

The Privatisation of Iceland Telecom hf.

Report on the Preparation and Implementation of the Sale of the State's Shares in Iceland Telecom hf.

I

Telephone services in Iceland have, from the start, been in the hands of by the state. Until recently, the general opinion was that capital-intensive operations of this kind could only be run by the State. Also, the operation comprised what was referred to as a natural monopoly, meaning that competition was impossible owing to market conditions. A line was first installed between Hafnarfjörður and Reykjavík in 1890, and 1905 saw the start of local telephone services in Reykjavík. The origin of a state telephone company in Iceland can be traced back to 1906, when a submarine cable was laid between Iceland and mainland Europe. The State has operated this service ever since. Until recently, the operation of telephone and postal services was the responsibility of the same public authority, the Post and Telecommunications Administration.

It has been quite some time since discussions of the privatisation of post and telecommunications services began. However, the matter did not gain any momentum until Iceland became party to the Agreement on the European Economic Area. In the course of events leading up to membership, the Minister for Communications appointed a committee to review legislation governing the management and operation of the Post and Telecommunications Administration. The mandate of the committee emphasised its assignment to review the legislation applicable to the Administration and, taking into account the changes that had already occurred, as well as anticipated changes, regarding the legal position of post and telecommunications authorities in neighbouring countries. The liberalisation of post and telecom services in Europe was greatly increased in the beginning of the last decade, at the same time that government intervention was curtailed. Changes were made to the operating arrangements of state-run telecom companies in the majority of European countries during this period, although there were differences in the degree of privatisation. In some countries the sale of the state shares was initiated, while in others changes in corporate form were regarded as sufficient. The emphasis everywhere, however, was on preparing the companies for increased competition, as EEA countries had, at that time, undertaken to abolish state monopolies on telecom services and to promote competition. The same applied in Iceland. The proposals of the committee mentioned above were aimed towards changing the corporate form of the Post and Telecommunications Administration into a limited liability company, although no provision was made for the sale of the shares. At the 120th legislative session of the Althing in 1995-1996, the Minister for Communications submitted a Bill for a legislative act concerning the establishment of a limited liability company to operate the Post and Telecommunications Administration. The Bill was approved and published as Act No. 103/1996.

The limited liability company, *Póstur og sími*, began operation in early 1997. At the same time, the Administration's tasks relating to public administration were transferred to the Post and Telecom Administration. At the beginning of 1998, postal services and telephone services were separated into two limited liability companies and Iceland Telecom hf. and Iceland Post hf. started operations.

II

Debate on the sale of shares in Iceland Telecom hf. began shortly after the establishment of the company and separation from postal services. There was no intention, however, to sell the shares during the election term. Following parliamentary elections in 1999, discussions were begun on selling the shares, and the Government's Policy Statement said that preparations for the sale of Iceland Telecom should be initiated. The Statement also said that the sale was subject to assurance of good services at the most favourable prices throughout the country and active competition on the telecommunications market. In February 2000, the Minister for Communications presented to the Government his proposals regarding preparations for the sale of shares in Iceland Telecom. With the approval of the Government, the Minister wrote a letter to the Executive Committee on Privatisation dated 23 February 2000, and instructed the Committee to submit proposals on the arrangement of the sale of shares in the Company. The Minister emphasised that the Committee should specifically examine stock options for employees, a public offering, the advantages and disadvantages of selling a substantial share in the Company to a single

investor and the feasibility of excluding certain aspects in the Company's operations, such as the public network.

The current members of the Executive Committee on Privatisation are Permanent Secretary Ólafur Davíðsson, Chairman, Mr. Jón Sveinsson, Supreme Court Attorney, Mr. Steingrímur Ari Arason, Economist, and Mr. Sævar Þór Sigurgeirsson, Chartered Accountant. Mr. Hreinn Loftsson, Supreme Court Attorney, was Chairman of the Committee until 10 February 2002 and was therefore responsible for most of the preparations for the sale of shares in Iceland Telecom. The employees of the Committee are Mr. Skarphéðinn B. Steinarsson, from the Prime Minister's Office, and Mr. Guðmundur Ólason, from the Ministry of Finance. For the preparations for the privatisation of Iceland Telecom hf., Mr. Jón Birgir Jónsson, Permanent Secretary in the Ministry of Communications, and Mr. Jakob Falur Garðarsson, Assistant to the Minister for Communications, took seats on the Committee. The contact party between the Committee and Iceland Telecom was Mr. Friðrik Pálsson, Chairman of the Board of Directors of the Company.

The Committee submitted its proposals on the procedure for selling the shares in the Company in a report that also addressed other aspects for consideration in the sale. In addition, the Committee participated in policymaking on various aspects regarding corporate activities in the telecommunications market in consultation with the Ministry of Communications and surveillance agencies in the telecommunications market.

The Committee submitted an exhaustive report to the Minister for Communications in late January 2001, covering issues that needed to be decided before the sale of the shares could take place. Included in the report was a description of the standing of Iceland Telecom in the telecommunications market, on the Company's telecommunications network and an analysis of its services. The report also contained an exhaustive breakdown of the position of telecommunications companies in the telecommunications market with respect to their legal environment which has changed extensively in recent years. Also addressed were agreements relating to Iceland Telecom which could have a bearing on the position of the Company on its privatisation. Competition between companies in the telecommunications market was discussed and, finally, the report contained a discussion of the advantages and disadvantages of dividing the Company prior to privatisation.

In its proposals, the Committee recommended that the sale of the State-owned shares in Iceland Telecom hf. should take place as soon as possible. The Committee recommended that the sale proceed in stages, as follows:

Stage 1. As in earlier privatisations, the main emphasis in Stage 1 should be on sales to the general public. The sale should be carried out in a similar process as the sale of shares in Búnaðarbanki Íslands and Landsbanki Íslands at the close of 1999. The Committee does not see any reason to differentiate between the customers of Iceland Telecom and other members of the public in the sale. There are justifications for inviting employees to purchase shares in the first stage of the sale, which, in fact, is traditional procedure. Prices to the general public and employees should be based on an assessment price calculated with the assistance of experts in the financial market. It is recommended that sales to the public and employees in Stage 1 should involve 14% of the total shares in the Company. It is also recommended that small and medium-sized investors should be given the opportunity to bid for larger stakes (up to 2-3% each) through an offer for tender in conjunction with the sale to the public under Stage 1. This method has been successfully used in recent privatisation projects. It is recommended that this share should be 10%. The first stage should take place in the spring of 2001 and the listing of the shares on the Iceland Stock Exchange should take place concurrently.

Stage 2 In the second stage a core investor should be sought with the aim of strengthening the Icelandic telecommunications market, reinforcing the Company and increasing its value in subsequent sales. This investor should be chosen through a competitive process, e.g. through a limited tendering procedure following pre-selection. Several foreign telephone companies have shown an interest in acquiring Iceland Telecom. It is suggested that this stake should be 25% and that the sale should take place in the second half of 2001; furthermore, it is understood that this stake may be increased to up to 30-35% in the third stage of the sale. Following the second stage of privatisation, the State will own 51% of the shares, while 49% will be held by private entities.

Stage 3 The third stage of the sale should emphasise a dispersed sale to the public and investors. A substantial share in the Company should be offered for sale on overseas markets as well as the Icelandic market, possibly starting in 2002. The decision on the arrangement and timing of the third stage will need

to take account of prevailing conditions on the stock market at such time. A decision will also have to be made on the size and scope of the sale and whether shares in the Company (15-20%) should be retained for sale later.

Following review in the Ministerial Committee on Privatisation, the matter was submitted to the Government, which approved the above proposal for the arrangement of the sale of shares on 26 January 2001. The Executive Committee on Privatisation was furthermore instructed to continue its work on the matter. This involved, *inter alia*, seeking appropriate expert assistance for the implementation of individual stages of the sale process.

The Minister for Communications submitted to the Althingi in early May 2001 a bill for a legislative act on the sale by the Treasury of shares in Iceland Telecom hf. The Bill, which authorised the sale of all the shares in the Company, was approved by the Althingi on 19 May 2001.

III

The Executive Committee on Privatisation decided to call for tenders from domestic and foreign consultants for certain delimited parts of the first and second stage of the sale of the shares. Documentation was sent to all consultancy firms and financial companies which had previously expressed an interest in participating in the work on privatisation. An advertisement was also published in the daily newspaper, *Morgunblaðið*, drawing attention to these projects so that all parties meeting certain criteria could submit a tender. The documentation revealed that the Executive Committee on Privatisation intended to employ both domestic and foreign consultancies to assist in the privatisation of Iceland Telecom hf. The purpose of this was to ensure that the implementation would be based on the most extensive knowledge possible and to avoid awarding all the work involved to a single consultant. Domestic and foreign consultants of the Committee were required to collaborate.

The decision was made to divide the consultancy into three parts. They were described in the prospectus sent to the consultancy firms as follows:

1. *Appraisal* Preparation of an appraisal of the State-held shares in Iceland Telecom hf. The appraisal should be carried out in accordance with traditional procedures and, *inter alia*, calculated based on discounted cash flow, asset appraisal and comparison of key indicators with those of comparable enterprises. A report to be submitted on the appraisal should contain a detailed analysis of the criteria for the appraisal, an opinion regarding the price of the shares in the individual stages of the sale, in the event of any difference, a sensitivity analysis and anything else of relevance to the seller of the shares in deciding the price. The project also entailed a due diligence study of the Company and a reasoned report of the study.
2. *Listing and sale of shares in Iceland* In the first stage of the sale, the emphasis would be on the sale of shares to the public and the employees of Iceland Telecom hf. The plan is to sell 14% of the total shares in the Company to these groups. At the same time, investors should be given the opportunity to bid for larger shares, in the range of 2-3% each, up to 10% of the total shares. This aspect of the project would include listing on the Icelandic Stock Exchange and the supervision of sales to employees and the public. Also, calls for tenders and investigating the legitimacy of submitted tenders based on rules laid down concerning the tender. The price of the shares for the public and in the offer for tender should be paid in cash although employees will be offered payment terms similar to previously applied terms in the sale of shares to employees of privatised companies.
3. *Sale to core investor* The intention is to sell 25% of the total shares to a core investor following pre-selection and a restricted tendering procedure. The sale is slated to take place in the second half of 2001. A more precise timing and terms to be decided in consultation with the consultancies chosen. The work involves drawing up terms in accordance with the requests of the buyer on the arrangement of the sale, advertising the invitation to participate, taking delivery of subsequent applications, submitting proposals on participants in the restricted procedure, drawing up terms and procedures regarding the restricted procedure, taking delivery of tenders, reviewing them and submitting proposals on which tender should be accepted. The buyer will handle completion of the documents regarding the sale to the core investor. In their tenders, bidders were asked to provide exhaustive information on their experience of similar projects. They were asked, furthermore, to describe their proposed arrangement for the solution of each tendered project unit. The advertisement specified that in the assessment of the tenders, a grade would be given for individual aspects, and that the proposed solution would account for 20%, experience, knowledge and work programme would account for 30% and the quoted price would

account for 50%. The selection of the consultant for individual project units would be based on the conclusion of this assessment.

Substantial interest was expressed in the project, and a total of 17 consultancy firms, domestic and foreign, submitted 14 tenders. According to the grading in the assessment of the tenders, the tender from PricewaterhouseCoopers (PwC) proved to be most favourable for project units 1 and 3, while the tender from Búnaðarbanki Íslands proved to be most favourable for stage 2. Contracts were negotiated with these companies on the basis of their tenders.

IV

Preparations for the sale of the shares were initiated when the consultants had been selected and contracts with them finalised. The decision was made to plan for the sale to the public, employees of Iceland Telecom and offers for tender to institutional investors to take place before mid-June 2001. Listing on the Iceland Stock Exchange was scheduled for the same time. The sale to the core investor would be carried out before year-end. Work on preparations had to be implemented quickly in order to meet this timetable.

In the privatisation of state-owned companies, the aim has always been to list the companies on the Icelandic Stock Exchange. On privatisation, companies have normally increased in price after being placed on the market. For this reason, it has been the general view of parties responsible for the arrangement of privatisation projects that the public should be allowed to buy in the first stage while the price is lowest. It was regarded as necessary to list the company concurrently with the sale to the public in order to ensure normal trading following the IPO. In light of this general policy, the decision was made that in the first stage of the sale of the shares in Iceland Telecom hf., the emphasis would be on sales to the public and investors such as pension funds.

Those who have criticised this arrangement of selling first to the public and later to a core investor believe that it would have been more natural to sell to the core investor first in order for the general shareholder to know who would control the company's future strategy when they purchased shares in the Company. The Committee still believes that it was sensible to arrange the sale of the shares in the order that it was carried out. It was clear that the core investor and the price that he paid for the shares in the Company would be based on the anticipated future value of the shares and that strategic decisions taken by the core investor would benefit the State and other shareholders.

V

A conventional audit of Iceland Telecom's operation and an appraisal of the value of the Company's shares was carried out in accordance with the privatisation procedures approved by the Government on 9 February 1996. Item 3 of the Procedures is as follows:

Before the ministry concerned decides to change the legal form of an enterprise or to sell an enterprise, a detailed review is conducted on the activities of the enterprise and its operating environment and how privatization will influence these factors. Such a review shall be made by the Committee on Privatization. The review shall involve an assessment of the enterprise's market value. In assessing the market value, the future flow of revenue shall be estimated, computed to the present value. Other methods shall also be applied for comparison. The purpose of the review is to ensure adequate information on the financial status of the enterprise before a decision is made to sell.

The appraisal was primarily based on a method designed to compute the net present value of the projected cash flow of the Company for the future. The long-term plans of the Company and assessment of the general trends in the market in which it operates were used as a basis.

The appraisal was prepared by PwC experts in London and Reykjavík. Work on the assessment began in early April and the assessment report was submitted to the Executive Committee on Privatisation in late May. A revised report was submitted in August after the sale had been postponed in the spring.

In addition to the appraisal, PwC returned an exhaustive due diligence report following its study of Iceland Telecom hf. The due diligence study involves an investigation and evaluation of all the undertakings, rights and obligations of the company. The report was updated at the end of the summer in the same manner as the appraisal.

PwC's conclusion from the appraisal was that the value of Iceland Telecom's equity was between ISK 42,976 million and ISK 47,154 million. The average of the two figures was ISK 45,064 million. This put the share price according to the appraisal at 6.08-6.68 and the average price at 6.38. The decision was made to price the shares in the tender at an approximately 10% discount from the average price, i.e. 5.75. This

discount was regarded as appropriate to ensure a reasonable profit for the members of the public participating in the tender. There are no precedents for higher discounts in Iceland and, in light of the fact that the sale of a company owned by the state was involved, there was no justification for going further. PwC's appraisal showed great caution regarding the premises underlying the Company's major plans, so that it appeared likely that the market would estimate the value to be higher than the appraisal.

Considerable public discussion has been in progress in recent months on the assessment of the value of shares in Iceland Telecom. In these discussions the words "assessment" and "pricing" have sometimes been confused. As mentioned earlier the decision was made to price the shares in the public sale based on a 10% discount from the average assessment value. It may be disputed whether a higher discount should have been given. However, no doubt has been expressed regarding the assessment itself among those who have studied the facts of the case, neither by Icelandic parties nor by foreign parties.

VI

As described earlier, the plan was to sell to the public and organise an offer for tenders for institutional investors in the spring of 2001. The sale was scheduled for mid-June. Extensive preparations were carried out within Iceland Telecom and by Búnaðarbanki Íslands hf. for this purpose, in addition to the work of PwC.

As the deadline approached, however, it became clear that time allotted for all the necessary preparations was too short. The sale was therefore postponed until autumn. Ever since the submission of the proposals of the Executive Committee on Privatisation in January 2001, it was clear that the preparation time for sale in the spring of 2001 was very short. Everything would have to go precisely according to plan if the sale was to take place. Authorisation had been obtained from the Althingi for the sale and preparations for listing on the Icelandic Stock Exchange and subscription sales were advanced. Various other aspects of the matter were, however, not as favourable. There was a great deal of uncertainty in financial markets at the time, the exchange rate of the Icelandic króna was unstable and the volume of trading on the stock market was low. In addition, The EFTA Surveillance Authority (ESA) had not yet handed down a decision in a case regarding state support in connection with the establishment of a limited liability company for the operation of the Post and Telecom Administration. Also, various aspects of the internal operation of the Company needed improvement, including budgeting. Finally, it was considered that further promotion of the sale would be advantageous.

At the preparation of the first stage of the sale, the Executive Committee on Privatisation sought the advice of the Institute of Economic Studies at the University of Iceland with regard to timing. The opinion of the Institute of Economic Studies, dated 7 May 2001, revealed that in light of general economic trends, including the falling price of the Icelandic króna and trends on the stock exchange, there were two choices available. Either to postpone the sale or increase the flexibility of its arrangement. A postponement could provide more time for preparation but could also represent a risk as it would delay the entire sale process. The analysis of the Institute of Economic Studies revealed that notwithstanding the unrest in the exchange rate, Iceland Telecom was an attractive option for long-term investors who probably would not be deterred by short term unrest.

In light of the above, the Executive Committee on Privatisation recommended that the subscription sales, sales to the employees of Iceland Telecom and offer for tender should be postponed until the autumn and take place on 19-21 September. This would provide more time to present the Company's plans for the future and the sale to the public. However, work would be continued on the preparation of the sale to a core investor and the change in schedule had no effect on this. The Ministerial Committee on Privatisation approved these changes to the schedule.

VII

A decision was made that following the first two stages of the sale of Iceland Telecom, the State would remain a majority owner of the Company with a 51% stake. When the core investor had exercised his option for a further 10%, the ownership of the state would be less than 50%. As details were further worked out, it was decided to offer employees and the public 16%, to allocate 8% to the offer for tender and 25% to a core investor, with an option to purchase a further 10%. Nominal value and minimum selling price in this first part of the sale were as shown in the following table (ISK):

Subscriptions	No.	Nominal	Price	Cash payment	Instalments	Total
Sale to public	1,956	184,382,738	1,060,200,744	894,011,974	166,188,770	1,060,200,744
Employees	613	27,601,660	158,709,545		158,709,545	158,709,545
Tenders	19	152,294,869	879,203,483	879,203,483		879,203,483
Total	2,588	364,279,267	2,098,113,772	1,773,215,457	324,898,315	2,098,113,772

From the outset, it was assumed that the employees of Iceland Telecom would be given the option of purchasing shares on similar terms as the employees of other companies privatised in recent years. Thus, they would be given the option of paying 10% on purchase and spreading the remainder of the payments over three years, without interest and inflation adjustments. The shares would be held as collateral until fully paid. In the same manner, it was understood that the sale to employees of the Company would take place concurrently with the sale to the public. During the course of preparations for the sale of the shares, there was some discussion of inviting the Company to buy shares in itself to offer to employees under a stock option plan developed within the company. The idea of offering shares for the stock option plan was not used at this time, but there are plans for doing so at a later date, and the Company would then be invited to buy shares from the State in order to conclude stock option contracts with employees.

The decision was made to sell a total of 14% of the total shares in the Company to the public and to employees. According to the terms decided, employees were invited to purchase approximately 1% of the total shares in the Company and the public approximately 13%.

The Executive Committee on Privatisation examined the possibility of inviting the public to spread payments over a period of up to one year. The liquidity position of the banks was rather poor at this time so it was not easy for buyers to obtain funding from the banks except at high interest rates. It could also be assumed that some buyers intended to sell other stocks in order to fund purchases of shares in Iceland Telecom. In light of the sluggishness of the share market, it was considered likely that it could take some time for investors to sell other stocks. The decision was made, in consultation with Búnaðarbanki Íslands, to invite the public to spread their payments.

In the offer for tender, each investor was permitted to make a bid for up to ISK 150 million, or approximately 2% of the total shares in the Company. In the offer for tenders, payment of shares would have to be in cash.

The terms and arrangement of the first stage of the sale is discussed in greater detail in the Company's Prospectus.

VIII

The sale to the public and to employees and the offer for tender were not as successful as hoped. When the results were clear following the close of the subscription period, on 19-21 September, 2,588 had subscribed to shares. They fell into the following categories:

Payments 08.01.2002	Sale Price		
	Paid	Unpaid	Total
Public Offering - cash	287,206,198	606,805,776	894,011,974
Instalments	40,786,923	284,111,392	324,898,315
Offer for tender	588,453,483	290,750,000	879,203,483
Total	916,446,604	1,181,667,168	2,098,113,772

Based on this, the end result was that approximately only a fifth of the shares on offer had been sold. Buyers had subscribed to approximately 5% of the shares in the Company.

Many reasons have been offered for why the sale did not show better results than it did. Four reasons were the most commonly cited in the course of public discussion. First, the tragic events of the terrorist attack on New York and Washington a few days before the sale began. The volume of trading on financial markets all over the world fell substantially following the attacks. The impact of the attacks was much greater than anyone could have foreseen. Second, there was discussion that the price of shares in Iceland Telecom was too high. The effect of the discussion was to discourage the public from buying. Third, conditions on the domestic financial market were difficult, and had been for some time, partly as a result of the fluctuations of the Icelandic króna. Fourth, the situation of telecommunications enterprises in various parts of the world had deteriorated with a corresponding decrease in investor interest. The surges in the price of telecommunications companies in the preceding years were being reversed.

Following the terrorist attacks on the US, the Executive Committee on Privatisation discussed suggestions of postponement of the sale of the shares. However, the suggestion was dismissed. The

reasons were primarily that the sale had been carefully prepared and everything was ready. There were some signs that the domestic stock market was recovering, and the general consensus was that a privatisation project on this scale, involving a large and powerful company like Iceland Telecom, would have a beneficial effect on the market. No-one could foresee the impact that the events in the US would have on the sale. Concurrently with the preparation of the first stage, preparations were made for the sale of a share to a prospective core investor. It was clear that if the first stage were postponed, either the proposed sale to a core investor would have to be postponed or that stage would have to be implemented before the first stage. In the opinion of the Committee, this would have been an extremely unfortunate arrangement as the desire was to offer the public and institutional investors an opportunity to invest first in the Company. The report of the Institute of Economic Studies mentioned above expressed the expert opinion that it was important, in contracting with parties outside Iceland, for a credible market value to be formed in the domestic market, and that this would also reduce the likelihood of criticism of the Government for selling state assets to foreign investors at a low price. Furthermore, the experts were of the opinion that the value of the Company would increase with the participation of a core investor and it was therefore important not to switch the first and second stages and to allow adequate time for a market price to emerge.

There were loud voices at this time that the shares in Iceland Telecom were too highly priced. Most vociferous in this group were the analysis departments of financial companies, pension funds and investors who had shown an interest in buying large stakes in Iceland Telecom. As recounted above, the appraisal was carried out based on accepted rules. Once PwC's assessment was available, Búnaðarbanki Íslands hf. was asked to review the assessment. The report from the Bank made no objection to the methodology used in the appraisal. A few comments were made, but these had no material significance for the conclusions. On the basis of these two reports it was impossible for the Committee to lower the price of the shares to meet the expectations of the stock market. The shares in Iceland Telecom were for sale at a price determined by recognised methods and the rules set by the government. If the investors were not interested in the offer, the State had no option but to continue to own the Company.

When the approval of the Board of Directors of the Iceland Stock Exchange was sought for the listing of Iceland Telecom's shares on the Main List of the Exchange, the condition was set that at least 15% of the shares would have to be sold. This did not happen. For this reason an application was later made for listing on the OTC market of the Exchange and this was accepted. The purpose of this listing was to ensure trading in the shares of the Company in a recognised, open market. It was the unanimous opinion of the Board of Directors of Iceland Telecom and the Executive Committee on Privatisation that this arrangement would benefit the shareholders of the company.

Because of the results of the offering, many of those who had subscribed to shares in Iceland Telecom chose not to honour their subscriptions. In light of this, the Committee issued a statement declaring that collection of payments would not be enforced, as the premises for the offering had changed somewhat. A settlement received from Búnaðarbanki in January 2002 showed the final results. The table below shows the itemised results:

Payments 08.01.2002	Sale Price		
	Paid	Unpaid	Total
Public Offering - cash	287,206,198	606,805,776	894,011,974
Instalments	40,786,923	284,111,392	324,898,315
Offer for tender	588,453,483	290,750,000	879,203,483
Total	916,446,604	1,181,667,168	2,098,113,772

Based on the collected payments, 2.26% of the shares in Iceland Telecom are now owned by parties other than the State.

IX

Concurrently with the sale of shares to the public and employees and the domestic offer for tender, work was carried out on the sale of a share to a core investor. PwC has been in charge of this sale.

The decision was made that the sale process would be as follows:

1. Determination of what kind of investor is being sought who would be advantageous for Iceland Telecom and the telecommunications market in Iceland. Decision on the rights and obligations to be offered to the core investor by Iceland Telecom.

2. A small brochure was prepared, briefly describing Iceland Telecom's operations, the operating environment in Iceland and the arrangement of the sale. The brochure was distributed to all the parties regarded by PwC as prospective core investors in Iceland Telecom. In addition, an advertisement was published in the *Financial Times* encouraging interested parties to contact PwC.

3. On the basis of the brochure, interested parties were asked to send a notice to PwC no later than 24 September 2001.

4. Those who met the criteria and signed the required declarations of confidentiality were invited to receive an Information Memorandum. The Memorandum contained exhaustive information on the past, present and future activities of Iceland Telecom. It also contained a report on the operating environment of the Company. The Memorandum was prepared by PwC in co-operation with Iceland Telecom and the Executive Committee on Privatisation.

5. On the basis of the Information Memorandum, interested parties were asked to submit a non-binding price offer to PwC by the end of October.

6. Of the parties who submitted a non-binding price offer, a limited number would be invited to receive further information on Iceland Telecom through presentations, visits and due diligence studies. On the basis of these studies they would then be able to make final binding offers.

7. Formal negotiations would be undertaken with the party making the best offer. In the opinion of the Government, both Iceland Telecom and the telecommunications market in Iceland would benefit substantially if a strong core investor could be found for the Company. This would strengthen the operation of the Company through increased knowledge and strength. The telecommunications market in Iceland is small in comparison with other countries, and would benefit from direct links with overseas telecommunications companies. The decision was made to establish three conditions to be met by prospective core investors. These conditions were:

- To have at least 1 million customers in a fixed-line or mobile telephone network.
- A turnover from telephone operations of at least USD 1 billion.
- No stakeholder interests in any Icelandic fixed-line or mobile telephone network.

In order to increase investor interest and ensure that the investor becoming the core investor in Iceland Telecom would concentrate on the management of the Company, the decision was made to issue an undertaking to the effect that as long as the core investor and the State held the majority of shares in the Company, the State would cast its votes at shareholders' meetings so as to effectively give the core investor a majority vote on the Board of Directors. This would, however, be subject to conditions to be laid down in an agreement between the parties. This agreement would, *inter alia*, provide for the obligations of the investor with regard to the Company concerning knowledge and the synergy effects with other aspects of his operations. In the event that these obligations were not met, or if the core investor did not fulfil the general obligations imposed on the Company by the telecommunications or competition authorities, this support in elections to the Board would be withdrawn. It was also made clear that the State intended to continue to sell its shares, so that sooner or later this joint majority would not be in place unless the core investor acquired additional shares on the market.

The conditions set for the size of the core investor were intended to ensure the necessary strength to play the role expected of him. For reasons of competition, companies already operating in Iceland were excluded from eligibility as a core investor in Iceland Telecom. Privatisation was intended to result in increased competition, not reduced competition.

X

Extensive presentation work on Iceland Telecom was carried out among potential investors. PwC handled this presentation work, using the resources of its offices all around the world. Also, all parties with a potential interest in the Company were contacted and sent presentation material. Ten presentations of Iceland Telecom were held for investors in Reykjavík and London. In addition to the representatives of PwC, these meetings were attended by members of the Board of Directors of Iceland Telecom and a representative of the Executive Committee on Privatisation.

By the time that the deadline for submitting participation notices expired, 17 notices had been delivered to PwC. The following companies sent in notices: TeleDanmark in Denmark, Telenor in Norway, Telesonique in Switzerland, Detecon (subsidiary of Deutsche Telekom) in Germany, Maltacom plc. in Malta, Western Wireless Corp. and Norðurljós samskiptafélag hf. in the US and in Iceland, Opin kerfi hf. in Iceland, Hringiðan hf. in Iceland, Guðmundur Franklín Jónsson in the US, Schrodgers Ventures in the

UK, Alacre in the US, Apax Partners in the UK, Soros Private Equity Partners in the UK, Spectrum Equity Partners in the UK, JP Morgan Partners in the UK, Providence Equity in the UK and Fay Ritchwhite/Berkshire Partners in Switzerland.

Despite the clear requirement that the core investor must be engaged in substantial telephony activities, investors were permitted to submit participation notices without actually meeting this requirement. It was understood that in the later stages of the process, these investors would be expected to meet the requirements, e.g. by establishing a company in co-operation with a telephone company or other parties meeting all the conditions.

Following review by PwC, the decision was made to invite 11 investors to receive an Information Memorandum in order to prepare a non-binding offer. Following signature of declarations of confidentiality, the Memorandum was sent. The following parties received a Memorandum: TeleDanmark, Telenor, Maltacom, Telesonique, Detecon, Apax Partners, Fay Ritchwhite/Berkshire Partners, Opin kerfi, Providence Equity, Schrodgers Ventures and Spectrum Equity.

On the basis of the Information Memorandum, seven parties submitted a non-binding offer or reacted by other means to the further progress of the offering process. These parties were: TeleDanmark, Telenor, Maltacom, Opin kerfi, Providence Equity, Schrodgers Ventures and Hringiðan.

Following proposals submitted by PwC, the Executive Committee on Privatisation decided to give three of these parties access to further information in order for them to take part in the next stage of the process, i.e. the submission of binding final offers. These investors were: TeleDanmark, Providence Equity and Maltacom. According to information from PwC, these three parties had all explained their plans and co-operation with other parties in such a way that it was regarded as certain that they fulfilled the conditions set for core investors in Iceland Telecom.

The deadline for submitting final offers expired at the close of 7 December 2001. Two offers were received, from TeleDanmark (TDC) and Providence. The offers addressed three issues, as provided for in the specification of the sale process, i.e. price, proposed focus of operation, and potential synergy effects of co-operation between Iceland Telecom hf. and other telecommunications companies. Following the receipt of the offers their substance was reviewed in consultation with PwC. In addition to the tenders, the Committee received letters from both parties. Even though the tender from TDC was in fact unacceptable, in the opinion of the Committee, it was nevertheless decided to attempt to enter into negotiations, as the information submitted justified such an attempt. The decision was made that negotiations should commence in January.

TDC's tender specified, on the one hand, the price to be paid for the shares in the prevailing circumstances, and, on the other hand, a detailed list of items requiring further discussion or clarification by the authorities. When tenders are submitted in transactions of this kind, they are rarely direct and unconditional as in the case of smaller and less complicated transactions.

XI

The first meeting with TDC took place in London on 8 and 9 January. The discussions were carefully prepared by PwC and conducted under their management. At the close of the meeting it was clear that there was a substantial gap in pricing ideas, taking into account the points laid down in TDC's tender. The representatives of the Executive Committee on Privatisation were not prepared to meet all the wishes of TDC regarding matters in the power of the government and relating to the Company and its operating environment. A careful study was carried out of the criteria underlying both parties' assessment of the share price. TDC was of the opinion that in order to raise the price that the company was prepared to pay for the shares, conditions would have to change and reference was made to the operating results of the year 2001 and the operating plans for the future. At that time it was already clear that there would be changes in these figures from previous projections as set out in the documents to which TDC had access. The decision was made to meet again when these figures were available but also to keep in touch until that time through PwC.

Little progress was made in the talks between PwC and TDC, which resulted in the decision in early February to investigate other possibilities. TDC was informed of this decision. The objective of this was, on the one hand, to investigate other possibilities by talking to the parties who had also shown an interest in purchasing shares in Iceland Telecom, i.e. Providence and possibly others. On the other hand, the objective was to underline for TDC, what had previously been outlined in the talks between the parties, that if the terms of the Government regarding price were not met, the shares would not be sold at this time.

In all the meetings held by the Executive Committee on Privatisation with potential investors, and in all the conversations held by PwC with parties showing an interest in the purchase of shares in the Company, it has been stated that the Icelandic government will not sell shares in Iceland Telecom at a price lower than 5.75, as there is an exhaustive appraisal of the Company to support this valuation. The State is not

compelled to sell and therefore deviation from this price is not an option. If the shares cannot be sold at an acceptable price, the State will continue to own them until conditions on the market improve.

XII

From the time that the Executive Committee on Privatisation chose to initiate negotiations with TDC until the decision was made to investigate other possibilities, it was known that Providence Equity was interested in exploring, through discussions with the Executive Committee on Privatisation, whether an agreement could be reached on their acquisition of the core investor's share. When TDC had been informed of the changed arrangement of talks, meetings were held with Providence, where the ideas on the sale by the state of shares in Iceland Telecom were examined. It had emerged previously that the company was willing to purchase a larger share than the shares offered, preferably a majority share.

Following detailed discussion with Providence it was clear that a conclusion acceptable to both parties would not be reached. Providence's idea was, *inter alia*, to purchase approximately 25% immediately and then have the option to purchase further shares at a higher price at a later date. When the figures were adjusted to net present value, however, it became clear that the discrepancy was too great. The talks were therefore ended.

A meeting was called with TDC on 22 February 2002, where the key indicators in the operating results of Iceland Telecom for the year 2001 were presented, together with a revised projection for the year 2002. The meeting revealed that there was still a substantial gap between the parties. The decision was made to have a telephone meeting at a later date and review the matter further, as a meeting of the Board of Directors on TDC had been scheduled where the matter would be examined further.

It has now become clear that no agreement will be reached between the State and TDC and the negotiations between the parties have therefore been formally terminated.

Reykjavík, 28 February 2002