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ICL Pathway Asset Co.

At our meeting last Friday, I promised to set out the choices open to ICL Pathway with respect to meeting its financing needs.

During the bid process, ICL made clear its intention, if successful, to finance the project using best PFI practice. At no stage did it signal that it might, or could, bankroll the project itself.

The terms of the Related Agreements render this contract unfinanceable in project finance terms. The Force Majeure provisions, corrupt gifts clause, tight termination review thresholds and lack of step-in rights for the lenders combine to create too great a theoretical exposure for the banking community to take on without substantial parent company guarantees.

After many months of testing those financing options which are open to us, we are now seeking agreement to a financing package which involves the creation of Asset Co.. This is a special purpose financing vehicle which benefits from certain undertakings by Fujitsu to the lenders. Having taken expert advice on a range of technical points, we consider that the package satisfies all the exacting provisions of the Related Agreements under all conceivable doomsday scenarios. We contend that it will result in BA/POCL being no worse off, and very probably better off, than under existing terms. We wish to proceed with those arrangements as speedily as possible in order that ICL Pathway can continue to finance the build phase of the programme.

Specifically, we are advised that the exclusive sales agency agreement backed by a security interest registered under Section 395 of the 1971 Power of Attorney Act *will* survive liquidation. That is the point of registration. We understand that you nonetheless wish to have a direct agreement between Fujitsu and the Authorities that it will not permit Asset Co. to be put into liquidation. Apart from our opinion that such a guarantee is unnecessary, we object on four grounds:

1. commercial interest: Fujitsu backing Asset Co. directly (as opposed to behind the scenes) would go against the fundamental commercial position which ICL has taken since the start of the bid process that either the Authorities would have to content themselves with an ICL plc guarantee (exception, if ICL's financial position worsens materially) or ICL would withdraw from the bidding. The direct agreement you seek (however limited in scope) breaks this rule and would serve to undermine ICL's commercial standing in the marketplace (and thereby destroy shareholder value).
1. commercial advantage: by backing Asset Co. and enabling a "ringfencing" of the project outside ICL's normal operations, Fujitsu is providing indirectly a separate source of

financial underpinning to ICL Pathway over and above the ICL plc parent company guarantee in respect of damages and over and above the capacity of ICL to support ICL Pathway through its own balance sheet. This underpinning is equivalent to a capital injection of £200m into ICL. The Authorities could not reasonably have expected this strengthening of ICL's ability to perform the services at the time when they contracted with ICL Pathway so it is unreasonable to demand that Fujitsu be further disadvantaged commercially as shareholders (as above).

1. comparative risk: the Authorities are already exposed to the risk of ICL Pathway's being put into liquidation whilst owning the assets (rendered less likely by the additional financial underpinning as above), or that of a leasing company owning the assets being put into receivership.
1. logic: because Asset Co. is obliged to pay 99.5% of any sales proceeds to ICL Pathway, the incentive for the receiver to seek a higher than contract transfer price from the Authorities is just 0.5%. The receiver would have to fight injunctions claiming prior claims on the assets and the rights to sell the assets, the legal and time costs of which would inevitably outweigh any conceivable 0.5% benefit should he fail in his bid to avoid the registered security interest. The risk of failure must be so high as to render the receiver either reckless or negligent if he were to pursue this course, which is not the way of receivers. The risk of this happening must therefore be minute.

ICL Pathway's options in the event we are unable to secure the Authorities' agreement are:

1. Sale and lease back: we hold that the Related Agreements entitle us to enter into such an arrangement without seeking any permissions. Whereas sale and lease back would therefore be the obvious course of action with respect to equipment, it does not yield sufficient funds to cover ICL Pathway's design and build costs including as they do software development, systems integration, systems test, roll out costs, ISDN line connections, training, customer education, etc., all of which are "soft" assets not amenable to a lease. However, it is a viable option. It would put ownership of the equipment into a leasing company which would not be subject to any parent company undertakings.
1. Go ahead with the proposed financing in the knowledge that assent had not been granted to these arrangements or to the subcontract assignments, risking termination for breach of contract: not an attractive option, but one which would, subject to termination, secure the PFI finances required to fund the design and build phases of the programme.
1. Rework the financing package: we have been round the options several times over the past year and consider this to be optimal. It is not clear how better we might satisfy the objections to the current scheme.
1. Escalate to Treasury/Ministers: this was billed as a PFI contract, yet the national security considerations running through the Related Agreements render it impossible to fund otherwise than on the service provider's own balance sheet. Having accepted that ICL's balance sheet would be sufficient at award stage, the effect of the Authorities rejecting our financing proposals would now be to demand direct recourse to Fujitsu's balance sheet. The implications of our not acceding are either that ICL will be forced to make cash savings in its normal business to fund this project, or else be unable to carry out its obligations under the Related Agreements. With such pressures being brought to bear, we would have little remaining option but to lobby Treasury for assistance. At stake is the preservation of a landmark PFI.

In summary, we believe that the proposed package provides improved security of asset tenure as compared with the leasing alternative. The aggregate value of financial underpinning for ICL Pathway is increased by £200m. Against these improvements, there is in our view a minute technical risk of Asset Co. liquidation for which there is absolutely no commercial incentive. This compares with an existing risk that ICL Pathway as owner of the assets *and* all of the operational and fraud risks could be put into liquidation.

We believe it is reasonable for us to expect the assent of the Authorities to proceed with the proposed financing package recognising that time is now of the essence for ICL Pathway.

Yours sincerely,

Tony Oppenheim
Director of Finance & Commerce

cc. Hamish Sandison, Bird and Bird