653
Sales and marketing expenses	448,385	285,229	229,918
General and administration expenses	200,125	183,677	160,951
	<u>648,510</u>	<u>468,906</u>	<u>390,869</u>
Operating Income (loss)	(82,705)	115,786	446,784
Financing expenses, net	(98,001)	(65,745)	(29,586)
Other income (expenses), net	1,715	521	(5,156)
Earnings (loss) before income tax	(178,991)	50,562	412,042
Tax benefit (income tax)	51,441	(25,171)	(158,973)
Earnings (loss) after income tax	(127,550)	25,391	253,069
Minority interest in losses of a subsidiary	9,790	—	—
Company's equity in losses of investee companies	<u>(10,923)</u>	<u>(3,978)</u>	<u>(1,128)</u>
Earnings (loss) before cumulative effect of change in accounting method	(128,683)	21,413	251,941
Cumulative effect as at beginning of year of change in accounting method	—	14,047	—
Net earnings (loss)	<u>(128,683)</u>	<u>35,460</u>	<u>251,941</u>

	Per cent of control and ownership as at	
	December 31, 2000 %	December 31, 1999 %
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	—
Proportionally Consolidated Company		
Telephone Communications Ltd.	50	50
GoNext Ltd. ⁽⁴⁾	25.5	—
Affiliated Companies		
The International Company for Underwater Cables Ltd. ⁽⁵⁾	50	50
Goldnet Communications Services — registered partnership ⁽⁶⁾	49	38
Emitel Telecommunication Corp. Ltd. (Hungary) ⁽⁷⁾	33	33
Fascel Ltd. (India) ⁽⁸⁾	—	16
D.B.S. Satellite Services (1998) Ltd. ⁽⁹⁾	30	33
Infogate Online Ltd. ⁽¹⁰⁾	29	29
Safe Com-Car Communication (hereinafter — Safe-Car) ⁽¹¹⁾	—	25.5
Walla! Communications Ltd. ⁽¹²⁾	38.5	26
Eden Telecom Ltd. ⁽¹¹⁾	23	—

(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 is subject to approval of the Ministerial Committee for Privatization.

(3) The company was founded in December 2000 and began operations in 2001.

(4) See Note 8I.

(5) 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.

(6) Under the agreement between the partners, the Company increased its investment in the partnership to 49% during the year. 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 shares 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.

(7) Indirect holding.

(8) See Note 8E.

(9) See Note 8H

(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 Telephone Communications 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, Telephone 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, Telephone held 51% of Safe-Car. The financial statements of Safe-Car were not consolidated since Telephone was not the controlling interest or joint controlling interest, pursuant to the establishment agreement of the company, which stipulates that material resolutions require a 75% majority.

(12) On December 26, 1999 Bezeq International Ltd. gave notice of its wish to exercise the option to purchase 26% of the issued share capital of Walla! Communications Ltd. ("Walla"). On January 3, 2000 the shares were transferred to the company in consideration of NIS 24.6 million. During 2000, Bezeq International increased its holding in Walla! So that at the balance sheet date, it holds 38.5% of the issued and paid up capital of Walla.

On December 31, 2000, Walla entered into an agreement with I.O.L. On line (2000) Ltd. ("IOL"), which stipulates that the shareholders of IOL will transfer all their shares to Walla in consideration of shares which will be allotted to them in Walla. After the said exchange of shares, Walla will transfer all its assets and liabilities to a company in its ownership and control ("the Merged Company") and will be wound up without liquidation. The agreement is subject to certain approvals.

On December 31, 2000, Bezeq International and Ha'aretz Newspaper Publishers Ltd. (which is the controlling interest in IOL) entered into an agreement which regulates the relations between them as shareholders in the Merged Company.

Furthermore, the agreement stipulates that the parties will act for the raising of ten million dollars in capital by the Merged Company by way of an issue of rights ("the Issue"). Each of the parties undertook to exercise all the rights offered to it in the Issue, if it is indeed made. In addition, it was agreed that if in the Issue, the Merged Company raises less than ten million dollars, Bezeq International undertakes to act for another issue of rights, on similar terms, and to exercise in the additional issue all of the rights offered to it up to an investment ceiling of 6 million dollars. The shareholders agreement will take effect on the date on which the merger transaction is closed.

APPENDIX A

DBS SATELLITE SERVICES (1998) LTD.

2000 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, 2000 and 1999 and the related statements of operations, changes in capital deficiency and cash flows for the year ended December 31, 2000 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 of 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, 2000 and 1999 and the results of its operations, the changes in its capital deficiency and its cash flows for the period from the date of incorporation (December 2, 1998) to December 31, 1999 and for the year ended December 31, 2000, 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 memorandum of terms signed by the Company and banks, the financing agreement between the Company and banks that has yet to be signed and the Company's preparations with regard to the process leading to the signing of this agreement.

Tel Aviv
March 12, 2001

DBS SATELLITE SERVICES (1998) LTD.

**BALANCE SHEETS
IN ADJUSTED NIS**

	Note	December 31	
		2000	1999
In thousands			
Assets	10		
CURRENT ASSETS:	9		
Cash and cash equivalents		422	44,855
Accounts receivable:			
Trade	11a	3,960	
Other	11b	42,851	7,937
Total current assets		47,233	52,792
BROADCASTING RIGHTS:			
Cost		215,739	61,085
Less — utilized rights		32,412	
		183,327	61,085
FIXED ASSETS:	2		
Cost		939,365	146,803
Less — accumulated depreciation		55,723	2,020
		883,642	144,783
ADVANCE ON ACCOUNT OF LICENSE FEES	3	29,772	30,102
		1,143,974	288,762
Liabilities, net of capital deficiency	9,10		
CURRENT LIABILITIES:			
Bank credit	11c	492,562	110,677
Accounts payable and accruals:			
Trade		478,389	115,482
Other	11d ⁽¹⁾	36,289	11,503
Total current liabilities	11d ⁽²⁾	1,007,240	237,662
LONG-TERM LIABILITIES —			
shareholders' loans	5	763,672	134,246
COMMITMENTS	6		
Total liabilities		1,770,912	371,908
CAPITAL DEFICIENCY	7	(626,938)	(83,146)
		1,143,974	288,762

Date of approval of the financial statements: March 12, 2001

Anat Leon-Weiner
Deputy VP — Finance

David Brodet
Chairman of the Board

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

DBS SATELLITE SERVICES (1998) LTD.

**STATEMENTS OF OPERATIONS
IN ADJUSTED NIS**

	<u>Note</u>	<u>2000</u>	<u>Period from December 2, 1998, to December 31, 1999 (see note 1a(1))</u>
			In thousands
REVENUES		26,281	
OPERATING EXPENSES	11e	<u>254,423</u>	
GROSS LOSS		228,142	
SELLING, MARKETING, GENERAL AND ADMINISTRATIVE EXPENSES:	11f		
Selling and marketing		185,700	18,878
General and administrative		<u>107,005</u>	<u>60,443</u>
LOSS FROM ORDINARY OPERATIONS		520,847	79,321
FINANCIAL EXPENSES, net	11g	<u>22,954</u>	<u>3,826</u>
LOSS FOR THE PERIOD		<u>543,801</u>	<u>83,147</u>
			Adjusted NIS
LOSS PER NIS 1 OF PAR VALUE OF SHARES	1g	<u>54,380</u>	<u>20,787</u>

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

DBS SATELLITE SERVICES (1998) LTD.

**STATEMENTS OF CHANGES IN CAPITAL DEFICIENCY
IN ADJUSTED NIS**

	<u>Share capital and premium</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 TO DECEMBER 31, 1999				
(see note 1a(1)):				
Issue of share capital	*			*
Receipts on account of shares to be allotted ...		1		1
Loss			<u>(83,147)</u>	<u>(83,147)</u>
BALANCE AT DECEMBER 31, 1999	*	1	<u>(83,147)</u>	<u>(83,146)</u>
CHANGES DURING 2000:				
Issue of share capital	10	(1)		9
Loss			<u>(543,801)</u>	<u>(543,801)</u>
BALANCE AT DECEMBER 31, 2000	<u>10</u>	<u>—</u>	<u>(626,948)</u>	<u>(626,938)</u>

* Four ordinary shares of NIS 1 par value each.

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

DBS SATELLITE SERVICES (1998) LTD.

**STATEMENTS OF CASH FLOWS
IN ADJUSTED NIS**

	<u>2000</u>	<u>Period from December 2, 1998, to December 31, 1999 (see note 1a(1))</u>
	In thousands	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Loss for the period	(543,801)	(83,147)
Adjustments required to reflect the cash flows from operating Activities (a)	<u>384,667</u>	<u>56,014</u>
Net cash used in operating activities	<u>(159,134)</u>	<u>(27,133)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of fixed assets	(783,923)	(97,828)
Purchase of broadcasting rights	(112,687)	(44,866)
Advance on account of license fees	<u> </u>	<u>(30,242)</u>
Net cash used in investing activities	<u>(896,610)</u>	<u>(172,936)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Receipt of long-term loans from shareholders	629,426	134,246
Receipts on account of shares to be allotted	—	1
Short-term credit from banks — net	<u>381,885</u>	<u>110,677</u>
Net cash provided by financing activities	<u>1,011,311</u>	<u>244,924</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	<u>(44,433)</u>	<u>44,855</u>
BALANCE OF CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	<u>44,855</u>	<u> </u>
BALANCE OF CASH AND CASH EQUIVALENTS AT END OF PERIOD	<u><u>422</u></u>	<u><u>44,855</u></u>

DBS SATELLITE SERVICES (1998) LTD.

**STATEMENTS OF CASH FLOWS
IN ADJUSTED NIS**

	2000	Period from December 2, 1998, to December 31, 1999 (see note 1a(1))
	In thousands	
(a) Adjustments required to reflect the cash flows from operating activities:		
Expenses not involving cash flows:		
Depreciation and amortization	86,445	2,020
Erosion of advances on account of license fees		140
	<u>86,445</u>	<u>2,160</u>
Changes in operating asset and liability items:		
Increase in receivables and other debit balances	(38,865)	(7,937)
Increase in payables and credit balances:		
Suppliers and service providers	312,301	50,288
Other	<u>24,786</u>	<u>11,503</u>
	<u>298,222</u>	<u>53,854</u>
	<u>384,667</u>	<u>56,014</u>
(b) Supplementary information on investing activities not involving cash flows:		
Purchase of fixed assets with suppliers' credit	<u>57,612</u>	<u>48,973</u>
Purchase of broadcasting rights with suppliers' credit	<u>58,186</u>	<u>16,219</u>

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

DBS SATELLITE SERVICES (1998) LTD.

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

The Company expects significant losses and a negative cash flow from current operations during the first years of its activities. The loss for 2000 amounts to approximately adjusted NIS 544 million (the loss during the period from December 2, 1998 until December 31, 1999 was approximately adjusted NIS 83 million). As a result of these losses, the operating capital deficiency increased to a total of adjusted NIS 960 million (including approximately adjusted NIS 493 million in short-term credit from banks; see below).

The Company's activities are financed by shareholders' loans and bank credit.

On August 1, 2000, DBS signed a memorandum of terms with banks, which indicates the terms and stipulations likely to be included in a financing agreement between them and under which the banks would be willing to consider consenting in principle to participate in the financing of DBS's operations. The memorandum prescribes, inter alia, preconditions for drawing funds from the credit line, including an undertaking by DBS to comply with cumulative milestones.

Furthermore, it was determined in the memorandum that "if the financing agreement is not signed by September 30, 2000, this memorandum will not be valid." In the period from October 1, 2000 to the date of signing the financial statements, the signatory banks to the above memorandum made another adjusted NIS 156 million of credit available to DBS. DBS considers that the delay in signing the financing agreement is technical, and does not harm its continued engagement with the banks in the manner defined in the memorandum.

3) Interested Party — 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 revenues and expenses during the reporting periods. Actual results could differ from those estimates.

DBS SATELLITE SERVICES (1998) LTD.

NOTES TO FINANCIAL STATEMENTS — (continued)

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 2000 adjusted NIS) — based upon the changes in the consumer price index; hereafter — the CPI.

The adjustment of the financial statements is based on the accounts of the company and its subsidiaries, maintained in nominal NIS.

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) Condensed nominal Israeli currency data of the company, on the basis of which its adjusted financial statements were prepared, are presented in note 14.

c. 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:

	%
Broadcasting and receiving equipment.....	10-15
Digital satellite decoders	25
Office furniture and equipment	7-15
Computers	33

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

d. Broadcasting rights

The cost 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. Advance on account of license fees

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.

DBS SATELLITE SERVICES (1998) LTD.

NOTES TO FINANCIAL STATEMENTS — (continued)

f. 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.

g. Loss per NIS 1 of par value of shares

The loss per NIS 1 of par value of shares — calculated in accordance with Opinion 55 of the Israeli Institute has been determined on the basis of the weighted average par value of the issued and paid in share capital outstanding during the period.

The par value of the shares used for calculation of the net loss per NIS 1 of par value of shares is:

	<u>Adjusted NIS in thousands</u>
Year ended December 31:	
2000	10
1999	<u>*</u>
	<u>10</u>

* Four ordinary shares of NIS 1 par value each.

h. Recognition of income:

- 1) Revenues from subscribers are allocated monthly to the statement of operations, upon the provision of the service to the subscribers.
- 2) The Company leases digital satellite decoders to its customers, on an operational lease basis. The income from the lease fees is allocated monthly to the statement of operations, over the lease agreement period.

i. Advertising expenses

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

j. Concentration of credit risks — allowance for doubtful accounts

The allowance is determined for specific debts doubtful of collection.

DBS SATELLITE SERVICES (1998) LTD.

NOTES TO FINANCIAL STATEMENTS — (continued)

NOTE 2 — FIXED ASSETS:

- a. Composition of fixed assets and accumulated depreciation, grouped by major classifications and changes therein in 2000 are as follows:**

	Cost			Accumulated depreciation			Depreciated balance		
	Balance at beginning of year**	Additions during the year	Retirements during the year	Balance at end of year	Balance at beginning of year**	Additions during the year	Balance at end of year	December 31,	
								2000	1999
	Adjusted NIS in thousands								
Broadcasting and receiving equipment*	100,111	403,459		503,570	56	28,647	28,703	474,867	100,055
Digital satellite decoders	5,289	285,955		291,244		7,279	7,279	283,965	5,289
Office furniture and equipment (including computers)	20,906	103,124		124,030	592	17,572	18,164	105,866	20,314
Leasehold improvements	12,613	7,908		20,521	1,372	205	1,577	18,944	11,241
Advances on account of fixed assets	7,884		(7,884)						7,884
	<u>146,803</u>	<u>800,446</u>	<u>(7,844)</u>	<u>939,365</u>	<u>2,020</u>	<u>53,703</u>	<u>55,723</u>	<u>883,642</u>	<u>144,783</u>
* Including capitalized installation costs	<u>27,294</u>	<u>317,772</u>		<u>345,066</u>	<u>50</u>	<u>15,930</u>	<u>15,980</u>	<u>329,086</u>	<u>27,244</u>

** Reclassified

- b. For 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 known index (see note 1a(1)). The accumulated amortization as at December 31, 2000 — NIS 330,000.

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. In the subsequent period, royalties will be 5% per year of the Company's revenues. The license fees in the amount of approximately NIS 30 million will be considered a non-refundable advance on account of these royalties.

NOTE 4 — EMPLOYEE RIGHTS UPON RETIREMENT

In accordance with labor laws in effect, the Company is liable for severance pay to employees who are dismissed or who retire in certain other circumstances. The Company's liability for the payment of severance pay to employees (which is based on the number of years worked and the last monthly salary) is covered by the 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.

NOTE 5 — SHAREHOLDERS' LOANS:

- a.** The loans from shareholders are linked to the CPI.
- b.** 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 bear linkage differentials and interest at an annual rate of 7%, from the date they were made until the date of their repayment, or the repayment of any part thereof, as the case may be, or other interest and linkage differentials if so decided by a meeting of the shareholders of the Company. These terms will apply also to loans which will be extended

DBS SATELLITE SERVICES (1998) LTD.

NOTES TO FINANCIAL STATEMENTS — (continued)

to the Company by the shareholders in the future, as long as no decision to the contrary is made by the shareholders' meeting.

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)).

The same decision also resolved that the 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 total amount of interest accrued until December 31, 2000 in accordance with the decision, amounts to approximately NIS 32.8 million.

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

NOTE 6 — COMMITMENTS:

- a. The Company has entered into agreements for the purchase of fixed assets, digital satellite decoders and broadcasting rights, as follows:

	<u>December 31, 2000</u>
	<u>Adjusted NIS</u> <u>in thousands</u>
Fixed assets	<u>4,000</u>
Digital satellite decoders*	<u>92,000</u>
Broadcasting rights	<u>75,700</u>

* See note 13c.

- b. To secure its liabilities, the Company has provided documentary credits and guarantees in the amount of approximately NIS 45,836,000.
- c. The Company has signed two operational lease agreements for buildings it uses. One agreement ends in 2003 with an option for an extension of three additional years, and the second agreement ends in 2009 with an option to extend for an additional 10 years. The rent is linked to the U.S. dollar (hereafter — the dollar).

The anticipated rent for the next five years, calculated according to the rent in effect on December 31, 2000, is approximately adjusted NIS 6 million per year.

- d. For the undertaking to pay royalties to the Government of Israel, see note 3.
- e. 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 from April 10, 1999, with an option for extensions of six months at a time. The lease is linked to the Dollar.

The estimated fixed lease fees for the next five years, calculated according to the lease fees in effect on December 31, 2000, are approximately adjusted NIS 35 million per year.

In addition, the Company must pay variable lease fees which are fixed according to increments in the number of subscribers.

DBS SATELLITE SERVICES (1998) LTD.

NOTES TO FINANCIAL STATEMENTS — (continued)

- f. The Company has entered into an agreement for 10 years, for the management and current maintenance of the user equipment installation array. In consideration for management and maintenance services, the Company will pay fixed amounts per installation plus amounts calculated at a fixed percentage of the cost of the equipment and labor, that rate being determined according to the number of subscribers.

Commitment costs in 2000 amounted to approximately adjusted NIS 318 million.

NOTE 7 — SHARE CAPITAL:

a. Composition:

	Number of shares and amount in NIS	
	Registered	Issued and paid
	December 31, 2000 and 1999	December 31, 2000
Ordinary shares of NIS 1 par value	<u>36,000</u>	<u>10,000</u>

- b. The ordinary shares vest in their owners the right to vote and participate in meetings of shareholders, the right to receive profits and the right to part of the surplus assets upon liquidation of the Company.

c. Employees' options

The employment agreements with a number of senior employees include an undertaking to allot options for the Company's shares should the Company introduce a stock options plan for employees of that rank. Until the signing of the financial statements, the Company had not adopted a stock options plan for employees.

The Company undertook towards one employee to allot up to 0.375% of the Company's shares at a price equivalent to their par value, according to their number on the date of signing the agreement with him and subject to the terms stipulated in his employment agreement.

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 at December 31, 2000, amount to adjusted NIS 622 million. Due to the uncertainty of their realization in the future, the Company has not allocated deferred taxes for these losses in its accounts. As at December 31, 2000, the amount of timing differences for which no tax asset was created is mainly in respect of carryforward losses. In accordance with the inflationary adjustments law, the balance of losses for tax purposes which is carried forward to subsequent years is linked to the CPI and can be utilized with no time limit.

DBS SATELLITE SERVICES (1998) LTD.

NOTES TO FINANCIAL STATEMENTS — (continued)

d. Tax assessments

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

NOTE 9 — LINKAGE OF MONETARY BALANCES:

a. As follows:

	December 31, 2000		
	Dollar or Dollar-linked	CPI-linked	Unlinked
	Adjusted NIS in thousands		
Assets:			
Current assets:			
Cash and cash equivalents			422
Receivables and other debit balances			46,811
			47,233
Liabilities:			
Current liabilities:			
Bank credit	134,428		358,134
Suppliers and service providers	24,134		454,255
Others			36,289
Long-term liabilities — shareholders' loans.....		763,672	
	158,562	763,672	848,678

b. Data regarding the exchange rate and the CPI:

	Exchange rate of one dollar	CPI*
At December 31:		
2000	NIS 4.041	168.53 points
1999	NIS 4.153	168.53 points
Changes in:		
2000	(2.7%)	0%
1999	(0.17%)	1.34%

* 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. Balance of secured liabilities and guarantees of the Company

	December 31	
	2000	1999
	Adjusted NIS in thousands	
Liabilities —		
Short-term credit from banks	492,562	110,677
Guarantees	45,836	37,524

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

DBS SATELLITE SERVICES (1998) LTD.

NOTES TO FINANCIAL STATEMENTS — (continued)

NOTE 11 — SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION:

Balance sheets:

a. Trade receivables

This item net of allowance for doubtful accounts of adjusted NIS 230,000.

b. Accounts receivable — other

	<u>December 31</u>	
	<u>2000</u>	<u>1999</u>
	Adjusted NIS in thousands	
Institutions (mostly VAT)	28,209	5,568
Advances to suppliers of purchased channels	14,601	2,228
Other	<u>41</u>	<u>141</u>
	<u>42,851</u>	<u>7,937</u>

c. Bank credit:

1) Classified by currency, linkage basis and interest rates, the short-term credit (not including current maturities of long-term loans) is as follows:

		<u>December 31</u>	
	<u>2000</u>	<u>2000</u>	<u>1999</u>
	Weighted interest rates	Amount	
	%	Adjusted NIS in thousands	
Bank credit:			
In dollar or linked to it	8.9%	134,428	41,560
Unlinked	10%	<u>358,134</u>	<u>69,117</u>
		<u>492,562</u>	<u>110,677</u>

2) Securities — see note 10.

d. Accounts payable and accruals:

		<u>December 31</u>	
		<u>2000</u>	<u>1999</u>
		Adjusted NIS in thousands	
1) Trade:			
Outstanding debts		342,723*	114,828
Notes and checks payable		<u>135,666</u>	<u>654</u>
		<u>478,389</u>	<u>115,482</u>
2) Other:			
Employees and employee institutions		8,978	3,809
Provision for vacation pay		2,983	1,195
Sundry		<u>24,328</u>	<u>6,499</u>
		<u>36,289</u>	<u>11,503</u>

* Including content suppliers, adjusted NIS 58,186,000.

DBS SATELLITE SERVICES (1998) LTD.

NOTES TO FINANCIAL STATEMENTS — (continued)

Statements of operations:

	<u>2000</u>	<u>Period from December 2, 1998, to December 31, 1999 (see note 1a(1))</u>
	<u>Adjusted NIS in thousands</u>	
e. Operating expenses:		
Salaries and expenses connected with employees.....	13,805	
Depreciation and amortization	51,703	
Amortization of broadcasting rights utilized	32,412	
Content costs	104,916	
Consumption of space segments	34,008	
Rent	3,263	
Other	14,316	
	<u>254,423</u>	
f. Selling, marketing, general and administrative expenses:		
Sales and marketing:		
Salaries and expenses connected with employees.....	43,048	2,900
Advertising	75,626	3,498
Marketing consultation	15,092	11,247
Commissions	14,739	
Rent and maintenance	6,606	
Depreciation	2,014	
Other	28,575	1,233
	<u>185,700</u>	<u>18,878</u>
General and administrative:		
Salaries and expenses connected with employees.....	31,585	14,152
Consultation and professional fees	40,125	27,852
Office supplies and printing	6,449	
Rent and maintenance	7,271	
Depreciation	316	
Other	21,259	18,439
	<u>107,005</u>	<u>60,443</u>
g. Financial expenses, net:		
Short-term credit	23,645	2,388
Other — net	(691)	1,438
	<u>22,954</u>	<u>3,826</u>

NOTE 12 — FINANCIAL INSTRUMENTS AND RISK MANAGEMENT:

a. Concentration of credit risks

The cash and cash equivalents as at December 31, 2000 and 1999 are deposited in Israeli banks. According to the Company's assessment, the credit risk inherent in these balances is remote.

The Company's sales are made in Israel to a large number of customers. Consequently, the balances of the Company's customers do not represent a significant concentration of credit risk as at December 31, 2000.

DBS SATELLITE SERVICES (1998) LTD.

NOTES TO FINANCIAL STATEMENTS — (continued)

b. Fair value of financial instruments

The Company's financial instruments as at December 31, 2000 and 1999 are composed mainly of non-derivative assets and liabilities (which include working capital and the current portion of long-term liabilities). Due to their character, the fair value of the financial instruments included in working capital is usually the same as or close to the value at which they are stated in the accounts. For shareholders' loans, see note 5.

NOTE 13 — TRANSACTIONS AND BALANCES WITH INTERESTED PARTIES:

a. Transactions with interested parties:

	2000	Period from December 2, 1998, to December 31, 1999 (see note 1a(1))
	Adjusted NIS in thousands	
1) Operating expenses	<u>46,971</u>	
Selling, marketing, general and administrative and expenses	<u>11,533</u>	
2) Benefits to interested parties — salary to an interested party employed by the Company and director's fee	<u>2,743</u>	<u>750</u>
Consultancy	<u>570</u>	<u>752</u>

3) 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.

At the date of the preparation of these financial statements, no notice had been received from the former CEO regarding his wish to require the Company to purchase the shares from him.

b. Balances with interested parties:

	2000	December 31 1999
	Adjusted NIS in thousands	
1) Current debts — stated in the balance sheets under the item "accounts receivable — other" as part of the current assets — balance as at the balance sheet date		<u>7</u>
2) Long-term liabilities — shareholders' loans (see note 5)	<u>(763,672)</u>	<u>(134,246)</u>
3) Current liabilities	<u>(78,725)</u>	<u>(7,130)</u>

c. The Company 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, 2000, the Company purchased decoders in a total amount of adjusted NIS 285 million.

d. The Company entered into an agreement with a third party and an interested party for the lease of space segments on the Amos 1 satellite. See note 6.

DBS SATELLITE SERVICES (1998) LTD.

NOTES TO FINANCIAL STATEMENTS — (continued)

NOTE 14 — NOMINAL DATA OF THE COMPANY:

a. Balance sheet data

	<u>December 31</u>	
	<u>2000</u>	<u>1999</u>
	<u>Nominal NIS in thousands</u>	
Assets		
Current assets:		
Cash and cash equivalents	422	44,855
Accounts receivable:		
Trade	3,960	
Other	<u>42,851</u>	<u>7,937</u>
	<u>47,233</u>	<u>52,792</u>
Broadcasting rights, net of rights utilized	<u>183,327</u>	<u>61,004</u>
Fixed assets:		
Cost	938,678	146,413
Less — accumulated depreciation	<u>55,631</u>	<u>2,007</u>
	<u>883,047</u>	<u>144,406</u>
Advance on account of license fees	<u>29,772</u>	<u>30,102</u>
	<u>1,143,379</u>	<u>288,304</u>
Liabilities, net of capital deficiency		
Current liabilities:		
Bank credit	492,562	110,677
Accounts payable and accruals:		
Trade	478,389	115,482
Other	<u>36,289</u>	<u>11,503</u>
	<u>1,007,240</u>	<u>237,662</u>
Long-term liabilities — shareholders' loans	<u>763,672</u>	<u>134,246</u>
	<u>1,770,912</u>	<u>371,908</u>
Capital deficiency	<u>(627,533)</u>	<u>(83,604)</u>
	<u>1,143,379</u>	<u>288,304</u>

b. Operating results data

	<u>2000</u>	<u>Period from December 2, 1998, to December 31, 1999 (see note 1a(1))</u>
	<u>Nominal NIS in thousands</u>	
Revenues	26,281	
Operating expenses	<u>254,369</u>	
Gross loss	228,088	
Selling, marketing, general and administrative expenses:		
Selling and marketing	185,694	18,788
General and administrative	<u>107,005</u>	<u>60,030</u>
Loss from ordinary operations	<u>520,787</u>	<u>78,818</u>
Financial expenses, net	<u>23,151</u>	<u>4,787</u>
Loss for the period — nominal	<u>543,938</u>	<u>83,605</u>

DBS SATELLITE SERVICES (1998) LTD.

NOTES TO FINANCIAL STATEMENTS — (continued)

c. Changes in capital deficiency

	<u>Share capital and premium</u>	<u>Receipts on account of shares</u>	<u>Accumulated deficit</u>	<u>Total</u>
	Nominal NIS in thousands			
Changes during the period from December 2, 1998 to December 31, 1999:				
Issue of share capital	*			*
Receipts on account of shares to be allotted		1		1
Loss			(83,605)	(83,605)
Balance at December 31, 1999	*	1	(83,605)	(83,604)
Changes during 2000:				
Issue of share capital	10	(1)		9
Loss			(543,938)	(543,938)
Balance at December 31, 2000	<u>10</u>	<u>—</u>	<u>(627,543)</u>	<u>(627,533)</u>

* Four ordinary shares of NIS 1 par value each.

“BEZEQ” THE ISRAEL TELECOMMUNICATION CORP. LIMITED

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2001

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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 Three Month and Six Month Periods Ended June 30, 2001**

At your request we have reviewed the interim balance sheet of "Bezeq" — The Israel Telecommunication Corp. Limited (the Company) and its consolidated companies as at June 30, 2001, as well as the consolidated statement of operations, the statement of changes in shareholders' equity and of the interim consolidated statement of cash flows for the six month and 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 constitute approximately 17.53% of the total consolidated assets on the interim consolidated balance sheet as at June 30, 2001 and whose revenues constitute approximately 27% of the total revenues included in the interim consolidated statement of operation for the six months and three months then ended. Furthermore, the data contained in the financial statements which relate to the equity of the investments and the Company's share of the results of affiliated companies, are based on financial statements which were reviewed by other auditors.

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

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

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

1. The anticipated opening of the communications sector to competition, changes in tariffs and their effect on the Company's financial position and operating results as described in Note 1.
2. A plan for further organizational change, as described in Note 5.
3. Claims made against the Company and against investee companies, as described in Note 6A.
4. The financial situation of an affiliated company, the signing of a financing agreement between the affiliated company and banking corporations, the non-fulfillment of suspending conditions prescribed in the agreement, and the assessment of the management of the affiliated company which relates to fulfillment of those suspending conditions, as explained in Note 4C.

Somekh Chaikin
Certified Public Accountants (Isr.)

August 28, 2001

Interim Consolidated Balance Sheet
In terms of shekels of June 2001

	June 30, 2001 (Unaudited)	June 30, 2000 (Unaudited)	December 31, 2000 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets			
Cash and cash equivalents	1,236,654	541,410	1,549,896
Short-term investments	266,607	153,329	190,460
Trade receivables	1,344,733	1,318,570	1,388,018
Other receivables and debit balances	435,254	513,861*	481,251
Inventory	158,894	119,106	135,917
	<u>3,442,142</u>	<u>2,646,276</u>	<u>3,745,542</u>
Materials and spare parts	<u>202,617</u>	<u>208,058</u>	<u>187,239</u>
Investments and long-term receivables			
Investments, deposits and debit balances	1,542,166	268,178	292,708
Investments in investee companies	373,948	252,625	174,593
	<u>1,916,114</u>	<u>520,803</u>	<u>467,301</u>
Fixed assets			
Cost	29,873,998	29,785,301	29,364,292
Less — accumulated depreciation	18,873,335	17,579,996	17,628,253
	<u>11,000,663</u>	<u>12,205,305</u>	<u>11,736,039</u>
Other assets			
Deferred charges and other assets	386,429	321,723*	382,286
Deferred taxes	314,712	152,333	640,377
	<u>701,141</u>	<u>474,056</u>	<u>1,022,663</u>
	<u>17,262,677</u>	<u>16,054,498</u>	<u>17,158,784</u>

	June 30, 2001 (Unaudited) NIS thousands	June 30, 2000 (Unaudited) NIS thousands	December 31, 2000 (Audited) NIS thousands
Current liabilities			
Short-term bank credit	687,775	483,558	743,301
Current maturities of:			
Long-term bank loans	1,034,953	912,952	381,778
Other debentures	232,583	215,325	227,083
Trade payables	817,713	947,695	1,058,506
Employee severance benefits	333,355	215,911	348,607
Other current liabilities	969,096	795,379*	978,116
	<u>4,075,475</u>	<u>3,570,820</u>	<u>3,737,391</u>
Long-term liabilities			
Long-term loans	2,196,160	3,384,500	2,856,138
Other debentures	2,450,144	1,130,493	2,175,962
Employee severance benefits	1,277,263	77,296	1,265,483
Deferred taxes	3,134	19,943	14,592
Deferred revenues	65,663	75,234	70,576
	<u>5,992,364</u>	<u>4,687,466</u>	<u>6,382,751</u>
Convertible debentures	<u>—</u>	<u>81,961</u>	<u>68,847</u>
Contingent liabilities			
Shareholders' equity	<u>7,194,838</u>	<u>7,714,251</u>	<u>6,969,795</u>
	<u>17,262,677</u>	<u>16,054,498</u>	<u>17,158,784</u>

Ido Dissentshik
Chairman of the Board

Ilan Biran
CEO

Oren Lieder
Chief Financial Officer

* Reclassified

Date of approval of the financial statements: August 28, 2001

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

Interim Consolidated Statement of Operations
In terms of shekels of June 2001

	For the six-month period ended June 30,		For the three-month period ended June 30,		For the year ended December 31,
	2001 (Unaudited)	2000 (Unaudited)	2001 (Unaudited)	2000 (Unaudited)	2000 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from telecommunications services					
(Note 8)	4,081,007	4,292,244*	2,018,261	*2,010,927	8,495,499
Costs and expenses					
Operating and general expenses (Note 9)	2,220,821	2,237,685*	1,158,551	*988,188	4,331,383
Depreciation	1,295,073	1,368,382	640,473	679,774	2,730,258
Royalties to the Government of Israel	138,736	158,768	57,996	75,969	318,048
	<u>3,654,630</u>	<u>3,764,835</u>	<u>1,857,020</u>	<u>1,743,931</u>	<u>7,379,689</u>
Operating income	426,377	527,409	161,241	266,996	1,115,810
Financing income (expenses)	(51,486)	(167,362)	1,149	(34,416)	(347,042)
Earnings after financing expenses	374,891	360,047	162,390	232,580	768,768
Other income (expenses), net	23,211	88,062	6,959	(3,292)	(1,286,780)
Earnings (loss) before income tax	398,102	448,109	169,349	229,288	(518,012)
Tax benefit (income tax)	(169,329)	(194,138)	(70,135)	(96,929)	155,025
	228,773	253,971	99,214	132,359	(362,987)
Equity in earnings (losses) of affiliated companies	(75,998)	(50,294)	(16,553)	(23,555)	(197,325)
Minority share in losses of consolidated company	3,396	398	1,449	398	4,950
Net earnings (loss)	<u>156,171</u>	<u>204,075</u>	<u>84,110</u>	<u>109,202</u>	<u>(555,362)</u>
Basic and diluted earnings (loss) per NIS 1 par value of common shares (in NIS)	<u>0.065</u>	<u>**0.086</u>	<u>0.035</u>	<u>**0.045</u>	<u>(0.229)</u>

* Reclassified

** Restated due to issue of bonus shares.

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

Interim Statement of Changes in Shareholders' Equity
In terms of shekels of June 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					
Six months ended June 30, 2001						
Balance as at December 31, 2000 (audited) ..	4,193,559	1,616,242	832,321	36,045	291,628	6,969,795
Net earnings (unaudited)	—	—	—	—	156,171	156,171
Conversion of convertible debentures (unaudited) ⁽¹⁾	6,000	—	62,872	—	—	68,872
Distribution of bonus shares (unaudited) ⁽⁵⁾ ..	<u>1,636,856</u>	<u>(1,616,242)</u>	<u>—</u>	<u>—</u>	<u>(20,614)</u>	<u>—</u>
Balance as at June 30, 2001 (unaudited)	<u>5,836,415</u>	<u>—</u>	<u>895,193</u>	<u>36,045</u>	<u>427,185</u>	<u>7,194,838</u>
Three months ended June 30, 2001						
Balance as at April 1, 2001 (unaudited)	5,836,415	—	895,193	36,045	343,075	7,110,728
Net profit (unaudited)	—	—	—	—	84,110	84,110
Balance as at June 30, 2001 (unaudited)	<u>5,836,415</u>	<u>—</u>	<u>895,193</u>	<u>36,045</u>	<u>427,185</u>	<u>7,194,838</u>
Six months ended June 30, 2000						
Balance as at December 31, 1999 (audited) ..	4,178,742	—	659,092	36,045	2,464,670	7,338,549
Erosion of dividend proposed in a previous year and paid this year (unaudited)	—	—	—	—	(1,438)	(1,438)
Net profit (unaudited)	—	—	—	—	204,075	204,075
Tax benefit in respect of shares to employees (unaudited)	—	—	22,000	—	—	22,000
Conversion of convertible debentures (unaudited) ⁽²⁾	13,501	—	137,564	—	—	151,065
Balance as at June 30, 2000 (unaudited)	<u>4,192,243</u>	<u>—</u>	<u>818,656</u>	<u>36,045</u>	<u>2,667,307</u>	<u>7,714,251</u>
Three months ended June 30, 2000						
Balance as at April 1, 2000 (unaudited)	4,192,021	—	816,961	36,045	2,558,105	7,603,132
Net earnings (unaudited)	—	—	—	—	109,202	109,202
Conversion of convertible debentures (unaudited) ⁽³⁾	222	—	1,695	—	—	1,917
Balance as at June 30, 2000 (unaudited)	<u>4,192,243</u>	<u>—</u>	<u>818,656</u>	<u>36,045</u>	<u>2,667,307</u>	<u>7,714,251</u>
Year ended December 31, 2000						
Balance as at December 31, 1999 (audited) ..	4,178,742	—	659,092	36,045	2,464,670	7,338,549
Net loss (audited)	—	—	—	—	(555,362)	(555,362)
Erosion of dividend proposed in a previous year and paid this year (audited)	—	—	—	—	(1,438)	(1,438)
Tax benefit in respect of shares to employees (audited)	—	—	22,000	—	—	22,000
Conversion of convertible debentures (audited) ⁽⁴⁾	14,817	—	151,229	—	—	166,046
Capitalization of undesignated earnings to a reserve fund for the distribution of bonus shares (audited) ⁽⁵⁾	—	1,616,242	—	—	(1,616,242)	—
Balance as at December 31, 2000 (audited) ..	<u>4,193,559</u>	<u>1,616,242</u>	<u>832,321</u>	<u>36,045</u>	<u>291,628</u>	<u>6,969,795</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.

(2) 134,870,728 par value convertible debentures were converted into 13,327,147 ordinary shares with a par value of NIS 1 each.

(3) 2,215,441 par value convertible debentures were converted into 218,917 ordinary shares with a par value of NIS 1 each.

(4) 147,652,429 par value convertible debentures were converted into 14,590,161 ordinary shares with a par value of NIS 1 each.

(5) See Note 7

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

Interim Consolidated Statement of Cash Flows
In terms of shekels of June 2001

	<u>For the six-month period ended June 30,</u>		<u>For the three-month period ended June 30,</u>		<u>For the year ended December 31,</u>
	<u>2001</u>	<u>2000</u>	<u>2001</u>	<u>2000</u>	<u>2000</u>
	<u>(Unaudited)</u>	<u>(Unaudited)</u>	<u>(Unaudited)</u>	<u>(Unaudited)</u>	<u>(Audited)</u>
	NIS thousands		NIS thousands		NIS thousands
Cash flows generated by operating activities					
Net earnings (loss)	156,171	204,075	84,110	109,202	(555,362)
Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities (see A below)	<u>1,358,411</u>	<u>1,365,878</u>	<u>591,717</u>	<u>744,196</u>	<u>3,856,823</u>
Net cash inflow generated by operating activities	<u>1,514,582</u>	<u>1,569,953</u>	<u>675,827</u>	<u>853,398</u>	<u>3,301,461</u>
Cash flows generated by investing activities					
Acquisition of fixed assets	(715,388)	(830,712)	(318,302)	(294,271)	(1,744,794)
Proceeds from disposal of fixed assets	41,565	12,468	29,790	7,434	34,978
Proceeds from disposal of investment in affiliated company	—	—	—	—	173,020
Investment in investee companies	(256,605)	(226,583)	(52,748)	(117,840)	(328,324)
Investment in long-term deposits and investments	(1,035,830)	(27,292)	(8,797)	(11,104)	(60,490)
Proceeds from long-term deposits and investments	10,486	35,284	6,530	3,934	60,686
Decrease (increase) in short-term investments, net	(72,224)	153,302	(44,336)	(16,177)	116,987
Decrease (increase) in materials and spare parts	28,409	12,530	37,576	(1,954)	58,603
Investment in other assets	<u>(106,518)</u>	<u>(127,900)</u>	<u>(51,336)</u>	<u>(55,130)</u>	<u>(265,920)</u>
Net cash outflow generated by investment activities	<u>(2,106,105)</u>	<u>(998,903)</u>	<u>(401,623)</u>	<u>(485,108)</u>	<u>(1,955,254)</u>
Cash flows generated by financing activities					
Repayment of debentures issued to the Government of Israel	—	(476,873)	—	(237,650)	(476,854)
Issue of other debentures (after deduction of issue expenses)	509,045	—	—	—	1,105,982
Repayment of other debentures	(133,830)	(146,486)	(20,854)	(16,570)	(228,765)
Receipt of long-term loans	154,692	664,698	152,721	355,001	811,850
Repayment of long-term loans	(196,100)	(645,762)	(120,094)	(398,074)	(1,843,072)
Receipt (repayment) of short-term bank credit, net	(55,526)	209,534	(175,505)	26,532	469,287
Dividend paid	—	(306,361)	—	—	(306,349)
Net cash inflow (outflow) generated by financing activities	<u>278,281</u>	<u>(701,250)</u>	<u>(163,732)</u>	<u>(270,761)</u>	<u>(467,921)</u>
Increase (decrease) in cash and cash equivalents	<u>(313,242)</u>	<u>(130,200)</u>	<u>110,472</u>	<u>97,529</u>	<u>878,286</u>
Cash and cash equivalents at beginning of period	<u>1,549,896</u>	<u>671,610</u>	<u>1,126,182</u>	<u>443,881</u>	<u>671,610</u>
Cash and cash equivalents at end of period	<u>1,236,654</u>	<u>541,410</u>	<u>1,236,654</u>	<u>541,410</u>	<u>1,549,896</u>

The notes to the financial statements are integral part thereof.

Interim Consolidated Statement of Cash Flows (Contd.)
In terms of shekels of June 2001

	For the six-month period ended June 30,		For the three-month period ended June 30,		For the year ended December 31,
	2001	2000	2001	2000	2000
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
A — Adjustments to reconcile net earnings to net cash flows generated by operating activities					
Revenues and expenses not involving cash flows:					
Depreciation	1,295,073	1,368,382	640,473	679,774	2,730,258
Provision for decrease in value of fixed assets	—	—	—	—	11,135
Deferred taxes	5,212	153,379	(9,569)	56,804	(311,614)
Company's equity in losses (earnings) of investee companies, net	75,998	50,294	16,553	23,555	197,325
Minority share in losses of a consolidated company	(3,396)	(398)	(1,449)	(398)	(4,950)
Increase (decrease) in employee severance benefits, net	(3,472)	(141,227)	(1,128)	(13,453)	1,179,673
Gain on disposal of fixed assets	(30,712)	(1,651)	(12,327)	(1,148)	(1,355)
Loss (gain) on disposal of investment in affiliated company	3,470	—	3,470	—	(140,277)
Erosion (appreciation) of and interest on long-term deposits and investments and futures contracts	(17,568)	23,122	60,471	(6,534)	15,596
Erosion (appreciation) of short-term investments, net	(3,923)	(2,137)	(779)	1,387	(2,965)
Appreciation (erosion) of long-term liabilities:					
Debenture issued to the Government of Israel	—	673	—	(1,128)	673
Other debentures	(95,533)	(3,309)	(75,170)	(7,085)	27,238
Long-term loans	33,663	(67,389)	(49,747)	(13,431)	(74,607)
Amortization of deferred expenses and other adjustments	107,462	65,201	57,402	34,768	152,127
Changes in asset and liability items:					
Decrease in trade receivables	51,153	222,112	54,008	87,481	152,827
Decrease (increase) in other receivables and debit balances	125,339	(71,154)	85,593	69,743	(83,503)
Decrease (increase) in inventory	(20,634)	(1,400)	14,496	(7,098)	(14,877)
Decrease in trade payables	(148,585)	(171,010)	(133,790)	(84,731)	(87,658)
Increase (decrease) in other current liabilities	(10,223)	(53,187)	(53,984)	(72,274)	120,855
Decrease in deferred revenues	(4,913)	(4,423)	(2,806)	(2,036)	(9,078)
	<u>1,358,411</u>	<u>1,365,878</u>	<u>591,717</u>	<u>744,196</u>	<u>3,856,823</u>
B — Non-cash transactions					
Acquisition of fixed assets, materials and spare parts on credit	<u>224,618</u>	<u>277,235</u>	<u>224,618</u>	<u>277,235</u>	<u>304,328</u>
Acquisition of other assets on credit	<u>1,666</u>	<u>—</u>	<u>1,666</u>	<u>—</u>	<u>—</u>
Sale of fixed assets on credit	<u>15,632</u>	<u>23,308</u>	<u>15,632</u>	<u>23,308</u>	<u>8,955</u>

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

**Notes to the Interim Consolidated Financial Statements
as at June 30, 2001 (Unaudited)**

NOTE 1 — GENERAL

- A. The interim statements have been prepared in accordance with generally accepted accounting principles, applicable to the preparation of interim periodic financial statements. These statements should be read in conjunction with the Company's annual financial statements and accompanying notes as at December 31, 2000 and for the year then ended.
- B. The Company presents in the notes to the interim financial statements only the significant changes in its business and legal environment which occurred between the date of the previous annual financial statements and the date of these interim financial statements. The extensive and detailed description, including significant changes and developments which occurred in recent years, particularly in the fields of cellular services, international communications services, domestic communications services, the opening of these markets to competition, and the decisions of the Ministerial Committee for Privatization to reduce the State's holdings in the Company, appears in Note 1 to the Company's annual financial statements as at December 31, 2000. The significant changes which occurred from the date of the annual financial statements to the date of these financial statements are detailed below:

1. Access fees from the international telecommunications operators were reduced as of January 1, 2001 by approximately 30%, in accordance with the licenses of the operators which determined that the access fees would be reduced every year by that percentage.
2. The annual updated tariffs took effect on March 1, 2001, including a reduction of the Company's call tariffs by an average of 1.4%, an increase in the tariffs for links to the cellular operators by an average of some 33%, and the tariffs for other services were reduced by approximately 2.79%.
3. Pursuant to notification from the Company to the cellular communication service operators, (hereinafter — the Operators), starting on March 1, 2000, the billing arrangement which was in effect between them was canceled and a new arrangement commenced, whereby the Company transfers to the operators only the amounts which it actually collected in respect of airtime less a collection fee, in contrast to the existing arrangement in which the transfer of 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 existing arrangement and one of them also filed a legal claim in which it requested that the Company be instructed to continue to act in accordance with the arrangement which had existed until then. The court denied the claim and confirmed the validity of the new arrangement instituted by the Company. The Operator appealed to the High Court. 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, 2001 to December 31, 2002, and with MIRS Communications Ltd. upon the start of its operations as a cellular service operator. The Company included in its financial statements a provision of approximately NIS 48 million to cover its obligations deriving from the agreement.

As a result of the change in the billing arrangements, as described above, starting on March 1, 2000, the Company's revenues and expenses from mobile wireless telephone do not include airtime. The airtime which is included in the revenues and expenses from mobile wireless telephone in the corresponding reported period last year, amount to approximately NIS 293 million.

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

The request of the Company to consider rescinding the notice naming it a monopoly in basic telephone services, which includes, according to the Company, both fixed and

**Notes to the Interim Consolidated Financial Statements
as at June 30, 2001 (Unaudited) (cont'd)**

mobile telephony, was rejected by the Anti-Trust Commissioner. The Company is considering what action to take.

5. In July 2001, regulations effective from January 2001 were published, which changed the arrangements which existed until that date for payment of royalties to the State by communications companies. Under the new regulations, the basis of revenues from which the royalties are calculated was broadened, along with a gradual reduction of the rate of royalties paid, until arriving at a uniform rate for all communications operators. The rates in effect for 2001 are 4% for fixed-line domestic telecommunication services, 4.5% for international telecommunication services, and 5% for cellular services. The rate of royalties for domestic telecommunication services will remain in effect through 2003, and in 2004 will be lowered to 3.5%. The rates of royalties for international and cellular services will be gradually lowered to 3.5% by 2004.
6. Further to Note 1E(3) in the financial statements of December 31, 2000, in July 2001 the Communications Law (Telecommunications and Broadcasts), 5742-1982 was amended. The amendment regulates, *inter alia*, the opening of the domestic communications market and the field of cable broadcasts to competition, by way of granting licenses for providing communication services. The amendment includes a large number of subjects which will affect the Company and other companies in the Group. The Law enables the cable companies to switch from a regime of franchises to one of licenses, so that they or companies with an interest in the cable companies will be able to receive a general license for providing telecommunication services. If an applicant for a license currently holds a franchise, the granting of the license will be contingent upon transfer of the activities involved in providing broadcasting services to such a company with an interest, and if the license applicant is such a company with an interest, the franchisee will transfer to that company the rights in the cable network used for the broadcasts. Upon granting the licenses in accordance with the law and the start of operations of the new licensees, full competition will commence in fixed-line domestic telecommunications, which is expected to have a materially adverse effect on the business results of the Company which cannot be estimated at this stage.
7. In August 2001 a draft of the amendment of the Telecommunications Order (Determining an essential service provided by Bezeq, The Israel Telecommunication Corp. Ltd.), 5757-1997, was submitted to the Company for its comments, following the privatization decisions of June 17, 2001 and August 27, 2001. The draft Order refers, *inter alia*, to the inclusion of additional services which the Company provides under the definition of "Essential Services", and an extension of the limitations on control and holding in the Company. The draft also includes a proposal for amendment of the Company's license following the privatization decision of June 17, 2001. The Company submitted its reservations and remarks on the draft to the Ministry of Communications. In the opinion of the Company, the Telecommunications Order in its proposed text restricts the Company's activities and also the chances of privatization.
8. In August 2001, the Ministry of Communications published a Request For Position in connection with the policy for regulating international telecommunication services. The document discusses the possibility of approving a merger between the competitors of the subsidiary Bezeq International Ltd., granting licenses to additional international telecommunications operators, and a structural separation of Internet activities of an international communications operator. The Company and its subsidiary, Bezeq International Ltd., have submitted their remarks, which include reservations as to the main points of the document.

NOTE 2 — ACCOUNTING POLICIES

- A. The significant accounting policies used in preparation of the financial statements, are the same as those used in the preparation of the latest annual financial statements.

**Notes to the Interim Consolidated Financial Statements
as at June 30, 2001 (Unaudited) (cont'd)**

- B. In the report period, the Israeli Institution for Standardization in Accounting published the following new regulations:

Accounting Standard No. 7 — Events after the balance sheet date. The new standard determines, in addition to the requirements to report on events after the balance sheet date, when a corporation must make adjustments in its financial statements for events after the balance sheet date, and the disclosure required of a corporation concerning the date on which the financial statements are approved for publication.

Accounting Standard No. 8 — Terminated operations. The standard sets out rules for the separate statement of information relating to a material business operation which is terminated by a corporation, from information relating to ongoing operations, and also determines the minimum disclosure of information concerning a termination operation.

Accounting Standard No. 11 — Sectoral reporting. The standard requires the inclusion of information in respect of business sectors and geographical sectors, and also gives detailed guidelines for the identification of business and geographical sectors.

Accounting Standard No. 7 will apply to financial statements for periods ending on December 31, 2001 or thereafter.

Accounting Standards Nos. 8 and 11 will apply to financial statements for periods starting on January 1, 2002 or thereafter.

In the opinion of the Company, the effects of the new standards will not be material.

- C. On July 17, 2001, the Professional Committee of the Israeli Institution for Standardization in Accounting approved Standard No. 12, which deals with the termination of inflationary adjustments in financial statements. Following the approval, the Institute of Certified Public Accountants in Israel requested that publication of the standard be delayed for a specified period. An additional public hearing of the standard was then scheduled for September. As at the date of publication of these financial statements, the standard is not final and has no legally binding effect. If the standard is approved in the future in its current text, it is liable to have a materially adverse effect on the reported results of the Company. The extent of that effect depends on the rate of inflation and on the Company's sources of finance.

NOTE 3 — FINANCIAL STATEMENTS IN ADJUSTED VALUES

The financial statements have been prepared on the agreed basis of historical cost adjusted for the effect of the changes in the general purchasing power of the Israeli currency. Comparative data in the financial statements have been adjusted to the shekel of June 2001. The changes which occurred in the consumer price index and the rates of exchange of the US dollar:

	<u>Consumer price index</u>	<u>Exchange rate of the US dollar</u>
	%	%
In the six-month period ended on		
June 30, 2001	1.10	3.07
June 30, 2000	0.37	(1.66)
In the three-month period ended on		
June 30, 2001	1.60	(0.64)
June 30, 2000	1.61	1.44
In the year ended December 31, 2000	0.00	(2.69)

NOTE 4 — INVESTMENTS IN INVESTEE COMPANIES

A. Pelephone Communications Ltd. ("Pelephone")

In September 2000 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

**Notes to the Interim Consolidated Financial Statements
as at June 30, 2001 (Unaudited) (cont'd)**

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, and the share purchase transaction was subsequently made by a corporation registered in the United States (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:

1. Motorola's shares in Pelephone were transferred to the Corporation in consideration of 591 million dollars. The consideration was partially financed by a loan of 240 million dollars 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.
2. 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").
3. 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.
4. The exercise price of the Short Option is return on the nominal investment plus 8 million US dollars, and of the Long Option is the higher of return on the nominal investment or a valuation of the market value of 20% of the Corporation's shares.

B. Emitel Telecommunication Corp. Ltd.

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 approval were obtained by June 30, 2001 and the transaction was closed. In consideration of the sale, Aphrodite received approximately 49 million US dollars and recorded a capital gain of approximately 32 million dollars in the second quarter of the year.

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

The Company holds 30% of the shares of D.B.S. Satellite Services (1998) Ltd. (hereinafter — DBS). In January 1999, DBS received a license from the Ministry of Communications for satellite television broadcasts, in exchange for payment of NIS 30 million and a guarantee in the amount of NIS 30 million. DBS foresees considerable losses and negative cash flow from operations in the first years of its activities. Its losses in 2000 amounted to approximately NIS 550 million, and for the six months ended June 30, 2001 amounted to approximately NIS 394 million. These losses have led to an increase in its working capital deficit to NIS 1,112 million (including NIS 694 million in short-term bank credit). The sources of finance for DBS's operations are shareholders' loans and bank credit.

The Company's investment in DBS as at the balance sheet date is approximately NIS 504 million. The Company's share in the accumulated losses of DBS is about NIS 309, of which NIS 118 million were recorded in the six months ended June 30, 2001.

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 1.6 billion). The Committee also approved an increase of

**Notes to the Interim Consolidated Financial Statements
as at June 30, 2001 (Unaudited) (cont'd)**

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 means of control in DBS by anyone who is a controlling interest in a broadcasting franchisee. The Regulations were amended on March 14, 2001.

On June 24, 2001, the Ministerial Committee for Privatization approved an infusion of up to 40 million dollars by the Company in DBS, without changing the actual holdings ratio. The Company undertook to endeavor that not later than 120 days from the date of the Committee's decision, the ratio of exposure to the rate of the Company's holdings would comply with the decision of January 21, 2001. The Company further undertook to convey to the Ministerial Committee, within 120 days of the date of the decision, the position of the Board of Directors and the Management of the Company on the financial viability of the DBS venture for the Company, and its implications for its strategic plan and privatization.

On May 23, 2001 a financing agreement between DBS and three banks was signed, determining, *inter alia*, preconditions for withdrawing funds from the credit lines, including an undertaking by DBS to meet the cumulative milestones stipulated in the agreement. The agreement also determines that if by June 30, 2001, all the suspending conditions in the agreement are not met, the agreement will be canceled. The last date for full compliance with the suspending conditions was postponed to July 31, 2001. As at the date of approval of these financial statements, not all the suspending conditions had been met. The Company and the banks are continuing with the last actions required for completion of the suspending conditions. In the opinion of DBS's management, completion of the suspending conditions is imminent, and the present delay should not prejudice the terms of the financing agreement.

On May 6, 2001, the Anti-Trust Authority notified the Company that in view of the domestic operator license received by a company in the Eurocom Group, as a result of which the Company and the Eurocom Group can be seen as competitors, the cross-holding of the companies in DBS is liable to reduce the competition between them and as such, can be construed as constituting a cartel. The parties were requested to act as quickly as possible to approve their joint venture in one of the way prescribed in the Anti-Trust Law. The Anti-Trust Commissioner also stated that without derogating from the aforesaid, he was willing to try to arrive at an agreed solution within 60 days. In response, the Company notified the Anti-trust Commissioner that the partnership between it and Eurocom in the satellite enterprise does not constitute a cartel, that all its activities in this field were accomplished in accordance with lawful approvals, and that without derogating therefrom, it has no objection to discussing and clarifying the matter with the Commissioner. A first meeting on the subject was held shortly after the dispatch of the Company's response.

D. Walla! Communications Ltd.

Upon receipt of all the requisite approvals, the merger of Walla! Communications Ltd. ("Walla") and AOL Israel On Line (2000) Ltd. ("IOL") was completed. Following the merger, the rate of the holdings of Bezeq International Ltd. in Walla decreased from 38.5% to 24.8% (as a result of an issue of shares to a third party), and Bezeq International Ltd. generated a loss from disposal of an investment. This loss, of approximately NIS 3.5 million, is included in the Other expenses item in the financial statements. Based on the IOL — Walla value ratio determined immediately prior to the merger and the amortization of goodwill at Walla following the merger, Bezeq International Ltd. set its investment in Walla while further amortizing in accordance with the value ratio and the additional elements connected with the investment. The amortization made as a result, about NIS 7.7 million, and the part of Bezeq International Ltd. in amortization of the investment made in Walla following the merger, which was about NIS 6.2 million, were included in the financial statements under Losses of affiliated companies.

**Notes to the Interim Consolidated Financial Statements
as at June 30, 2001 (Unaudited) (cont'd)**

NOTE 5 — EMPLOYEE SEVERANCE BENEFITS

Early retirement plan

- A. As part of the plan for organizational change in the Company, which was approved by the Board of Directors in March 2000, 438 employees retired from the Company between December 31, 1999 and June 30, 2001.
- B. 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 has not yet started.

The financial statements for the year 2000 include an expense of approximately NIS 1,393 million in respect of the expected cost of implementation of this plan. The Company's management estimates that the possibility of additional employees retiring under a compensation arrangement is slight, and accordingly, no provision was made therefor in the financial statements.

NOTE 6 — CONTINGENT LIABILITIES

A. Claims and contingent liabilities

The Company and investee companies have contingent liabilities in respect of which the maximum possible exposure is considerable. A detailed description of these contingent liabilities appears in Note 21A to the annual financial statements of the Company as at December 31, 2000. No material changes occurred in the contingent liabilities up to the date of signing these financial statements, except for the following:

1. Further to Note 21A(4) to the financial statements of December 31, 2000 concerning a class action in which the plaintiff alleges that the tariffs for international telecommunications services in the years 1996 and 1997 were exorbitant and unreasonable, the Supreme Court allowed the appeal of the Company and Bezeq International Ltd. and the decision of the District Court in the matter of approval of the action as a class action was overruled. The class action was stricken, while reserving the right of the plaintiff to file it anew and while retaining all the allegations of the litigants.
2. Further to Note 21A(21) to the financial statements of December 31, 2000, the (first) action was amended, as was the application for approval of the action as a class action, so that the amount of the action is now estimated at more than one billion shekels (rather than about 750 million shekels as in the original application). In addition, the application for combining the hearing of the two claims referred to in the Note was approved, and the plaintiffs filed a revised action and application for approval of the action as a class action.
3. Further to Note 21A(12) to the financial statements of December 31, 2000, concerning a financial claim and class action of Company workers and pensioners, on May 8, 2001, the District Court dismissed the claim, partly due to limitation and partly due to absence of cause. The plaintiffs have appealed this decision in the Supreme Court.
4. Further to Note 21A(26) to the financial statements of December 31, 2000, concerning a petition in the High Court of Justice for the provision of a blocking service for every Company subscriber against outgoing calls to the area code of cellular phones, as a positive default, 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 Commu-

**Notes to the Interim Consolidated Financial Statements
as at June 30, 2001 (Unaudited) (cont'd)**

nications. The Ministry of Communications stated that it sees no reason for approving a block to cellular phones or for the promulgation of regulations in the matter. The Company has filed an application to expedite the hearing of the petition.

5. 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 alleged personal losses of 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.
6. Further to note 20A(6) to the financial statements of December 31, 2000 concerning a class action in connection with actions of Bezeq International Ltd. upon the start of competition, the District Court decided, on June 19, 2001, to reject the application for approval as a class action.
7. Further to Note 21A(2) to the financial statements of December 31, 2000 concerning the prices of direct dial international calls, the Supreme Court ruled, on July 2, 2001, to allow the appeal of the Company and Bezeq International Ltd. On July 17, 2001 the plaintiff filed an application for an additional hearing of the case. The Company's legal advisers are unable to estimate whether the plaintiff's application for an additional hearing will be allowed, and if so, what might be the results of the proceeding.
8. Further to Note 11E(2) to the financial statements of December 31, 2000 concerning assessments issued to the Company for the years 1994-1999, an agreement was signed in June 2001 between the Company and the Income Tax Authorities for final assessments for those years. Under the agreement, the Company's claim to increase the depreciation rate of exchanges was recognized, and several other issues were also agreed, 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 as at June 30, 2001 in respect of preceding years, amounting to approximately NIS 12 million, as well as financing income of approximately NIS 73 million (tax exempt) deriving from the rebate payable to the Company.
9. Further to Note 21A(16) to the financial statements of December 31, 2000, on July 25, 2001 a decision was given which strikes the claim, following a consensual application which was filed on behalf of both parties.
10. Further to Note 21A(22) to the financial statements of December 31, 2000 concerning a class action filed against the Company in respect of unlawful collection of VAT for some collect calls received by subscribers in Israel from abroad, the plaintiffs have filed an application to add the Director of Customs and VAT as a defendant. Furthermore, the Attorney General gave notice that he will present himself in this proceeding.
11. In July 2001 a claim was filed in the District Court against Pelephone Communications Ltd. ("Pelephone"). The plaintiffs allege that Pelephone's pre-paid service constitutes infringement of their patent. Among the reliefs claimed are that Pelephone be instructed 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 compensation. At this stage, Pelephone is unable to estimate the outcome and the implications of the claim.
12. In August 2001 an application was filed in the Tel Aviv District Court for approval of a class action against Pelephone Communications Ltd. ("Pelephone"). The applicant, through its legal representatives, alleges that Pelephone acted unlawfully when it

**Notes to the Interim Consolidated Financial Statements
as at June 30, 2001 (Unaudited) (cont'd)**

collected from it and its other subscribers who were in arrears, arrearage interest and linkage differentials at a rate exceeding the provisions of the license it was awarded by the Ministry of Communications, whereby it should have collected linkage differentials and linked annual interest at 4%, rather than the rate actually collected. The plaintiff alleges that the amount of the action if recognized as a class action could be as much as NIS 2.5 million (and could even reach NIS 23 million). Pelephone and its legal advisers are studying the claim material and are unable to estimate, at this stage, its chances and its implications.

13. In August 2001 an application was filed in the Tel Aviv District Court for approval of a class action against Pelephone Communications Ltd. ("Pelephone"). The applicant alleges that the Pelephone collected payment for a change of discounted destination, despite the fact that when the contract was made with him, he was notified that changing a discounted destination does not involve payment (even though this is not written in the contract). The plaintiff is requesting to represent all the customers who signed contracts with Pelephone for the receipt of cellular communication services, and he alleges that they too were promised that the change of destination service is free of charge. Pelephone and its legal advisers are studying the claim material and are unable to estimate, at this stage, its chances and its implications.
14. In August 2001 an application was filed in the Tel Aviv District Court for approval of a class action against Pelephone Communications Ltd. ("Pelephone"). The applicant, through his lawyer, alleges that Pelephone collected from its customers excess amounts for reciprocal connection fees, in contravention of the regulations applicable thereto and/or of its license. Pelephone and its legal advisers are studying the claim material and are unable to estimate, at this stage, its chances and its implications.
15. Further to Note 21A(14) to the financial statements of December 31, 2000 concerning a class action against Pelephone Communications Ltd. on the matter of charging value added tax within the territory of the Eilat free trade zone, in light of the consensual application filed by the parties, a decision was given whereby the application for approval of the action as a class action will be stricken with no order to pay costs.

B. Forward exchange contracts

The Company has entered into forward exchange contracts as a hedge against exposure resulting from changes in the CPI and from changes in the exchange rates of foreign currencies. As at June 30, 2001, the Company contracted to purchase approximately US \$316 million (approximately NIS 1,316 million) for which it will pay approximately NIS 1,318 million linked to the CPI, and approximately 107 million euros (approximately NIS 379 million), for which it will pay approximately NIS 400 million linked to the CPI. The contracts mature on various dates, the last of which is April 2003. The Company also contracted to purchase approximately US \$61 million (approximately NIS 254 million), for which it will pay approximately NIS 255 million at predetermined rates, and approximately 195 million euros (NIS 688 million), for which it will pay approximately NIS 720 million at predetermined rates, and approximately NIS 502 million linked to the CPI, for which it will pay approximately NIS 508 million.

NOTE 7 — SHARE CAPITAL

- A. 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. For this purpose, it was resolved to capitalize undesignated earnings to a reserve fund which will be earmarked for the distribution of bonus shares, and to authorize the Board of Directors to issue those bonus shares. In January 2001, approval was received from the Ministerial Committee for

**Notes to the Interim Consolidated Financial Statements
as at June 30, 2001 (Unaudited) (cont'd)**

Privatization for the increase of the registered capital for allotment of the bonus shares. The increase in the registered capital and the allotment of the bonus shares as aforesaid, were implemented in February 2001.

- B.** The General Meeting which convened on April 30, 2001 resolved to approve an increase in the registered capital of the Company by 130 million of ordinary shares, which will be designated for raising capital as defined in the privatization resolution of the Company dated August 27, 2001. The terms for the cancellation of capital that is not allotted were also resolved. On June 11, 2001 the Ministerial Committee for Privatization approved the resolution of the General Meeting stated above.

NOTE 8 — REVENUES FROM TELECOMMUNICATION SERVICES

	For the six-month period ended June 30,		For the three-month period ended June 30,		For the year ended December 31,
	2001 (Unaudited)	2000 (Unaudited)	2001 (Unaudited)	2000 (Unaudited)	2000 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from telephone services					
Domestic fixed-line communications	1,201,999	1,281,744	582,215	604,117	2,553,733
Cellular telephone ⁽¹⁾	1,029,841	1,159,136	528,794	490,003	2,169,353
Fixed fees	1,035,929	996,728	514,037	498,174	2,010,724
International communications and Internet services	384,681	410,073*	190,074	204,247*	855,765
Installation and sale of equipment to subscribers	219,244	254,088	105,903	121,203	501,777
Other	64,673	72,478	28,024	32,099	141,947
	<u>3,936,367</u>	<u>4,174,247</u>	<u>1,949,047</u>	<u>1,949,843</u>	<u>8,233,299</u>
Other revenues	144,640	117,997	69,214	61,084	262,200
	<u>4,081,007</u>	<u>4,292,244</u>	<u>2,018,261</u>	<u>2,010,927</u>	<u>8,495,499</u>

(1) See Note 1B(3)

* Reclassified

NOTE 9 — OPERATING AND GENERAL EXPENSES

	For the six-month period ended June 30,		For the three-month period ended June 30,		For the year ended December 31,
	2001 (Unaudited)	2000 (Unaudited)	2001 (Unaudited)	2000 (Unaudited)	2000 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Salaries and related expenses	954,659	867,690	482,766	423,888	1,694,787
Cellular telephone expenses ⁽¹⁾	229,570	350,123	156,530	58,112	515,386
General expenses	336,903	306,819*	163,117	141,895*	687,870
Materials and spare parts	243,713	214,211	130,327	117,748	422,742
Services and maintenance by sub-contractors	162,545	193,594	85,074	93,789	402,523
Building maintenance	195,634	185,290	94,588	88,953	392,974
International communications expenses	108,616	143,217	49,923	74,212	253,852
Vehicle maintenance expenses	39,753	35,322	20,053	18,480	73,404
Collection fees	18,979	20,003	9,621	10,226	39,442
	<u>2,290,372</u>	<u>2,316,269</u>	<u>1,191,999</u>	<u>1,027,303</u>	<u>4,482,980</u>
Less — salaries charged to investment in fixed assets	69,551	78,584	33,448	39,115	151,597
	<u>2,220,821</u>	<u>2,237,685</u>	<u>1,158,551</u>	<u>988,188</u>	<u>4,331,383</u>

* Reclassified

(1) See Note 1B(3)

**Notes to the Interim Consolidated Financial Statements
as at June 30, 2001 (Unaudited) (cont'd)**

NOTE 10 — CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY

A. Statements of operations

	For the six-month period ended June 30,		For the three-month period ended June 30,		For the year ended December 31,
	2001 (Unaudited)	2000 (Unaudited)	2001 (Unaudited)	2000 (Unaudited)	2000 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from telecommunication services (Note 10B)	2,980,600	3,255,779	1,472,715	1,461,720	6,321,662
Costs and expenses					
Operating and general expenses (Note 10C)	1,278,508	1,428,615	678,035	543,158	2,564,330
Depreciation	1,071,017	1,141,083	527,948	569,107	2,271,231
Royalties to the Government of Israel	95,837	102,222	43,613	47,876	203,105
	<u>2,445,362</u>	<u>2,671,920</u>	<u>1,249,596</u>	<u>1,160,141</u>	<u>5,038,666</u>
Operating income	<u>535,238</u>	<u>583,859</u>	<u>223,119</u>	<u>301,579</u>	<u>1,282,996</u>
Debentures:					
Financing income (expenses), net	(17,397)	(147,309)	11,983	(28,428)	(297,605)
Earnings after financing expenses	517,841	436,550	235,102	273,151	985,391
Other income (expenses), net	19,211	114,853	672	7,708	(1,246,541)
Earnings (losses) before taxes on income	537,052	551,403	235,774	280,859	(261,150)
Tax benefit (income tax)	(187,572)	(200,423)	(73,271)	(102,724)	140,333
	<u>349,480</u>	<u>350,980</u>	<u>162,503</u>	<u>178,135</u>	<u>(120,817)</u>
Company's equity in losses of affiliated companies	(193,309)	(146,905)	(78,393)	(68,933)	(434,545)
Net earnings (loss)	<u>156,171</u>	<u>204,075</u>	<u>84,110</u>	<u>109,202</u>	<u>(555,362)</u>

B. Revenues from telecommunications services

	For the six-month period ended June 30,		For the three-month period ended June 30,		For the year ended December 31,
	2001 (Unaudited)	2000 (Unaudited)	2001 (Unaudited)	2000 (Unaudited)	2000 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from telephone services —					
Domestic fixed-line communications	1,213,009	1,290,839	587,784	608,585	2,574,883
Cellular telephone ⁽¹⁾	347,033	556,575	185,267	153,778	851,843
Fixed fees	985,146	932,351	489,394	464,742	1,903,256
International communications	162,950	185,293	82,125	95,289	392,779
Installation and sale of equipment to subscribers	71,226	103,935	33,391	47,769	213,628
Other	64,614	73,219	27,829	32,454	145,722
	<u>2,843,978</u>	<u>3,142,212</u>	<u>1,405,790</u>	<u>1,402,617</u>	<u>6,082,111</u>
Other revenues	<u>136,622</u>	<u>113,567</u>	<u>66,925</u>	<u>59,103</u>	<u>239,551</u>
	<u>2,980,600</u>	<u>3,255,779</u>	<u>1,472,715</u>	<u>1,461,720</u>	<u>6,321,662</u>

(1) See Note 1B(3).

**Notes to the Interim Consolidated Financial Statements
as at June 30, 2001 (Unaudited) (cont'd)**

C. Operating and general expenses

	For the six-month period ended June 30,		For the three-month period ended June 30,		For the year ended December 31,
	2001 (Unaudited)	2000 (Unaudited)	2001 (Unaudited)	2000 (Unaudited)	2000 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Salaries and related expenses	752,459	697,890	377,646	337,380	1,327,229
Cellular telephone expenses ⁽¹⁾	70,297	294,613	70,297	—	306,199
General expenses	123,750	111,127	65,395	52,382	236,242
Materials and spare parts	35,782	16,506	16,369	8,287	39,454
Services and maintenance by sub-contractors	136,779	167,602	70,020	77,912	344,497
Building maintenance	172,348	163,375	83,952	77,655	347,708
International communications expenses	5,016	6,200	2,417	3,130	12,280
Vehicle maintenance expenses	32,819	30,060	15,906	15,353	63,105
Collection fees	18,809	19,826	9,481	10,174	39,213
	<u>1,348,059</u>	<u>1,507,199</u>	<u>711,483</u>	<u>582,273</u>	<u>2,715,927</u>
Less — salaries charged to investments in fixed assets	69,551	78,584	33,448	39,115	151,597
	<u>1,278,508</u>	<u>1,428,615</u>	<u>678,035</u>	<u>543,158</u>	<u>2,564,330</u>

(1) See Note 1B(3).

**NOTE 11 — CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND
PELEPHONE COMMUNICATIONS LTD.**

1. Bezeq International Ltd.

A. Balance sheet

	June 30, 2001 (Unaudited)	June 30, 2000 (Unaudited)	December 31, 2000 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	204,118	335,881	269,758
Investments	14,586	—	38,593
Fixed assets	376,463	348,960	363,696
Other assets	20,224	15,311	18,403
	<u>615,391</u>	<u>700,152</u>	<u>690,450</u>
Current liabilities	329,219	422,595	504,969
Long-term liabilities	191,913	1,451	33,106
Quasi-capital receipt	160,242	160,242	160,242
Shareholders' equity (deficit)	(65,983)	115,864	(7,867)
	<u>615,391</u>	<u>700,152</u>	<u>690,450</u>

**Notes to the Interim Consolidated Financial Statements
as at June 30, 2001 (Unaudited) (cont'd)**

1. Bezeq International Ltd. (Contd.)

B. Statement of operations

	For the six-month period ended June 30,		For the three-month period ended June 30,		For the year ended December 31,
	2001 (Unaudited)	2000 (Unaudited)	2001 (Unaudited)	2000 (Unaudited)	2000 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from international telecommunications services	325,440	343,646*	161,749	166,422*	679,181
Operating expenses	252,408	295,110	124,831	140,603	571,203*
Gross profit	<u>73,032</u>	<u>48,536</u>	<u>36,918</u>	<u>25,819</u>	<u>107,978</u>
Marketing expenses	58,247	63,382	26,776	26,896	167,233
General and administrative expenses	50,518	41,818*	25,338	20,759*	91,292*
	<u>108,765</u>	<u>105,200</u>	<u>52,114</u>	<u>47,655</u>	<u>258,525</u>
Operating loss	<u>(35,733)</u>	<u>(56,664)</u>	<u>(15,196)</u>	<u>(21,836)</u>	<u>(150,547)</u>
Financing income (expenses), net	<u>(6,167)</u>	<u>3,550</u>	<u>(3,073)</u>	<u>1,799</u>	<u>(3,214)</u>
Loss after financing, net	<u>(41,900)</u>	<u>(53,114)</u>	<u>(18,269)</u>	<u>(20,037)</u>	<u>(153,761)</u>
Other revenues (expenses), net	<u>4,321</u>	<u>(26,037)</u>	<u>5,845</u>	<u>(11,160)</u>	<u>(40,158)</u>
Loss before taxes on income	<u>(37,579)</u>	<u>(79,151)</u>	<u>(12,424)</u>	<u>(31,197)</u>	<u>(193,919)</u>
Income tax	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>(1,638)</u>
Loss after taxes on income	<u>(37,579)</u>	<u>(79,151)</u>	<u>(12,424)</u>	<u>(31,197)</u>	<u>(195,557)</u>
Company's equity in losses of affiliated company	<u>(20,537)</u>	<u>(3,251)</u>	<u>(16,652)</u>	<u>(1,749)</u>	<u>(10,576)</u>
Net loss	<u><u>(58,116)</u></u>	<u><u>(82,402)</u></u>	<u><u>(29,076)</u></u>	<u><u>(32,946)</u></u>	<u><u>(206,133)</u></u>

* Reclassified

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

2. Pelephone Communications Ltd.

A. Balance sheet

	June 30, 2001	June 30, 2000	December 31, 2000
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	1,113,588	1,070,725	1,142,469
Long-term trade receivables	90,837	47,586	72,044
Investment in affiliate	66	—	1,456
Reserve for compensation fund, net	—	1,560	—
Fixed assets, net	2,800,782	2,688,446	2,894,659
Other assets	688,660	590,716	686,943
	<u>4,693,933</u>	<u>4,399,033</u>	<u>4,797,571</u>
Current liabilities	1,919,436	1,710,833	2,106,724
Provision for losses of investee company	—	9,205	—
Long-term liabilities	1,022,510	713,070	796,625
Minority rights	13,717	477	5,699
Shareholders' equity	<u>1,738,270</u>	<u>1,965,448</u>	<u>1,888,523</u>
	<u><u>4,693,933</u></u>	<u><u>4,399,033</u></u>	<u><u>4,797,571</u></u>

**Notes to the Interim Consolidated Financial Statements
as at June 30, 2001 (Unaudited) (cont'd)**

B. Statement of operations

	For the six-month period ended June 30,		For the three-month period ended June 30,		For the year ended December 31,
	2001 (Unaudited)	2000 (Unaudited)	2001 (Unaudited)	2000 (Unaudited)	2000 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from Telephone services, sales and services	1,768,718	1,700,824	885,270	862,924	3,480,237
Cost of Telephone services, sales and services ...	1,542,055	1,412,604	786,971	733,246	2,908,169
Gross profit	<u>226,663</u>	<u>288,220</u>	<u>98,299</u>	<u>129,678</u>	<u>572,068</u>
Sales and marketing expenses	241,355	206,061	115,840	114,432	453,348
General and administrative expenses	112,113	100,571	60,269	49,451	202,340
	<u>353,468</u>	<u>306,632</u>	<u>176,109</u>	<u>163,883</u>	<u>655,688</u>
Operating loss	(126,805)	(18,412)	(77,810)	(34,205)	(83,620)
Financing expenses, net	(55,218)	(50,753)	(15,117)	(15,411)	(99,086)
Other income, net	1,601	401	1,053	654	1,734
Loss before taxes on income	<u>(180,422)</u>	<u>(68,764)</u>	<u>(91,874)</u>	<u>(48,962)</u>	<u>(180,972)</u>
Tax benefit	26,767	19,969	1,427	14,678	52,010
Loss after taxes on income	<u>(153,655)</u>	<u>(48,795)</u>	<u>(90,447)</u>	<u>(34,284)</u>	<u>(128,962)</u>
Minority equity in losses of a consolidated company	6,793	796	2,897	796	9,900
Company's equity in losses of an investee company	<u>(3,390)</u>	<u>(5,183)</u>	<u>(1,350)</u>	<u>(2,725)</u>	<u>(11,044)</u>
Net loss	<u><u>(150,252)</u></u>	<u><u>(53,182)</u></u>	<u><u>(88,900)</u></u>	<u><u>(36,213)</u></u>	<u><u>(130,106)</u></u>

APPENDIX A

DBS SATELLITE SERVICES (1998) LTD.

**CONDENSED INTERIM FINANCIAL STATEMENTS
AS OF JUNE 30, 2001
(Unaudited)**

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August 13, 2001

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

Re: Review of unaudited condensed interim financial statements for
the periods ended June 30, 2001

At your request, we have reviewed the condensed interim balance sheet of DBS Satellite Services (1998) Ltd. (hereafter — the Company) as of June 30, 2001 and the condensed interim statements of operations, changes in the capital deficiency and cash flows, for the six 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 meeting of shareholders, the board of directors and its committees, and making inquiries of financial 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 these condensed interim financial statements.

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

We draw attention to note 3 to the financial statements, concerning the financial position of the Company, the signing of a financing agreement between the Company and banks, the non-compliance with suspending conditions stipulated by such agreement, and the evaluation of the Company's management regarding compliance with such suspending conditions.

Sincerely yours,

DBS SATELLITE SERVICES (1998) LTD.

**CONDENSED BALANCE SHEET
AS OF JUNE 30, 2001
IN JUNE 2001 ADJUSTED NIS**

	June 30		December 31, 2000
	2001	2000	(Audited)
	(Unaudited)		
	In thousands		
Assets			
CURRENT ASSETS:			
Cash and cash equivalents	40	8,642	427
Accounts receivable:			
Trade	10,331		4,004
Other	24,970	29,311	43,329
Total current assets	<u>35,341</u>	<u>37,953</u>	<u>47,760</u>
BROADCASTING RIGHTS:			
Cost	274,201	131,499	218,146
Less — utilized rights	57,343		32,774
	<u>216,858</u>	<u>131,499</u>	<u>185,372</u>
FIXED ASSETS:			
Cost	1,199,255	416,924	949,844
Less — accumulated depreciation	135,239	17,116	56,345
	<u>1,064,016</u>	<u>399,808</u>	<u>893,499</u>
ADVANCE ON ACCOUNT OF LICENSE FEES	<u>28,094</u>	<u>30,352</u>	<u>30,104</u>
	<u>1,344,309</u>	<u>599,612</u>	<u>1,156,735</u>
Liabilities, net of capital deficiency			
CURRENT LIABILITIES:			
Bank credit	693,603	58,226	498,056
Accounts payables and accruals:			
Trade	431,120	161,282	483,726
Other	23,031	7,513	36,694
Total current liabilities	<u>1,147,754</u>	<u>227,021</u>	<u>1,018,476</u>
LONG-TERM LIABILITIES			
shareholders' loans	1,224,190	577,648	772,191
Total liabilities	2,371,944	804,669	1,790,667
CAPITAL DEFICIENCY	<u>(1,027,635)</u>	<u>(205,057)</u>	<u>(633,932)</u>
	<u>1,344,309</u>	<u>599,612</u>	<u>1,156,735</u>

David Brodet
Chairman of the Board of
Directors

Shlomo Liran
Chief Executive Officer

Joshua Harel
VP-Finance

Date of approval of the financial statements: August 13, 2001

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

DBS SATELLITE SERVICES (1998) LTD.

**CONDENSED STATEMENTS OF OPERATIONS
FOR THE 6 AND 3 MONTH PERIODS ENDED JUNE 30, 2001
IN JUNE 2001 ADJUSTED NIS**

	6 months ended June 30		3 months ended June 30		Year ended December 31,
	2001	2000	2001	2000	2000
	(Unaudited)		(Unaudited)		(Audited)
	In thousands				
REVENUES	107,543		62,076		26,574
OPERATING EXPENSES	<u>295,819</u>		<u>147,890</u>		<u>271,346*</u>
GROSS LOSS	188,276		85,814		244,772
SELLING, MARKETING, GENERAL AND ADMINISTRATIVE EXPENSES:					
Selling and marketing	93,816	37,471	59,117	10,651	167,762*
General and administrative	<u>70,165</u>	<u>77,988</u>	<u>34,802</u>	<u>60,540</u>	<u>114,124*</u>
LOSS FROM CURRENT OPERATIONS ..	352,257	115,459	179,733	71,191	526,658
FINANCING EXPENSES (INCOME), net	<u>41,446</u>	<u>5,524</u>	<u>28,272</u>	<u>(4,967)</u>	<u>23,209</u>
LOSS FOR THE PERIOD	<u>393,703</u>	<u>120,983</u>	<u>208,005</u>	<u>66,224</u>	<u>549,867</u>

* 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 6 AND 3 MONTH PERIODS ENDED JUNE 30, 2001
IN JUNE 2001 ADJUSTED NIS**

	<u>Share capital and premium</u>	<u>Payments on account of shares</u>	<u>Accumulated deficit</u>	<u>Total</u>
	In thousands			
BALANCE AS OF JANUARY 1, 2001 (audited) . . .	10		(633,942)	(633,932)
CHANGES DURING THE 6 MONTHS ENDED				
JUNE 30, 2001 (unaudited) — loss	<u> </u>		<u>(393,703)</u>	<u>(393,703)</u>
BALANCE AS OF JUNE 30, 2001 (unaudited) . . .	<u>10</u>		<u>(1,027,645)</u>	<u>(1,027,635)</u>
BALANCE AS OF JANUARY 1, 2000 (audited) . . .	*	1	(84,075)	(84,074)
CHANGES DURING THE 6 MONTHS ENDED				
JUNE 30, 2000 (unaudited) — loss	<u> </u>		<u>(120,983)</u>	<u>(120,983)</u>
BALANCE AS OF JUNE 30, 2000 (unaudited) . . .	<u>*</u>	<u>1</u>	<u>(205,058)</u>	<u>(205,057)</u>
BALANCE AS OF APRIL 1, 2001 (unaudited) . . .	10		(819,640)	(819,630)
CHANGES DURING THE 3 MONTHS ENDED				
JUNE 30, 2001 (unaudited) — loss	<u> </u>		<u>(208,005)</u>	<u>(208,005)</u>
BALANCE AS OF JUNE 30, 2001 (unaudited) . . .	<u>10</u>		<u>(1,027,645)</u>	<u>(1,027,635)</u>
BALANCE AS OF APRIL 1, 2000 (audited)	*	1	(138,834)	(138,833)
CHANGES DURING THE 3 MONTHS ENDED				
JUNE 30, 2000 (unaudited) — loss	<u> </u>		<u>(66,224)</u>	<u>(66,224)</u>
BALANCE AS OF JUNE 30, 2000 (unaudited) . . .	<u>*</u>	<u>1</u>	<u>(205,058)</u>	<u>(205,057)</u>
BALANCE AS OF JANUARY 1, 2000 (audited) . . .	*	1	(84,075)	(84,074)
CHANGES DURING THE YEAR ENDED				
DECEMBER 31, 2000 (audited):				
Issue of share capital	10	(1)		9
Loss	<u> </u>		<u>(549,867)</u>	<u>(549,867)</u>
BALANCE AS OF DECEMBER 31, 2000 (audited)	<u>10</u>	<u>—</u>	<u>(633,942)</u>	<u>(633,932)</u>

* Composed of 4 ordinary shares of NIS 1 par value.

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

DBS SATELLITE SERVICES (1998) LTD.

**CONDENSED STATEMENTS OF CASH FLOWS
FOR THE 6 AND 3 MONTH PERIODS ENDED JUNE 30, 2001
IN JUNE 2001 ADJUSTED NIS**

	6 months ended June 30		3 months ended June 30		Year ended December 31,
	2001	2000	2001	2000	2000
	(Unaudited)		(Unaudited)		(Audited)
	In thousands				
CASH FLOWS FROM OPERATING					
ACTIVITIES:					
Loss for the period	(393,703)	(120,983)	(208,005)	(66,224)	(549,867)
Adjustments required to reflect the cash flows from operating activities**	<u>23,327</u>	<u>37,536</u>	<u>172,245</u>	<u>(4,509)</u>	<u>401,150</u>
Net cash used in operating activities ..	<u>(370,376)</u>	<u>(83,447)</u>	<u>(35,760)</u>	<u>(70,733)</u>	<u>(148,717)</u>
CASH FLOWS FROM INVESTING					
ACTIVITIES:					
Purchase of fixed assets	(211,376)	(274,693)	(107,708)	(158,383)	(792,668)
Purchase of broadcasting rights	<u>(71,102)</u>	<u>(66,790)</u>	<u>(33,302)</u>	<u>(47,860)</u>	<u>(126,136)*</u>
Net cash used in investing activities ..	<u>(282,478)</u>	<u>(341,483)</u>	<u>(141,010)</u>	<u>(206,243)</u>	<u>(918,804)</u>
CASH FLOWS FROM FINANCING					
ACTIVITIES:					
Receipt of long-term loans from shareholders	456,920	441,903	59,002	216,150	636,447
Short-term bank credit — net	<u>195,547</u>	<u>(53,687)</u>	<u>117,808</u>	<u>16,695</u>	<u>386,145</u>
Net cash provided by financing activities	<u>652,467</u>	<u>388,216</u>	<u>176,810</u>	<u>232,845</u>	<u>1,022,592</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(387)	(36,714)	40	(44,131)	(44,929)
BALANCE OF CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	427	45,356		52,773	45,356
BALANCE OF CASH AND CASH EQUIVALENTS AT END OF PERIOD ...	<u>40</u>	<u>8,642</u>	<u>40</u>	<u>8,642</u>	<u>427</u>

* Reclassified.

DBS SATELLITE SERVICES (1998) LTD.

**CONDENSED STATEMENTS OF CASH FLOWS
FOR THE 6 AND 3 MONTH PERIODS ENDED JUNE 30, 2001
IN JUNE 2001 ADJUSTED NIS**

	6 months ended June 30		3 months ended June 30		Year ended December 31,
	2001	2000	2001	2000	2000
	(Unaudited)		(Unaudited)		(Audited)
	In thousands				
**Adjustments required to reflect the cash flows from operating activities:					
Income and expenses not involving cash flows:					
Depreciation and amortization	105,473	15,073	50,835	10,743	87,410
Appreciation (erosion) of principal of long-term loans	(4,921)		(1,608)	168	
Liability for employee rights upon retirement		55		55	
	<u>100,552</u>	<u>15,128</u>	<u>49,227</u>	<u>10,966</u>	<u>87,410</u>
Changes in operating asset and liability items:					
Decrease (increase) in accounts receivable	12,032	(21,198)	(4,789)	(11,272)	(39,299)
Increase (decrease) in trade payables . .	(75,594)	47,780	120,894	36,177	327,977*
Increase (decrease) in other payables . .	(13,663)	(4,174)	6,913	(40,380)	25,062
	<u>(77,225)</u>	<u>22,408</u>	<u>123,018</u>	<u>(15,475)</u>	<u>313,740</u>
	<u>23,327</u>	<u>37,536</u>	<u>172,245</u>	<u>(4,509)</u>	<u>401,150</u>
Supplementary information on investing activities not involving cash flows:					
Purchase of fixed assets on suppliers' credit	<u>96,290</u>		<u>96,290</u>		<u>58,255</u>
Purchase of broadcasting rights on suppliers' credit	<u>31,597</u>		<u>31,597</u>		<u>46,644*</u>

* Reclassified.

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

DBS SATELLITE SERVICES (1998) LTD.

NOTES TO CONDENSED FINANCIAL STATEMENTS AS OF JUNE 30, 2001 (Unaudited)

- 1) The condensed interim financial statements as of June 30, 2001 and for the six 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 (Periodic and immediate reports) Regulations, 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 a period of six additional years on 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.

- 3) The Company's financial position

The Company expects significant losses and a negative cash flow from current operations during the first years of activity. The loss for 2000 amounted to approximately adjusted NIS 550 million, and the loss for the six months ended June 30, 2001 amounted to approximately adjusted NIS 394 million. As a result of these losses, the working capital deficiency increased to approximately adjusted NIS 1,112 million (including approximately adjusted NIS 694 million in short-term bank credit).

The financial sources for the Company's activities are shareholders' loans and bank credit.

On August 1, 2000, the Company and certain banks signed a memorandum setting out terms, which constituted an indication of the terms and conditions which were to be included in a financing agreement to be concluded between them.

On May 23, 2001, the said financing agreement was signed and it contained, *inter alia*, prerequisite conditions for utilization of the credit lines, including an undertaking by the Company to meet certain specified cumulative milestones. The financing agreement provides, *inter alia*, that if the Company would not fulfill all of the suspending conditions set out in the agreement, by June 30, 2001, the agreement would be null and void. The target date for the fulfillment of the suspending conditions was extended until July 31, 2001. As of the date of the approval of these financial statements, not all of the said suspending conditions had yet been fulfilled. Concurrently, the Company and the banks are continuing to carry out the final acts necessary to achieve the fulfillment of the said conditions. It is the opinion of the Company's management, that the fulfillment of the suspending conditions will be achieved shortly, and that the present delay will not have a negative effect on the terms of the financing agreement.

- 4) On May 10, 2001, a lawsuit was filed against the Company alleging that the Company is misleading its customers in its advertisements regarding the possibility of purchasing only certain channels, and also as concerns the quantity of channels being offered. The lawsuit further alleges that the Company obliged its customers to purchase a package of channels of maximum size, even though they did not choose to purchase such a package.

The plaintiff filed the lawsuit as representative of the Company's customers, and also petitioned to have the claim certified as a class action under the Consumer Protection Law.

DBS SATELLITE SERVICES (1998) LTD.

**NOTES TO CONDENSED FINANCIAL STATEMENTS — (continued)
AS OF JUNE 30, 2001**

The damage claimed to have been sustained by the plaintiff personally, is negligible, and the amount stated as the cumulative damage of all the members of the represented group, comes to NIS 177 million.

In the opinion of the Company's legal counsel, the chances of its successfully defending against the claim, as a class action, are good.

- 5) Termination of the agreement with Baran Raviv Establishment and Enterprises Ltd. (hereafter — Baran)

On July 17, 2001, the Company entered into an agreement with Baran, providing for the termination of the contract, previously signed between them, for the management of the installation and maintenance of end-user equipment on the premises of the subscribers. In accordance with the agreement, the above contract between the companies will terminate on September 19, 2001.

Upon the termination of the said contract, the Company intends to establish its own organization to handle installations and to provide maintenance services.

The cost, to the Company, of the contract with Baran, in 2000, came to NIS 345 million.

- 6) Below are the changes which occurred during the reported periods 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>
Six months ended June 30:		
2001	3.1%	1.1%
2000	(1.7%)	0.4%
Three months ended June 30:		
2001	(0.6%)	1.6%
2000	1.4%	1.6%
Year ended December 31, 2000	(2.7%)	0%

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