



Chapter A – Description of Corporation’s Operations

In this report, which contains a description of the Corporation’s business operations as at December 31, 2008, the Company has included forward-looking information, as defined in the Securities Law 5728-1968 (the Securities Law). Such information includes forecasts, targets, appraisals and assessments which apply to future events or matters the realization of which is not certain and is not under the Corporation’s control. Forward-looking information in this report will usually be identified specifically, or by employing statements such as “the Company expects”, “the Company assesses”, “it is the Company’s intention”, and similar statements.

Forward-looking information is not a proven fact and is based only on the Company’s subjective assessment, based, inter alia, on a general analysis of the information available at the time of drafting of this report, including public announcements, studies and surveys, and they contain no undertakings as to the correctness or completeness of the information contained therein, and the Corporation does not independently check the correctness thereof. The Company’s assessments vary from time to time, depending on circumstances.

In addition, the realization and/or otherwise of the forward-looking information will be affected by factors that cannot be assessed in advance, and which are not within the control of the Company, including the risk factors that are characteristic of its operations as set out in this report, and developments in the general environment, and external factors and the regulation that affects the Company’s operations, as set out in this report.

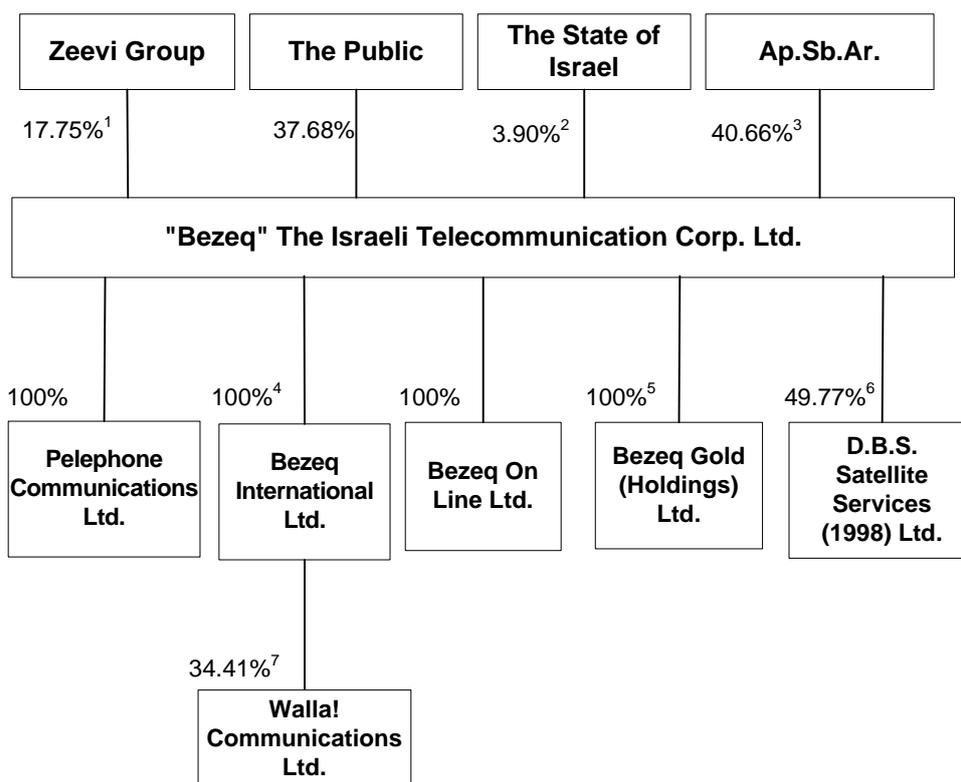
Bezeq The Israel Telecommunication Corporation Limited (the Company or Bezeq) along with the subsidiaries that it owns in whole or in part, whose financial statements are consolidated with the Company’s, shall be jointly referred to in this periodic report as the Group or the Bezeq Group.

1. Description of General Development of Group Operations

1.1 Group Activity and Description of its Business Development

- 1.1.1** As at the date of this periodic report, the Bezeq Group is the principal provider of communications services in Israel. The Bezeq Group implements and provides a broad range of telecommunications operations and services, including domestic fixed-line, cellular and international communication services, multi-channel television, satellite broadcasts, internet services, customer call centers, maintenance and development of communications infrastructures, provision of communications services to other communications providers, television and radio broadcasts, and supply and maintenance of equipment on customer premises (network end point – NEP – services).
- 1.1.2** The telecommunications sector is developing rapidly in global markets and in Israel. The telecommunications sector is affected by changes in technology, in relation to both the business structure of the industry and the applicable regulations.
- 1.1.3** The Company was founded as a government company in 1980 and has been privatized over a period of years. The Company became a public company in 1990 and its shares are traded on the Tel Aviv Stock Exchange.
- 1.1.4** Since October 11, 2005, the controlling shareholder of the Company is Ap. Sb. Ar. Holdings Ltd. (Ap. Sb. Ar.) which holds 40.66% of the shares in the Company (38.62% in full dilution) on March 23, 2009 after exercising an option to purchase 10.66% of the Company’s shares held by the State (see section 1.3.1 below).

The following chart describes the structure of shareholdings of the Company, and the Company's shareholdings in its principal subsidiaries and affiliates, as at March 22, 2009.



The holdings in the diagram above are correct as at the date of publication of this periodic report. As set out in section 2.9.6 below, the State issued the Company's employees with 122,697,648 options, exercisable for 122,697,648 of the Company's shares held by the State. Under an employee option plan (apart from members of senior management), the Company allotted 78,151,368 options, exercisable into 78,151,368 of the Company's shares,⁷ and as part of an options plan for senior managers and employees of the Group – 59,550,000 options (net, less expired options) exercisable into 59,550,000 of the Company's shares.

The following are details of the rates of holdings of the Company under full dilution, assuming exercise of all of the options allocated to the Group's employees and managers as at December 31, 2008 and March 23, 2009 .

¹ Of this, 17.63% are held by Zeevi Communications Holdings Ltd., to which a receiver has been appointed, with authority to exercise the rights flowing from the shares in accordance with the ruling and approval of the Court. 0.12% of the Company's shares are held by D.E. Dirot Elite Ltd.

² For the option granted to Ap. Sb. Ar. to purchase up to approximately 10.66% of the State's shares, see section 1.3 below; for the options to employees for the State's shares in the Company, see section 2.9.6.1 below.

³ The shareholders in Ap. Sb. Ar. are 1. SCG Israel Ventures LLC (capital 45%, voting 40.5%), controlled by private companies controlled by Haim Saban; 2. Purple Green Project and Investment Co. Ltd. together with Yellow Green Financing and Investment Ltd. (jointly: capital 45%, voting 40.5%), indirectly wholly owned (100%) by corporations in the Apax Europe VI Fund, managed by Apax Europe Managers Ltd. 3. Arkin Communications Ltd. (capital 10%, voting 19%), which is wholly owned (100%) by Moshe Arkin.

⁴ A company whose only activity is to hold series 5 debentures of the Company (see section 2.13.7 and 2.17.1 below)

⁵ As of the date of publication, the Company has option warrants which afford it the right to increase its holdings in DBS to approximately 58.36% (see section 1.1.5(A) below).

⁶ 34.25% as at December 31, 2008 and 32.42% in full dilution

⁷ Of this amount, 59,574 options were allotted to two employee-directors.

Shareholders	Percentage of holdings		
	As at December 31, 2008	As at March 23, 2009	Fully diluted
Ap. Sb. Ar.	40.66%	40.66%	38.62%
State of Israel	4.38%	3.90%	0.96%
Zeevi Group	17.75%	17.75%	16.86%
The Public	37.21%	37.68%	43.56%

1.1.5 **Mergers and acquisitions**

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

On August 2, 2006, the Company and DBS submitted merger notices to the Antitrust Commissioner regarding the exercise of options for DBS's shares by the Company, which, if exercised, will increase the Company's holdings in DBS from 49.8% to 58%. On December 31, 2006, the Antitrust Commission gave notice of the Antitrust Commissioner's objection to the merger and on May 15, 2007, the Company appealed the decision.

On February 3, 2009, the Antitrust Tribunal approved the merger under terms that are subject to approval by the Company within three months. The Antitrust Authority and Eurocom DBS Ltd. (a shareholder in DBS) appealed the Tribunal's ruling. In addition, after the Antitrust Authority's request to delay implementation of the ruling was denied by the Antitrust Tribunal and an additional request to delay implementation was filed with the Supreme Court, the parties reached an agreement, at the request of the Supreme Court, which received the effect of a ruling, whereby at this stage, implementation of the merger would be delayed. A hearing of the appeals was set for the first week of June 2009.

For additional details regarding the Company's investment in DBS, see also Note 33 to the Company's financial statements for the year ended December 31, 2008, included in this periodic report.

1.1.6 **Disposals**

Satellite communication operations

On March 26, 2008, the Company signed an agreement with RRsat Global Communications Network Ltd., a company registered in Israel whose shares are traded on the NASDAQ in the USA. The agreement was for the sale of the Company's satellite communications operations (Inmarsat and Bezeq Sat) and assets relating to such operations, including the satellite communications site at the Ella Valley. Under the agreement, the operations are to be sold in consideration for the total NIS equivalent of US \$15 million plus VAT, subject to price adjustments. Completion of the transaction was subject, inter alia, to regulatory approvals and on November 4, 2008, the transaction was completed after the fulfillment of all the conditions required for its completion, including the receipt of the regulatory approvals. The Company recorded a capital gain of approximately NIS 50 million for this transaction (gross, before tax) in its financial statements for the year ended December 31, 2008.

1.2 **Areas of Operation**

The Group has four principal areas of operation. These four areas of operation are reported as business segments in the Company's consolidated financial statements (see also Note 28 to the Company's financial statements for the year ended December 31, 2008, included in this periodic report).

1.2.1 **Domestic fixed-line communications**

This segment primarily includes the Company's operation as a domestic operator, including telephony services, internet services, transmission services and data communications.

1.2.2 **Cellular Radio Telephone (MRT)**

Cellular mobile radio-telephone services (cellular communications), marketing of end-user equipment, installation, operation and maintenance of cellular communications equipment

and systems. These operations are performed by Pelephone Communications Ltd. (Pelephone).

1.2.3 International communications, internet services and NEP

International communications services, internet access (ISP) services, and NEP services. These operations are carried out by Bezeq International Ltd. (Bezeq International). Bezeq International also holds 34.25% (32.42% fully diluted)⁸ of Walla! Communications Ltd., an Israeli company whose shares are listed on the Tel Aviv Stock Exchange and which provides internet and portal services (see section 4.14 below).

1.2.4 Multi-channel television

Multi-channel digital television broadcasts to subscribers over satellite (DBS) and provision of value-added services to subscribers. This operation is carried out by DBS Satellite Services (1998) Ltd. (DBS).

Note that there is another sector of operations headed "Other", which, from the financial statements of 2007, mainly include customer call center services (through the subsidiary Bezeq Online Ltd.) and investment in a venture capital fund. This sector is not substantial on the Group level.

1.3 Investments in Equity and Share Transactions

1.3.1 In 2005, the State of Israel completed proceedings for the sale of its control core of the Company to Ap. Sb. Ar. In this context, the State sold to Ap. Sb. Ar., by way of private sale, 30% of the share capital of the Company (held in trust by Romema Investment Company Ltd.), and granted Ap. Sb. Ar. options to purchase an additional 10.66% of the share capital of the Company.

On September 25, 2008, Ab. Sb. Ar. acquired 277,697,862 ordinary shares of the Company from the State by fully exercising these options. The consideration for the option exercise is NIS 1.08 billion. Per Ap. Sb. Ar.'s request, ownership of the acquired shares is registered in the name of the trust company (Romema Trust Ltd.). As a result of the exercise of options, Ap. Sb. Ar.'s holding in the Company increased to 40.66% (38.62% fully diluted) and the State's holding declined as a result to 4.95% (0.96% fully diluted). From that date onwards, the State ceased to be an interested party in the Company by virtue of its holdings.

Note that Ap. Sb. Ar. has undertaken to the Company that during the four years following the date of execution of the new collective agreement of December 5, 2006 (see sections 2.9.1 and 17.4(F) below), Ap. Sb. Ar. will not purchase shares in the Company that will result in a holding for Ap. Sb. Ar. of more than 90% of the share capital of the Company, and shall not respond to a full sale offer. This undertaking is noted in the collective agreement signed on December 5, 2006 (see section 2.9.1 below).

1.3.2 Employee option plans

As at the date of publication of this periodic report, there are three option plans for shares of the Company:

- A. An employee option plan of 2005, in which employees of the Company were offered up to 122,697,648 options for shares of the Company held by the State of Israel.
- B. An employee option plan of 2007, in which the Company allotted 78,151,368 options for shares of the Company to its employees.
- C. An options plan for managers and senior employees of the Group, of November 2007, for the allotment of up to 65,000,000 options for shares of the Company to senior managers and employees of the Company and its affiliates (the general meeting approved the issue of the options under this plan on January 31, 2008). Of this sum, as at the date of this periodic report, 59,550,000 options were allotted (net, less options that vested).

For further details regarding the above compensation, see section 2.9.6 below.

⁸ See footnote 6 above.

1.4 Payment of Dividends

- 1.4.1 Pursuant to a resolution of the board of directors on March 1, 2006, resolutions regarding the distribution of dividends are to be passed specifically in accordance with the Company's financial results, financial state and the other relevant circumstances and data.
- 1.4.2 Below are details of distributions made by the Company in 2007-2008 and up to the date of publication of this periodic report

Date of distribution	Type of distribution	Total distributed amount (NIS millions)	Distributed amount per share (NIS)
January 9, 2007	Cash dividend	300	0.1151612
February 26, 2007	Cash dividend ⁹	1800	0.6909668
October 15, 2007	Cash dividend	760	0.2917415
April 28, 2008	Cash dividend	679	0.260648
October 29, 2008	Cash dividend	835	0.3205318

In addition, on March 23, 2009 the Board of Directors of the Company resolved to recommend to the general meeting of shareholders of the Company to distribute a cash dividend to shareholders in the amount of NIS 792 million.

1.4.3 Distribution of a cash dividend not in accordance with the earnings test

On December 28, 2006, the general meeting of the Company's shareholders approved the recommendation of the board of directors of the Company to distribute a cash dividend of NIS 1,800,000,030 (amounting to NIS 0.6909668 per share), as a distribution which does not comply with the earnings test. The court approved the distribution on February 4, 2007, and the distribution was made on February 26, 2007.

- 1.4.4 It is noted that under the agreement between the State and Ap. Sb. Ar. for the sale of the controlling interest in the Company, Ap. Sb. Ar. undertook, inter alia, to operate by virtue of its holdings in a way that it would not make a distribution from the Company's accumulated retained earnings on December 31, 2000 (it was clarified that this would not prevent the distribution of earnings generated after December 31, 2000 in accordance with the Companies Law, 5759-1999).

⁹ Distribution of a cash dividend not in accordance with the earnings test. See section 1.4.4 below.

1.5 Financial Information Regarding Areas of Group Operations

1.5.1 2008

	Domestic fixed-line communications	Cellular	International communications, internet services and NEP	Multi-channel television	Other	Adjustments to consolidated *	Consolidated
	<u>NIS millions</u>	<u>NIS millions</u>	<u>NIS millions</u>	<u>NIS millions</u>	<u>NIS millions</u>	<u>NIS millions</u>	<u>NIS millions</u>
Total revenue:							
From externals	5,179	4,448	1,243	1,506	31		12,407
From other areas of operations in the group	319	265	63	7	44	(698)*	
Total	5,498	4,713	1,306	1,513	75	(698)	12,407
Total attributed costs							
Costs not constituting revenues in another area of operation	3,743	3,614	928	1,222	73	10	9,590
Costs constituting revenue from other areas of operation	280	166	136	114	2	(698)*	
Total	4,023	3,780	1,064	1,336	75	(688)	9,590
Operating profit	1,475	933	242	177	-	10	2,817
Total identifiable assets as at December 31, 2008	7,325	4,641	947	1,129	51	(181)*	13,912
Minority percentage in the segment					28.19%		

* Details of the nature of the adjustments to the consolidated – transactions between areas of activity

1.5.2 **2007**

	Domestic fixed-line communications	Cellular	International communications, internet services and NEP	Multi-channel television	Other	Adjustments to consolidated *	Consolidated
	<u>NIS millions</u>	<u>NIS millions</u>	<u>NIS millions</u>	<u>NIS millions</u>	<u>NIS millions</u>	<u>NIS millions</u>	<u>NIS millions</u>
Total revenue:							
From externals	5,373	4,380	1,226	1,403	18	-	12,400
From other areas of operations in the group	340	304	78	12	46	(780)	-
Total	5,713	4,684	1,304	1,415	64	(780)	12,400
Total attributed costs							
Costs not constituting revenues in another area of operation	4,102	3,711	960	1,228	63		10,064
Costs constituting revenue from other areas of operation	332	168	140	139	1	(780)	
Total	4,434	3,879	1,100	1,367	64	(780)	10,064
Operating profit	1,319**	805	204	48	-		2,376**
Total identifiable assets as at December 31, 2007	7,756**	4,290	837*	1,097	59	(229)**	13,810 **
Minority percentage in the segment					17.5%		

* Details of the nature of the adjustments to the consolidated – transactions between areas of activity

** Reclassified

1.5.3 **2006**

	Domestic fixed-line communications	Cellular	International communications, internet services and NEP	Multi-channel television	Other	Adjustments to consolidated *	Consolidated
	<u>NIS millions</u>	<u>NIS millions</u>	<u>NIS millions</u>	<u>NIS millions</u>	<u>NIS millions</u>	<u>NIS millions</u>	<u>NIS millions</u>
Total revenue:							
From externals	5,514	4,141	1,219	1,339	19		12,232
From other areas of operations in the group	285	337	82	23	37	(764)	-
Total	5,799	4,478	1,301	1,362	56	(764)	12,232
Total attributed costs							
Costs not constituting revenues in another area of operation	4,670**	3,625	1,090	1,209	54		10,648**
Costs constituting revenue from other areas of operation	364	161	92	145	2	(764)	
Total	5,034**	3,786	1,182	1,354	56	(764)	10,648**
Operating profit	765**	692	119	8			1,584**
Total identifiable assets as at December 31, 2006	9,837	3,717	784**	1,008	47	(214)**	15,179**
Minority percentage in the segment							

* Details of the nature of the adjustments to the consolidated – transactions between areas of activity

** Reclassified

1.5.4 **Principal results and operational data**

A. Bezeq Fixed-Line (the Company's activity as domestic operator) (NIS millions except where stated otherwise)

	2008	2007	Q4 2008	Q3 2008	Q2 2008	Q1 2008	Q4 2007	Q3 2007	Q2 2007	Q1 2007
Revenue	5,498	5,713	1,348	1,388	1,354	1,408	1,453	1,425	1,393	1,442
Operating profit	1,475	1,319*	257	422	428	368	380*	327	243	369
Depreciation and amortization	852	941	209	214	211	218	232	236	236	237
EBITDA	2,327	2,260*	466	636	639	586	612*	563	479	606
Investment in property, plant & equipment and intangible assets	616	504	170	156	132	158	141	149	101	113
Proceeds from sale of property, plant & equipment	117	153	20	12	25	60	23	16	96	18
Number of active subscriber lines at end of period	2,615	2,761	2,615	2,645	2,681	2,711	2,761	2,767	2,778	2,798
Average monthly revenue per line (NIS) (1)	83	87	82	85	82	84	86	86	86	89
No. of outgoing minutes (in millions) (2)	13,439	14,869	3,154	3,428	3,346	3,511	3,653	3,760	3,654	3,802
No. of incoming minutes (in millions) (3)	6,691	6,411	1,648	1,719	1,651	1,673	1,661	1,651	1,553	1,545
No. of ADSL subscribers at end of period (in thousands)	1,005	963	1,005	994	982	970	963	942	924	912
Average monthly revenue per ADSL user (NIS) (4)	67	64	67	68	66	68	69	64	62	62

* Reclassified

- (1) Not including revenue from data transmission and communication services, internet services, services to communication operators, contract work and other revenue. In this section, there were minor adjustments in the prior quarters due to retroactive classifications and changes in revenue.
- (2) Outgoing minutes were updated retroactively to exclude the number of direct dial internet calls and calls of Bezeq's operational lines.
- (3) Incoming minutes were updated retroactively to include the number of international calls.
- (4) The average monthly income for ADSL subscribers was updated retroactively to include revenue from equipment.

B. Telephone

(NIS millions except where stated otherwise)

	2008	2007	Q4 2008	Q3 2008	Q2 2008	Q1 2008	Q4 2007	Q3 2007	Q2 2007	Q1 2007
Revenue	4,713	4,684	1,138	1,214	1,188	1,173	1,182	1,203	1,152	1,147
Operating profit	933	805	159	293	266	215	133	219	240	213
Depreciation and amortization	523	478	135	129	130	129	125	121	115	117
EBITDA	1,456	1,283	294	422	396	344	258	340	355	330
Net profit	682	585	128	211	180	163	104	154	173	154
Cash flow from current operations *	1,277	1,228	298	379	344	256	245	387	241	355
Investment in property, plant & equipment and intangible assets	798	381	163	350	182	103	120	81	117	63
Proceeds from sale of property, plant & equipment	3	5	1	-	1	1	3	-	-	2
No. of subscribers at end of period (in thousands)	2,649	2,622	2,649	2,698	2,636	2,595	2,622	2,560	2,513	2,478
Average monthly minutes of use (MOU) per subscriber	352	354	335	359	358	355	358	363	350	344
Average monthly revenue per ADSL subscriber (NIS)	126	131	122	129	128	126	130	135	129	132
No. of subscribers at end of period (in thousands)	1,151	749	1,151	1,068	977	867	749	607	471	358
Revenue from value added services and content, of revenues from cellular services (%)	16.3%	12.7%	18.4%	16.2%	15.5%	15.0%	13.6%	12.8%	12.5%	12.0%

* From the fourth quarter of 2008, interest and dividends received were reclassified from cash flow from operating activities to investment activities. The data was adjusted retroactively.

C. Bezeq International

(NIS millions except where stated otherwise)

	2008	2007	Q4 2008	Q3 2008	Q2 2008	Q1 2008	Q4 2007	Q3 2007	Q2 2007	Q1 2007
Revenue	1,306	1,304	337	329	326	314	334	326	321	323
Operating profit	242	204	65	59	63	55	45	54	54	51
Depreciation and amortization	80	87	20	20	20	20	21	21	22	23
EBITDA	322	291	85	79	83	75	66	75	76	74
Net profit	178	153	46	44	47	41	38	39	39	37
Cash flow from operating activities *	163	93	72	32	51	8	30	33	32	(2)
Investment in property, plant & equipment and intangible assets	118	104	26	33	31	28	36	29	18	21
Proceeds from sale of property, plant & equipment	1	4	1	-	-	-	2	2	-	-

From the fourth quarter of 2008, interest and dividends received were reclassified from cash flow from operating activities to investment activities. The data was adjusted retroactively.

** This item also includes long-term investments in assets

D. DBS

(NIS millions except where stated otherwise)

	2008	2007	Q4 2008	Q3 2008	Q2 2008	Q1 2008	Q4 2007	Q3 2007	Q2 2007	Q1 2007
Revenue	1,513	1,415	377	375	380	381	347	360	354	354
Operating profit	177	56	56	52	43	26	4	(4)	31	25
Depreciation and amortization	250	273	66	59	60	65	70	66	69	68
EBITDA	427	329	122	111	103	91	74	62	100	93
Net profit (loss)	(265)	(118)	(18)	(82)	(99)	(66)	(75)	70	(65)	(48)
Cash flow from operating activities	347	250	134	97	32	84	76	56	25	93
Investment in property, plant & equipment and intangible assets *	238	255	63	56	40	79	81	84	45	45
Proceeds from sale of property, plant & equipment	-	-	-	-	-	-	-	-	-	-
No. of ADSL subscribers at end of period (in thousands)	560	549	560	556	551	549	549	545	543	542
Average monthly revenue per subscriber (NIS)	228	217	225	226	230	231	212	220	218	218

* This item also includes investments in the cost of acquiring subscribers.

1.6 Forecast for the Group

As the challenges facing the global economic environment have translated into a slowdown in the Israeli economy, Bezeq is monitoring the potential impacts on its business on an ongoing basis. Despite this challenging economic backdrop, in 2009 we aim to maintain EBITDA, operating cash flows and gross capital expenditures close to those of full year 2008 performance levels. This forecast is underpinned by the strength of Bezeq's comprehensive consumer and business communications offerings, a strict focus on improving operating efficiencies and strong operating cash flows. With specific regards to gross capital expenditures, 2009 will reflect continuing investment in Pelephone's HSPA network investment, which was successfully launched with national coverage at the end of January 2009, and the modular deployment of Bezeq's Next Generation Network (NGN), expanding its coverage to reach a meaningful part of Israeli households during 2010.

The information in this section contains forward-looking information, based on the Company's assessments. Actual results might be substantially different from these assessments, taking into account the changes that might occur to commercial conditions, and the possible impact of regulatory decisions.

1.7 General Environment and Effect of External Factors on the Group's Activities

The Group's business is affected by the level of the financial activity in the domestic market and therefore, positive or negative developments at this level are expected to have a corresponding impact on the business of the Group.

The Israeli communications market is characterized by a high level of concentration and a complex structure of cross-ownerships which are a fertile ground for the setting up of a number of communications groups operating on the basis of marketing cooperation between a number of companies and/or joint holdings for the supply of inclusive communications services, while using the marketing and operating advantages that such a structure permits. Given the regulatory limitations imposed at present upon the Group in the context of generation of cooperation between all of the companies in the Group, the Group is having difficulty providing an appropriate response to threats stemming from the increasing competition on the part of the other communications groups.

Global economic crisis

In the last quarter of 2008, the global economic crisis has sent global markets into a recession and credit crunch. It is expected that the impact of the process will continue to be felt in 2009 and possibly even later, and there will be a transition from growth to recession. The local market is also expected to experience a significant slump together with a deterioration in business operations and central economic parameters. The Company estimates that the crisis could have an adverse effect on its operations, however at this stage, it is unable to assess the impact of the crisis on the Group's operations. The Group is closely following the economic situation and the changes in its performance so that it will be able to provide a timely and optimum response to changes.

This information contains forward looking statements, based on the Company's assessments. The actual results may differ materially from these assessments if there is a change in any of the factors taken into account in these assessments.

2. Domestic Fixed-line Communication –

Bezeq The Israel Telecommunication Corporation Limited (the Company)

2.1 General Information on the Area of Operations

2.1.1 Structure of area of operations and changes therein

The Company has a general license for the provision of domestic fixed-line communication services. The Company's services include telephony, broadband internet access (ADSL), home networks, transmission, information and data communication, IP-VPN, remote access, and maintenance and development of infrastructure. Other operations include the establishment and operation of broadcast facilities for radio and television transmissions, laying and maintenance of television cables, sale of terminal equipment, billing and collection services and other services to other communications operators, and IP Centrex. The telecommunications sector is developing rapidly in global markets and in Israel. The sector is affected by changes in technology, in relation to both the business structure of the industry and the applicable regulations.

2.1.2 Statutory restrictions and special constraints

The Company's activity is subject to comprehensive regulation and control that relate, inter alia, to matters such as determining and approving the fields of the Company's permitted activity and services, holding and transferring means of control, licensing, determining tariffs, quality and terms of service to subscribers and obligation to pay royalties. These regulations and controls are attributable to the status of the Company as a licensee under the Communications (Telecommunications and Broadcast) Law, 5742-1982 (the Communications Law), and are subject to the provisions of the Communications Law as well as the regulations and rules that have been promulgated there under, and the terms of its general license. The Company's status as an essential telecommunications service provider is subject to the provisions of the Communications Order based on section 4(D) of the Communications Law and other laws.

The tariffs for the Company's main activities are subject to strict regulation under various provisions of the law. The tariffs are updated and change from time to time in regulations, inter alia, according to recommendations of the Committee for the Regulation of Bezeq's Tariffs. The tariffs were recently amended on June 1, 2008. The Company's interconnect tariffs were reduced as of June 11, 2008 (see section 2.16.1).

The Company was declared a monopoly in its main fields of activity, and is also subject to control and restrictions under the Antitrust Law, 5748-1988.

Furthermore, some of the Company's activities involve the use of wireless frequencies and the operation of devices emitting electromagnetic radiation, which are subject, respectively, to the Wireless Telegraph Ordinance (New Version), 5732-1972 (see section 2.16.8 below), the Non-Ionized Radiation Law, 5766-2005 (see section 2.15 below) and National Outline Plan 36 and National Outline Plan 56 (see section 2.16.11 below).

2.1.3 Changes in the volume of operation and profitability in the sector

See section 1.5.4(A) above.

2.1.4 Developments in the market and in customer attributes

In recent years, competition between fixed-line and cellular telephony has intensified. In the past, almost all calls were made between two fixed lines, however today, in the Company's assessment, more than two-thirds of calls are made over cellular networks. The number of cellular subscribers has grown and reached approximately 9.1 million subscribers (according to data published by the cellular companies), while there has been a decline in the number of households and businesses holding a fixed line as well as a decline in the number of lines per customer. Furthermore, there has been an ongoing average decline in the Company's regulated and unregulated tariffs (see section 2.16.1 below). For a description of the development of competition in domestic fixed-line communications, see section 2.6 below.

2.1.5 Technological changes that materially impact the area of operation

- A. Penetration of broadband internet and the availability of new IP-based technologies offer consumers a wide variety of applications and services over IP-based infrastructures, such as voice, video streaming and network with web-based organizational applications (such as ERP and CRM).

In recent years, bandwidths to the customer home or business have been increasing, allowing penetration of applications required for high-volume data streaming at a fast rate as well as voice services for regular phone calls over the internet and/or IP networks. For a description of competition through the provision of telephony over the Company's broadband network (VoB), see section 2.6.1 below. Given this trend, the Company is adapting its infrastructures to allow it to provide its customers with significant bandwidths. For a description of the new generation network (NGN), see sections 2.6.7 and 2.7.2.

- B. The increase in the number and capacity of cellular networks, along with technological enhancements, enable cellular service providers to compete with the Company's services more effectively in comparison to existing technologies.
- C. In addition, wireless technology (such as WiMAX) allows the supply of services that compete with the Company's services, in the area of voice calls as well as data communications and broadband internet, without the need to invest heavily in land-based access infrastructure.
- D. Technological developments may enable other operators to build networks that provide services similar to those offered by the Company, at lower cost. Furthermore, as a result of the advances in technology on the one hand, and the aging technology implemented in the Company's systems, which may be difficult for suppliers to support, on the other hand, it may be necessary to switch to other technologies or to improve the existing systems.

2.1.6 Critical success factors in area of operations and changes therein

- A. Regulatory decisions.
- B. The ability to offer reliable communication systems at a competitive price based on a cost structure that is adjusted to the frequent changes in the Company's business environment.
- C. The ability to maintain innovation and technological leadership, and to translate those into advanced, reliable applications of value to customers, within short response times.
- D. Technological and marketing innovation.
- E. Efficacy of internal and external sales systems and distribution channels.
- F. The ability to provide high quality commercial and technical service to customers of the Company.
- G. Management of an intelligent price policy, subject to regulatory limitations, in view of growing competition and technological changes that are reflected in generally lower prices in the industry.
- H. Intelligent migration of customers from traditional networks to next-generation networks.
- I. Maintaining brand values and adjusting them to the changing competitive environment.

2.1.7 Main entry and exit barriers for the area of operations and changes therein

Traditionally, the main entry barrier in the domestic fixed-line communications market is attributable to the need for substantial investments in technological infrastructure and complementary systems until economies of scale are achieved, and from the high costs involved in establishing marketing, sales and customer support systems and the construction of brands. In recent years, the traditional entry barriers to the Company's areas of activity have been to a great extent removed, as a result of technological improvements, reduction of infrastructure and equipment prices, the regulatory relief given to new competitors, and the ability to exploit existing systems, including the Company's

network (inter alia due to regulatory decisions) by competing communications operators or operators intending to compete with the Company.

Regulation of VoB-based competition (and in the future, to the extent possible, competition based on regulations for sub-loop unbundling and wholesale services) significantly reduces investments by the Company's competitors and thus reduces the entry barriers to competition in the telephony sector.

The main exit barriers are attributable to the following: the obligation of the Company, as stipulated in its license, to provide services at a defined quality of service on a universal basis; its being subject to the emergency regulations and the provisions of the Communications Order based on section 4(D) of the Communications Law; the obligation to some of its employees as part of collective agreements; long-term agreements with infrastructure providers; large investments requiring a long time to return on investment; and an obligation to repay long-term loans taken to finance the investments.

2.1.8 Substitutes and changes in products in the sector

In recent years, cellular communication services have largely become an alternative to services offered by the Company, in telephony as well as data communications.

There is also a growing trend of streaming voice over the internet or over public and private IP-based networks, using dedicated software provided free of charge or at a discounted price by companies in Israel and abroad. Furthermore, the internet enables email applications and instant messaging, which to a certain extent are also alternatives to telephone calls.

In the area of data transfer and communication services, technological advances enable the provision of new high-speed services at low prices.

2.1.9 Competitive environment and changes therein

The data transfer and communications sector, particularly at high band rates, was opened to competition at the end of 2000.

In the broadband internet sector, cable company partnerships began to compete against the Company in March 2002.

In the field of telephony, HOT Telecom, a partnership of the cable companies (HOT or HOT Telecom) started to provide services on a commercial basis on November 25, 2004. A number of companies were also given special general licenses for the provision of domestic fixed-line communications services, without an obligation to provide services to everyone. Additionally, the Company views cellular telephony services as an alternative to the telephony services it provides.

Competition in the sector is dependent on a variety of factors, including provision of licenses to other domestic operators; possible changes to conditions of the licenses of the Company and the subsidiaries, and conditions of the licenses of their competitors; mergers and joint ventures between companies in competition with companies in the Group; financing universal service; the new services that the Company is permitted to offer; tariff policy and the level of flexibility available to the Company in offering service packages, including with subsidiaries.,

For a description of developments in competition, see section 2.6 below.

2.2 Products and Services

2.2.1 The Company provides a wide range of communications services to business and private customers. The main services offered by the Company include telephony, associated and value-added services, internet access, data transfer and communications over a wide range of infrastructures for businesses and other communication operators.

2.2.2 Telephony

The Company's telephony services include, mainly, basic telephone services via household telephone lines, installations and transfers of telephone lines, sale of terminal equipment and other auxiliary services such as voice mail, caller ID, 144 information service, call waiting, follow-me, speed dialing and conference calls.

Furthermore, the Company provides number services for businesses that enable incoming calls from anywhere through a single short speed dial (asterisk plus four digits), and via the 1-700, 1-800 area codes. These area codes enable business customers to determine whether the company or the customer will pay for the call. On April 7, 2008, the Ministry of Communications published a draft amendment to the license and service file of the toll free service (1-800). The significance of the amendment is, inter alia, that the Company's 1-800 subscribers will pay the cellular companies a much higher tariff for calls made to them from the cellular network. On May 6, 2008, the Company submitted its comments on this amendment to the Ministry of Communications. On November 26, 2008 the Ministry of Communications received a revised draft incorporating some of the Company's comments, including a more moderate increase paid by the 1-800 subscriber to the cellular operator. On December 17, 2008, the Company submitted its response to this draft.

The Company currently operates approximately 12,500 public telephones around the country that are operated by prepaid cards (Telecard), billing a Bezeqcard or calling collect. In 2005, draft regulations were compiled, designed to ease the obligation of deployment of public telephones, however the draft was not approved by the Knesset Economics Committee, which resolved that the Ministry of Communications should submit a revised draft. As at the date of publication of this periodic report, the Company is not aware as to whether an amended bill has been submitted by the Ministry of Communications, however to the best of its knowledge, the Ministry of Communications intends to start working anew in this regard.

Under the amendments to the license, commencing February 8, 2007, the Company is required to provide, itself or through another entity acting on its behalf, a telephone number information service for all subscribers of a fixed-line or cellular operator, with the exception of unlisted numbers, for the public and without payment via the internet and for its subscribers at a reasonable price through a service center. Since February 8, 2007, the Company has operated a unified service center, by a network code set by the Ministry of Communications (1344), including for the cellular operators and for HOT. This is in addition to the Company's 144 service.

Following the Company's application filed for the sake of caution, on August 12, 2008, the Antitrust Commissioner granted the Company an exemption from obtaining the approval of the Antitrust Tribunal for a restrictive agreement to operate a telephone and online information service shared by all companies holding a domestic operator or cellular license. The exemption was granted under conditions and for three years.

The Company's telephony services are among the main services provided by the Company, and in recent years they have been on a downward trend, in terms of both use and revenues. This is mainly due to the telephony services offered by competing domestic communications operators and alternative services provided by the cellular companies, since use of cellular phones is, to a great extent, an alternative to making a call on a fixed-line phone.

As part of the Company's marketing strategy, it is acting to develop and introduce new services in both the private and business sectors. The Company intends to continue launching additional products, in accordance with market trends and customer needs.

2.2.3 Internet access services

These services enable access to the internet and are in principle high speed internet services using ADSL technology

At the end of 2008, the Company had approximately 1,005,000 ADSL subscribers (compared to approximately 963,000 subscribers at the end of 2007), amounting to approximately 60% of the broadband internet market in Israel (based on items in the Israeli media regarding the number of subscribers who are not subscribers of the Company). For changes in the number of the Company's ADSL subscribers and average monthly revenue per ADSL subscriber, see section 1.5.4(A) above.

The high speed internet market is one of the markets that has shown the most growth in recent years, and this growth is reflected in the Company's business. As hundreds of thousands of customers have subscribed to high speed internet services over the past five years, this service has become one of the Company's main operations and a major channel for its investments in technology, marketing, advertising and customer acquisition.

The high speed internet market is also marked by fierce competition against HOT, which offers high speed internet services over cable.

The Company's service portfolio regarding high-speed access service via ISP has been amended so as to enable broadband access to internet service providers (ADSL) without such supply being conditional upon the purchase of a basic telephone subscription (ADSL only). Payment for the ADSL-only service is prescribed by the Company, in accordance with section 17 of the Communications Law. According to the Ministry's decision, the Company started to supply the service on May 15, 2008.

2.2.4 Transmission and data communication services

Data communications services are network services for point-to-point transfer of data over the Company's infrastructures, transfer of data between computers and various communications networks, services to connect communications networks to the internet and remote access services.

Data communication services are provided over established traditional infrastructures such as digital and frame relay lines, on ATM infrastructure and on innovative and advanced infrastructures such as Metro Ethernet and IPVPN (Virtual Private Network). The IPVPN infrastructure enables managed communications solutions for businesses by connecting the various branches of the organization. Metro Ethernet infrastructure enables the supply of communication infrastructure with Ethernet technology for services in the business and private sector. In recent years, customers have been switching from data communication solutions provided over older traditional infrastructures to IP-based infrastructures and Ethernet.

The Company offers transmission services, including high speed services, to its business customers and communication operators over a variety of protocols (see section 2.6.3 below).

2.2.5 Other services

A. Services to communication operators

The Company provides services to other communication operators, including cellular, international, NEP and domestic operators, cable broadcasting licensees, ISPs, and Palestinian Authority communication providers.

The Company's services include infrastructure, connection to the Company's network, transmission, billing and collection, rental of space and rights of use at the leaseholds, and rights of use for seabed cables.

B. Broadcasting services

The Company operates and maintains radio networks operated, inter alia, by the Israel Broadcasting Authority, television transmitters of Channel 1, Educational Television, Channel 2 and regional radio stations. The Company is only responsible for operation and maintenance of the transmitters for distribution of radio and television broadcasts and not for the content of the broadcasts. In this regard see also section 2.15.1 above.

C. Contract work

The Company performs setup and operation work on networks and sub-networks for various customers (such as the Ministry of Defense, HOT, radio and television broadcasting companies, cellular and international communication operators, local authorities, municipalities and government agencies).

The Company and HOT have agreements for the provision of installation and maintenance services of cable networks, on the Company's infrastructure, from the starting point of the licensees' operating point, up to the point of delivery at the entrance to subscribers' homes. The connection and maintenance from these points up to the subscribers' homes is not within the Company's responsibility.

D. IP Centrex

The IP Centrex service is a virtual private exchange service.

E. Data Center

At the beginning of 2008, the Company launched its Data Center project, which enables provision of a total solution for customers, including in aspects of backup and survivability of services.

2.3 Revenue and Profitability of Products and Services

The following table provides data on the breakdown of the Company's revenues by the main products and services in its area of activity, which represent 10% or more of the Company's revenues (in NIS million and as a percentage of total revenues) over the past two years:

	2008		2007		2006	
	NIS millions	% of revenue	NIS millions	% of revenue	NIS millions	% of revenue
Telephony	3,572	65%	3,905	68%	4,148	72%
Internet	790	14%	712	13%	608	10%
Data transmission and communications	811	15%	754	13%	711	12%
Other services	325	6%	342	6%	332	6%
Total	5,498	100%	5,713	100%	5,799	100%

For updates of the information about the distribution of the Company's revenue by products and services, see Note 32 (G) to the Company's financial statements for the year ended December 31, 2008.

2.4 Customers

2.4.1 The Company is not dependent on any single customer or on a limited number of customers, which if lost would significantly affect the area of activity.

2.4.2 The Company does not have any single customer generating revenues of 10% or more of its total revenues.

2.4.3 Company sales are divided into two main sectors: the private sector (approximately 60%) and the business sector (approximately 40%). This division is based on revenue.

2.5 Marketing, Distribution and Service

2.5.1 The Company has marketing, sales and service systems for the private and business sectors, which include customer managers for the business sector, joint sales and service centers (including the 199 center) located throughout the country, technical support centers for private and business customers and 17 points of sale and service (the Bezeq Store network) around the country.

2.5.2 The Company markets its services mainly through advertising in the mass media and telesales centers, customer representatives and through a system of independent marketers including ISPs, DBS, sales centers working on an outsourcing model, D2D and resale systems that operate points of sale in shopping centers.

2.6 Competition

The following is a description of the development of competition in the domestic fixed-line communications market:

The Minister of Communications adopted the conclusions of the Gronau Committee for formulating detailed recommendations concerning the policy and rules of competition in the communication sector in Israel.

On March 12, 2008, the Gronau Committee published its report. The Committee was appointed by the Minister of Communications to formulate detailed recommendations regarding policy and rules of competition in the field of communications in Israel. On August 13, 2008, the Minister of Communications announced his decision to adopt the conclusions of the committee, subject to a number of changes and emphases, and they will become the policy guiding the Ministry in the years

to come. The Minister's decision increases the level of regulatory clarity to some extent. The main assumptions are described below.

Structural changes in the fixed-line sector

Recommendations of the Gronau Committee

1. To act to develop the wholesale market in the fixed-line sector, centered around the sub-loop unbundling obligation. In this context, the owners of universal infrastructure are required to sell services wholesale and lease access segments to competitors. For reasons of technological applicability, at this stage the local loop unbundling obligation will only apply to the Company.
2. Within 15 months of the date of adoption of the recommendation by the Minister of Communications, the regulating body will publish maximum tariffs for bitstream access and resale services in the wholesale market and the conditions for provision of such services. Such tariffs and conditions are to be determined subsequent to hearing the positions of the entities operating in the segment.
3. To issue a permit to the Company's subsidiaries to supply subsidized bundled service packages,¹⁰ which include Bezeq Fixed-Line telephony and broadband services and IPTV, after implementation of the arrangement set out in section 1 above. On that date, the subsidiaries of the Company shall also be entitled to receive special licenses for the supply of domestic operator services that are not VOB.
4. The structural separation in the Company is to remain so long as there are only two companies with nationally deployed fixed line infrastructure. Likewise, if the Minister of Communications finds, within a reasonable time of implementation of the local loop unbundling (LLU) arrangement (no longer than two years), that the Company's actions are preventing expansion of competition in the domestic communications market, the recommendation is that he will exercise his powers under section 4(D2)(3) of the Communications Law regarding structural separation between operation of the infrastructure and operation of services at the Company.

The decision of the Minister of Communications

The Ministry of Communications will start to prepare the regulatory and pricing infrastructure required in the wholesale market, including LLU arrangements. However, to encourage the Company to realize the arrangements of the wholesale market as soon as possible, the Company will be permitted to present the Ministry with a commercial agreement for the supply of wholesale services with a communication operator, which is not a subsidiary of the Company.

The Minister agrees with the Committee in respect of the importance of upgrading fixed-line communication infrastructure. Therefore, if the Minister believes that there should be incentives for the Company, which will advance universal and rapid deployment of the NGN, he will act accordingly.

Tariff flexibility for Bezeq – alternative service packages

Recommendations of the Gronau Committee

So long as the Bezeq Group's market share is greater than 60%, supervision of the Company's tariffs shall continue in the format of fixing binding tariffs (fix). Various restrictions (as set out in the recommendations) shall be set with respect to approval of alternative tariff bundles for the Company. With respect to supervised tariffs – up until the middle of 2009, cost-based tariffs will be prescribed for call completion on the fixed-line network. With respect to non-supervised tariffs, loyalty discounts will be prohibited so long as the Company is a monopoly. PRI lines – if there is no significant change in market share, the prices of these will come under supervision.

The decision of the Minister of Communications

To improve the process for approving alternative service packages and provide a higher level of certainty for the Company, the Minister decided to change the system for approving alternative payment packages, such that the Company will not be required to wait for the explicit approval of both Ministers, and will be able to offer the package 45 days after submitting a detailed application to the Ministry of Communications, unless the Minister of Communications or the Minister of Finance informs the Company of their objection to the application. Note that the Minister adopted the recommendations of the Committee because as long as the Group's market share is more than 60%, supervision of the Company's tariffs will continue in the format of fixed prices and in the matter

¹⁰ For which there is no obligation that any service included can also be purchased separately under the same terms as in the bundle.

of the alternative payment packages – the maximum discount allowed will be higher as long as the Group's market share in fixed-line telephony is smaller (it will be 15% provided that the market share is higher than 85%; 25% when the market share is between 75% and 85%; and 40% when the market share is between 60% and 75%). Note that according to the recommendation, the alternative payment package will only be approved if it is feasible for at least 30% of the subscribers consuming the services offered in the package.

Competition in the mobile sector

Recommendations of the Gronau Committee

It is necessary to accelerate the regulation processes required for the entry of mobile virtual network operators (MVNO), to accelerate the WiMAX tender in order to strengthen competition in the mobile sector and additionally, during 2009, to check the cost of call completion on mobile networks and to amend the tariff accordingly.

The decision of the Minister of Communications

The Minister instructed the Director General of the Ministry of Communications to work towards advancing the licensing policy for MVNO. On January 5, 2009, the Ministry of Communications scheduled a hearing for a license to provide cellular services involved in using the cellular system of another operator and the terms and reservations in the submission of the application. In this regard, see also section 3.7.2 below.

Multi-channel television – basic channel package

Recommendations of the Gronau Committee

Setting up of a narrow basic channel package, including 5-10 channels (open channels and channels of special social or cultural value), with the possibility that the regulating body might determine the price of the package.

The decision of the Minister of Communications

The Minister decided to conduct a more comprehensive examination of all aspects of broadcasting. Therefore, he announced that in the near future, it is his intention to appoint a committee to provide recommendations regarding policy and terms of competition in the multi-channel and commercial television sector. Note that the Minister of Communications appointed an inter-ministerial committee to regulate commercial television broadcasts and on October 12, 2008, the committee scheduled a hearing. In this regard, see also section 5.1.3.3 below.

Structural separation in the HOT Group

Recommendations of the Gronau Committee

Enforcement of structural separation between HOT Broadcasts and HOT Telecom in the framework of their licenses, in accordance with the existing format in place in the Company

The decision of the Minister of Communications

The Ministry will work to ensure that companies in the HOT Group comply with the rules of structural separation established in their licenses, with the exception of the option available to the companies to market service packages that include services offered by the companies on a regular basis, as is currently permitted by their licenses, contrary to the committee's decision, according to which the rules of structural separation should be enforced in the format applicable to the company. In this regard see also section 2.6.1 above.

The guidelines for structural separation should allow the implementation of the recommendations regarding the wholesale market in general, and its prices in particular.

International call sector – entrance of players controlled by cellular companies to the international calls market

Recommendations of the Gronau Committee

The committee recommends that international call tariffs via mobile telephones will be prescribed by the international calling company, and that company will make payments to the cellular company at the tariff determined in the Interconnect Regulations for call completion on mobile networks. Furthermore, new players controlled by the cellular companies shall be permitted entry into the international call sector.

The decision of the Minister of Communications

The Minister is of the opinion that the recommendations of the Committee regarding setting fees for outgoing international calls using a mobile network in the framework of the interconnect regulations should be advanced.

General

Additional committee recommendations adopted by the Minister of Communications – Consumer issues

The OECD recommendations are guidelines for addressing consumer issues. It shall be prohibited to change fixed tariffs in a contract with customers during the contract term, the term of contracts shall be limited to 18-24 months and the prevention of transfer due to the tying of purchase of a handset to purchase of services will be removed.

Royalties – adoption of the position taken by the Kroll Commission regarding the gradual reduction of the rate of royalties payable by licensees, up to cancellation of such royalties in the future. If there is a reduction of taxes during 2008-2012, the royalties will be cancelled. It is appropriate that cancellation of the royalties accompany a parallel reduction in tariffs.

At this stage, the Company is unable to assess the precise impact on its business results and those of its subsidiaries.

See also updates to sections 3.7, 4.1.2 and 5.1.3.2 below.

2.6.1 Telephony

Competition with HOT, which received a general license for the provision of domestic fixed-line services including telephony, is increasing, and is expressed, *inter alia*, in offers by HOT which combine broadband internet, telephony and cable television, aimed mainly at households. In addition, HOT markets telephony services to business customers.

The Company petitioned the High Court of Justice against the Minister of Communications, in an application for immediate enforcement of HOT's obligations and commitments under its license, concerning structural separation. The petition was amended so as to include the Company's reservations against amendment of HOT's license enabling it to market a basket of services including HOT Telecom services and broadcast services provided by HOT's broadcast company. On January 7, 2009, proximate to the court hearing, the Ministry of Communications scheduled a hearing for the Company and HOT to amend HOT's general license, including reservations regarding structural separation. In the hearing on January 8, 2009, the court ruled that since there might be a decision to amend HOT's license in the near future, there is no point in hearing the petition. The State attorney will file updated notice within 4.5 months from the hearing. HOT and the Company will be given the opportunity to respond. Once all the notices are filed, the court will decide whether to continue with the petition.

On December 2, 2007, implementation of the number portability program commenced. Number portability increased the level of competition in domestic operator sector. In this regard, see also section 2.6.6(A) below.

As of September 2004, the Minister was entitled to issue special general licenses for the provision of domestic fixed-line telecommunications services, including telephony, with no obligation to provide universal service or minimal geographical deployment. To the best of the Company's knowledge, such licenses were granted, *inter alia*, to GlobeCall Limited Partnership (which was merged with Barak and NetVision), Cellcom Fixed-Line Communications Services Limited Partnership, 012 Telecom Ltd. and Partner Fixed-Line Communication Solutions (trial license). The operators which received such licenses provide services in accordance with their licenses. Two subsidiaries, Bezeq International Ltd. and Pelephone Communications Ltd. applied for these licenses. On February 8, 2009, a corporation wholly-owned by Bezeq International received a special general license to provide VOD service (see sections 3.7.4 and 4.1.2.2 below).

According to the announcement of the Ministry of Communications on March 9, 2009, in November 2008, the market share was 82.3% in the residential sector and 88.1% in the business sector. Additionally, commencing from November 2008, the Ministry of Communications also measured the market share using a new format recommended by the Gronau Committee – separate measuring for regular lines and for traffic lines. In accordance with the new measuring system, the Company's market share based on normative income is 80.7% for regular lines and 84.4% for traffic lines.

On February 1, 2009, the Ministry of Communications scheduled a hearing to consider ordering the Company to stop using the conventional tariffs system in PRI service, regarding the price determined by the Company in the price list and the special marketing offers in relation to service. In addition, the Ministry of Communications dismissed the Company's application for an alternative basket of payments for PRI traffic.

VoB service policy¹¹

Pursuant to a policy paper published by the Ministry of Communications on January 31, 2007, the Company and its subsidiaries shall be entitled to supply VoB services only after the Company's market share in the field of domestic fixed-line telephony in any particular customer sector (business or private) falls below 85%. With respect to calculation of market share, see section 2.16.2 below. On August 12, 2008, the Company applied to the Ministry and requested, for the sake of good order, to make an addition to the Services Addendum to the Company's license for broadband telephone service, if it reaches a market share of 85%. It is noted that according to the Ministry of Communications' announcement on August 25, 2008, the Company's market share has dropped to below 85% in terms of normative revenue, as at June 2008, in the fixed-line telephony sector (private sector)(see the announcement of the Ministry of Communications in respect of the market share in November 2008). As stated above, on February 8, 2009, a wholly-owned company of Bezeq International received a special general license to provide service.

Regarding the call completion tariff in the network of a VoB operator, it was determined that it will be the same as the payment for call completion in a public telecommunications network of a fixed-line domestic operator (in other words, the same as the payment which the Company receives for completing a call in its network), for two years from the effective date. No later than by the end of two years, the Ministry will re-examine the arrangement, noting, inter alia, the actual development of competition in the field.

According to the policy document, the Company will also not receive additional payment from a VoB operator who uses its network, beyond the payment made by the end user for the broadband access service.

The regulation for the provision of a private organizational network in IP technology for transferring calls will be similar to that for NEP services. In this context, the policy document notes that the Ministry of Communications intends to adapt the NEP service licensing policy for a body that is one legal entity even if not in continuous premises, and to consider expanding the use of the IP/VPN service to intra-organizational telephony.

Implementation of these provisions could harm the Company and its ability to compete in a way that cannot be assessed by the Company. Implementation of ADSL only (see section 2.2.3 above) could increase the attractiveness of VoB services offered by the competitor.

For the positions of the subsidiaries Pelephone, Bezeq International and DBS in this regard, see (respectively) sections 3.7.4, 4.1.5 and 5.6.5(G) below.

2.6.2 Broadband internet access

In the broadband internet sector, competition has been keen since the cable partnerships (now HOT) began competing with the Company in this sector in March 2000. On March 5, 2008, the Ministry's decision was handed down regarding requiring the Company to provide broadband access to internet service providers without a telephone line (see also section 2.2.3 above).

HOT has access to a cable and fiber-optic infrastructure over significant parts of Israel and a relatively high penetration rate into homes in those areas. The cable network underwent a major upgrade recently and is currently a digital broadband network. A wide range of advanced communications services and advanced interactive applications can be provided over this network. This network is currently the main universal alternative for competition against the Company in the private sector.

In 2008, the cellular companies deepened their broadband operations on cellular infrastructure in the private sector as well as in the business sector.

2.6.3 Data transmission and communications

¹¹ Voice over Broadband

The companies that operate in this area are Cellcom, Partner, HOT, and the internet companies that also make use of leased infrastructure.

Cellcom has set up an independent backbone to connect its switches, which it uses for both its own purposes (instead of transmission which in the past was provided by the Company) and for competition against the Company in the data transmission and communications market.

On August 15, 2006, Partner was granted a special license for providing data transmission and communication services, after purchasing the operations of Med-1.

2.6.4 Competition from cellular companies

The penetration rates of cellular technology in Israel are among the highest in the western world. The Company's opinion, which is not accepted by the Ministry of Communications or the Antitrust Commissioner, is that the penetration rate, combined with airtime tariffs which are low in international terms, have made cellular phones a product which is largely interchangeable with telephone lines. Over the past two years, there has been steady erosion, albeit at varying rates, in the number of voice minutes over the Company's network, as a result of a slowdown in the pace of growth of the cellular companies. There has also been an increase rise in calls from the networks of fixed-line domestic operators to the cellular networks. The Company believes that increasing interchangeability between fixed-line and cellular telephones is one of the reasons for the growing rate at which telephone lines are being removed, to the extent that approximately 16% of Israeli households today do not have a fixed line (compared to approximately 5% in 1996).

Cellcom is operating in the domestic communications market, and to the best of the Company's knowledge, Cellcom has deployed a fiber-optic infrastructure reaching, inter alia, industrial and commercial sites, office buildings and business centers. This infrastructure is used by Cellcom to connect business customers to its installations in order to provide communications services as an alternative to the services the Company is currently providing to some of these customers. Entry into the domestic fixed-line telecommunications market has enabled Cellcom to offer its customers a complete line of solutions, including domestic telephony, and data and cellular communications, while using its own infrastructure and sales system.

Partner Fixed-Line Communication Solutions has also been granted a license for providing domestic fixed-line services and it has recently launched fixed-line telephony services with VoB technology and ISP services.

2.6.5 VoB service policy¹²

In July 2007, an amendment to the Communications Law was passed, entitling additional content providers other than HOT to provide content upon subscriber demand over a broadband-managed access network, using IP technology. The significance of this amendment, according to the restrictions set out in it is, inter alia, that the Company's subsidiaries (apart from DBS) will not be allowed to supply that service.

In this regard, see also sections 5.4 and 5.6.5 below and section 1.1.5 above.

2.6.6 Additional factors that may affect competition

A. Numbering and number portability

On December 2, 2007, the number portability plan began to be implemented, enabling a transfer of customers between the various communication operators without changing their telephone numbers, and the petitions to the High Court of Justice filed by the cellular companies and by the Company were withdrawn by the consent of all of the parties, whilst reserving their rights.

Number portability increases competition and the strength of such competition, as well as customer awareness of the market.

Note that on May 24, 2007, the Company received a notice from the Director General of the Ministry of Communications stating that he was considering imposing financial sanctions on the Company under Chapter (G)1 of the Communications Law, 5742-1982, due to alleged breach of the duty to provide number portability as of September 1, 2006.

¹² Video On Demand (VOD) services

The Company, Pelephone and Bezeq International responded to the notices of the Ministry of Communications. On November 20, 2008, the Ministry asked the Company (and the other relevant licensees) for information about the dates of actual implementation number portability. According to the Ministry, the request was made to formulate its position on the question of the Company's compliance. According to information available to the Ministry, the Company did not provide number portability on September 1, 2006, under the provisions of the law and the number portability plan. On January 5, 2009, the Company submitted its position and the information to the Ministry.

On September 1, 2008, the numbering plan was amended such that in respect of the entitlement to number portability, a subscriber would be deemed to include an NEP licensee with allocated telephone numbers paying for use of these numbers, and the end user will not be entitled to port such a number. Nonetheless, the Ministry noted in an accompanying document that it intends to examine regulating the relationship between the end user and the NEP license holders, in whose name the telephone numbers are registered, so that the number portability regulation will also be applicable to the end users.

On May 4, 2008, the Company received an Administrative Directive from the Ministry of Communications to the effect that a customer which has been allotted a speed dial business number (asterisk plus four digits) may port such a number.

B. Other potential competing infrastructures

In addition to HOT's cable and fiber-optic network and Cellcom and Partner's fiber-optic infrastructures, there are a number of fiber-optic networks in Israel today, most of which are owned by State-owned companies or government agencies. These include Israel Electric Corporation, Israel Railways, Mekorot, the Oil Infrastructure Company and the Cross-Israel Highway Company. At this stage, there is no use of the aforesaid infrastructure in competition with the Company. Some municipalities are also attempting to create an alternative to the laying of pipelines by communications licenses, via the infrastructure held by such municipalities.

On March 1, 2009, the Ministry issued a policy for allocating frequencies for wireless broadband access networks. The Ministry decided that the Company and HOT Telecom would not be permitted to participate in a tender for the allocation of 3.5 GHz frequencies. Under the policy, allocation of access network frequencies will only be carried out according to the tender. In this context, significant weight will be given to the projected contribution of the offerer to improve consumer welfare and increase competition. This will be reflected in frequencies allocated for domestic operator services and for including characteristics in the framework of the weighting formula, for example, scope and rate of network deployment, including in remote or sparsely-populated areas, bandwidth and service quality for the subscriber. Regarding the preferences in the 3.5 GHz range, the Ministry ascribes great importance on providing preference in allocating access frequencies for operators interested in supplying universal broadband service nationwide, and therefore will prefer a new domestic operator to a special domestic operator. For 3.7 GHz frequencies, the Ministry decided that participation in the tender will be open to all domestic operators, including the Company, to allow service on these frequencies for the supply of broadband services in remote areas and as a complementary means. For allocation in the 2.5GHz range for cellular operators, see section 3.7.5 below. Parallel to the determination of the general policy, there were negotiations between the Company and the Ministry of Communication with respect to the allocation of alternative frequencies for the Company in return for vacating frequencies that the Company currently uses to provide services to the radio systems subscribers, as required by the Ministry of Communications (see section 2.16.8 below). On March 1, 2009, the Ministry notified the Company that it had decided to allocate an alternative 5MHz bandwidth in frequencies between 3.6 GHz and 3.8 GHz (the 3.7 frequency range). This alternative frequency is not included in the frequencies in the policy, and the Company is permitted to participate in this tender, so that it can be allocated 3.7 GHz frequencies.

C. Technological developments

The development of competition in the market, which harms market segments, rests, inter alia, on frequent technological developments and breakthroughs in the various communication sectors. Technological progress is expected to enable competing companies to introduce technology quickly at a relatively low cost, which will enable

supply of telephony and data communications services over private and public IP networks, as well as via advance cellular infrastructure. At the same time, the main traditional barrier to the entry of competitors into the sector – access infrastructure connecting the subscriber to the communication network of a competing operator – is becoming less significant. The rapid growth in the number of cellular and broadband internet subscribers, improved quality of sound and increasing bandwidth enabling alternative technologies have an adverse effect on the number of calls passing through the Company's network, causing a decline in its revenue from telephony services and moderating the growth potential in its revenue from advanced internet and data communication applications.

2.6.7 The Company's preparations and methods for coping with the growing competition

The Company is coping with competition in domestic fixed-line telecommunications services in several ways:

- A. The Company is launching new communications services and value-added applications, among other reasons, to increase the volume of use of subscriber lines, respond to customer requirements and enhance the image of technological innovation. The Company invests in improving and modernizing its infrastructure in order to be able to provide advanced products and services to its customers.
- B. The Company worked to introduce broadband (high-speed) internet services using ADSL technology and is working to increase the number of customers it has in this area. The Company provides a secured business access service, which provides secure connectivity of branches and enables employees to connect from their homes to their organization's network. It also launched an ADSL-based service for business customers and high-speed data communications services for business customers and communications providers.
- C. The Company is working constantly to improve the quality of its services and to retain its customers.
- D. The Company has simplified its tariff structure and offers customers a number of alternative payment packages and special offers.
- E. The Company will implement a new billing system for business and private customers.
- F. The Company is working to heighten awareness of the use of fixed-line telephony and to promote the use of other services which increase telephone use, such as numbering services, voice mail, marketing of digital cordless phones, telephone information services and other value-added services.
- G. The Company is adjusting expenditures with the goal of focusing investments in fixed assets in growth activities and reducing operating costs. The Company has a policy of selective investments, effective utilization of existing resources and reducing the prices of the equipment and services it purchases. The Company has also changed the mix of its investments: less emphasis on investments for maintenance of existing items and greater emphasis on development of growing services (such as ADSL and IPVPN), and the integration of advanced information systems for achieving its marketing and business-related goals. Notwithstanding the foregoing, the Company's ability to make adjustments in its expenses in the short and medium term is limited due to its cost structure, which mainly comprises rigid short- and medium-term costs. These costs consist mainly of depreciation expenses and expenses related to salary and benefits. Furthermore, the Company has other operating costs such as infrastructure maintenance and leasing as well as maintenance of buildings, which are also rigid short-term costs.
- H. In continuation of the Company's examination of its integration into the process faced by other communications companies around the world, regarding the deployment of uniform infrastructure for transmission of voice communications services, high-speed internet services and content, leisure and entertainment applications, the Company's board of directors approved the entry into specific content and implementation of the next generation network (NGN) (the Project). In this context, the board of directors approved detailed planning of the project, setting-up of two areas as operational pilots and the purchase of soft switches. The project will be implemented in modules with Company assessments on a regular basis, and after each stage of implementation it will reconsider the viability of continuing the project, looking at all the variables that could influence its viability and therefore the need to revise the project outline. The

content, pace of performance and the amounts to be invested in the project, will be determined each year in the framework of the annual budget of the Company. Accordingly, the work plan for 2009 was approved and the Company expects that it will expand the network coverage to a significant number of households in Israel in 2010. See also section 2.7.2 below and Note 9 (G) to the Company's financial statements for the year ended December 31, 2008.

- I. In 2008, the Company continued to assimilate the new brand that it launched towards the end of 2007.
- J. For a description of how the Company intends to cope with the impact of the global economic crisis, see section 1.7 above.

2.6.8 Positive and negative factors affecting the Company's competitive status

Positive factors

- A. National deployment of infrastructure through which a variety of services are provided
- B. Presence in most businesses and households
- C. Strong capital structure and positive cash flow
- D. Expansive service infrastructure and various customer interfaces
- E. Professional, experienced and skilled staff
- F. Strong, well-known brand

Negative factors

Regulation

The Company believes that the various restrictions imposed on it under the existing regulatory guidelines impede its ability to compete in its areas of activity. The following are the main restrictions in this regard:

- A. Restrictions on the marketing of packages of services jointly by the Company and companies in the Group

The Company has been prohibited from offering packages of services jointly with companies in the Bezeq Group, although these types of packages are offered by its competitors. The absence of such an option is a major disadvantage in the Company's ability to compete. In the matter of the draft amendment of the Company's license, see section 2.16.2 below.

- B. Lack of tariff flexibility

The Company is restricted in its ability to grant discounts on its principal services and to offer differential tariffs. Even the tariff packages (which should, inter alia, offer an immediate alternative to the normal tariffs) are so tied up in bureaucracy that they are frequently pointless. For a description of the recommendations of the Gronau Committee adopted by the Minister of Communications in respect of improving the efficiency of the system for approving the basket of tariffs, see section 2.6: Tariff flexibility.

- C. Obligation of structural separation

Under its license, the Company is required to maintain full structural separation, in the form set out in the license, between itself and those subsidiaries and affiliated companies that are specified in the license. There is also a separation between the Company's operations and those of Pelephone due to the conditions of the merger approved by the Antitrust Commissioner and the ruling of the Antitrust Tribunal regarding the merger of the Company and DBS under terms referring to structural separation between the two companies (see section 1.1.5 above). At this stage, the format restrictions that apply to the Company do not apply in practice to the other organizations operating in the communications market, and thus put the Company in an inferior position.

- D. Universal service obligation

The Company is under an obligation to provide services to the entire public in Israel (universal service), and as a rule, the Company is in compliance with this obligation. This obligation is not imposed on the special local operator licensees, which can offer

their services to the Company's profit-bearing customers (particularly business customers), which represent a significant source of revenue for the Company.

The Company believes that a fund should be established to finance this universal service, so that an operator that does not provide service to any party requesting it will pay into the fund through which the universal service will be funded.

E. Accessibility deficit

The Company's telephony tariffs are prescribed in regulations made by the Minister of Communications with the consent of the Minister of Finance. As a result of intentional regulatory policy, the monthly usage tariff for a telephone line is set at a level that does not cover the costs involved in providing the line (a situation known as an 'accessibility deficit'). This deficit has been reduced over the years, inter alia as a result of the activities of the various tariff committees, however it still exists. Note that given that competition relies on the Company's infrastructure and (such as VOB services) exploits the accessibility deficit, the negative impact of this factor is increasing.

F. Amendment to the Consumer Protection Law regarding a fixed transaction (see section 2.16.9 below)

Labor relations

Labor relations in the Company make flexibility of its operations and its ability to deal with competition more difficult (see also section 2.20(D) below).

2.7 Property, Plant and Equipment

2.7.1 The Company's fixed assets primarily include: domestic telecommunications infrastructure, exchanges, various networks, real estate (property and buildings), computer systems, vehicles and office equipment.

2.7.2 Domestic fixed-line telecommunications infrastructure

This infrastructure is comprised of five principal components deployed throughout the country.

A. Exchanges

Used for switching calls and transferring them from their origin to their destination based on the signal (dial) received from the subscriber.

B. Transmission network

A system through which there is connectivity between exchanges. This system actually functions as a national backbone that connects the local networks, which each comprise an exchange and an access network. The transmission network is based primarily on fiber-optic systems and in part (minimal) on radio systems.

C. Data communications networks

Networks for the provision of data communications services at various speeds.

D. Access network

A system that connects subscriber NEPs to the exchange. The network is based on copper pairs, fiber-optic cables and in part (minimal) on wireless systems.

E. Terminal equipment

Equipment installed at the subscriber site (such as telephones, private exchanges, fax machines, modems, routers, etc.) through which the subscriber receives the service.

NGN

The requirements for communication services in Israel, as in the entire world, includes a requirement for increasing bandwidths and an advanced IP platform. In order to provide a response to these needs, the Company has started to gradually establish, commencing in late 2008, a new generation network (NGN) based on the core of the IP network and bringing fiber optic infrastructure to street switching cabinets (the topology of the network is referred to as fiber to the curb – FTTC). With this network, it is possible to supply broadband technology up to 50 Mbit/s in the download channel and innovative added-value

services. In addition, the NGN will allow the Company to make the network more efficient. The project for establishing the new network will be implemented gradually, with the pace of the deployment being tested annually. In this respect, see section 2.6.7, above, and Note 9 (G) to the financial statements for the year ended December 31, 2008.

The information in this section contains forward-looking information, based on the Company's assessments. Actual results might be substantially different from these assessments, taking into account the changes that might occur in technology and in the communication market.

2.7.3 Computing

The Company's IT system supports four central areas:

A. Marketing and customer management

The computing system supports, *inter alia*, management of the customer database, orders for services, follow-up of customer complaints, sales and customer service processes and implementation of the number portability program and billing. The billing and collection system includes production of bills to customers for services provided and for services of other communication operators. This includes the managing of accounts with communication operators.

B. Information systems for engineering infrastructures of the telecommunications networks

Support planning, management, control and maintenance of engineering resources for the purpose of supply and assurance of services. *Inter alia*, the systems manage the number inventory and support massive conversions of numbers and equipment.

C. Information systems for management of Company resources

Support management, control and maintenance of the expenses of the Company, such as financial information (including budget and controls), procurement and inventory processes, property, real estate, human resources and wage controls, vehicle fleet and Company projects.

D. Cross-organization systems

The Company's IT system is large and complex, supports mission-critical work processes and handles very large amounts of data. The system is made up of a large number of systems, some of them old systems developed many years ago, operating on central computers, and some of them modern systems developed and implemented in recent years, operating in open computer environments.

The systems support decision-making processes via a data warehouse system (DWH) operated by the Company. Likewise, the Company operates a website which provides information on the Company's services and enables presentation of information regarding telephone bills, payment of telephone bills and other services. The Company also operates computerized office systems (such as email and resolution follow-ups), knowledge management systems, etc.

2.7.4 Real estate

A. General

The Company's real estate assets come from two sources: assets transferred to the Company by the State under an asset transfer agreement in 1984 and assets to which the Company received or purchased rights after this date, including assets it leases from third parties.

As at the date of publication of this periodic report, the Company has freehold or leasehold title or the right to lease approximately 425 real estate assets around the country. The total area over which the Company has full title or capitalized long-term lease rights (including joint long-term lease rights as set out below), amounts to approximately 1,185,000 sq m of land, of which approximately 355,000 sq m is built up. Six of these properties are in Judea and Samaria, covering lots of approximately 7,000 sq m and built up areas of approximately 500 sq m.

In addition, the Company has a right to land of approximately 7 hectares at Sakia (near Messubim Junction), for the purposes of storage and offices. The Company

received a draft contract for a planning permit for this land from the Israel Lands Administration (ILA) and submitted its reservations regarding the contract to the ILA.

As at the date of publication of this periodic report, of these properties, 52 are jointly held with the Ministry of Communications and/or the Postal Authority (now the Israel Postal Company Ltd.). On June 30, 2004, The Company entered into an agreement with the Postal Authority to define and clarify the rights of both in these properties (see section 2.17.2(C) below). The parties are following the provisions of the agreement, inter alia, to separate joint charges and systems.

In addition to these 425 properties, as at the date of publication of this periodic report the Company holds some 70 properties in Israeli settlements in Judea and Samaria, in a total area of approximately 9,600 sq m of land, on which about 1,700 sq m is built up. No written arrangement of the contractual rights in these properties exists, but in the Company's opinion, this does not constitute a significant problem.

The Company uses this land for communications operations (such as switchboards, concentration rooms and broadcast sites) and for other operations (such as transmitters and warehouses). Some of the Company's properties are undeveloped or partially developed, and can be exploited further.

As at the date of publication of this periodic report, the Company leases about 150 land assets, with a total area of 60,000 sq m, of which 55,000 sq m are built-up, from various lessors.

The Company has easements (rights of way, etc.) over other real estate (to erect transmitters and deploy cables). The Company also has about 330 concentration rooms at its disposal (rooms for cables and installations for the purpose of neighborhood communications), with a total area of approximately 4,400 sq m, most of which are not regulated by written arrangements of rights with the owners (such as: the Israel Lands Administration, settling organizations, entrepreneurs of projects on which the properties are situated, and cooperative house committees).

B. Registration

As of the date of this periodic report, the Company's rights in a considerable portion of its land assets are not registered with the Land Titles Registration Office and are therefore merely contractual rights. The Company is in the ongoing process of registering those land assets which can be registered in the Land Titles Register.

C. Property settlement

On March 10, 2004, the settlement signed by the Company, the Israel Lands Administration (the ILA) and the State (the settlement agreement) was given the force of a judgment after a drawn out dispute over most of the real estate assets transferred to the Company under the real estate transfer agreement which was executed when the Company began its commercial operations. The settlement provided that the assets that remain in the Company's possession have the status of a capitalized lease. The settlement agreement also provides that 17 properties specified in the agreement will be returned to the State through the ILA on various dates (by 2010) and in accordance with the terms stipulated in the agreement.

As at the date of publication of this periodic report, the Company has returned 14 properties to the ILA. Three additional properties will be returned to the ILA after the Company receives substitute properties, in accordance with the settlement agreement.

D. Sale of real estate assets

During 2006-2008, the Company sold 21 assets (in full or in part), amounting to approximately \$82.7 million. Out of this amount, in 2008, the Company sold three real estate assets in a total area of approximately 40,480 sq m in land and approximately 6,541sq m built-up area, for a total sum of \$ 22 million.

Further to the renewed examination by management of the Company with respect to the sale of its real estate assets, the board of directors approved the continued sale of inactive real estate assets and/or assets that can be relatively easily vacated, without incurring significant expenses, in accordance with lists presented to it from time to time. Likewise, the board of directors approved a detailed working procedure with respect to the sale of the Company's real estate assets, and a procedure for

approving such transactions. The NGN should allow the Company to improve the efficiency of its network structure and the sell some of the real estate assets that will be vacated following migration to the new network.

From the second half of 2008, the real estate market in Israel experienced a slowdown, which led to a slump in the sale of the Company's real estate assets.

2.8 Intangible Assets

2.8.1 The Company's general license

The Company operates under the terms of a general license which, inter alia, serves as the foundation for its domestic fixed-line telecommunications activity. For a description of the principles of the general license, see section 2.16.2 below.

2.8.2 Trademarks

The Company uses trademarks that reflect its products and services.

As of the date of this periodic report, the Company has approximately 130 trademarks registered in its name or in the process of being registered at the Registrar of Patents and Trademarks. The main trade marks are:

Bezeq – Company name

B – Company logo

The main trademarks are advertised in the various media outlets such as the press, radio, television, billboards and mailings.

The investment in advertising the trademarks is intended to increase the level of public exposure and awareness of the trademarks to create differentiation which will have an effect on customer purchasing decisions and preferences.

2.9 Human Resources

2.9.1 Organizational structure and employees according to organization structure

In 2006 and 2007, the Company worked in coordination with the workers' union to bring about a change in the Company's organizational structure, with the aim of making the Company compatible with the competitive market in which it operates, by focusing on the customer and achieving operational and procedural efficiency.

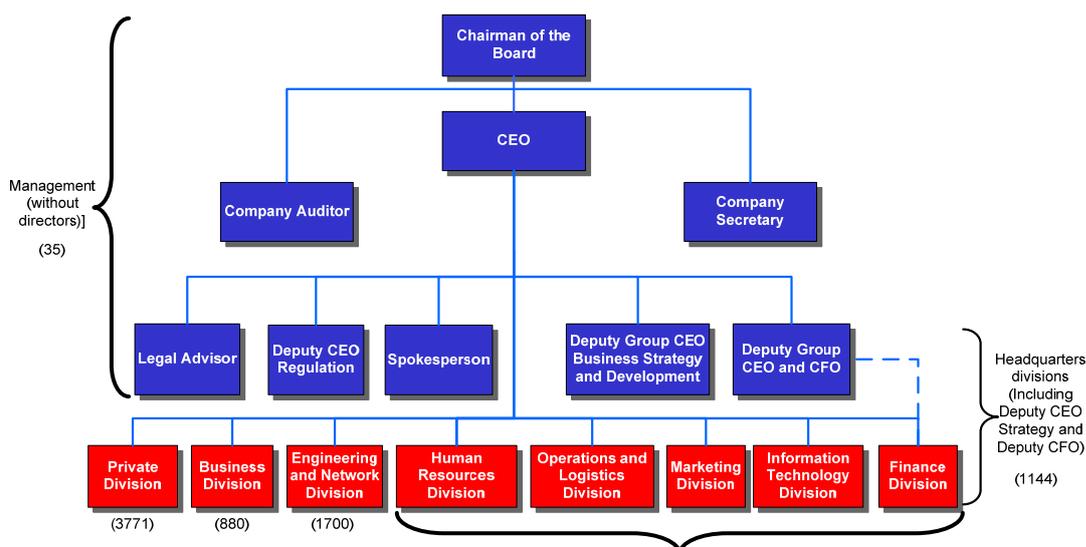
On December 5, 2006, a special collective agreement was signed between the Company and the workers' union and the New General Trade Union, setting out the employment relationships at the Company following transfer of control of the Company from the State of Israel to Ap. Sb. Ar. Holdings Ltd. The main points of the agreement are set out in section 2.17.4 below.

The new collective agreement provides, inter alia, that a total organizational change would be made in the Company based, inter alia, on a transition from a geographical structure to a functional structure, which would be implemented gradually over two years.

In addition, the collective agreement provides mechanisms for the payment of annual incentives (bonuses) in accordance with criteria prescribed by management.

In May 2008, the amendment to the new collective labor agreement was completed, concerning bringing forward completion of the implementation of the organizational structure and bringing forward the retirement dates and changing the mix of those scheduled to retire under the new collective agreement by the end of 2008.

The following is a diagram of the Company's general organizational structure:



* Answers to CEO regarding the Company's activity as a domestic operator and to the board of directors regarding subsidiaries. As at the reporting date, the position of VP strategy and business development is unfilled.

On September 4, 2007, the board of directors of the Company resolved, pursuant to section 50(A) of the Companies Law, 5759-1999, and in accordance with articles 119 and 121.1 of the Companies articles of association, that the CEO's powers with respect to the corporations held directly or indirectly by the Company (including Telephone Communications Ltd., Bezeq International Ltd., DBS Satellite Services (1998) Ltd., Walla! Communications Ltd., Bezeq Online, Bezeq Zahav Holdings Ltd., and BezeqCall Ltd.) shall be transferred to the board of directors, and the board of directors has passed resolutions regarding implementation of the above.

2.9.2 Personnel according to employment framework

Description of employment framework	Number of employees	
	As at December 31, 2008	As at December 31, 2007
Senior managers excluded from application of the Company's collective bargaining agreements. Their terms of employment are set in personal agreements.	63	87
Permanent employees employed through collective agreements.	3,320	3,315
Employees employed through personal contracts that are not part of the collective agreements.	600	695
Employees employed under detailed agreements under collective agreement conditions (rank rating contracts).	183	341
Employees engaged in defined activities, which in the past were staffed by workers from employment agencies. The conditions of employment of employees in this category were recently updated in the special collective agreement of December 5, 2006 (Generation 2000 Employees)	0	55
Employees employed under the special collective agreement of December 5, 2006, on an hourly basis	2,241	2,192
Employees employed under the special collective agreement of December 5, 2006, on a monthly basis	1,123	926
Other	0	3
Total	7,530	7,614

Note: 1. In the matter of tenured employees employed under collective agreements: in 2008, 97 employees retired under this agreement (another employee was

transferred to the group of senior managers) and the increase is due to the transfer of 103 employees from other agreement frameworks to this framework.

2. Former Generation 2000 employees are included under the hourly collective agreement as are employees under the former temporary hourly agreement and new employees recruited for hourly employment. Former Generation 2000 employees who were hired to perform jobs that are monthly by nature are included under the monthly collective agreement, as are employees under former total salary contracts and new employees recruited for monthly employment.

Note that all 975 employees who were supposed to terminate their employment at the Company between 2006-2008 under early retirement tracks or increased severance pay tracks, under the collective agreement of December 5, 2006 (see section 2.17.4(f) below), have retired from the Company.

During 2008, the number of employees of the Company fell from 7,614 employees on December 31, 2007, to 7,530 employees on December 31, 2008 (a net reduction of 84 employees) as a result of retirements from the Company (in parallel with the recruitment of employees required, such as sales representatives).

In the fourth quarter of 2008, the Company's board of directors resolved to approve the resignation of 245 employees during the course of 2009, at a cost of NIS 177 million, in accordance with the terms of the collective agreement of December 2006.

2.9.3 Hiring and retirement of employees from January 1, 2008 through December 31, 2008

Employment framework	Intake	Retirement
Senior managers	2	27
Permanent employees	0	97
Employees under other employment arrangements	1,402	1,364
Total	<u>1,404</u>	<u>1,488</u>

Note that between January 1, 2009 and February 28, 2009 a further 72 permanent employees retired from the Company.

2.9.4 Company's investment in further study, training of employees and higher education

The Company conducts internal training sessions given by professional experts who are Company employees and at times, with the assistance of external organizations, in all its areas of activity. Total work days allotted to training of all employees in 2008 – approximately 31,000 days, or an average of 3.5 training days per employee. This training activity includes professional training in technology, sales, management, service and others.

The Company operates a service school that works to instill a service-oriented culture and customer-centric service values, as well as providing knowledge and skills in the provision of excellent customer service. The Company also participates in funding higher education.

Total investments by the Company in the above activities in 2008 amounted to approximately NIS 3.7 million, over and above the cost of work days of employees with respect to training and study days.

2.9.5 Nature of employment agreements at the Company

Labor relations at the Company are regulated, in addition to labor laws, by the collective agreements between the Company, the representatives of Company employees and the New General Federation of Labor (the Histadrut) and personal contracts. Additionally, expansion orders to certain general collective agreements apply to Company employees. These include agreements on cost-of-living allowance.

For a list of the significant agreements with respect to labor relations, see section 2.17.4 below.

2.9.6 Employee remuneration schemes

2.9.6.1 Employee option plan of 2005

On November 15, 2005, the Company published an outline of an offer of the State's shares to employees of the Company. The offer is for up to 122,697,648 options, exercisable for up to 122,697,648 shares of the Company held by the State of Israel and constituting approximately 4.71% of the shares in the Company, exercisable in three equal portions after approximately two years, three years and four years following the date of allotment. As of January 1, 2008, the employees are entitled to exercise the first installment of the plan and as of November 15, 2008, the employees are entitled to exercise the second installment of the plan. In this regard, see also Note 26 to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

2.9.6.2 Employee option plan of 2007

On February 22, 2007, the board of directors of the Company approved an employee option scheme and on the same date, the Company published an outline with respect to the scheme. Under the scheme, the Company shall issue its employees with options exercisable for shares at 3% of the issued share capital of the Company, at an exercise price (adjusted for each kind of distribution etc.), of 50% of the last closing price of the share prior to the date of issue, (apart from senior management staff), for no consideration, in accordance with criteria prescribed in the collective agreement of December 5, 2006.

Accordingly, on March 25, 2007, the Company allotted 78,091,794 options (out of a total sum of 78,151,368 options¹⁴) to employees, exercisable for 78,091,794 ordinary shares of the Company of NIS 1.00 par value each at an exercise price of NIS 3.201 per share, linked to the CPI for February 2007 (adjustments for all kinds of distributions etc. shall apply to the exercise price). The options shall be blocked for a period of two years as of the date of their issue, and shall be exercisable over three years from the end of the blockage period.

The total value of the benefit to the employees under this scheme, according to the opinion of an external economic adviser, and based on the price of the Company's share as at February 18, 2007, is approximately NIS 170 million. However, the recording of the expenses for this scheme for accounting purposes cannot take into account the effect of the obstruction arrangements in the options, and therefore, the Company has recorded the sum of approximately NIS 287 million as a salary expense in its financial statements (see Note 26 to the financial statements of the Company for the year ended December 31, 2008, which are included in this periodic report).

2.9.6.3 Options plan for senior managers and employees of the group, of November 2007

On November 20, 2007, the board of directors of the Company resolved to adopt an options plan for managers, and senior employees in the Company and/or affiliates, allocating 65,000,000 non-negotiable options exercisable for up to 65,000,000 shares of the Company and comprising approximately 2.5% of the issued share capital of the Company, and at full dilution, approximately 2.36% of the share capital. The option warrants will vest in three equal annual portions. The vesting dates of each installment shall fall at the end of each of the first year, the second year and the third year after the date of grant, accordingly. The exercise price of each option is NIS 5.50, reflecting a discount of approximately 16.8% compared with the closing price of the Company's shares on the Tel Aviv Stock Exchange on January 31, 2008, the date of approval by the general meeting. The allocation under the plan shall be under the capital gain track, with a trustee as set out in section 102(b)(2) of the Income Tax Ordinance [New

¹⁴ The rest of the options (59,574 options) were allotted on January 2, 2008 to two employee directors following approval of the allotment by the general meeting of the Company's shareholders, at an exercise price of 50% of the share price on the date of allotment of the options (exercise price of NIS 2.9991 per share). The total value of the benefit is approximately NIS 237,006 as at October 21, 2007. See also the immediate report of the Company of October 29, 2007.

Version], 5721-1961. The option plan and allocation of all of the options under it were approved by the general meeting of the Company on January 31, 2008, in accordance with the articles of association of the Company.

On December 25, 2007, the Company published an outline of an allocation of options from the plan in accordance with the Securities (Details of Outline of Offer of Securities to Employees) Regulations, 5760-2000, setting out the conditions of the plan, inter alia, and a report of private placement under the Securities (Private Placement of Securities in a Listed Company) Regulations, 5760-2000.

Accordingly, as at the date of publication of this periodic report, 59,550,000 options exercisable for up to 59,550,000 shares have been offered (less options that have expired) under the option plan, including to the CEO of the Company and the chairman of the board.

According to the resolution of the board of directors on June 26, 2008, the exercise price for each option allocated from this date onwards will be the same as the average closing price of the Company's share on the stock exchange in the 30 days' trading prior to the date of the board resolution to grant the options.¹⁵ In addition, the options allocated to the chairman of the board will vest in 12 equal quarterly installments.

In this regard, see also Note 26 to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

2.9.7 Company officers and senior executives

As of the date of this periodic report, the Company has 16 directors¹⁶ and 14 senior executives.

The two external directors acting on the board of directors of the Company receive remuneration in accordance with the Companies (Rules Regarding Remuneration and Expenses of an External Director) Regulations, 5760-2000. The other directors of the Company do not receive any remuneration or salary for their office as directors. On April 17, 2008, the board of directors of the Company, after receiving the approvals of the compensation and audit committees of the board of directors, approved the conditions of employment of the chairman of the board of directors as set out in the immediate report of the Company published on April 18, 2008. The conditions of employment of the chairman of the board of directors were approved by the general meeting of the Company's shareholders on June 1, 2008 and on September 28, 2008.

For the management agreement between a management company owned by the shareholders of Ap. Sb. Ar., see section 2.17.5 below and Note 29(D) to the Company's financial statements for the year ended December 31, 2008, included in this periodic report.

The senior members of management are employed under personal agreements which include, inter alia, pension coverage, the payment of bonuses based on goals and advance notice months. The Company also allocates options for the Company's shares to members of senior management, at its discretion (see section 2.9.6 above).

For 2008, payment of grants to members of senior management and the chairman of the board of directors was approved in the total sum of approximately NIS 8.9 million.

2.10 Raw Materials and Suppliers, Purchase of Equipment and Suppliers

2.10.1 The main raw materials used by the Company are: exchanges, copper cable, fiber-optic cables, transmission equipment, data communications systems and equipment, servers, routers and XDSL routers. The Company purchases most of the equipment required for its communications infrastructures from Israeli companies connected with communications equipment manufacturers from around the world. The Company purchases hardware and software from a number of main suppliers. Most of the equipment purchased for data communications, switching, transmission and radio systems was unique equipment, and it

¹⁵ With the exception of the allocation to the CEO of a subsidiary on September 25, 2008, under the original terms (exercise price of NIS 5.5 and adjusted to the distribution of a dividend).

¹⁶ Including two external directors and two directors from among the employees.

has only been possible, over the years, to receive support services from the manufacturer (in this regard see also section 2.10.3 below).

2.10.2 The table below includes details of the rate of the Company's acquisitions from the main suppliers in 2008 and the type of agreement:

Main products	Main supplier	Form of agreement	Percentage of purchases out of the total purchases in the operating sector
Leased vehicles	Supplier A	Framework and orders agreement	6.8%

2.10.3 In the Company's opinion, it is dependent on the Alcatel Group, which is represented in Israel by Alcatel Telecom Israel Ltd., for public switching equipment. For collection systems for business customers, the Company is dependent on Amdocs Software Systems and for transmission, on ECI.

As for the Company's relationship with the Nortel Group, which is represented in Israel by Nortel Israel (Sales and Marketing) Ltd., the Company and Nortel have an upgrade and maintenance agreement for switches manufactured by Nortel, which was in force until the end of 2007. Prior to termination of the term of the agreement, a comprehensive examination was performed at the Company and it was found that in view of the Company's experience in operating Nortel switches, the low probability (based on past experience) of faults that the Company is unable to solve by itself, and the very high costs involved in renewing the agreement, it would be more correct not to renew the contract under the proposed conditions. As a result, the Company's dependence on Nortel dropped. For further information see section 3.1.3 below.

2.11 Working Capital

2.11.1 The cash and cash equivalents component and short-term investments in working capital are generally significant and designed to allow the Company flexibility in its activities.

2.11.2 The inventory purchased by the Company is for the most part intended for investment in fixed assets. The Company's inventory policy strives to maintain an inventory sufficient for the Company's needs for average consumption from time to time, with flexibility for special cases according to the nature of the consumption and price of the item. Orders from suppliers are made taking into consideration past demand and forecasts for the future.

2.11.3 The following table presents data on supplier and customer credit in 2008:

	Average scope of credit in NIS millions	Average days credit
Customers	996	EOM + 16
Suppliers	328	EOM + 30

2.12 Investments

For information on investments in subsidiaries, see Note 33 to the financial statements for the year ended December 31, 2008, which are included in this periodic report. See also sections 3 and 4 in Chapter D of this periodic report.

2.13 Financing

2.13.1 Average interest rate on loans

As at 31 December 2008, the Company is not financed by any short-term credit (less than one year).

Distribution of the loans:

Source of financing	Type of currency or linkage	Average interest rates
Non-banking sources	Index-linked shekels	4.31%

2.13.2 Credit limits

A. With respect to limitations on Company loans – see Note 13 to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

B. Bank of Israel restrictions regarding sole debtor and group of debtors

The Bank of Israel directives include restrictions on liabilities of a single borrower and of a group of borrowers towards the banks. These provisions may, from time to time, affect the ability of some banking institutions to issue additional credit to the Company. As the Company does not have data and exact information regarding the restrictions on individual borrowers that apply to the banks, and given the fact that the Company cannot quantify the number of debentures issued by the Company and held by the banks, the Company is not able to estimate when and at what level of debt, if at all, these restrictions will impact on the Company's ability to secure credit.

2.13.3 Credit received during the reporting period

Commencing from June 2008, the Company takes out on-call loans, usually in amounts that are not significant. As at the date of this report, the Company has no such loans.

2.13.4 Credit received after December 31, 2008

On March 12, 2009, the Company raised bank credit amounting to NIS 400 million. The credit was provided in the form of shekel loans (unlinked) for a period of three or four years at average interest (including commissions) of prime + 0.97% (at the date of the loan – 3.22%).

2.13.5 Variable interest

As at December 31, 2008, the Company had no variable interest loans. For the variable interest bank loan raised on March 13, 2009, see section 2.13.4 above.

2.13.6 Credit rating

The Company is rated by four credit rating agencies. The following are details of the rating given by each of the rating companies as at the date of publication of this periodic report (including latest rating updates):

Rating agency	Rank	Changes in rating	Type of credit rated
Standard & Poors Maalot	AA +	<p>August 25, 2008: The Company's debt rating was raised from AA to AA+ with a stable forecast. The raised rating is based primarily on the Group's improved performance and operational effectiveness, the stability of the Company's managerial structure and the changes to the structure of the business risks as a result of the change in the mix of the Group's revenue.</p> <p>October 13, 2008: The validity of this rating was confirmed, and this, inter alia, following examination of the anticipated impact of the exercise of the purchase option (10.66%) executed by Ap.Sb.Ar. (see section 1.3.1)</p>	All debentures series

Rating agency	Rank	Changes in rating	Type of credit rated
Midroog	Aa1	May 21, 2008: Return of the Company's rating outlook from negative to stable in view of the improvement in the Company's financial results, and the continued presentation of a strong financial profile, compensation for erosion in the fixed line communications segment via operations in the other segments and very low rates of financing despite the distribution of all of the net profit as dividend, after the transfer of the control core of the Company.	Debenture series 4 and 5
Standard & Poors	BBB+	August 12, 2008: Change in the Company's rating outlook from negative to stable, on the basis of its re-examination of its operating performance and the leverage within the company. The Company's rating relies, inter alia, on its leadership as the national communications operator, its operational efficiency, the range of services it offers in the communications market and its adequate financial profile. October 7, 2008: The validity of this rating was confirmed, following examination of the exercise of the purchase option (10.66%) executed by Ap.Sb.Ar. (see section 1.3.1)	The rating is for the Company
Moody's	Baa1	November 24, 2008 – rating left at Baa1(stable)	The rating is for the Company

2.13.7 Estimate of fundraising in the coming year (2009) and sources of financing

The Company will repay some of its loans during 2009. If necessary, the Company will raise additional debt in 2009. The financing options open to the Company are: raising debt by the sale of series 5 debentures held by a wholly-owned subsidiary, Bezeq Gold (Holdings) Ltd., raising debt by new loans from banking corporations and/or by raising debt or capital on the capital market.

The Company estimates that it could raise from time to time short-term loans from banks and/or other credit suppliers to bridge any gaps in the cash flows, from time to time.

For the bank loan raised on March 12, 2009, see section 2.13.4 above.

2.13.8 Liens and guarantees

For information regarding the Company's liens and guarantees, see Notes 13 and 19 to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

2.14 Taxation

For information regarding taxation, see Note 8 to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

2.15 Environmental Quality

2.15.1 The Non-Ionized Radiation Law, 5766-2006 (the Law)

The Law regulates the handling of sources of electromagnetic radiation (Radiation Source), their erection, operation and supervision. The Law provides, inter alia, that the erection and operation of a radiation source will require a permit; imposes penal provisions and severe provisions with respect to liability of officers; imposes recording and reporting obligations on a permit-holder and grants the Commissioner for Radiation supervisory powers,

including with respect to the conditions of the permit, cancellation of the permit and removal of the Radiation Source. Note that the Company's installations, such as broadcast installations or wireless communication installations, are included under the definition of Radiation Source.

The Company obtained operating permits from the Commissioner for Non-Ionized Radiation at the Ministry of the Environment (the Commissioner), all in accordance with the Law for the communication facilities and broadcasting sites it operates.

Note that the Commissioner may require building permits as a condition of the continued validity of the operating permits for communications facilities (including broadcast facilities) granted by him. See also section 2.16.11 below.

The Company has work procedures for the set-up, operation and measurement of non-ionized radiation sources, and an appropriate compliance procedure which was approved by the board of directors of the Company.

New regulations regarding non-ionized radiation which were published on January 19, 2009 prescribe payment of fees for the filing of an application for a radiation source permit. Following approval of the regulations, the Company is expected to be required to pay fees in a non-substantial sum, which will be payable over a number of years. These regulations also prescribe criminal liability for failure to prepare measurements and report the measurements in accordance with the provisions of the regulations.

2.15.2 For permits for broadcasting installations that are required by the Planning and Building Law, 5725-1965, see section 2.16.11 below.

2.15.3 For claims filed regarding alleged radiation from the Hillel broadcasting station – see Note 17(A)(5) to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

2.16 Restrictions on and Supervision of Operations

The Company is subject to a variety of laws which govern and restrict its commercial operations. The principal body that supervises the Company's operations as a communications company is the Ministry of Communications.

2.16.1 Regulation of Company tariffs

The Company's tariffs are controlled by Sections 15 to 17 of the Communications Law.

A. The tariffs for the Company's supervised services, stipulated in these regulations are updated using a linkage formula, less an efficiency coefficient, as set forth in the regulations and based on the recommendations of public committees for the review of the Company's tariffs.

On March 20, 2008, a letter was received from the Ministry of Communications under which the next update of tariffs on June 1, 2008 will be based on the existing tariff outline prescribed by the Gronau Committee in 2003, in accordance with the formula set out in the Communications (Telecommunications and Broadcasts) (Calculation and Linkage of Payments for Telecommunications Services) (Amendment) Regulations, 5767-2007. According to the letter, after and to the effect that the Gronau Committee's recommendations regarding policy and rules of competition in the communications market are adopted, the path will be laid for the work of a commission to prescribe new tariff arrangements for the coming years. On June 1, 2008, the Company's tariffs were reduced in accordance with a formula fixed in the Calculation Regulations, at the average rate of approximately 2%, except for the fixed fee for a telephone line that was updated in accordance with the increase in the CPI (3.4%). The interconnect tariffs currently paid to domestic operators by licensees were reduced by an average of approximately 2%, effective June 11, 2008. From January 1, 2009, the interconnect charges for call completion are calculated by one-second segments instead of by 12-second segments. With respect to the update of the Company's tariffs, see also the update regarding publication of the recommendations of the Gronau Committee and their adoption by the Ministry of Communications in 2006 above.

In view of the fact that the Gronau settlement ended in 2008, after an extension of one year, the issue of tariff updates, and including the efficiency coefficient, is under discussion with the Ministry of Communications.

- B. Pursuant to section 15(A) of the Communications Law, if tariffs are stipulated for the supervised services under the above section 15, the Minister may, with the consent of the Minister of Finance, approve the request made by the Licensee for an alternative payment basket for a package of services.
- C. Under Section 17 of the Communications Law, "a Licensee may request a reasonable payment for a telecommunications service for which no payment is stipulated in Section 15." For these types of services provided by the Company (including broadband internet access service and business access) the Company sets tariffs and informs the Ministry of Communications of them in accordance with its general license. For additional provisions of the general license regarding tariffs, see section 2.16.2 (C) below.

2.16.2 The Company's general license

The Minister's policy paper

On March 31, 2004, a comprehensive and far-reaching amendment was made to the Company's general license, by virtue of which the Company, inter alia, operates. The then Minister of Communications attached a policy paper to said amendment regarding the ability of the Company to offer discounts for size and service packages, as follows:

Volume discounts - Once a competing domestic operator begins providing commercial telephony services, the Ministry will permit the Company to grant volume discounts of no more than 10% of the payment stipulated for the service, under Section 15 of the Communications Law. Such size discounts will be determined by way of an alternative basket of payments according to Section 15(A) of the Law. The discount shall not apply to the services for which discounts higher than 10% are set today in the regulations. Note that on May 24, 2006, an additional payments package (in force as of June 1, 2006) was approved by the Ministers of Communications and Finance, which allows the Company to give volume discounts of up to 10%.

Basket of services - Once the market share of the Company in domestic fixed-line telephony in a particular customer segment (business or private) falls below 85%, the Company's license will be amended so as to enable it to submit an application for the Minister's approval to market a basket of services in that customer segment, which includes telecommunications services provided by the Company and by a subsidiary, including broadcasts. The Minister's approval to market a basket of services will be granted on the status of competition in the area of telecommunications or broadcasts. The Minister's approval to market a basket of services will be granted, *inter alia*, on the basis of the following: (1) The existence of a group of services in a similar format, sold by a competitor as a package; (2) the Company and the subsidiary allowing customers to purchase any service included in the basket of services separately on identical terms to those offered in the basket; (3) that the basket of services be offered to customers on an equal and non-discriminatory basis. If even before the Company's fixed-line telephony market share falls below 85%, a material deterioration occurs in the competitive status of a subsidiary of the Company, stemming from marketing a package of services that includes, among other things, telephony by a competitor, the Minister will consider amending the Company's license as stated above.

In the Company's opinion, the conditions that will enable it to sell joint service bundles with its subsidiaries as set out above, harm the efficacy of such bundles.

On July 3, 2008, the Company received a draft amendment of the Company's license and the licenses of its subsidiary companies Pelephone, Bezeq International and D.B.S. regarding the marketing of joint service packages. On July 27, 2008, the Company submitted its position to the Ministry of Communications, stating that the amendment of the licenses represents an intensification of regulation in comparison to the policy document of the Minister of Communications dated March 31, 2004, which is supposed to reflect relief for the Company, and it would be appropriate to allow a model for marketing of joint packages of services that represents relief for the Company now that its market share has decreased to 85% or less, together with ministerial supervision using more moderate measures than those proposed in the draft amendment to the license. On January 22, 2009, draft amendments to the general licenses of the Company and its subsidiaries were submitted to the companies and published on the Ministry's website. The amendments addressed the approval for marketing of the joint packages. On February 8, 2009, the Company submitted its position, stating that the Company's material remarks were not

reflected in the draft, without explanation. The Company requested material amendments to the first draft amendment, including in respect of the required approvals and the obligation for unbundled package components. Regarding the positions of the subsidiary companies on this matter, see sections 3.18.3.1, 4.1.2 and 5.6.5, below.

According to the announcement of the Ministry of Communications on August 25, 2008, as at June 2008, the Company's market share has declined in the fixed-line telephony sector (private sector) to below 85% in terms of normative revenue. In addition, in accordance with the notice of the Ministry of Communications on March 9, 2009, commencing from November 2008, the market share is 82.3% in the residential sector and 88.1% in the business sector. For further information relating to this matter also see section 2.6.1 above.

Main points of the general license

A. Scope of license and obligation to provide service to all (universal service obligation)

The Company is required to supply basic services, ancillary and other services as set forth in the appendix to the license; the term of the license is not limited in time; the license anchors the Minister's existing powers under the Law, to modify, revoke and suspend the license; the Company is required to supply its services to all persons (the universal service obligation), on equal and nondiscriminatory basis with respect to each class of service, regardless of the location or the unique cost.

B. Rules of structural separation

The Company must establish a structural separation between it and a subsidiary, the definition of which, for this purpose, includes Pelephone, Bezeq International, DBS, Bezeq On-line, and BezeqCall Communications, and GoldNet which have, in the meantime, been merged into Bezeq International. The Minister has the authority to expand the application of the rules of structural separation to an affiliated company,¹⁷ if it has been established that there is a real fear of injury to competition or to the public. Full separation is required between the managements of the various companies, including with respect to the business system, the finance system and the marketing system; full separation of assets; prohibition against employing the Company's employees at a subsidiary, and employees of a subsidiary at the Company (as at the date of publication of this periodic report, a small number of employees remain who were loaned, in the past, from Bezeq to Bezeq International and BezeqCall, due to an arrangement in the Company's previous general license and following the merger with Pelephone, Bezeq International now bears the costs of employment of these people); prohibition against the transfer of commercial information to a subsidiary (the definition of "commercial information" having been expanded to include commercial information regarding the Company as well). No employee of the Company may be appointed a director of a subsidiary, if, within the scope of his duties in the Company, he has access to "commercial information" concerning a competitor, the use of which by the subsidiary could damage competition between it and the competitor. This limitation on appointment does not apply to the chairman of the board of directors of the Company.

The Company must set rules and procedures to preserve the confidentiality of commercial information on licensees competing with the Company's subsidiary, and it is prohibited from transferring said information to the subsidiary. The Company has set such rules.

It is noted that on March 9, 2009, the Company received a letter from the Director General of the Ministry of Communications announcing that he is considering imposing monetary sanctions on the Company under section 37(B)(4) of the Communications Law, in the amount of NIS 15.024 million, for alleged violation of the provisions of the Company's general license regarding structural separation. The Company was given the opportunity to present its claims to the Director General of the Ministry of Communications by April 8, 2009 and is studying the contents of the letter.

C. Tariffs

Should the Director General (according to the license: the Director General of the Ministry of Communications or a person authorized by the Minister with respect to

¹⁷ Parent company, subsidiary, interested party, affiliated company, related company or partner

licenses in general or with respect to this license in particular, as a rule or for a specific issue) announce that the Minister intends to set a tariff for a new service in accordance with Section 15 of the Communications Law, the Company shall not begin provision of the service before a tariff has been specified, unless the Minister so permits. The Company shall not charge a discriminatory price.

The Company shall provide service or a package of services, in respect of which no tariff is stipulated under Sections 15 or 15(A) of the Law, at a reasonable price, and shall offer them to any person so requesting, without discrimination, at a uniform tariff.

When the Company collects payment for the services of another operator, it shall do so according to its own tariffs without any increment, and the tariffs for calls between the Company's subscribers and those of other domestic operators, will be uniform and accordingly inclusive.

On April 14, 2008, the Company's license was amended such that it is permitted to require a subscriber to pay by stop order or credit card, with the exception of a private subscriber who does not have a bank account.

D. Investments in other fields and restrictions on cooperation

A provision has been added allowing the Company to invest in any calendar year up to 25% of its annual earnings (not including the income of companies linked to the Company) in activity not designated for provision of the Company's services. The Minister is also entitled to authorize this percentage to be exceeded.

The Company's agreements for performance of services through another licensee requires the Director's approval and contractual arrangements for performance of telecommunications services or telecommunications operations in conjunction with another licensee or broadcasting licensee requires the Minister's approval.

The Company shall not conduct any activity and shall not be party to any agreement, arrangement or understanding which is designed or which might limit or harm competition in the field of telecommunications. The Minister may direct the Company on the steps to be taken in order to prevent harm to competition in the field of telecommunications or broadcasting.

E. Numbering and number portability

It has been prescribed that the Company is to operate in accordance with the numbering plan and with the provisions regarding activation of number portability. For the numbering plan and number portability, see section 2.6.6(A) above.

F. Operation of company networks and service levels

The Company must maintain and operate the network and provide its services 365 days a year, around the clock, including at times of emergency, in a regular and proper manner, commensurate with technical requirements and service quality. The Company is also bound to work towards improving its services. The Company's general license includes an appendix regarding the "level of service for subscribers", which is to be amended after the Company provides the Ministry with data. The Company provided the Ministry with a proposal to amend the Appendix, adjusting it to the current state of affairs and the licenses of other carriers, but this amendment has not yet been made.

G. Interconnections and use

Infrastructure services - the Company will supply such services to another licensee such that it will be required to meet the requirements of its license, under reasonable and non-discriminatory conditions, avoiding preference in favor of a licensee that is an affiliated company. New provisions have been made regarding provision of essential information which another licensee may need in order to receive service from the Company, and in order to supply services so as to enable it to meet the service level requirements imposed upon it and so as not to discriminate between recipients of the Company's services and the other licensee's customers.

Interconnectivity - new provisions were included which are essentially designed to enable the implementation of interconnectivity between the Company's network and that of another public network. Similar provisions exist with respect to providing the option of use to another licensee.

H. Security arrangements

Provisions were included for operation of the network in times of emergency. The Company is to set up and operate its network in a manner which will prevent its collapse at the time of emergencies and enable a reduction of activity in certain sectors.

The Company is to perform telecommunications services and set up and maintain the end equipment infrastructure for the security forces in Israel and abroad, as provided in agreements with the security forces. The Company will further supply special services to the security forces as set out in an appendix, which is top secret. The Company will take action to ensure that each purchase and installation of hardware in its telecommunications installations, except for end equipment, will be made in full compliance with instructions that are given to the Company according to Section 13 of the Law.

The Company shall appoint a security director and fully comply with the security instructions contained in the appendix to the license (Israeli requirements, security clearance for the appointment of certain officers, nondisclosure of classified information, including to a shareholder, if the revelation contradicts the security provisions, board meetings discussing security issues, guarding secrecy, protecting systems and limiting reporting or publication pertaining to the provision of classified service to the security forces).

I. Warranty and insurance

Detailed provisions have been added regarding the obligation to insure the Company's liability.

J. Control and reporting

Wide-ranging reporting duties have been imposed on the Company, such as filing the reports specified in the license and on-demand reports on various matters.

The Director has also been granted authority to enter facilities and offices used by the Company, and to inspect and copy documents and demand information and reports from the Company.

K. Miscellaneous matters

The general license includes cross-ownership restrictions.

Neither the license nor any part thereof is transferable, or may be made subject to a charge or lien.

Under the amendment to the license, the Company is to prepare a draft contract it intends to offer to subscribers, and shall submit such to the director for review, upon the demand of the latter. The Director shall have the authority to order changes. The Company is in the ongoing process of preparing this contract.

The Company must provide a bank guarantee to secure performance of the license conditions and indemnify the State for any damage that may be incurred by it following the breach thereof, such guarantee to be in an amount equal to US\$10 million. The Company has furnished the guarantee as required. The Minister may forfeit the guarantee or part thereof under the conditions set out in the license (note that the Ministry of Communications has in the past exercised this power with respect to the Company. In this regard, see also Note 19(A) to the Company's financial statements for the period ended December 31, 2008, which are included in this periodic report).

Under the provisions of the Law, the Minister of Communications has the authority, at any time, to revoke, limit or suspend a license, if, for among other reasons, performance of telecommunications activity or provision of telecommunications services by a Licensee do not conform with the standard and at a proper level of similar activity or service, in accordance with the rules stipulated in the Law, or if the Licensee is in material breach of the terms of the license. The Director General of the Ministry of Communications is authorized to impose a monetary sanction on breach of any of the terms of the license. For the increase of the sum of the sanctions, see section 2.16.13 below.

On October 28, 2008, the Ministry of Communications approved the Company's cessation of the services relating to the satellite communications operations and its general license, and the fourth addendum to the Telecommunications Order (Telecommunications and Broadcasts) (Determination of Essential Service Provided by Bezeq The Israel Telecommunication Corp., Limited), 5757-1997 was amended accordingly (see section 1.1.6 above).

2.16.3 Royalties

The Communications Law stipulates that Licensees for the provision of telecommunications services shall pay royalties to the State of Israel on its revenues from the provisions of telecommunications services at a rate to be determined by the Minister of Communications and the Minister of Finance and approved by the Knesset Finance Committee. The rate of royalties stipulated in the Law is 11%, but the provisions allow other rates to be stipulated.

The Telecommunications (Royalties) Regulations, 5761-2001 (the Royalties Regulations), expanded the revenue base on which royalties must be paid, while at the same time gradually reducing the rates. Under the regulations, any party that received a general telecommunications license for the provision of fixed-line domestic services (including the Company), international telecommunications services and cellular services must pay royalties on revenues (without VAT) from the subscriber services in the Schedule to the regulations, including revenues from these services in Judea, Samaria and the Gaza Strip (except for areas in the Palestinian Territory) and including revenues from the provision of these services to the security forces under Section 13 of the Law. On August 31, 2006, an amendment of the Royalties Regulations was published regulating the reduction of the royalty rate for all royalty-owing licensees, commencing on January 1, 2006, by a rate of 0.5% per annum, up to a rate of payment of royalties of 1% per annum as of 2010. The royalty rate in 2008 was 2% compared to 2.5% in 2007.

The Company filed a petition at the High Court of Justice a number of years ago regarding special licenses for data communication services. The court ruled that the State is required to amend the Royalties Regulations, such that a domestic operator's revenue generating by data transmission services, data network management and P2P lines, at high speed and with specific connections, when one of the parties is a corporation, will be exempt from payment of royalties, effective from January 1, 2004. The draft amendment of the Royalties Regulations, which included other amendments, such as the obligation to pay royalties for revenue deriving from telecommunication services, instead of the current version that requires payment of royalties for revenue from providing telecommunication services, was submitted to the Finance Committee of the Knesset on December 31, 2007 and was not approved by the committee. The Company reminded the Ministry of Communications of the State's commitment to amend the regulations to include this exemption, according to the undertaking before the High Court of Justice, without making this amendment contingent on other amendments to the Royalties Regulations.

2.16.4 Authority with respect to real estate

According to the provisions of Section 4(F) of the Communications Law, the Minister of Communications granted the Company certain powers in connection with real estate, as set out in Chapter Six of the Law.

Amendment No. 25 of the Law, of 2001, distinguished between land owned by the State, the Development Authority, the Jewish National Fund, a local authority or corporation established by law and which was owned by one of them, and a road (public land) and other land (private land). With respect to public land, the Company and any person authorized by it, may enter and perform work on the land, provided that approval for deployment of the network has been granted by the local planning and building committee. The local committee must decide on a request to approve such a plan within 60 days of it being filed, and in the absence of a decision, the plan will be deemed to have been approved. In most cases, it is necessary to give the occupier 21 days' advance notice and the latter may appeal to the Court.

Under the provisions of the regulations for operation and maintenance, if the Company is of the opinion that providing telecommunication service to an applicant requires installation of a Bezeq transmitter or switch on the premises of the applicant (or in shared premises or property), the Company is permitted to ask the applicant, as a prerequisite for providing the required service, to allocate a suitable place on the premises for installation of the

equipment, for the sole use of the Company, and it may use the equipment to provide service to other customers.

Deployment of a network on private land requires the consent of the landowner, the long-term lessee or protected tenant, depending on the circumstances. In a condominium, the consent of a majority of the apartment owners is required. Notwithstanding the above, the Law contains provisions regarding the deployment of a network in a condominium at the request of an apartment-owner, even in the absence of the consent of a majority of the apartment-owners, while providing powers to the condominium committee and the Condominium Inspector.

2.16.5 Immunities

The Minister of Communications granted the Company certain immunities as listed in Chapter 9 of the Communications Law, pursuant to his authority to grant immunity to a general license holder. A licensee granted immunities according to the aforesaid (an Immune Licensee), its employees and all persons acting on its behalf shall not bear liability in tort, with the exception of the following:

- (1) Direct damage caused by the restriction or discontinuance of a telecommunications service
- (2) Damage arising out of an intentional act or gross negligence of the immune licensee, its employees or persons acting on its behalf

Additionally, an immune licensee, its employees and all persons acting on its behalf shall not bear liability for damage caused by:

- (1) Non-provision, delay, restriction or discontinuance of telecommunications services and accessory services as arises out of an intentional act of the Immune Licensee insofar as such act is necessary for the performance of a telecommunication operation or the provision of a telecommunications service
- (2) An error in providing a telecommunications service or a telecommunications message or an omission therefrom, failure to transmit a telecommunications message or delay in transmission thereof, delivery of a telecommunications message to an incorrect address or erroneous recording in a subscriber directory or other publication of the holder of immunity, unless done with grievous negligence.

Under Section 13 of the law which relates to the provision of telecommunications services to the security forces, a licensee or any of its employees shall bear no criminal or civil liability for any act committed in the performance of a direction to be given according to said section, except in circumstances in which the State employee bore liability for the act. Under the Civil Wrongs Ordinance, in any action other than negligence, a public servant will have a defense if the act was within the lawful field of their authority or was committed by him in good faith and he understands that he was acting within the scope of his lawful authority.

On May 18, 2008, the Ministry of Communications applied to communication licensees, stating that the Ministry of Communications is of the opinion that following the adoption of the Civil Wrongs Ordinance Amendment (No. 10) Law, 5765-2005, under which the restrictions of the State's liability in tort were reduced, there might be grounds to consider reducing the existing immunity arrangement granted to general licensees and special general licensees. The licensees were requested to submit their positions to the Ministry of Communications by June 18, 2008. On July 31, 2008, the Company submitted its position to the Ministry of Communications stating that the Amendment 10 does not change any of the arrangements regarding liability for torts to an extent that justifies reducing the existing immunity arrangement and assigning responsibility to the communications companies. Additionally, expansion of responsibility means placing a heavy burden on communications companies, including the Company, because of the potential extent of the indirect damages and the dimensions of the possible suits.

2.16.6 Regulations and rules under the Communications Law

As at the date of this periodic report, regulations in three main additional areas apply to the Company: (1) the termination, delay or restriction of a telecommunications operation or service; (2) installation, operation and maintenance; (3) methods of inspecting the acts of the Licensee; in addition to which the Company, with the Minister's approval, sets rules regarding the Company's services to subscribers.

The regulations and rules mentioned above regulate the conditions on which the Company may disconnect, discontinue and renew the service at or without the subscriber's request, terminate a service, connect another subscriber to the telephone line of an existing subscriber, and remove telecommunication installations. In addition, the regulations regulate the Company's powers and duties, as well as the rights and obligations of each subscriber. The regulations also regulate the provision of information and entertainment services over the Company's network.

According to the regulations, the Company shall provide its subscribers with the telecommunications services listed in the general license, in a proper and regular manner.

The Company may, with the consent of the Minister, terminate, disconnect or limit the provision of a telecommunications service if the service becomes outdated on technological grounds, or if the service is abused in such a way as to cause tangible financial harm to the public or a part of it, or to the Licensee. Pursuant to the regulations regarding methods of supervision of the acts of a Licensee, the Minister of Communications appointed a manager (an employee of the Ministry) authorized, *inter alia*, to ensure adherence to the provisions of the Communications Law, the regulations and license, for the classes of telecommunications services and conditions thereof, quality of such services and level of maintenance.

In addition, provisions exist regarding reporting, according to which every Licensee must file periodic reports and reports of special events. Rules regarding the Company's services contain provisions relating, *inter alia*, to the issue of bills to subscribers, charging in installments, an appeal committee for complaints regarding charges, and the publication of an entry in the subscriber directory.

The Company acts to locate debtors and to collect debts from its customers. In cases where debts are not paid, legal action is usually taken through external lawyers.

According to the regulations, the Company may disconnect a line if the bill in respect thereof is not paid within 21 days of the payment date prescribed in the bill, and discontinue the service if prior written notice thereof has been given.

On February 6, 2008, draft regulations regarding the set-up of an 'exceptions committee' with the purpose of examining requests by Bezeq or Hot for an exemption or delay in providing or installing services (as the case may be) and to make recommendations to the Minister of Communications regarding the grant of such exemption or delay or otherwise, were provided to the Company and Hot for comment. The Company has provided the Ministry with its responses.

2.16.7 Antitrust laws

- A. On June 27, 1995, the Antitrust Commissioner (the Commissioner) declared the Company to be a monopoly in the following areas: basic telephone services, provision of communication infrastructure services, unlimited bi-directional international telephone services (including service for incoming calls) and transfer and transmission broadcasting services to the public.

The Commissioner's declaration of the Company as a monopoly constitutes *prima facie* evidence of the terms thereof in any legal proceeding, including criminal proceedings. Therefore, a plaintiff - being a person or consumer organization - who seeks to sue the Company either by a personal civil action or class action will be excused from proving the fact that the Company is a monopoly, to the extent this proof is relevant for its claim, in reliance on the Commissioner's declaration, and the Company will have to discharge the burden of proof in rebutting the contents of the Commissioner's declaration in this respect.

- B. On December 11, 2000, the Commissioner declared the Company a monopoly in the field of "telecommunications infrastructure for the provision of high-speed access services via internet service providers".

On November 10, 2004, the Commissioner announced that he had decided to split the existing declaration into two separate declarations:

- (1) Provision of high-speed access services to subscribers through the access network,

- (2) Provision of high-speed access services to ISPs through a central public telecommunications network.
- C. On August 26, 2004, the Commissioner approved the merger between Pelephone and the Company (following the acquisition of Shamrock's share of Pelephone by the Company) under conditions that limit certain joint operations and transfer of commercial information as defined in these conditions.
- D. On December 24, 2007, the Antitrust Commissioner issued a ruling by virtue of his powers under section 43(A)(5) of the Antitrust Law, stating that Bezeq had abused its status in the market in contravention of the provisions of section 29A of the Law in failing to respond as required and on time to steps taken by its employees during the course of a labor dispute relating to the operations of other communications carriers, and in not being prepared, according to the ruling, to immediately apply to the Labor Court with respect to the disconnection of its network from that of HOT. Note that Bezeq filed its application for an injunction to the Labor Court in the afternoon of May 18, 2006, the day following the date of the fault in HOT's network (May 17, 2006 in the afternoon).

The ruling further states that pursuant to section 43(e) of the Antitrust Law, the ruling itself will be prima facie evidence of the prescription in it in any legal proceedings, and that pursuant to section 43(f) of the Law, the Commissioner's exercise of power under section 43, or lack thereof, shall not constitute any obstacle to trying any person who violates the provisions of the law.

On March 16, 2008, the Company appealed the decision of the Commissioner. With respect to this matter and to the matter of the class action regarding the issue, see Notes 17(A)(11) and 17(C)(1) to the financial statements of the Company for the year ended December 31, 2008, included in this periodic report.

- E. On October 18, 2007, the Company gave the Antitrust Authority data and documents at the Authority's request regarding the alleged provision of information to a subsidiary.
- F. For the Commissioner's objection to the merger of the Company and DBS, see section 1.1.5 above.
- G. The Company has adopted an internal compliance policy (the Policy) containing internal reporting and internal procedures which essentially ensures that the activity of the Company and its employees is carried out in accordance with the provisions of the Antitrust Law, 5748-1988 (the Antitrust Law). The Policy includes a general explanation regarding the Antitrust Law, guidelines for the Company's and its employees' conduct so as not to breach the provisions of the Antitrust Law. Under the Policy, the Company's internal compliance officer issues, from time to time, general and specific directives on various issues (such as pricing, relations with subsidiaries, contacts with customers and the like). The internal compliance officer's directives bind all of the Company's employees and managers.

2.16.8 The Wireless Telegraphy Ordinance

The Telegraphy Ordinance regulates the use of the electromagnetic spectrum, and applies, inter alia, to the Company's use of radio frequencies, as part of its infrastructure. The set-up and operation of a system making use of radio frequencies is subject, under the Telegraph Ordinance, to the issue of a license, and the use of radio frequencies is subject to designation and allocation of a suitable frequency. The Telegraph Ordinance imposes license fees and fees for designation and allocation of frequencies.

For a number of years, the Government has been dealing with a shortage of radio frequencies for public use in Israel (among other reasons, due to the allocation of a large number of frequencies for security purposes), by limiting the number of licenses granted for the use of frequencies on the one hand, and increasing the fees payable for allocation of a frequency in the lower range, on the other. On October 25, 2007, the Ministry of Communications notified the Company that it is considering ordering it to cease using neighborhood radio and rural radio systems and the frequencies allocated to it for the purposes for which they are being used, inter alia, in order to provide its services in areas where an infrastructure of telephone lines does not exist. On December 25, 2007, the Company submitted its response in which it clarified that the Ministry must allocate alternative frequencies and that the Ministry's requirement would create difficulties for the

Company and requires extensive deployment and operations that would entail significant expenses. Furthermore, the Company noted that it would be required, within of two years, to transfer subscribers from the existing systems to new systems and demanded that the State bear the costs of migration from systems that the Company would be required to evacuate. Since then, the Company has been negotiating with the Ministry of Communications with respect to the allocation of alternative frequencies for those frequencies that the Company is required to vacate.

The Company and the Ministry of Communications have a number of differences of opinion regarding fees which the Company claims it does not owe and therefore has not paid. Following a clarification with the Ministry regarding these disputes, most of them have been settled. The main sum remaining in dispute relates to fees in Judea, Samaria and Gaza, and amounts, as at December 31, 2008, to approximately NIS 59 million.

For an update on WiMAX, see section 2.6.6(B) above.

2.16.9 Legislation amendments

In April 2008, the Knesset approved an amendment to the Consumer Protection Law regarding fixed transactions (the Amendment). Under the Amendment, dealers will be required to inform consumers of the date of termination of a fixed transaction prior to termination of such, and of the conditions that will apply after the date of termination. In addition, dealers will be required to obtain the positive consent of the consumer to continue with the contract beyond the fixed period. If positive consent is not obtained, the consumer will be disconnected from the service to which the fixed transaction applied, apart from basic telephone services as defined in the Communications Law (voice services). This amendment came into force on January 10, 2009. The Ministry of Communications also held a hearing for the Company regarding the amendment to the Company's license and those of other licensees in this regard, proposed by the Ministry of Communications. In this context, the Ministry of Communications announced on October 29, 2008 that with regard to the secondary hearing with respect to setting a uniform tariff for the commitment period, the Ministry decided to amend only the licenses of general licensees for providing cellular services in a way that will obligate a uniform tariff as aforesaid. This amendment came into effect on December 31, 2008. Furthermore, the Knesset approved an amendment to the Consumer Protection Law regarding disconnection from ongoing services (effective October 2008) allowing a private subscriber to disconnect from ongoing service by using mail, electronic mail or telephone. In addition, the Knesset approved the amendment to the Consumer Protection Law (effective September 2008) which imposes, in certain circumstances, fines if a technician is late and an amendment to the Communications Laws regarding junk mail (effective November 2008), according to which, among other provisions, as a general rule, a subscriber's explicit permission is required to receive advertising by way of electronic mail, facsimile, automatic dialing systems and SMS.

2.16.10 Security arrangements

In addition to the special provisions that apply to the Company in the field of security by virtue of the general license (see section 2.16.2H above), special provisions also apply to it under the Communications (Telecommunications and Broadcasts) (Prescription of Essential Service Provided by Bezeq, The Israel Telecommunications Corp. Ltd.) Order 5757-1977.

2.16.11 Establishment of communications installations

A. The National Outline Plans for Communications, NOP 36 (within the green line) and NOP 56 (in the Administrated Territories) are designed to regulate the deployment and method of establishing communications installations to secure their functioning throughout the entire country, for radio broadcasting and reception, television and wireless communication, while minimizing harm to the environment and the landscape.

B. NOP 36A

- (1) Part I of NOP 36, dealing with building permits for small and micro-broadcasting installations, was approved by the Government on May 2, 2002.

From time to time, the need arises to add broadcasting installations, which require the obtaining of building permits under NOP 36A. As at the date of the publication of this periodic report, the Company is dealing with the production of

building permits for 18 small broadcasting facilities and is involved in legal proceedings for another seven broadcasting facilities.

- (2) The NOP 36 drafting committee has decided that the distinction between NOP 36A and NOP 36B will be based on the size of the public safety range, irrespective of the size of the installation. Pursuant to this decision, under the draft amendment of NOP 36A of January 2008, the licensing process for microwave installations which were previously classified as small broadcast installations, and which have a safety range of more than 12 meters, will fall under NOP 36B, which prescribes more stringent conditions for issuing building permits.

The draft amendment of NOP 36A of January 2008 also prescribes different licensing tracks according to the location and safety range to the public of an installation, where an obligation to deposit deeds of indemnity for compensation under section 197 of the Planning & Building Law, in various indemnity sums (depending on the track) is set for each track.

- (3) Given the provisions of the Planning and Building Law, 5725-1965 and the provisions of the Communications Law, the Company believes that the obligation to be issued building permits for micro-broadcasting installations, which are "wireless access facilities" do not apply to it under said laws.

With respect to wireless access installations, there are a number of initiatives to cancel the exemption from a building permit. If the Company is required to provide an affidavit of an exemption from a building permit as set out in section 2.15.1 and/or if the exemption from a building permit is given, this might have substantial adverse implications which the Company is unable to estimate at this stage. For the implications on the subsidiary Pelephone, see section 3.18.3.3 below.

C. NOP 36(B)

As set out in paragraph (b) above, under the January 2008 draft, the licensing process for broadcast installations previously classified as large, which have a smaller safety range than 12 meters, shall come within NOP 36A, the current draft of which does not include transitional provisions enabling an abridged licensing procedure.

The January 2008 draft proposes transitional provisions to the effect that: (1) a building permit issued for a broadcasting installation according to a previous plan which does not comply with the provisions of the NOP 36(B), shall be regarded as irregular use that was permitted for a period of 24 months from the date of the approval of the Plan. If the operator of the installation submits to the institution that approved the erection of the installation, a permit from the Commissioner on Radiation of compliance with the safety restrictions prescribed in the Plan, within said period, the permit will be regarded as being in compliance with the provisions of NOP 36(B). Otherwise the building permit shall expire. (2) A permit may be granted for broadcasting installations erected prior to the approval of the NOP 36(B) at a broadcasting site which existed prior to January 31, 1984, even if the installations do not comply with the provisions of the NOP 36(B), provided they meet the safety restrictions specified in NOP 36(B).

Note that the Company's broadcast installations were mostly set up many years ago (prior to January 31, 1984), some of them by authorities of the State.

The January 2008 draft also proposes including a provision requiring that an applicant for a permit from a local committee to give a deed of indemnity regarding compensation under section 197 of the Planning & Building Law, should a ruling be made against the local authority for all of the installations contained in NOP 36(B), including broadcast installations erected prior to January 31, 1984, which were exempt from the indemnification obligation under previous drafts of NOP 36(B). The Company has submitted its objection to the inclusion of this provision in NOP 36(B).

D. General

On April 17, 2008, the Company submitted its reservations concerning the proposed draft of National Outline Plan for Communications – NOP/36(A) Small Broadcasting Installations, and NOP/36(B) Large Broadcasting Installations. In brief, the reservations are that the plans as proposed, and in particular as they relate to

changing the definitions of large and small broadcasting installations, create practical difficulties which could prevent the Company from granting the public some of the varied services it provides and is obligated by law to provide.

- E. With respect to radiation permits for communications and broadcasting installations, see section 2.15 above.

The information in this section 2.16.11 includes forward-looking information, based on the Company's assessments. Actual results might be substantially different from these assessments.

F. NOP 56 – Communication facilities in the Administrated Territories

On July 29, 2008, the Company received notice that in June 2008, NOP 56 which regulates the establishment and licensing of communications facilities in the Administrated Territories, took effect. The plan includes transition directives for facilities established prior to 1984 and for existing facilities.

The plan includes a requirement for a communication license and approval from the Commissioner of State Property in the Civil Administration. The Company disagrees with the amounts required by these officers as a condition for issuing the approvals. The Company is examining the financial requirements in the context of wider discussion, and as of the reporting date, it is unable to assess the expected implications.

- 2.16.12** On February 4, 2008, an amendment was published to the Second Television and Radio Authority Law, 5750-1990 under which the Second Television and Radio Authority would set up and operate a digital terrestrial television (DTT) broadcast array backed up by a digital satellite array for the transmission of the television broadcasts of television franchisees freely to the entire Israeli public, and nationally (see also section 5.1.3.3 below) so that such distribution would be effected no later than December 1, 2008. The technological change involved in the transition from analog services to digital services in the area of television might harm the Company's revenues however, at this stage, the Company is unable to assess the aggregate harm that will be caused as a result of closing the analog networks and setting up the digital network.

2.17 Substantial Agreements

The following is a summarized description of the substantial agreements that are not part of the Company's ordinary course of business, and that were signed and/or were in force during the period of this periodic report:

2.17.1 Agreements relating to debentures

A. Deed of trust for debentures (series 4) dated May 24, 2004

A deed of trust signed with the Mizrahi Bank Trust Company Ltd. for a series of 1,200,000,000 debentures of NIS 1 par value each, repayable in four equal annual installments on June 1 of each of the years 2008 to 2011, bearing annual interest of 4.8%, linked (principal and interest) to the CPI for April 2004. Of these, 800,000,000 Debentures were to the public by prospectus (the Prospectus) on May 24, 2004, and 400,000,000 were purchased by a wholly owned and controlled subsidiary of the Company, Bezeq Zahav (Holdings) Ltd. (Bezeq Zahav Holdings) immediately prior to the Prospectus and were listed for trade according to the Prospectus.

B. Deed of trust for debentures (series 5) dated May 24, 2004

A deed of trust signed with the Mizrahi Bank Trust Company Ltd. for a series of 600,000,000 debentures of NIS 1 par value each, repayable in six equal annual installments on June 1 of each of the years 2011 to 2016, bearing annual interest of 5.3%, linked (principal and interest) to the CPI for April 2004. The debentures were issued prior to the Prospectus to institutional investors and to Bezeq Zahav Holdings and listed for trade according to the Prospectus.

An addendum to the deed of trust for the debentures in this series relates to the issue of an additional 1,500,000,000 debentures which were issued by the Company to Bezeq Zahav Holdings under the same conditions and listed for trade on the stock exchange (subject to lock-up restrictions).

On March 30, 2005, a further addendum to this deed of trust was signed regarding the issue of NIS 286,967,000 par value debentures of the same series.

2.17.2 Real estate

A. Asset transfer agreement between the Company and the State dated January 31, 1984

An agreement between the State and the Company, under which the Company was conferred the State's rights in assets which the Ministry of Communications used for providing telecommunication services, and the Company assumes the rights of the State with respect to those assets and the obligations and liabilities with respect to these rights immediately prior to implementation of the Agreement. Moreover, under that Agreement, the State's rights, powers, obligations and duties according to the agreements, contracts and transactions that were in force with respect to telecommunications services immediately prior to implementation of the Agreement, were transferred to the Company.

B. Settlement agreement of May 15, 2003 between the Company, State and Israel Lands Administration regarding rights related to land

See Section 2.7.4(C) above.

C. Agreement between the Company and the Israel Postal Authority

An agreement dated June 30, 2004 between the Company and the Israel Postal Authority to define and arrange the rights of the Company and the Postal Authority to their joint assets. The agreement listed the joint assets and defined the share each party has in them. It was determined that each of the parties shall have exclusive rights to their share, except with regard to rights in joint assets, building rights or rights that have been explicitly clarified elsewhere. With regard to a number of additional assets, the party with exclusive rights to them, in whole, will be one party that was so determined.

2.17.3 Agreements with DBS and its other shareholders

A. A founders' agreement of December 4, 1998, between the Company, Eurocom Communications Ltd. (whose holdings were subsequently transferred to Eurocom DBS Ltd.), Lidan Business Enterprises Ltd. (whose holdings in DBS were subsequently transferred to Lidan Business Enterprises (10994) Ltd.), and Gilat Communications Ltd. (which transferred its holdings in DBS to Gilat DBS Ltd.), governing the incorporation and management of DBS and the relationship of its shareholder

B. An agreement dated December 30, 1998 between the shareholders of DBS and DBS, stipulated the establishment of an executive committee and its authorities.

C. An agreement of November 2001 between the DBS shareholders and DBS, which amended the dilution formula prescribed in the founders' agreement and determined that the holdings of shareholders in DBS be adjusted to their respective investments in DBS so that for the purposes of dilution, the investments (made by way of shareholders' loans) as of the date prescribed in the agreement would bear linkage differentials and cumulative linked interest on an annual basis at a rate of 5.5% per annum from the date of incorporation of DBS.

D. An agreement dated December 30, 2002, as amended on August 6, 2003, between DBS shareholders and DBS determines preference for shareholder loans given as of July 10, 2002 over the loans made prior to that date. The agreement prescribed that these loans would bear CPI linkage differentials and annual linked compound interest at a rate of 5.5%, while the loans extended as of April 27, 2003 will bear CPI linkage differentials and annual linked compound interest of 11%. Likewise, the agreement set up a mechanism for the issue of shares or options for shares to shareholders who invest in DBS so that their holdings in DBS will be equivalent to their adjusted investment in it. The agreement also determined information rights as determined for its shareholders who are interested parties (for the Company's actions to exercise the options issued to it, see section 1.1.5 above).

In this matter also see section 5.16.7 below.

2.17.4 Labor agreements

- A. A comprehensive pension agreement was executed on September 21, 1989 between the Company, the Histadrut and the joint representation of the workers' committees and Makefet Fund – Center for Pensions and Remuneration Cooperative Society Ltd.

The agreement provided a full and autonomous arrangement regarding the pension insurance of Company employees. The agreement applies to all transferred employees (who were transferred from the Ministry of Communications to the Company), to all of the members of the cumulative pension fund employed by the Company on the date of execution of the pension agreement and to all of the permanent and temporary employees of the Company, with the exception of special employee groups (students, employees under personal contracts or employees under some other alternative arrangement).

- B. Special collective bargaining agreement for early retirement, dated November 23, 1997 as amended and extended on September 4, 2000, March 18, 2004, April 17, 2005 and June 28, 2005 between the Company, the Histadrut and the Workers' Organization

For information in this regard and regarding early retirement, see Note 16 to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

- C. Agreement to anchor rights of September 4, 2000 between the Company, the Histadrut and the Workers Organization

A special collective agreement between the Company, the Histadrut and the Workers Committee, inter alia regarding anchoring the rights of the transferred employees. This agreement was intended to anchor the rights of the transferred employees to the pension rights to which they were entitled by virtue of their being former public servants, under the Company's pension agreement, adopted by the Company under its pension agreement. According to this agreement, these rights became personal rights which could not be cancelled, other than by waiver of personal rights under law (in other words, by personal waiver by the employee himself or herself).

In this regard see also section 2.9.5 above.

- D. Generation 2000 agreement of January 11, 2001 between the Company, the Histadrut and the Workers Union

Following an amendment in July 2000 to the Employment of Employees by Human Resources Contractors (Amendment) Law, 5760-2000, a special collective bargaining agreement was signed between the Company, the Histadrut and the Workers Committee on January 11, 2001 to recruit new employees and stipulate their salary conditions. The agreement applies to new employees and to employees who were previously employed at the Company via human resources companies, in positions listed in the appendix to the agreement (customer service representatives at call centers, administrative workers, typists, warehouse employees, secretaries, mail sorters and distributors etc., administrative employees such as porters, drivers and forklift operators, and others). Under the special collective agreement of December 5, 2006, it was agreed that the Generation 2000 agreement would not apply to such employees as had been recruited into the Company since July 1, 2006. It was also agreed to insert non-substantial amendments into the conditions of employment of employees recruited for employment under the Generation 2000 agreement.

- E. Agreement of April 17, 2005 with alternative entity in lieu of the Makefet Fund with respect to early retirement arrangements for employees of the Company

On April 17, 2005 a special collective agreement was signed between the Company, the Workers Organization and the Histadrut, concerning an arrangement with an alternative entity to the Makefet Fund for all matters relating to early retirement arrangements for Company employees.

In addition, on June 28, 2005, an agreement was entered into between Harel Insurance Company Ltd. ("Harel") and the Company (the "June 2005 Agreement"). The contract regulates payment of pensions for early retirement and provisions for old-age and survivor pensions deriving from legislative amendments under the Israeli Economy (Recovery Program) Law for employees who retired from the Company from

the end of 2003 / beginning of 2004 and/or who will retire from the Company in accordance with the special collective agreement for retirement of September 2000 as amended on March 18, 2004 and April 17, 2005. Following execution of the agreement with Harel, the special collective agreement between the Company, employee representatives and the General Trade Union as aforesaid was amended on the same date (June 28, 2005).

On February 14, 2008, Harel and the Company signed an amendment to the June 2005 agreement, the main points of which were: (1) The June 2005 agreement would also apply to employees of the Company who resign from their employment at the Company prior to December 31, 2013 under the early pension track, in accordance with an option granted to the Company in the special collective agreement of December 5, 2006, if and to the extent that the Company chooses to exercise such option. (2) Reduction of the consideration paid by the Company to Harel for every retiree insured under the June 2005 agreement and policies have not been issued by Harel on the date of execution of the amendment to the June 2005 agreement.

In this regard, see Note 16(G) to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

Special collective agreement dated December 5, 2006

A collective agreement was signed between the Company and the workers' organization and the New General Trade Union, setting out the employment relationships at the Company following transfer of control of the Company from the State of Israel to Ap. Sb. Ar. Holdings Ltd., and prescribing a new organizational structure for the Company (see section 2.9.1 above).

Under the agreement, all agreements, arrangements and procedures existing in the Company prior to execution of the agreement, including the mechanism of linkage of salaries to the public sector, shall continue to apply to permanent, senior employees of the Company only, to whom the agreement applies, subject to amendments made expressly in the agreement. Existing and new temporary employees shall be employed on the basis of monthly / hourly salary agreements that are based on a market salary model according to their businesses, with a high level of administrative flexibility.

The agreement also provides that in 2006-2008, 975 permanent employees shall retire from the Company under early pension schemes or increased severance pay schemes. The Company shall also be entitled, at its discretion, to terminate the employment of a further 1225 permanent employees (245 permanent employees during any one or more of the years 2009-2013). The retirement conditions to be offered to the retirees shall be identical, for the most part, to the retirement conditions employed at the Company at present.

The agreement shall be valid from the date of execution of through December 31, 2011. The Company has an option to extend the agreement for two more years through December 31, 2013. The retirement chapter of the Agreement shall, in any event, expire on December 31, 2013.

For the amendment of the agreement see section 2.9.1.

2.17.5 Management agreement

On March 23, 2006, the general meeting of the shareholders of the Company approved entry by the Company into an agreement with a company which is to be owned and controlled by the shareholders of Ap. Sb. Ar. under which the Company shall be given ongoing management and consultancy services, including via directors who may act from time to time in the Company and/or its subsidiaries, all in return for \$1.2 million each year. The term of the contract is from October 11, 2005 (the date of completion of acquisition of 30% of the shares of the Company by Ap. Sb. Ar.) and until December 31, 2008, unless one of the parties gives notice to the other of its desire to terminate the contract by way of prior notice of three months in advance. On July 29, 2007, a management agreement was executed between the Company and a corporation owned and controlled by the shareholders of Ap. Sab. Ar. Holdings Ltd. This agreement is in force as of October 11, 2005.

2.18 Legal Proceedings

For information on legal proceedings see Notes 15, 16 and 17 to the financial statements for the year ending December 31, 2008, included in this periodic report, and section 1.1.5 above.

2.19 Business Objectives and Strategy

2.19.1 Forward-looking information

It is only natural that a review of Company strategy involves expectations regarding future developments with respect to customer behavior and needs, adoption rate of new services, technological advances, regulatory policy, marketing strategy employed by competitors, and the effectiveness of the Company's marketing strategy.

The Company's strategy and the business objectives derived from it are based on internal research, secondary information sources and primarily on reports issued by research groups, publications regarding activities by similar communications providers in Israel and around the world, and the work of consultants who have assisted the Company.

However, there is no certainty that the strategy and main activities described below will actually be realized or realized in the manner described below. The circumstances that may lead to non-implementation of the strategy or even its failure relate to frequent technological changes, regulatory constraints, design of a sustainable business model for new services the Company plans on providing and implementation of a preferable marketing strategy by competitors. Furthermore, a change in the ownership of the Company may also lead to changes in its strategy and business objectives.

2.19.2 Summary of strategy and future plans

The Company is operating to implement a strategy of going from a company that provides infrastructure only, to a company that provides a variety of products and services that are tailored to customers' needs.

Vision and objectives

The Company has set a goal of reinforcing its position as the leading telecommunications company in Israel, while providing end-to-end solutions to business customers and creating a user experience for private customers, and providing quality service and business excellence.

In order to achieve this goal, the Company faces a number of challenges:

- A. Maintaining its leading position in an ever-more competitive environment (leadership in service and strengthening values – product innovation, reliability, closeness to customer);
- B. Reducing the decline in revenues from core services;
- C. Generating new sources of revenue;
- D. Adapting the organization to the competitive environment and operational excellence.

To implement the strategy and achieve said goals and objectives, the Company uses and will continue to use the following:

Business customers

- A. Offering variety in its basket of products and services
- B. Providing a comprehensive solution based on the needs of the customer, while using a policy that dictates a commitment to quality and availability of service
- C. Encouraging customer migration from basic services for managed solutions to organizational and inter-organizational connectivity
- D. Offering a variety of value-added services

Private customers

- A. Continuing to penetrate broadband and improving infrastructures to increase bandwidth
- B. Providing differential pricing tracks

- C. Strengthening the positioning of the Company's telephony services, while focusing on advanced applications and penetration of advanced terminal equipment

Network

In order to achieve its strategic goals, the Company is using its best endeavors to improve its existing network and to make it comply with its commercial goals, inter alia by laying optical fibers and making investments in the network core. See also sections 2.6.7 and 2.7.2 above for a description of the NGN.

2.19.3 Development trends in Company activities

- A. The Company is working to increase bandwidth and data transmission rates for the services it provides to its customers. The Company takes marketing initiatives which are designed to switch its customers to its high speed internet service. Furthermore, the Company offers its business customers fast transmission and data communications services over a variety of protocols.
- B. The Company is working towards integrating itself in IP (Internet Protocol) applications. It has therefore set up an IP network to serve as a platform for the services it currently provides and the additional services it plans to offer in the future.
- C. The Company is examining the technological viability of distributing digital contents over the Company's network and infrastructure.
- D. The Company launched fixed-line and wireless home network services that enable multiple computers to connect simultaneously to the internet from a number of computers.
- E. The Company has launched a variety of billing tracks for telephony services along with its basic tariff structure to increase the use of its services.

2.19.4 Main projects in the planning or execution stage

The main projects executed by the Company include deployment of the NGN based on the outline for 2009 as approved by the board of directors, as well as the expansion of capacity for the Company's networks with the aim of providing its business customers with high speed data transmission and communication services. Additionally, the Company is developing and assimilating advanced computing systems, including CRM and network engineering management and management of orders and supply of services.

2.20 Risk Factors

A. Increasing competition

Competition in the field of domestic fixed line communications is increasing. Furthermore, the Company views the cellular telephony market as a market which, to a large extent, is an alternative to the fixed-line domestic telephony market.

The companies that are currently in competition with the Company, or that are likely to compete with it in the future, enjoy much greater commercial flexibility than that of the Company, including an ability to cooperate with subsidiaries and affiliates and to market service bundles together with them. HOT's ability to market service bundles (triple play) with flexibility as to tariffs, compared with the Company's inability to do so, harms the Company's ability to compete.

The number portability that was commenced on December 2, 2007 (see section 2.6.6(A) above) contributes to increase competition in the industry.

Likewise, the possibility of providing telephony services over the Company's and HOT's broadband infrastructure (VoB) could also contribute to increased competition.

Organization of the provisions of the policy in the spirit of the recommendations of the Gronau Committee, as adopted by the Minister of Communications could result in accelerated competition in the Company's sector of operations.

B. Government supervision and regulation

The Company is subject to government supervision and regulation that, among other matters, relate to licensing for activity, determining permitted areas of activity, determining tariffs, operation, competition, payment of royalties, obligation to provide universal service, ability to hold its shares, relationships between the Company and its subsidiaries and prohibition to terminate or restrict its services (which may force the Company to provide services even when

not economically feasible or when it goes against its interests). This supervision and regulation at times lead to State intervention, which the Company believes adversely affects its business operations.

C. Regulation of tariffs

The Company's tariffs for services are subject to State regulation. These tariffs are stipulated in regulations, and regulations also stipulate a formula for linking them to the changes in the Consumer Price Index, less an amount for depreciation. The practical implications of this system is real erosion in the tariffs of the Company. Some of the Company's tariffs are subject to the Supervision of Prices for Commodities and Services Law. For the uncertainty regarding the continued update arrangement of the Company's supervised tariffs, see section 2.16.1 above. Additionally, regarding the reference of the Gronau Committee to flexible tariffs, see section 2.6 above.

D. Difficulties in labor relations and human resources

As a part of the preparations to cope with the increasing competition in the field, the Company must continue to formulate additional plans for organizational changes and make a further reduction in the number of personnel. The implementation of these plans has involved and is expected to involve, coordination with the employees and substantial costs, including the cost of compensation for early retirement, over and above the costs which are stipulated in existing agreements. The implementation processes of these plans have in the past caused and may cause in the future unrest in labor relations and hurt the Company's regular business.

E. Restrictions on relations between the Company and companies in the Bezeq Group

The Company's general license obligates it to ensure that its relationship with its principal subsidiaries in the Bezeq Group does not cause them to be preferred over their competitors. Under the general license, separation is required between the respective managements of the Company and said companies, and separation is also required in the financial and marketing systems, as well as assets and employees, which causes high administration overheads. The Company is also not allowed, at this stage, to offer joint service bundles with the aforesaid companies. In view of the entry of communication companies into direct competition with the Company in most of its sectors of operation based on the supply of a package of services to the customer, whether directly or through cooperation, there is a greater risk that this factor will affect the Company's operations. Nonetheless, with regard to the matter of the permit to provide non-divisible services packages, see section 2.6 above (adoption of Gronau Commission recommendations).

The Antitrust Authority's objection to the merger between the Company and DBS so that the Company's holdings of DBS will increase from 49.8% to 58% (see section 1.1.5(A) above) harms the Company's ability to realize its holdings of DBS.

F. Legal proceedings

The Company is a party to legal proceedings, including class-action claims, which may cause it to have to pay significant sums, most of which cannot be estimated. Therefore provisions have not been made in the Company's financial statements and in those of companies in the Group.

Class-action claims can reach large amounts, as virtually all residents of the country are consumers of the Company's services, and a claim that relates to minor injury to a single consumer may become a significant case for the Company if it is recognized as a class action that applies to all consumers or a significant portion of consumers. Additionally, as the Company provides communications infrastructures as well as billing and collection services to other Licensees, parties initiating legal action against said Licensees in other class action cases may even try to involve Company as a party to these proceedings.

For a description of the legal proceedings, see section 2.18 above, which refers, inter alia, to Note 17 to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

G. Exposure to exchange rate fluctuations and inflation

The Company assesses exposure to changes in exchange rates and inflation by the surplus or deficit of assets against liabilities based on the type of linkage. The Company's exposure to changes in currency exchange rates against the shekel is low. The Company's exposure to inflation changes is high and therefore the Company takes the required steps to cover part of the inflation exposure.

H. Electromagnetic radiation and licensing of broadcast installations

The issue of electromagnetic radiation emitted from broadcast facilities is regulated mainly in the Non-Ionized Radiation Law, 5766-2006 (see sections 2.15 and 2.16 above).

The Company is working to obtain permits to build and operate its various broadcasting installations, however, the difficulties it faces in this activity, including difficulties related to the change in policy maintained by the various relevant organizations and amendments to statutes and standards, may negatively impact on the infrastructure of the said installations and on the regularity of provision of services using them. The Company's third-party liability policy does not currently cover electromagnetic radiation.

I. Frequent technological changes

The communications field is characterized by frequent technological changes and a shortening of the economic life-span of new technologies. These trends mean a lowering of entry barriers for new competitors, an increase in depreciation rates and in certain cases, redundancy of technology and networks owned by the Company, the cost of investment in which may still be recorded on its balance sheets.

J. Global economic crisis

In the last quarter of 2008, the global economic crisis has sent global markets into a recession and credit crunch. It is expected that the impact of the process will continue to be felt in 2009 and possibly even later, and it is possible that there will be a transition from growth to recession. The local market is also expected to experience a significant slump together with deterioration in business operations and central economic parameters. The Company estimates that the crisis could have an adverse effect on its operations, inter alia, as a result of the damage to the Company's revenue and difficulty in selling its real estate assets.

This information contains forward looking statements, based on the Company's assessments. The actual results may differ materially from these assessments if there is a change in any of the factors taken into account in these assessments.

Summary of risk factors

	Effect of risk factor on Company activity		
	Major	Moderate	Minor
Macro risks			
Exposure to exchange rate fluctuations and inflation			X
Sector risks			
Increasing competition	X		
Government supervision and regulation	X		
Regulation of tariffs	X		
Electromagnetic radiation and licensing of broadcast installations		X	
Frequent technological changes		X	
Company-specific risks			
Exposure in legal proceedings		X	
Difficulties in labor relations		X	
Restrictions on relations between the Company and companies in the Bezeq Group	X		
Global economic crisis		X	

3. Mobile Radio Telephone – Pelephone Communications Ltd. (Pelephone)

3.1 General Information on Area of Operations

3.1.1 Pelephone's field of activity

Four companies operate in Israel's cellular communications market under general license to provide MRT services. Activity in the mobile radiotelephone sector (MRT or Cellular Communications) began with the incorporation of Pelephone in 1985. Pelephone deals in the provision of cellular communications services, and sale and repair of terminal equipment. Pelephone's revenues include, inter alia, the charging for MRT communications customers (payments for call minutes, regular subscriptions, added value services and roaming services), payment for the sale of terminal equipment and in respect of terminal equipment services and revenues from other communications providers for interconnect (see sub-paragraph 3.2 below).

As of August 2004, Pelephone is wholly owned by Bezeq.

3.1.2 Legislative and secondary legislation restrictions applicable to Pelephone

3.1.2.1 General license

Pelephone operates in accordance with an operating license from the Ministry of Communications - General License for the Provision of Mobile Radio Telephone Services, which is valid until 2022 (hereafter: the License). The license prescribes conditions and rules that apply to Pelephone's operations, and the competent authorities may amend the licensing conditions subject to the law.

3.1.2.2 Tariff control

The tariffs that Pelephone is permitted to collect from its subscribers are regulated by its license with the exception of tariffs for interconnection between operators for the completion of calls and SMS messages, which are regulated under regulations. In December 2004, the Telecommunications (Telecommunications and Broadcasts) (Payments for Interconnect) Regulations, 5760-2000, were amended in such a way as to reduce tariffs for interconnect to the MRT network regarding call completion, transmission of SMS messages and to modify the method of calculating the duration of chargeable time beginning in 2009 (see sub-paragraph 3.18.2 below).

3.1.2.3 Royalties

Under its license and under the Telecommunications (Royalties) Regulations 5761-2001, Pelephone pays the State of Israel royalties out of its revenues which bear royalties due to the provision of telecommunications services (see section 3.18.3.2 below).

3.1.2.4 Environmental matters

The laying and operating of a wireless infrastructure including cellular communications is subject to the provisions of the Non-Ionized Radiation Law and the permits from the Ministry of the Environment that are required in it (see section 3.17 below).

3.1.3 **Changes in the volume of activity and profitability in the field**

The following are financial and quantitative data regarding Pelephone's scope of operations and profits for 2007-2008:

	2008	2007
Revenue (NIS millions)	4,713	4,684
Operating profit (EBIT) (NIS millions)	933	805
Operating profit before depreciation and amortization (EBITDA) (NIS millions)	1,456	1,283
Number of subscribers at end of period ¹⁸ (in thousands)	2,649	2,622
Average minutes of use (MOU) ¹⁹ per subscriber per month	352	354
Average monthly revenue per subscriber (NIS) (ARPU) ²⁰	126	131

According to Pelephone's license and the Telecommunications (Payments for Interconnect) Regulations, 5760-2000, as of January 1, 2009, the charge for air time and completing a call will be calculated according to segments of one second unlike the charging system in force until then, which enabled charging per segments of 12 seconds or more. This change is expected to adversely affect Pelephone's revenues.

3.1.4 **Market development and changes in customer attributes**

In recent years, the cellular market has been characterized by lower growth rates than in the past due to saturation of penetration rates. The competition's focus on increasing growth rates encourages the companies in the field to increase the range of services offered to customers, to increase their segmentation and make special offers to various target groups, providing specific responses to their needs.

3.1.5 **Technological changes affecting the Company's field of activity**

3.1.5.1 There are two main technological tracks in Israel's cellular industry:

- A. The CDMA track, which developed in the 2.5 generation to 1X and in the third generation to EVDO (CDMA Technology) (see section 3.1.5.2 below).
- B. The GSM track, which developed in the 2.5 generation to GPRS and in the third generation to UMTS, and in the 3.5 generation to HSPA – the networks of Pelephone's principal competitors in Israel use this technology.

Pelephone's network used the CDMA track until the end of 2008. During 2008, Pelephone established an additional cellular network using the HSPA/UMTS technology which began operating commercially during January 2009 (for details see section 3.9.1 below).

3.1.5.2 In 2004, Pelephone launched 3G services by means of CDMA 2000 EVDO technology which connects up to CDMA 2000 1XRTT technology that is deployed throughout the country. The EVDO network was deployed in urban areas during 2004-2006 (for details see section 3.9 below). 3G services enable streaming of data, including video, at higher speeds and enables Pelephone to offer its customers a wide range of added value services (for details see section 3.2.1 below).

3.1.5.3 On November 1, 2007 the general shareholders' meeting of Pelephone adopted Pelephone board of directors' resolution from September 2007 regarding establishment of a network using HSPA/UMTS technology at a total investment of NIS 1 billion. This cost includes the cost to the network supplier, establishment of

¹⁸ Subscriber data relate to active subscribers having received or made at least one call in the past six months or having paid the company for services. On December 31, 2008, the company adopted a strict subscriber counting policy according to which customers, who receive SMS messages only are not counted as subscribers. This change resulted in a one-time deletion of approximately 92 thousand subscribers.

¹⁹ MOU (Minutes of Use) – average monthly minute use per subscriber. This index is calculated in accordance with an annual average of the sum total of outgoing and incoming minutes each month, divided by the average number of subscribers during that month.

²⁰ ARPU (Average Revenue Per User). This index is calculated by averaging the division of total revenue from cellular services and repairs each month by the average number of active subscribers in that month.

the new sites required to operate in the new frequency range, conversion of existing sites and services to HSPA/UMTS and unfreezing the right to implement frequencies. Ericsson was chosen as the system supplier. The new network began operating during January 2009 (see section 3.9.1 below). The establishment of the new network enables Pelephone to provide services requiring quicker transmission of information, which permits, inter alia, expansion of the variety of terminal equipment and roaming services. In 2008, the principal investment was made in the network and the rest of the investment will be spread out over the next three years.

3.1.5.4 Pelephone uses frequencies in the 850 MHz range in order to operate the CDMA network, and in the 850 MHz and 2100 MHz range to operate the HSPA/UMTS network.

3.1.6 Critical success factors in area of operations and changes therein

In the estimation of Pelephone, the following constitute the principal factors of success in its field of activity:

- National deployment of a high-quality, advanced MRT network, ongoing maintenance of the network at a high level and significant investments, on an ongoing basis, in cellular infrastructure, for the purpose of improving high-quality coverage around the country, which is a basic condition for the provision of Pelephone's services, and in order to provide customers with the most advanced services, via the most advanced technological infrastructure.
- Expansion of the variety of terminal equipment to leading suppliers.
- Provision of high-quality call services and advanced added value services.
- National deployment of service and sale centers which enable high quality customer support and service which allows the Company to successfully deal with a competitive market.
- Professional, high-quality, human resources.
- Marketing strategy for establishing and reinforcing the brand name.

3.1.7 Main entry and exit barriers

The principal barriers to entry to the area of operations are:

- The need for a MRT license, the allocation of frequencies, and operations being subject to the regulatory supervision that applies to the market (see section 3.18 below).
- The need for significant financial resources for making serious investments in infrastructures, which are affected by frequent technological changes, and the importance of providing a response to the needs of the market.
- The difficulty involved in setting up radio sites due to regulatory restrictions and public objections.

It is important to note that the investment barriers do not apply to a potential virtual carrier (see section 3.7.2 below).

The principal barriers to exit from the area of operations are:

- Long-term agreements with infrastructure suppliers and property owners with whom Pelephone has entered into lease agreements.
- Large investments which require long periods to recoup the investment.
- The obligation to provide services to customers in accordance with conditions prescribed in the license.

3.1.8 Substitutes for Pelephone products

Domestic fixed-line telephone services provided by the domestic operators under the licenses granted to them may constitute a substitute for some of the services provided by Pelephone.

Telephony services based on VOIP/VOB technology might constitute a substitute for cellular services.

3.1.9 Competitive environment and changes therein

Until the end of 1994, Pelephone was Israel's sole cellular company (until the end of 1993 – by virtue of Bezeq's license and on its behalf²¹). In May 1994, Cellcom Israel Ltd posted the successful bid in an invitation to tender for a second operator for MRT service (the Second Operator or Cellcom). In February 1998, a third operator was selected by invitation to tender – namely Partner Communications Ltd. (the Third Operator or Partner). As of February 2001, MIRS Communications Ltd., (MIRS) has been operating as an additional cellular operator. After the entry of the second operator, and later, the third operator, into the cellular market, fierce competition developed among the carriers (primarily between the three main carriers). This competition resulted in market saturation expressed in the diminution of the number of subscribers joining the Company, an increase in the transfer of customers between the cellular companies and an erosion in the prices collected by Pelephone from its customers for services rendered by it. Recently, Cellcom and Partner have entered the ISP (Internet Service Provider), domestic operator, and VOB (Voice Over Broadband) fields, and market bundle packages (see section 3.7 below). In addition, the Ministry of Communications recently granted trial licenses for VOC (voice over cellular) service users, which enables voice calls on the HSPA/UMTS network's data channel.

3.2 Products and Services

3.2.1 Services

Pelephone provides its subscribers with comprehensive services of voice transmission, transmission of text messages, data communications and advanced multimedia services as follows:

Basic telephone services (VOICE) – Pelephone's service package includes basic voice services, call completion services and also auxiliary services such as – call waiting, follow-me, voice mailbox, voice conference call and caller ID.

Third generation and advanced services (Added Value Services) – Pelephone offers to its customers value added services such as text message services and information services using SMS, multimedia MMS messages, voice information services using special-purpose asterisks, information and entertainment services via the Internet portal and advanced content services such as games, network games and video games. Among other things, subscribers may choose animation items, different ring-tones and music files from Pelephone's internet portal, and may download them to their handsets. Also, subscribers may receive services connected to their electronic diaries (Outlook services) enabling subscribers to obtain SMS messages regarding the arrival of e-mail messages. Moreover, using their handsets, subscribers can peruse and update their electronic diaries, and view their address list. Subscribers can also receive SMS notice of scheduled events in their electronic diaries.

The value added services offered by Pelephone are location-based services. These services also enable, while driving, early warning of an approaching police speed trap, guidance as to the fastest route from point to point, and information regarding the nearest points at which certain services needed by the subscriber may be obtained. The service also enables employers to obtain information as to the location of employees who have cellular handsets.

Pelephone offers its customers added value services using third generation technology, including, inter alia, viewing its various television channels such as: music, sports, news and a variety of entertainment channels, the ability to film and transfer video files, GPS cellular services, AGPS based Navigator services, and a high-speed Netstick cellular modem.

At present, some 1.2 million subscribers have handsets which enable use of third generation services. As part of the third generation services, Pelephone offers its customers internet access from laptops using a cellular modem.

²¹ Bezeq's license was in fact amended in April 1994, when it was prohibited from supplying a cellular service. A general license was in fact granted to Pelephone in February 1996, which had retroactive application back to 1994.

At the end of March, 2002 the Ministry of Communications published a public hearing document concerning policy to regulate commercial telephone services via a public telecommunications network. Commercial telephone services include voice and visual data services, entertainment, matchmaking, etc, which are provided to subscribers through terminal equipment connected to the network. It is important to note that the commercial telephone services field constitutes a source of revenue in Pelephone's content world, as well as that of the rest of the cellular operators. In proposed regulation, the regulator would like to change the commercial telephone services regulations in a way which may damage Pelephone's revenues in this field. The Ministry of Communications asked all the relevant authorities operating in the commercial telephone field to respond to the aforementioned hearing by May 29, 2008. Pelephone submitted its viewpoint on the matter according to which, inter alia, it asked the Ministry of Communications to hold frontal meetings on the subject of the hearing prior to making decision. During August, 2008, the Ministry of Communications called frontal meetings on the subject with all of the cellular operators and some of the content providers. During the aforementioned meetings, Pelephone presented its opinion on the subject to the Ministry's representatives. The Ministry has not yet set final policy on the subject.

Roaming services – Pelephone provides roaming services (communications via MRT from various locations worldwide), in accordance with agreements that it has with cellular providers around the world where this technology is used. In order to facilitate similar services in Europe and in other countries where the network is not based on CDMA technology (mainly GSM technology), Pelephone leases handsets to its customers that are adapted to the technology in use in those countries, in accordance with agreements between Pelephone and cellular operators in those countries. Pelephone has agreements which enable its customers to receive services in 207 countries worldwide.

The establishment of a HSPA/UMTS network (see section 3.1.5.3. above) enables increasing the variety of handsets and reducing the marketing gap in the area of roaming services.

With the launching of the HSPA/UMTS network, Pelephone enables its customers with HSPA/UMTS technology handsets to travel around the world with the personal handset and even provides these customers extensive roaming coverage in 207 countries, thanks to agreements with Vodafone, Holland. The agreement also allows roaming coverage for third generation services, video calls and internet access abroad, in countries where these services exist.

Maintenance and repair services – Pelephone offers its customers ongoing repair service, against a monthly payment that provides warranty for the cellular telephone or for a one-time payment at the time of the repair.

3.2.2 Products

Terminal handsets – Pelephone offers its customers various kinds of mobile telephone handsets, vehicle handsets, hands-free sets and assorted accessories which support the variety of services that it provides. When Pelephone launched the HSPA/UMTA network, it expanded the array of terminal equipment offered to its customers and added Nokia and Sony Ericsson to the collection of handsets it sells.

Recently, Pelephone has also begun providing its customers with modems and laptops, which allow surfing the web through the Pelephone network.

3.3 Revenue and Profitability of Products and Services

The following are data on Pelephone profitability (in NIS millions):

	2008	2007
	NIS millions	NIS millions
Revenue from cellular services, sale of terminal equipment and terminal equipment services	4,713	4,684
Percentage of gross profit	32%	29%

In 2006, 2007 and 2008, revenues from added value services amounted to 11%, 13% and 16% respectively of revenues from cellular communications (payments for call minutes, fixed subscription fees, added value services and roaming services).

3.4 New Products

In 2008 Pelephone continued to improve and expand its range of added value services and to increase the number of subscribers who use these services, including internet packages using a cellular modem (Netstick).

3.5 Customers

As at the end of 2008, Pelephone had 2.649 million subscribers. Approximately 65% of Pelephone's subscribers are private customers and 35% of Pelephone's subscribers are business customers.

3.6 Marketing, Distribution and Service

Pelephone's distribution system is based on 43 service and sales centers including laboratories spread around the country, which deal in service and sales to customers, treatment of malfunctions or provision of a substitute handset while sending the malfunctioning handset for repair, installation of handsets and customer retention. The distribution system is strengthened with stores and stands spread over 115 points of sale (some of which are operated by Pelephone employees, and others of which are operated by authorized sellers). In addition, there are various sellers that operate a door to door system, and service and sales representatives for the business sector.

Pelephone's subscriber service system includes 12 designated telephone call centers which provide information, service on various matters and in three languages, technical support, data regarding customer billing, added value services, sales and general information.

In September 2008, Pelephone signed a memorandum of understanding with Superpharm, which has until now operated as a Partner distributor, following which Pelephone's distribution network will be extended significantly.

3.7 Competition

3.7.1 Pelephone faces fierce competition from the other cellular operators: Partner, Cellcom and MIRS. This competition brought about an increase in the size of the market, the addition of new subscribers and an erosion of prices. This competition even strengthened as a result of the entry of number portability into force (see section 3.7.3 below) and will even deteriorate upon implementation of the Ministry of Communications' policy concerning MVNO/VOC (see section 3.7.2).

To the best of Pelephone's knowledge from the data published by each of the cellular companies in Israel, as at the end of 2008, there are approximately 9.1 million cellular subscribers in Israel: Pelephone has approximately 2.6 million subscribers, Cellcom reported approximately 3.2 million subscribers, Partner reported approximately 2.9 million subscribers and MIRS, approximately 0.4 million subscribers²².

²² This data relates to active subscribers as reported by the cellular companies in Israel.

For the recommendations of the Gronau Committee and their adoption by the Ministry of Communications, see section 2.6 above.

During the Government's deliberations on the Budget Law for 2009, additional Governmental decisions were made concerning the communications industry in general and the cellular industry in particular, inter alia, following the Gronau Commission's recommendations:

1. The roaming cellular tariffs will be examined by an interministerial Government team. The team will submit its recommendations concerning the possibilities of reducing the roaming tariffs by the end of 2008. In addition, the Ministry of Communications, in cooperation with other relevant Government ministries, will act to apply the European regulation in the roaming tariff field by February 28, 2009. In November, the Ministry of Communications approached the cellular operators and requested extensive and detailed data concerning roaming tariffs. At present, no decisions have been made in this matter.
2. An inter-ministerial team, in cooperation with the Ministry of Communications and the Ministry of Finance, will examine the option of reducing the interconnection tariffs. The team was to be established by September 15, 2008 and will submit its recommendations by March 31, 2009.
3. The Ministry of Communications will examine the option of allocating frequencies to establish an additional communications network by a new operator which will enter the communications market. The examination must be completed by the end of 2008. As at the date of this report, no decision has been taken on the subject.

3.7.2 Mobile Virtual Network Operator – MVNO:

In the framework of the deliberations on the Government's budget for 2008, the Government decided that the Ministry of Communications would prepare to grant MVNO licenses as from December 31, 2007 to anyone who is interested. If such a MVNO license is granted and the owner of such a license holds negotiations with the cellular operators that after 6-9 months do not end successfully and it is proven that the reason is the anti-competitive behavior of the cellular operators, the Minister of Communications shall then consider interfering in the matter of the MVNO entering the market in accordance with the powers granted to him by law.

In September 2008, as part of the government deliberations regarding the Budget and Economic Arrangement Laws for 2009, the Government decided to determine that the Minister of Communications will complete all the procedures required for granting MVNO licenses by April 1, 2009.

On January 5, 2009, the Ministry of Communications published a public hearing in which he requested response to his proposed draft license as the format for granting a MVNO license, as well as the key regulation rules of the Communications Law which the Minister intends setting in order to regulate the conditions and issues for granting MVNO licenses in accordance with the policy proposed by the Ministry in this matter. Pelephone submitted its response to this hearing.

3.7.3 Number portability

On March 22, 2005, the joint Finance and Economics Committee of the Knesset approved an amendment to the Communications (Telecommunications and Broadcasts) Law, 5742-1982 to the effect that the Minister of Communications is to prepare a numbering plan regarding number portability with respect to a general licensee for provision of MRT services and a licensee for domestic fixed-line communications services, and is to instruct them regarding the implementation and activation of it by September 1, 2006. According to the amendment, the licensee is required to provide number portability for any subscriber who may request same, free of charge to the subscriber or from any licensee.

Due to the short time schedules provided for the preparations, the cellular operators did not meet the date provided in the Communications Law. Nonetheless, the regulator decided to not postpone the date for implementing the portability plan beyond September 1, 2006. Following this decision, both Pelephone (together with the other cellular companies) and Bezeq filed petitions in the High Court of Justice for a decree nisi against the Government of Israel and the Minister of Communications.

On May 24, 2007 Pelephone received notice from the Ministry of Communications stating that it was considering imposing a monetary sanction on Pelephone for alleged breach of the obligation to provide number portability as of September 1, 2006. The notice also stated that December 1, 2007 is a reasonable date by which the relevant licensees are required to amend the alleged breach.

In 2007 Pelephone continued to prepare for implementation of the number portability plan and towards December 1, 2007, the date the Ministry of Communications determined to be the reasonable and final date for implementation of the plan, it completed its preparations, including all the necessary tests. In November 2007, after consulting with the Minister of Communications and the CEOs of the communications companies regarding readiness for number portability and the final date of beginning implementation of the plan, Pelephone expressed a position by which the date of implementation should not be postponed beyond December 1, 2007, since Pelephone is prepared and ready to begin the process. At the end of the aforementioned meeting the Minister of Communications decided not to change the implementation date (December 1, 2007).

The number portability process began as scheduled. Pelephone and the other cellular companies that filed the petition requested from the High Court of Justice that it dismiss the petition. As a result of this request the petition was dismissed. As at the date of this report, Pelephone has not been requested to pay any penalties in respect of postponement of the implementation date.

The "Number Portability Program" intensified the already fierce competition between the operators. Such competition gave rise to an increase in marketing campaigns, benefits granted to customers and an erosion of prices.

3.7.4 Domestic operator license

On June 3, 2004 the Communications (Telecommunications and Broadcasts) (Processes and Conditions for Obtaining a General Special License) Regulations 5764-2004 were published. Under the aforementioned Regulations, an application may be filed for a special general domestic license, i.e. for a license for the provision of domestic fixed line telecommunications services, which does not involve an obligation to provide service to the entire public everywhere in Israel. Pelephone, as a subsidiary of Bezeq, is obliged, unlike the other cellular companies, to apply to the Minister of Communications and persuade him that the award of a license to Pelephone, as a subsidiary of Bezeq, is such as to promote the competition in the telecommunications field or is in the public interest.

Bezeq's license imposes restrictions on it in all matters pertaining to cooperation with its subsidiaries. In the opinion of Pelephone and Bezeq, to the extent that these restrictions remain in force, without, at the same time, similar restrictions being imposed on the competing MRT operators, they will adversely affect Pelephone's ability to compete with its rivals in the industry. For the restrictions imposed on Bezeq and Pelephone by virtue of the merger conditions, see section 3.18.3 below.

In the last quarter of 2006, the Ministry of Communications held a renewed hearing on the matter of final formulation of its policy regarding licensing of the supply of telephony services using broadband access (VOB). On February 1, 2007, the Ministry published its final policy document on VOB in which it prescribed that Bezeq and the companies in the Bezeq Group (including Pelephone) shall be entitled to take part in this industry in the business and private sectors only once Bezeq's market share of the domestic fixed-line telephony industry falls to below a threshold of 85% in each of the sectors separately. Pelephone objects to this policy and is of the opinion that it should be treated as an independent body, due also to the existence of the restrictions imposed upon it regarding joint marketing and the sale of joint bundles with Bezeq. Pelephone expressed its opinion during the hearing before the Ministry of Communications and before the committee headed by Prof. Gronau for examining the policy and rules of competition in the communications industry in Israel.

It is noted that Partner and Cellcom, the principal competitors of Pelephone, own such a general domestic and VOB license, and in the last year have even increased their activity in the area. This grants them a clear competitive advantage over Pelephone due to the ability of the competitors to offer packages that combine mobile and fixed-line communications.

3.7.5 WiMAX technology

In September 2007 the Ministry of Communications published a hearing on the policy of allotting frequencies for operating the WiMAX technology, which is a network technology allowing broadband communication. In accordance with the proposed policy, new operators and the smallest Israeli cellular operator (Mirs) will be given priority in the allotment. Pelephone has submitted its response to the hearing, by which priority should be granted to fourth generation cellular technology that requires use of WiMAX technology frequencies, and has expressed its objection to a tender for the allocation of frequencies that discriminates in favor of MIRS or other operators.

Following the hearing of September 2007, the Ministry of Communications published a secondary hearing in July 2008 on its policy in the matter of allocating frequencies, inter alia, in the 2.5 MHZ range. This frequency range is intended for WiMAX technology in mobile telephony as well as fourth generation cellular technology. According to the proposed policy, the aforementioned frequencies will be allocated in two separate tenders: The first will take place by the end of 2008, in the framework of which frequencies will be allocated in first preference to a new operator and in second preference to Mirs (in order to establish a WiMAX network). The second tender will be held starting from mid 2011, after clearing additional frequencies in the aforementioned frequency range, and the other cellular operators will also be able to participate in this tender. Pelephone has submitted its response to the aforementioned policy document in which it has expressed its opposition to the preference to Mirs in the first tender and has demanded governmental responsibility to clearing additional frequencies towards the second tender in order to ensure a natural fourth generation development track in the cellular technology.

On March 1, 2009, the Ministry of Communications published its policy regarding the allocation of frequencies for WiMAX technology. The main change in respect of the hearing is that the tender for frequencies will be held in September 2009 and Mirs will not be permitted to participate in this tender.

3.7.6 Positive and negative factors affecting Pelephone's competitive position

Positive factors

- A. Launching a HSPA/UMTS network, which will appeal to additional target audiences and increasing the services provided to the existing customers, including roaming services.
- B. An advanced product range including DATA solutions for businesses, and a broad spectrum of multimedia and entertainment services.
- C. Service system and range of customer service interfaces enabling the provision of high-level service to customers.
- D. An extensive distribution system specializing in the provision of solutions appropriate to each type of customer, high-quality human resources, and expanding it by adding the SuperPharm chain.
- E. Strong capital structure and positive cash flow.

Negative factors

- A. As a subsidiary of Bezeq, Pelephone is subject to regulatory restrictions on entering into additional fields of activity and on expanding its customer service baskets, which do not apply to its competitors.
- B. There are restrictions on joint activity with Bezeq, including in the marketing of joint service bundles.
- C. CDMA technology does not enable the provision of roaming services in the same manner as this service is provided by competitors, and the technology is less common around the world. The subscribers joining the HSPA/UMTS network will benefit from broader roaming services.
- D. The cost of operating two networks is high.

3.8 Seasonality

Pelephone's revenues and profitability are affected, albeit not to any material extent, by seasonality and holidays. The second and third quarters are characterized by higher revenues than the first and fourth quarters. This is due primarily to different usage patterns prevailing in the summer months compared to the winter months and the holiday season. Seasonal fluctuations primarily affect cellular services revenues, but, as stated, the effect is not material.

3.9 Property, Plant and Equipment

Pelephone's fixed assets include the infrastructure equipment of the network core, radio sites, electronic equipment, computers, motor vehicles, terminal equipment, office furniture and equipment and leasehold improvements.

3.9.1 Infrastructure

Pelephone presently operates three fundamental communications networks:

- A Digital technology using CDMA2000 1XRTT. The advantages of this technology are the ability to provide advanced services, greater capacity for talk calls and data for a given quantity of frequencies and data communications at a speed of up to 144KB per second.
- B Digital technology using the EVDO method – see section 3.9.1 below.
- C. Digital technology using the HSPA/UMTS method. The advantages of this technology, inter alia, is in supporting download speeds of up to 14.4 Mbps and upload speeds of up to 5.7 Mbps.

It should be noted that the actual surfing speed depends on a number of factors, including place, momentary load in the network, transmission support, the internet network performance and the laptop and terminal equipment compatibility.

EVDO/CDMA200 1XRTT network

As at the date of publication of the report, Pelephone's MRT infrastructure (CDMA) is based primarily on 8 digital switches manufactured by Nortel, connected to approximately 1,540 radio sites (cells), in a countrywide spread. Each radio site incorporates an antenna for reception and transmission and a computerized control system, and covers a certain geographic area. The cells are connected to base station controls (BSC) that are hooked up to the switches. The switches are connected to one another and to all the other telecommunications operators (Bezeq, Partner, Cellcom, MIRS, HOT, and international operators).

The depreciation period for site equipment is up to 10 years. Depreciation for switching equipment is between 5 and 7 years. The depreciation period of the equipment is determined on the basis of engineering opinions based, inter alia, on generally accepted practice among communications operators in various other countries.

Pelephone's infrastructure equipment is manufactured by Nortel and Motorola. Each of Pelephone's digital switching networks is manufactured by Nortel, and a Nortel telecommunications network covers most of the coastal plain and Jerusalem (from Ashdod to Haifa). The Pelephone network in the rest of Israel uses the Motorola-manufactured telecommunications network.

Pelephone's investments in EVDO/CDMA2000 1XRTT network infrastructure

The principle investments in 2003 to 2007 were used to upgrade the network to CDMA 200 1XRTT and EVDO technology using equipment purchased from Nortel and Motorola. In addition, in 2006 and 2007, the network capacity was broadened, additional sites were established (some as substitutes for existing sites due to engineering requirements) and the network was adapted to support number portability.

As of 2004, the Pelephone Board of Directors began upgrading the CDMA2000 1XRTT network to EVDO technology by means of the addition of a special-purpose carrier for data communications in the urban areas of Israel. This technology enables communication between the network and the terminal equipment at rates of up to 2,400 KSS (downlink) and between the terminal equipment and the network at rate of up to 144 KSS (uplink). The EVDO equipment is manufactured by Nortel. Parallel to setting up the network, a

portal was set up for video services enabling customers to view live broadcast channels, to download music clips, entertainment, news, etc. This portal is the key service using EVDO technology.

At the end of 2007 a triennial agreement was signed with Nortel by which it would continue to support and upgrade the 1X and EVDO networks for a total consideration of \$ 22.5 million (also see section 3.12.3 below).

The HSPA/UMTS network

On November 1, 2007 the general shareholders' meeting of Pelephone adopted the resolution of Pelephone's Board of Directors from September 2007 regarding establishment of a network using HSPA/UMTS technology at a total investment of NIS 1 billion. This amount includes the cost of the network supplier, of constructing the new sites required in order to operate in the range of the new frequency, and of converting existing sites and services to HSPA/UMTS and unfreezing the right to implement frequencies. Ericsson was chosen as the supplier of the system. The new network is based on two network centers that will be connected to the existing sites and the new sites that are in the process of acquisition/licensing and construction. The sites operating on CDMA technology were converted in order to adapt them to the new frequency and be added the new radio equipment. The network enables higher transfer speeds of information from the subscriber to the network and from the network to the subscriber using HSDPA and HSUPA technology. The establishment of the new network enables Pelephone to provide services requiring the rapid transmission of information, may partly solve the problem of wireless disturbances (see section 3.24.2.5 below) and enables use of standard terminal equipment supporting HSPA/UMTS technology which enables the diversification of terminal equipment and the expansion of roaming services. In 2008, Pelephone invested NIS 616 million in establishing a HSPA/UMTS network. The rest of the investment is expected to be spread over the next three years.

3.9.2 Premises used by Pelephone

Pelephone does not own any land, and it leases the premises which it uses for its operations from others, including Bezeq. The following is a description of the main premises used by Pelephone:

3.9.2.1 The land which Pelephone uses for installation of radio and switching sites, as set out in section 3.9.1, are spread out around the country, and are leased for various periods (in many cases, for 5 years plus an option to extend the agreement for another 5 years). For site licensing, see section 3.18.3.3 below.

3.9.2.2 Pelephone leases some of the sites from the Israel Lands Administration (ILA). Pelephone has an agreement for payments due to the ILA for the period up to December 31, 2008.

3.9.2.3 In January 2009, Pelephone filed a claim for declaratory relief and mandatory injunctions at the Petach Tikva District Court.

The claim referred to the ILA's demand, which was sent by email to Pelephone, for payment of a cumulative amount of over NIS 200 million for a five year period, for continuation of its "consent" to the presence and setting up of new cellular antennas on ILA land. In the claim, Pelephone alleges that the ILA is not permitted to charge Pelephone for setting up broadcasting equipment; the demand is excessive; and the ILA is abusing its monopolistic power and acting in bad faith. Pelephone's consultants estimate that the company has sound claims against the ILA. However, as the procedure is in the initial stages, and the ILA has yet to submit its respond to the claim, it is not possible to assess the chances of this claim.

3.9.2.4 Pelephone's head offices have been in Givatayim since 1997, and cover a total area of 17,000 sq m. In 2006, Pelephone signed an agreement to extend the lease term until December 31, 2010 and is in the advanced stages of negotiations with the owners of the property to extend the lease until 2011.

3.9.2.5 For the purpose of service and sale operations, Pelephone leases 77 service and sale centers spread out around the country.

3.9.2.6 Pelephone has additional lease agreements with respect to warehouses, offices and telephone call centers which it uses for the purpose of its operations.

3.10 Intangible Assets

3.10.1 MRT license

Pelephone operates under a general license for the provision of mobile radio telephone (MRT) services), which is valid until 2022 (see section 3.18.1.1 below). The license constitutes the basis of Pelephone's activity.

3.10.2 Frequency usage right

Pelephone uses frequencies in the 850 MHz range granted pursuant to its license. Pelephone uses these frequencies mainly for CDMA2000 / 1XRTT / EVDO /UTMS technology. In addition, in 2008, Pelephone submitted an application to the Ministry of Communications to exercise its right to for the allocation of frequencies in the 2100 MHz range. To execute this right, Pelephone is required to pay an additional sum of approximately NIS 181 million for license fees and retroactive frequency fees from the day on which it won a tender for these frequencies to the date of exercise of the right to receive them. In September 2008, Pelephone paid this amount for receipt of the frequencies from the Ministry of Communication.

In January 2009, the Ministry of Communications granted approval for Pelephone to return to the 5MHz frequency range, known as TDD, from the aforementioned band of frequencies.

3.10.3 Trademarks

Pelephone has a number of registered trademarks. The principle trademark is Pelephone.

3.10.4 Customer base

Pelephone has a large number of customers, many of which have entered into agreements to receive Pelephone's services for 18 to 36 months.

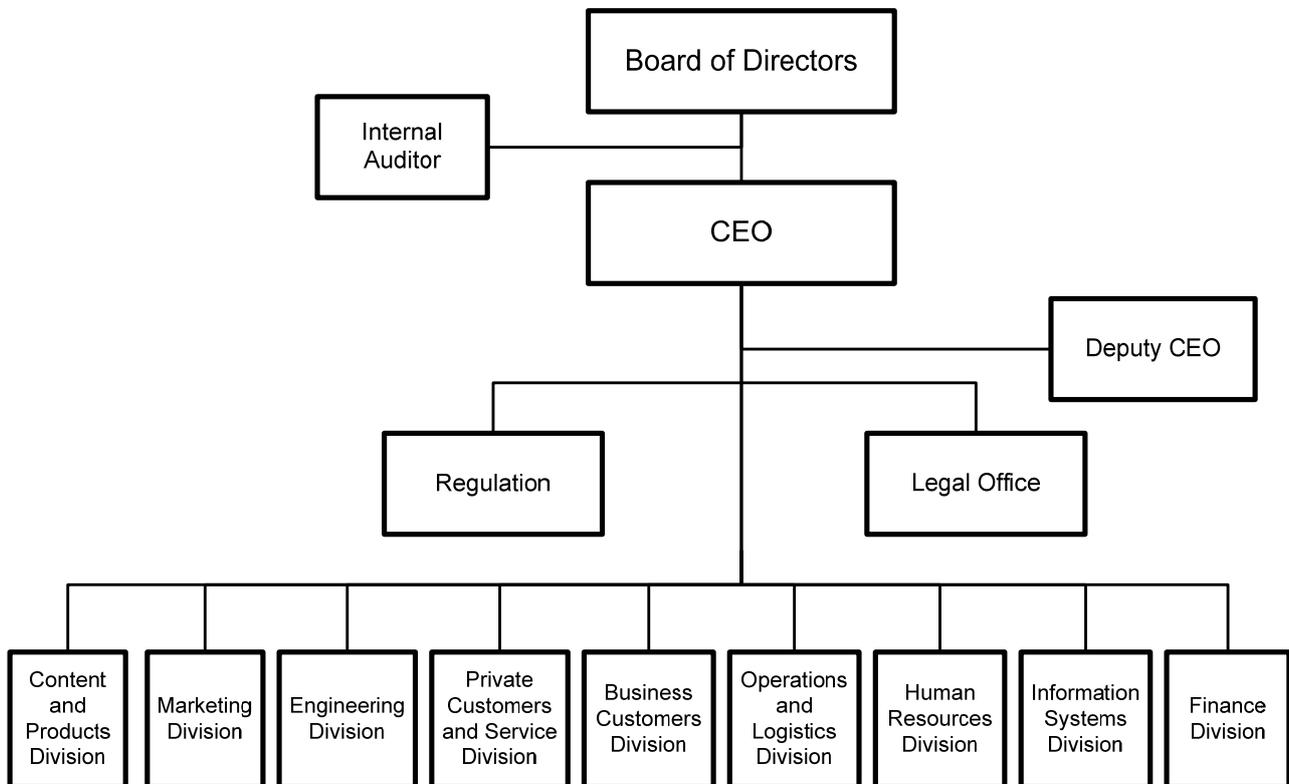
3.10.5 Software, computer systems and databases

Pelephone uses software and computer systems, some under licenses purchased by Pelephone and others developed by Pelephone's IT division. Most of these licenses are restricted in time and are periodically renewed. The main systems that Pelephone uses are Oracle Application and an Amdocs billing system.

3.11 Human Resources

3.11.1 Organizational structure

Pelephone's organizational structure:



3.11.2 Employees

The table below describes the number of employees²³ at Pelephone in accordance with its organizational structure:

Division	Number of employees	
	December 12, 2008	December 12, 2007
Headquarters and management	310	295
Content marketing and products division	92	102
Customer service and private sector division	2,453	2,971
Business division	499	534
Operations and logistics division	222	292
Engineering and information systems division	624	617
Total	4,200	4,811

3.11.3 Changes in the number of employees during 2008

At the end of 2008, Pelephone's human resources stand at approximately 4,200 employees, compared with approximately 4,811 at the end of 2007. The decrease is mainly

²³ The number of employees represents the number of calculated positions at Pelephone (the total number of work hours divided by the monthly quota of work hours).

in the service and sales divisions that were strengthened towards the implementation of number portability.

3.11.4 Instruction and training

Pelephone invests resources in professional training in accordance with the type of employee and occupation. Most training courses take place in service, primarily in the service division. Pelephone's total expenses in 2008 and 2007 in respect of instruction and training amount to NIS 8.5 million and NIS 10.4 million, respectively. There is a high churn rate for sales and service representatives and telephone call center employees, which requires constant investment in new employees.

3.11.5 Employee and manager reward schemes

Pelephone awards its employees and managers grants and incentives on a monthly, quarterly and annual basis commensurate with their achievement of the targets set for them and in accordance with the type of work done by the employee.

For the options plan for senior officers see Note 26 to the Company's financial statements for the year ended December 31, 2008 included in this annual report.

3.11.6 Employment contracts

Pelephone employees have standard personal contracts in accordance with their professions and occupations.

3.12 Products and Suppliers

3.12.1 Terminal equipment suppliers

The product inventory of Pelephone includes a range of cellular telephone units auxiliary accessories (such as batteries, hand-free kits, earphones, data cables and chargers). Pelephone also maintains spare parts to supply repair services to its customers and an inventory of used handsets.

Pelephone purchases the terminal equipment and accessories from a variety of suppliers and importers in Israel. Contractual engagements with most of the suppliers are based on framework agreements setting forth, inter alia, the technical support provided by the supplier for the terminal equipment it supplies, availability of the spare parts turnaround time for repairs. These agreements do not include a commitment to make acquisitions, which are implemented regularly by means of purchase orders.

If a contract with a particular terminal equipment supplier is discontinued, Pelephone may increase the quantity purchased from other terminal equipment suppliers or procure terminal equipment from a new terminal equipment supplier. If the replacement of a supplier is required, as aforementioned, the replacement shall not be immediate, and shall be subject to a special preparatory period for purchasing spare parts and accessories, including the repair capacity for all kinds of malfunctions, to enable the provision of service to customers as agreed. Replacement of a supplier involves the addition of exceptional costs due to the need to purchase equipment a period of re-organizing affairs with the replacement suppliers.

The splitting of terminal equipment purchases between suppliers does not create significant dependency on any one supplier or equipment model.

In preparation for migration to HSPA/UMTS technology, Pelephone had expanded the range of equipment it offers to customers and the number of its terminal equipment suppliers.

3.12.2 Value added service suppliers

Pelephone has agreements with suppliers for content such as information services by voice, SMS or Pelephone's portal, games, animations, ring-tones, location services, content and the rights to broadcast over third generation technology. As is usual in this industry, a large portion of these agreements are based on a model of dividing revenues between Pelephone and the content suppliers for the services provided to customers. Termination of contracts with certain suppliers might cause delays in supplying some of the services pending contracting with substitute suppliers.

3.12.3 Infrastructure suppliers

As set out in section 3.9.1 above, Pelephone's present infrastructure equipment is manufactured by Ericson, Nortel and Motorola. Pelephone has long-term maintenance, support and software upgrade agreements with these suppliers and depends on them with respect to support of the network equipment that they produce. Regarding other agreements with these suppliers and an agreement for the establishment of an additional network see section 3.9.1 above.

Due to the financial difficulties of the Nortel Group internationally, in 2009, the management of the corporation made a decision that all companies in the Group would apply, at the same time, to the courts in the countries in which they are domiciled, for legal protection against their creditors and to freeze the proceedings against them by declaring them as bankrupt. As part of the process, an urgent application was filed at the Tel Aviv District Court for an order to suspend proceedings for Israeli companies of the Nortel Group, serving as a local branch of the Nortel Group in Israel.

3.13 Working Capital

3.13.1 Stock policy

Pelephone's inventory mainly includes cellular terminal equipment and a variety of accessories (such as batteries, hands-free-sets and earphones). Pelephone also holds spare part inventory.

The period over which inventory is held is derives from Pelephone's service policy and its sales requirements. The requirements require holding an inventory for a period of 3 – 5 inventory months, depending on the type of inventory. As at the end of 2008, the inventory level stands at approximately NIS 124 million.

3.13.2 Returns policy for terminal equipment purchased

As a rule, the return of handset inventory may be implemented by cancellation of a transaction or by the replacement of a handset for another (of the same standard or a higher standard against incremental payment to cover the price difference.)

Pelephone's policy, as at the date of this report, enables its customers to return equipment purchased shortly after the transaction, according to its judgment and subject to the law, in accordance with the agreement with customers and the conditions thereof, provided that no use has been made of either the product or its accessories.

With respect to remote sales transactions and peddling transactions as defined in the Consumer Protection Law, 5741-1981, return of equipment is permitted up to fourteen days after the date of the transaction, in accordance with the provisions of the Law.

3.13.3 Company policy with respect to product warranty

Pelephone provides service, warranty and maintenance for terminal equipment in accordance with the level of service and repairs to which the customer has subscribed and of course in accordance with the provisions of any law regulating warranties for cellular terminal equipment.

3.13.4 Policy governing credit to customers

Credit in handset sale transactions – Pelephone enables most of its customers purchasing a mobile telephone to pay in up to 36 equal installments. In the past, Pelephone's policy was to discount part of the transactions that are paid by credit card installments with discount companies. In 2007, Pelephone stopped discounting credit card vouchers.

Credit by monthly charging in respect of MRT services – Pelephone customers are charged once a month in charging cycles taking place on different dates over the course of the month, for consumption of MRT services in the preceding month.

As at 2008, total average customer credit less doubtful debts amounts to NIS 1.530 billion.

3.13.5 Credit from suppliers

Pelephone receives credit from its suppliers for periods ranging from 30 days to 90 days. As at 2008, total average credit from suppliers and service providers amounts to NIS 579 million.

3.14 Investment in Investees and in a Partnership

Pelephone has no active investments in investees and partnerships.

3.15 Financing

3.15.1 Pelephone's operations are financed by cash flows from operating activity generated by the company, shareholders' equity, bank loans, debentures, previously by discount of credit cards (see section 3.13.4 above) and supplier credit.

The average interest rate in 2008 for Pelephone loans:

	Long-term loans (Including current maturities)
Banking sources: CPI-linked – NIS	4.65
Non-banking sources: CPI-linked – NIS	4.64

3.15.2 Restrictions

3.15.2.1 Undertakings towards banks

As part of the arrangements made with banks in Israel in connection with the provision of credit to Pelephone, Pelephone provided the aforementioned banks with certain irrevocable undertakings to comply with financial covenants, consisting primarily of the following:

- A. Pelephone's total debts are not to exceed three times its shareholders' equity.
- B. Provided total debts exceed shareholders' equity by more than 2.5, Pelephone shall not pay out dividends and shall not pay management fees to shareholders. If Pelephone is in breach of this undertaking, it shall, within 120 days of demand, be required to repay the bank all loans outstanding to the credit of the bank at such time, or, alternatively, to amend the breach by increasing its shareholders' equity or repaying Pelephone's loan in such a way that the aforesaid ratio is preserved.
- C. Total debts shall not exceed NIS 3.8 billion (linked to the CPI known as at January 2002). The sum of the debts shall be checked once every quarter in accordance with financial statements reviewed by accountants;
- D. Pelephone's assets will not be mortgaged under a fixed or floating charge, in any manner or way, or of any kind or degree, without obtaining the bank's prior written consent to such.
- E.. Pelephone's shareholders or any third party whatsoever will not be given any security or charge over the assets of Pelephone or any guarantee to secure credit received by the shareholders, without obtaining the prior written consent of the banks to such.
- F. Pelephone's shareholders will not be granted any loan or credit without obtaining the bank's prior written consent to such.
- G. Information, details and various reports will be provided to the banks.
- H. If Pelephone is in breach of these undertakings, then the banks shall be entitled to call for immediate repayment of the amounts of the loans extended to it.
- J. Undertaking to a particular bank – in addition to the above undertakings, Pelephone has undertaken to ensure that the cumulative sum of all of its debts and liabilities towards a particular bank shall be no greater than the equivalent of 40% of the cumulative sum of all of Pelephone's debts to financial entities including debenture holders.

3.15.2.2 Immediate repayment of the loan

A lender may call a loan for immediate repayment in certain instances (usually after serving written warning notice on Pelephone), foremost among such instances being: (A) if any debt to the lender was not paid; (B) if Pelephone adopts a liquidation resolution or if application for liquidation or for the appointment of a liquidator is filed against it or if there is cause for its being liquidated, or for the appointment of a receiver or a trustee; (C) if application is filed for the imposition of an attachment or if an attachment is imposed on the assets of Pelephone or if any execution proceeding is taken against its assets or if it ceases to repay its debts; (D) if Pelephone adopts a resolution in favor of restructuring, merger or settlement or if the control therein is transferred without the lender's consent; (E) if Pelephone ceases to repay its debts or reaches a compromise with its creditors or any of them; (F) if Pelephone is in breach of any undertaking that it has assumed toward the lender or if it should transpire that a material declaration by Pelephone toward the lender is untrue; or (G) if an event should have occurred as a result of which any entity shall have the right to call for immediate repayment of Pelephone's debts towards it (even if such concerns does not make use of its right).

3.15.3 Issue of debentures

In 2004-2005, Pelephone issued three series of index-linked debentures by way of private placements to institutional investors in a total sum of NIS 1.133 billion par value, in consideration for their par value

At the time of issue of the debentures, trust deeds were signed with Union Bank Trust Co. Ltd., which is to act as trustee for the debenture-holders. Pursuant to this agreement, Pelephone undertakes to pay principal, interest and indexation differences in accordance with the terms of the debentures. The debentures are not secured by any charge, and the conditions of the negative pledge and the financial covenants undertaken by Pelephone towards the Israeli banking system will also apply to the debenture holders (see section 3.15.2 above). The agreement details the conditions for immediate repayment of the debentures, being essentially as follows: (A) If Pelephone does not repay any amount whatsoever being due from it pursuant to these debentures by 30 days from the due date; (B) if a liquidator is appointed for Pelephone; (C) if charges are realized; (D) if an attachment is imposed on material assets of Pelephone; (E) if Pelephone ceases to exist or (F) if Pelephone discontinues its payments or serves notice of its intention to discontinue them. The trustee is entitled to take steps for immediate repayment in order to protect the debenture holders. The agreement moreover sets forth principles for indemnifying the trustee, trusteeship of the receipts, investment of moneys and conditions for convening a general meeting and adopting resolutions.

As at December 31, 2008, Pelephone is in compliance with its commitments to the banks and to the debenture holders.

In 2008, there were no new long-term loans and loans and debentures were repaid in the amount of NIS 270 million.

For additional details regarding the composition of the loans and debentures, the conditions thereof and the date of repayment thereof during the report period, see Note 13 of the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

3.15.4 Credit facilities

As at December 31, 2008, Pelephone has bank credit of NIS 356 million.

3.15.5 Guarantees and charges

See Note 13 to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

3.15.6 Credit rating

The rating company Maalot assigned Pelephone an AA minus rating on the placements of the debentures (see section 3.15.3 above).

The ratings published from the time of the placements and up to the reporting date remained unchanged.

On October 28, 2008, Maalot announced validation of the unchanged rating of Pelephone's debentures (AA minus), notwithstanding the crisis in the credit market. See the description of macro-economic risk factors in section 3.24.1 below.

3.15.7 Pelephone's estimate of fundraising in the coming year and sources of financing

Pelephone expects to repay a portion of its loans in 2009, and plans additional investments in property, plant and equipment (see section 3.9.1 above). Pelephone does not expect to increase capital or new loans in 2009.

The above information includes forward-looking information that is based on Pelephone's assessments taking into account its plans and the expectation that such will be realized. Actual results might be substantially different from the assessments set out above, if there is any change in any of the factors taken into account in making these assessments. For risk factors, see section 3.24 below.

3.16 Taxation

See Note 8 to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

3.17 Environmental Quality

3.17.1 On January 1, 2007 the Non-Ionized Radiation Law, 5766-2006 came into effect. The Non-Ionized Radiation Law replaces the previous legal arrangement regarding non-ionized radiation in the Pharmacists (Radioactive Elements and Products) Regulations 5740-1980 (the Pharmacists Regulations).

The purpose of the law is to regulate radiation sources and their construction and operation, as well as the provision of radiation measurement service. The law requires obtaining a permit from the commissioner for constructing, operating and providing radiation measurement service, other than the construction or operation of a radiation source specified in the Appendix to the law (the Additional Permit).

The law provides a two-step licensing mechanism: the applicant is to first request a permit to construct a radiation source (the Construction Permit), which will be in effect for no more than three months and can be extended by the commissioner for up to nine months; and then a permit to operate the radiation source (the Operation Permit), which will be in effect for five years or as otherwise determined by the Minister of the Environment in cases or under circumstances determined by him, taking into consideration the type of the radiation source or its location.

As regards the construction permit, by law, provision of the permit is contingent on an assessment of the maximum radiation levels to which human beings and the environment are expected to be exposed from the radiation source, once it is operated, including in the event of a malfunction, and to implementing the measures needed to limit the exposure levels of human beings and the environment to the radiation expected from the radiation source once it is operated, including implementation of technological means that are in use (the Limiting Measures).

As regards the operation permit, by law, provision of the permit is contingent on implementation of the limiting measures and to measuring the exposure levels of human beings and the environment to the radiation generated when operating the radiation source, with these levels not exceeding the maximum exposure levels provided by the commissioner in the law. Furthermore, by law, provision of the operation permit is contingent on presentation of a license under the Communications (Telecommunications and Broadcasts) Law 5742-1982 and the Planning and Building Law, 5725-1965, except when a building permit is not required, in which case the applicant submits a statement to the local committee specifying the reasons that a building permit is not required for the radiation source. If the local council engineer or district planner does not object to granting the operation permit within 21 days from the day the statement is submitted, the applicant will submit an additional statement stating that the aforementioned period has passed and no objection has been received as aforementioned.

The law includes a punitive section by which, inter alia, the construction or operation of a radiation source in contravention of the provisions of the permit and the construction or

operation of a radiation source without a permit, after having been warned in writing by the commissioner, are strict liability offenses, in respect of which the punishment for the entity is double the penalty provided in Section 61(a)(4) of the Penal Law , 5737-1977.

A small number of city engineers have acted according to the mechanism provided in the law and have provided notice that some access device or another requires a building permit, and have objected to granting it an operation permit.

The law also indirectly amends the Planning and Building Law, 5725-1965 and provides that a building permit to a cellular broadcasting facility is contingent on the deposit of a deed of indemnity in respect of claims for compensation pursuant to section 197 of the Planning and Building Law, 5725-1965, providing that such a demand is in accordance with the instructions of the national council. Regarding this matter see section 3.18.3.3 below.

The Minister for Environmental Protection prepared the regulations according to the Non-ionized Radiation Law (the Regulations). These regulations were promulgated and approved by the Interior and Environment Committee of the Knesset and were published on January 19, 2009.

On July 17, 2008, a petition was filed at the High Court of Justice requesting an order nisi against the Minister for Environmental Protection, the Minister of Communications and others because of an alleged failure to reach an agreement on the wording of regulations by virtue of sections 25(A)(2) and 25(A)(5) of the Radiation Law, 5766-2006, despite the obligation stated in the law to issue the regulations by January 1, 2007. An application for an interim injunction was dismissed. The petition is yet to be heard. The regulations are yet to be issued.

3.17.2 Anticipated costs and investments

Pelephone conducts periodical radiation tests in order to ascertain that it is in compliance with the permitted operating standards and the standards of the International Radiation Protection Agency. These tests are outsourced to companies authorized by the Ministry of Environmental Protection. Pelephone invests on average NIS 4.5 million per annum in respect of this activity. The Radiation Regulations will require paying fees of insignificant amounts for the provision and renewal of permits required according to the Radiation Law.

3.18 Restrictions on and regulation of Pelephone's operation

The provisions of Non-ionized Radiation Law described in section 3.17.1 are expected to have an adverse effect on the construction and operation of broadcasting sites in a number of ways including, inter alia, on the following matters: a significant restriction on the possibility of using access devices in highly populated areas; more difficulties in obtaining radiation permits for existing and new broadcasting devices and for changes in their operation; a requirement to pay fees on the construction and operation of existing and new broadcasting devices.

3.18.1 Statutory restrictions

3.18.1.1 Communications Law and licensing obligation thereunder

The Communications (Telecommunications and Broadcasts) Law 5742-1982 stipulates, inter alia, that that telecommunication activity and telecommunication services, including MRT, are subject to a license from the Minister of Communications (in this chapter: the Minister). Pelephone holds a general license for the provision of MRT services. The Minister is empowered to modify the terms of the license, to add thereto or to detract therefrom, while taking into consideration, inter alia, government telecommunications policy, considerations of public interest, suitability of the license holder to provide the services, the contribution of the license to competition in the telecommunications sector and to the level of service therein. Moreover, the Minister is empowered to annul, restrict or suspend a license in a number of situations (see Section 3.18.3.1 below).

The law authorizes the Director General of the Ministry of Communications to impose financial sanctions for violations of the provisions of the law and of orders and directives issued by virtue thereof, and for violation of the license terms

3.18.1.2 The Wireless Telegraph Ordinance

The Wireless Telegraph Ordinance (New Version), 5732-1972 (the Telegraph Ordinance) regulates the use of electromagnetic spectrum, and applies, *inter alia*,

to the Company's use of radio frequencies, as part of its infrastructure. Under the Telegraph Ordinance, the establishment and operation of a system using radio frequencies requires a license, and the use of radio frequencies requires designation and allocation of a suitable frequency. The Telegraph Ordinance imposes license fees and fees for designation and allocation of frequencies.

For several years, the Government has been coping with the existing shortage of radio frequencies for public use in Israel (inter alia, due to the allocation of a great many frequencies for security uses), by limiting the number of licenses issued for the use of frequencies, on the one hand, while increasing fees payable in respect of the allocation of a low range frequency on the other.

The Wireless Telegraph (Licenses, Certificates and Fees) Regulations 5747-1987, stipulate various fees for business stations (including MRT business stations), MRT, P2P wireless lines and satellite stations). For the allocation of radio frequencies to Pelephone, see section 3.10.2 above.

3.18.1.3 Facilities emitting electromagnetic radiation – for this matter see section 3.17 above.

3.18.1.4 The Consumer Protection Law

During the course of its operations, Pelephone is subject to the Consumer Protection Law, 5741-1981 (the Consumer Protection Law). In December 2005, the Consumer Protection Law was amended so that the prohibition against misleading conduct contained in the Law immediately prior to entry of the amendment into force, and the option of suing on grounds of misleading conduct by a dealer prior to the date of the contract, was extended to include misleading conduct by a dealer after the date of the contract.

In April 2008, the Knesset approved an amendment to the Consumer Protection Law regarding fixed transactions (the Amendment). Under the Amendment, dealers will be required to inform consumers of the date of termination of a fixed transaction prior to termination of such, and of the conditions that will apply after the date of termination. In addition, dealers will be required to obtain the positive consent of the consumer to continue with the contract beyond the fixed period. If positive consent is not obtained, the consumer will be disconnected from the service to which the fixed transaction applied, apart from basic telephone services as defined in the Communications Law (voice services). The amendment came into effect on January 10, 2009. Pelephone is acting accordingly to implement the amendment.

3.18.2 Controlled tariffs

Payments for interconnection:

The Telecommunications (Interconnect Fees) Regulations 5760-2000 (the Regulations) prescribe limitations regarding payments to be made or to be received from a domestic operator or another MRT operator under the regulations. In December 2004, the regulations were amended as follows:

- A. For the purpose of interconnection payments received from a domestic operator or from another MRT operator for completion of one traffic minute on an MRT network, the current tariff for call completion is to be scaled down gradually to NIS 0.22 in accordance with the following outline (tariffs do not include VAT):
 - 1. As of March 1, 2005, the current tariff of NIS 0.45 per traffic minute was reduced to a maximum of NIS 0.32.
 - 2. As of March 1, 2006, the tariff was reduced to a maximum of NIS 0.29.
 - 3. As of March 1, 2007, the tariff was reduced to a maximum of NIS 0.26.
 - 4. As of March 1, 2007, the tariff was reduced to a maximum of NIS 0.22.
- B. With regard to payments to be made by Bezeq International, as an international licensee, for the completion of traffic on a cellular network, the present tariff of NIS 0.25 for call completion was reduced from March 1, 2008 to a maximum of NIS 0.22.
- C. With respect to payments received from another MRT operator for transfer of short messages (SMS) over an MRT network, the tariff was reduced in two stages so that

as of March 1, 2005, the maximum tariff for all SMS messages was set at NIS 0.05 and as of March 1, 2006, this tariff was reduced to a maximum of NIS 0.025.

- D. The tariffs set forth in sections A-C above will be updated once a year, commencing March 1, 2006, in accordance with the percentage of the change in the CPI.
- E. To calculate payment to an MRT network for airtime and call completion, as of January 1, 2009, the charge will be made in accordance with segments of one second (unlike the current charging system which enables charging per segments of up to 12 seconds). Consequently, as of January 1, 2009, the payments payable by the MRT operator for interconnect services to a domestic operator's network will also be revised.

The following table itemizes tariff development:

	Domestic interconnect	International interconnect	
Date	(per minute tariff)	(per minute tariff)	SMS
From May 2004	45.0		28.5
From March 2005	32.0		5.0
From March 2006	29.69	25.57	2.56
From March 2007	26.59		
From March 2008	23.27	23.27	2.64

Note: The tariffs are presented in agorot and do not include VAT. The tariffs as of March 2009 are adjusted for the CPI known in January 2009.

3.18.3 License and site licensing

3.18.3.1 Pelephone's license

The general license for the provision of MRT services granted to Pelephone on February 7, 1996 was for a period of 10 years commencing January 1, 1994, with an option of extending it for additional periods of six years each, under the conditions set forth in the license, consisting primarily of compliance with statutory conditions. Following the tender in which Pelephone was allotted third generation frequencies, the license was extended to be valid for 20 years as of September 9, 2002. For the arrangement with the State regarding the right to use frequencies, see Note 18 (H) to the financial statements of the Company for the year ended December 31, 2008 that are included in this periodic report.

Likewise, in April 2001, the Civil Administration for the Judea and Samaria Region awarded Pelephone a general license for the provision of MRT in the region of Judea and Samaria. The provisions of the general license awarded to Pelephone by the Ministry of Communications are applicable to this license (with some changes).

The following are the principal provisions of Pelephone's license in this section the Licensee):

- A. Under certain circumstances, the Minister is entitled to modify, restrict or suspend the conditions of the license, and in certain instances to even revoke it.
- B. The license is non-transferable, and neither may 10% or more of any means of control in the licensee be transferred either directly or indirectly, nor may any means of control in the licensee or any portion of any means of control be transferred in any manner in such a way as to confer control in the licensee, nor may control in the licensee be acquired, either directly or indirectly, unless the Minister shall have given his consent beforehand.
- C. A shareholder in Pelephone or a shareholder in an interested party therein may not mortgage his shares in such a way that realization of the lien will result in a change of ownership of 10% or more of the means of control in the licensee, unless the agreement contains a provision whereby the lien may not be realized except with the prior consent of the Minister.

- D. The licensee shall take steps to establish interconnectivity of the network to another public telecommunications network in the State of Israel (including towns, military sites, and military bases in the areas of Judea and Samaria and the Gaza Strip). The licensee is obliged to provide interconnect service on equal terms to any other operator and must refrain from any discrimination in implementing interconnectivity
- E. The licensee shall refrain from awarding preference in the provision of infrastructure services to a licensee being a company with an interest²⁴ over another licensee, whether for the payment for the service, whether in the conditions of the service, whether in its availability or otherwise.
- F. The licensee is not entitled to sell, lease or mortgage any of the assets used for the implementation of the license without the consent of the Minister of Communications, except for:
 - (1) Charging of any of the licensee's assets in favor of a banking corporation duly operating in Israel, for the purpose of obtaining bank credit, provided that notice shall have been served to the Ministry of Communications regarding the lien proposed to be made, whereby there is included in the mortgage agreement a clause ensuring that realization of rights by the banking corporation will not, in any event, result in any damage whatsoever to the provision of the services pursuant to the license.
 - (2) Sale of items of equipment during an upgrade procedure, including sale of equipment by the trade-in method.
- G. The director (under the license: the Director-General of the Ministry of Communications or whoever he shall have empowered for the purpose of the license) is entitled to issue directives concerning number portability such that any subscriber of another MRT licensee may transfer to and become a subscriber of the licensee or receive services from the licensee without changing his or her telephone number, and vice versa, and in such case, the licensee must incorporate into its telecommunications network devices enabling the application of such feature, as instructed by the director.
- H. During states of emergency, whoever shall have been statutorily empowered therefor shall have the authority to issue the licensee with certain instructions as to its mode of operation and/or mode of provision of services.
- J. The license sets forth the types of payments that the licensee is entitled to collect from its subscribers for cellular services, mechanisms of setting tariffs, reports the licensee is obliged to submit to the Ministry of Communications and also the duty of serving notice to the Ministry of Communications prior to modifying tariffs. The license also determines the Minister's power to intervene in tariffs, in certain cases.
- J. The license commits the licensee to a minimal standard of service, including setting up of service call centers, the determination of a maximum period for repair of malfunctions, an accounts collection procedure and protection of the privacy of the recipient of the service.
- K. To secure the licensee's undertakings and to compensate and indemnify the State of Israel for any damage due to acts of the licensee, the licensee is required to furnish a bank guarantee for \$ 10 million. The license determines the instances in which such guarantee maybe forfeited.

As aforesaid, the Minister is authorized to amend, add to or detract from the conditions of the license. The following are the principal amendments to Pelephone's license that are being examined by the Ministry of Communications or that were imposed in the last year:

²⁴ "Company with an interest" - as defined in the Telecommunications (Processes and Conditions for Obtaining a General License for the Provision of Domestic Fixed Line Telecommunication Services) Regulations 5760-2000. These Regulations define a company with an interest as "a parent company, subsidiary, sister company, interested company, affiliate, related company or partner company" and each of these terms is defined in the Regulations.

- A. In August 2006, the Ministry of Communications wrote to the cellular companies asking for a response to its intention to amend the companies' license regarding removal of the connection between an MRT terminal handset purchase transaction and the giving of benefits. Pelephone expressed its objection to this license amendment and submitted an economic opinion together with its objection. In November 2007 the Ministry of Communications published an alternative hearing on the same matter, by which any connection between prices of terminal equipment and airtime, as proposed by the MRT providers, should be cancelled. For example, in accordance with the present hearing it will not be possible to offer plans that include a credit for payments in respect of terminal equipment when a certain use threshold is reached in terms of airtime (debit-credit plans). It is noted that most of Pelephone's present plans are of this type. Pelephone has expressed its objection to this change. The Ministry of Communications has not yet made a decision on the matter.
- B. In April 2007, the Ministry of Communications published its decision regarding amendment of the license with respect to changing the mechanism used for identifying users of erotic services as adults. In accordance with the amendment, the denial of access to erotic services will be removed by submitting a written request together with a photocopy of an identifying document or by physically appearing before a service representative. The amendment that was supposed to come into effect on May 25, 2007 has been delayed for the time being according to a temporary injunction issued by the Supreme Court, until the request for the temporary injunction and the petition is heard by a panel of three judges. The temporary injunction was awarded in the framework of a private petition to the High Court of Justice against the aforementioned amendment that was filed in May. The petition includes a request for a temporary injunction suspending the coming into effect of the amendment.
- C. In June 2008, the Ministry of Communications scheduled a hearing regarding proper disclosure for telephone bills. During this hearing, a number of changes in the structure of the bills were proposed
- The hearing was based on the recommendations of the Subcommittee of the Knesset Economics Committee and recommendations of the professional committee of the Ministry of Communications regarding the structure of the invoice, which completed its work in 2008.
- Pelephone submitted its position to the Ministry of Communications. Implementation of the recommendations as proposed will require Pelephone to make appropriate operational arrangements.
- In February 2009, the Ministry of Communications published its final decision on this matter in the context of the new appendix for MRT licenses. The appendix stipulates the changes required in the structure of the customer invoice. Additionally, the Ministry published a hearing for the amendment of Pelephone's license, including the date for implementation of the changes in the invoices (September 1, 2009). Pelephone intends to apply for a postponement of the final implementation date.
- D. In March 2008, the Ministry of Communications made a decision to implement the amendment to the MRT licenses under which the maximum obligation term for customers who are not business customers would be reduced to 18 months, and the operators would be required to offer customers a reasonable no-obligation alternative. This resolution was passed following a hearing into this matter. The amendment came into effect on April 22, 2008.
- E. In October, 2008 the Ministry of Communications published an amendment to the MRT licenses regarding a fixed transaction. Under the amendment, as of December 31, 2008 in communication contracts with new subscriptions for plans which include a commitment period, the operators will be obligated to set the service prices in advance and may not update them until the end of the commitment period. Without derogating from the aforesaid, the

operators may lower the preset prices during the commitment period. Pelephone applies the amendment from December 31, 2008.

- F. In September 2008, the Ministry of Communications published an amendment to the cellular operator's licenses regarding the following matters:
1. Termination of service to a dormant subscriber – under this amendment, the operator is entitled to terminate service to a subscriber who does not use the cellular service for 2 months. Termination will be possible after the operator notifies the subscriber of its intention to terminate the service, in the format set forth in the license amendment. A subscriber requesting continuation of the service despite being a dormant subscriber will not be disconnected by the operator. The operator may only send a second notice of disconnection to the subscriber (the second notice) after the additional 12 months from the date of the first notice, provided the subscriber meets the definition of a dormant subscriber for the entire additional 12-month period. In the second notice, the operator is entitled to notify subscribers that if they remain dormant for another 12 months, the operator will be permitted to disconnect the subscriber finally, without further notice.
 2. Blocking end equipment in the event of loss / theft – according to this amendment, the cellular operators are obligated to maintain a joint store of end devices which were reported lost or stolen and ensure that these devices are blocked from any use immediately upon receipt of the loss / theft report. This amendment is effective from January 31, 2009.
- G. Further to the hearing held on the subject, in July 2008, the Ministry of Communications published a legal opinion stating that it is prohibited to make the purchase of a 3G instrument conditional on the purchase of 3G services. According to this opinion, customers must be offered an economically effective alternative for purchasing a 3G instrument without a package of 3G services requiring monthly payment.
- H. According to the policy document of the Ministry of Communications from 2004, Bezeq will be permitted to market joint packages of services with its subsidiaries when its market share for fixed telephony services drops to 85%. In 2008, Bezeq's market share dropped below 85%. Accordingly, the Ministry of Communications recently announced a hearing including the proposed amendments to Pelephone's license.

According to the proposed amendment, Bezeq and Pelephone will be permitted to market combined packages (for fixed and mobile telephony) but only subsequent to approval being received from the Minister of Communications for marketing the package, provided this package will be completely unbundled, meaning that each component of the package will also be offered to customers, at the same price, outside of the package, and provided that there is proof that there is a similar package on the market. Pelephone submitted its position to the Ministry of Communications.

In January 2009, a secondary hearing was scheduled, according to which Pelephone will be permitted to market a package of services together with Bezeq and subsidiaries in the Group. The joint package must be completely unbundled if it included Bezeq's fixed-line telephony components. On the other hand, unbundling will not apply to the infrastructure component for ADSL or any other component supplied by subsidiaries. Unbundling will apply to the joint package marketed by Bezeq, in other words, all components in the package will be offered to the customer at the same price when sold separately. A proposal was also made for Ministry approval of the joint packages in two stages:

1. Approval in principle from the Minister of Communications, contingent on the availability of similar packages in the market.

2. Individual approval of the joint package, contingent on the submission of an individual application to the Ministry of Communications.

Pelephone is preparing its response to this hearing.

3.18.3.2 Royalties

Pursuant to the Telecommunications (Royalties) Regulations, 5761-2001 and its license, Pelephone pays royalties to the State of Israel out of its revenues subject to royalties from the provision of telecommunications services, *inter alia* less revenues and expenses in accordance with the guidelines in the Royalties Regulations. In 2006, these royalties were 3% of its revenues subject to royalties. Under the Regulations, the rate of royalties is to be reduced by 0.5% to 1% from 2010 and onwards, so that in 2007, Pelephone will pay royalties at the rate of 2.5%, in 2008 - 2%, in 2009 - 1.5% and from 2010 onwards - 1%. In this regard, see also reference to a lawsuit filed by the State of Israel against Pelephone with respect to non-payment of royalties in Note 17 to the Company's financial statements for the year ended 2008, included in this periodic report.

3.18.3.3 Site licensing

Pelephone's MRT service is provided, *inter alia*, through cellular sites spread over Israel in accordance with engineering requirements. The constant need to upgrade and improve the quality of the MRT services necessitates setting-up cellular sites and changes in configuration and antenna systems.

Pelephone deploys two main types of broadcasting sites under two tracks: macro sites that require a building permit from planning and building councils and wireless access devices (access devices), which are exempt from a building permit in accordance with section 27 of the Communications Law and section 266(C) of the Planning and Building Law 5725-1965 (the Exemption Provision).

The licensing of building cellular broadcasting sites that require building permits is governed by National Outline Plan 36 (NOP 36). The purpose of NOP 36, which came into effect in 2002, is to regulate the deployment and manner of setting-up broadcasting facilities, so that the entire country is covered for transmission and reception, with minimal damage to the environment and the landscape.

The licensing process of NOP 36 requires, *inter alia*, obtaining a number of approvals from government authorities and regulators, including:

- A. Approval for construction and operation from the Ministry of the Environment (see Section 3.17.1 above)
- B. Approval of the Civil Aviation Administration in some cases.
- C. Approval of the Israel Defence Forces.

Various parties have criticized NOP 36, resulting in the preparation of a proposal for its amendment. At the end of 2005, the State of Israel rejected the proposed amendment to NOP 36 prepared by the planning administration of the Ministry of the Interior and requested that a committee of director generals prepare recommendations on the matter, returning NOP 36 to the national planning and building council for further deliberation.

In the time that has passed since then and in an indirect amendment to the planning and building law that came into effect upon the issuance of the Non-ionized Radiation Law on January 1, 2006, it was provided that before approving the construction of a cellular broadcasting facility, the local council will request a deed of indemnity for claims for compensation in respect of loss of value pursuant to section 197 of the Planning and Building Law and the indemnity will be according to the instructions of the national council, which will be in effect until approval of the national outline plan regulating this matter. On January 3, 2006, the national council decided that local councils are to request full indemnity (100%) from those requesting such a permit. It was also decided that a committee of editors would examine the recommendations of the director generals' committee. The committee of editors will present its recommendations regarding the need for changing the NOP and its contents. As at the date of this

update, Pelephone has deposited 234 deeds of indemnity with various local councils, in accordance with the law.

On December 4, 2007, the national council discussed the matter and decided to transfer a new version of NOP 36 to the district councils for comments and public objections. After receiving the comments and reservations, an expert investigator was appointed to recommend to the subcommittee the principle planning issues of the National Council for Planning and Building regarding the comments and reservations. The hearing of the comments and reservations has been completed and the recommendations are yet to be submitted. This new version, if it should pass all the necessary proceedings and come into effect, will replace the present NOP 36. The new version is more strict and demanding than the present NOP 36 and it is expected to delay, complicate and make it more difficult to obtain building licenses for cellular sites under this track. The amendment to NOP 36 is subject to the approval of the national planning and building council and the State of Israel.

Allegations were raised against the present NOP 36, claiming that it does not regulate the permits for facilities operating under third generation frequencies, which are not included in the list of frequencies attached to NOP 36. Pelephone's competitors have a large number of sites broadcasting under third generation frequencies and have received building permits according to NOP 36. Pelephone disagrees with these allegations and will use the third generation frequencies it acquired from the Ministry of Communications in the same way as its competitors. The proposed new version of NOP 36 includes a clarification for this matter.

Pelephone (and its competitors) encounters difficulties in obtaining some of the required approvals, and in particular approvals from planning and building authorities.

Pelephone's ability to maintain and preserve its MRT service quality as well as the coverage, is partially due to its ability to set up cellular sites and install infrastructure equipment, including broadcasting sites. The difficulties encountered by Pelephone in obtaining the required permits and approvals may adversely affect the existing infrastructure, network performances and the establishment of any additional cellular sites required by the network.

The inability to resolve these problems on a timely basis is also liable to prevent the attainment of the service quality goals specified in its license.

A number of sites established several years ago still do not have approvals from the Civil Aviation Administration and the IDF, even though the applications for the approvals have long since been submitted to them. Similarly, there are administrative or other delays in some planning and building councils in the issue of building permits for sites. Therefore, Pelephone operates a number of broadcasting sites that have not yet received building permits. Pelephone has applied to the planning and building authorities for the building permits and these are at various stages of discussion and approval.

The establishment of a broadcasting site without obtaining a building permit constitutes a breach of the Planning and Building Law, 5725-1965, and in some instances, this has resulted in demolition orders against sites or indictments or the initiation of civil proceedings against Pelephone and some of its officers.

As at the date of this report, Pelephone has succeeded, in most of these cases, to avoid demolition or to delay the execution of demolition orders pursuant to arrangements it reached with the planning and building authorities to resolve the matter of the deficient licensing. These arrangements have not required any admission of guilt by officers of Pelephone and/or their conviction. However, it is not certain that this state of affairs will continue in the future, or that there will be no further instances in which demolition orders are issued and indictments are filed in respect of building permits, including against officers.

Pelephone, similar to other MRT operators in Israel, is liable to be required to dismantle broadcasting sites for which the necessary approvals and permits have not been obtained in accordance with the dates prescribed by law. If it is legally

required that sites in a given geographic area be simultaneously demolished, service in that area is liable to deteriorate until substitute broadcasting sites can be built.

The second track under which Pelephone establishes broadcasting sites is the access devices track. Access devices require specific radiation permits according to the radiation law but are exempt from a building permit if they are constructed pursuant to the conditions provided in the exemption provision.

Some local authorities have disputed the applicability of the exemption provision to access devices of a cellular network and to its use. Pelephone's position regarding the applicability of the exemption was accepted in a number of rulings and decisions by local affairs courts and the use of such facilities and the supporting equipment was approved. One verdict in the same instance provided an opposite ruling. Appeals have been filed for some of these rulings and decisions.

On May 22, 2008, Tel Aviv District Court, sitting as a Court of Appeals, handed down a ruling regarding the issue of wireless access devices. The main points of its determination were as follows:

- A. The exemption from a building permit does not apply to access devices operating in a cellular network constructed on the roofs of buildings.
- B. Wireless access devices, as defined by law, are fixed devices.
- C. The antenna is not included in the definition of an exception to the requirement for a building permit for an "internal change in an apartment".

The Attorney General's opinion in this respect is described below.

Pelephone disagreed with the district court's ruling and on June 10, 2008, it filed a request for permission to appeal to the Supreme Court. In the context of the request for permission to appeal the Attorney General stated, inter alia, that the exemption in section 26 (C) of the law also applies to wireless access devices.

Two additional rulings were recently passed down in the courts for local affairs regarding access devices. The rulings recognized the legality of installing wireless access devices used by cellular networks, also after this district ruling. In another ruling passed down by the district court, to which Pelephone is not party, limited interpretation was given for the term "building roof" to which the exemption can be applied.

On July 21, 2008, the Union of Local Authorities in Israel and others filed a petition with the High Court requesting an order nisi instructing the Attorney General to appear and explain, inter alia, why the enforcement guidelines he issued to municipal prosecutors stating that charges not be filed and administrative demolition orders not be issued for the construction and operation of cellular access devices without a permit should not be cancelled. Furthermore, the High Court was asked to determine, inter alia, that the position of the Attorney General (in a document dated May 1, 2008) contains an extreme lack of reasonableness. Furthermore, a request was made for a temporary injunction to instruct the Attorney General to defer or suspend the validity of the enforcement guidelines or, alternately, to forbid the construction of cellular access devices without a building permit, until the court meets and rules on the petition.

A petition was submitted to the High Court of Justice against the legality of using the exemption provision for cellular network access devices, which was dismissed because of threshold conditions. In this framework, the State Attorney announced that the Attorney General is preparing his opinion on this matter and is holding staff work between the relevant government offices.

On May 1, 2008, the Attorney General expressed his position regarding wireless access devices and stated that he accepts the opinion that the exemption, according to its wording and purpose, also applies to wireless communications devices for cellular communications and represents the balance that the legislator created between the various interests. Despite this, and because of changes and developments in the law and the factual reality, the Attorney General asked that an inter-ministerial committee re-examine the significance and ramifications of

continued application of the exemption for cellular devices, the purpose of developing an updated position regarding a worthy justification for the exemption for cellular telephone devices, by the end of 2008. The committee has yet to submit its opinion.

Pelephone uses access devices to provide coverage and capacity to highly populated areas. Reducing or preventing use of the access devices track in a given geographical area may have an adverse effect on service in that area until substitute broadcasting sites can be built. If it is legally required that sites in a given geographic area be simultaneously demolished, service in that area is liable to deteriorate until substitute broadcasting sites can be built. As at the date of this report, Pelephone operates 396 wireless access devices.

Likewise, Pelephone, similar to other MRT operators in Israel, provides internal relays inside buildings to provide service in the buildings. These relays are small 60-cm devices attached to external antennas. This antenna receives a broadcast signal from a nearby broadcast site, which is then relayed into the building. Radiation emissions from these kinds of small antennas are similar to emissions from cellular terminal equipment. These relays and others have received a class approval from the Ministry of Communications.

Given the planning authorities' lack of clarity in policy matters relating to internal relays and the work patterns of all MRT operators in Israel, permits were not sought from the planning authorities in respect of these internal relays.

A number of local authorities have recently presented to the Commissioner of Radiation in the Ministry of the Environment their objection to the construction of access devices, based on a clause in the Non-Ionized Radiation Law prescribing that provision of operation permits for access devices is contingent on the approval of the relevant authority. As a result of these objections the Ministry of the Environment sometimes refuses to issue operation permits to access devices established according to the law in these authorities.

It is hereby clarified that Pelephone continues to construct wireless access devices. The rejection of Pelephone's position by the courts, in whole or in part, will have an adverse impact on the possibility of deploying sites, pace of deployment, and so forth. Termination of the operation of access devices will also damage service in the areas where these devices operate.

3.18.4 Antitrust

The document setting out the terms of the merger between Pelephone and Bezeq includes various restrictions as to cooperation between the companies. In 2006, Pelephone applied to the Antitrust Commissioner to cancel the conditions of the merger with Bezeq or to provide relief for such conditions so as to enable cooperation between Pelephone and Bezeq. Pelephone has not yet received a response from the Antitrust Authority.

3.18.5 Standards

Pelephone conducts routine durability and quality control tests of its facilities. The quality control and supervision do not detract from Pelephone's responsibility towards its customers for the quality of the services it provides.

In April 1996, the Israel Standards Institute found Pelephone to be in compliance with the requirements of Israel Standard ISO 9001:2000 for mobile radio telephone (cellular) services.

Pelephone received certification on January 11, 2004, valid until October 2010.

ISO 9001:2000 addresses a series of standards for quality management in the services. This is a standard for quality control systems that defines requisite conditions for compliance with service process standards and also constant improvement and testing of the effectiveness of the quality management system and its components.

Pelephone carried out the required adjustment for obtaining the approval in line with the tendency of the business-industrial world in general of its customers in particular, to contract exclusively with suppliers complying with the standard.

3.19 Substantial Agreements

For undertakings to banks, see section 3.15.2 above.

For trust deeds signed with Union Bank Trust Co. Ltd. at the time of issue of debentures, see section 3.15.3 above.

3.20 Joint Venture Agreements

For joint venture agreements with content suppliers regarding value added services, see section 3.12.2 above.

For roaming agreements, see section 3.2.1 above.

For a memorandum of understanding with the Super-Pharm chain, see section 3.6 above.

3.21 Legal Proceedings

For legal proceedings, see Note 17 to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

3.22 Goals and Business Strategy

Pelephone's principal strategic goals are:

1. To increase revenue and improve profitability
2. To maintain leadership in third generation
3. To increase its market share in the long term

To achieve its goals, Pelephone operates on a number of principal levels:

1. Increasing customer satisfaction

Pelephone acts to increase customer satisfaction and strengthen customer loyalty to Pelephone's services. These actions are reflected in improvement of the service system, offers to upgrade terminal equipment, and benefits for Pelephone customers under a marketing package reinforcing the Pelephone-customer relationship. Pelephone uses an advanced measurement system to monitor customer satisfaction, so that it may learn from it and constantly make improvements.

2. Third generation leadership

Pelephone has set itself the goal of being a third generation leader. In 2008, Pelephone continued to maintain its leadership in this area and it presently has the largest number of subscribers with third generation handsets compared to its competitors. This leadership is reflected in increased revenue from 3G services and by the number of subscribers joining such services.

3. Managing migration of customers to HSPA/UMTS

To lever the new technology to improve customer satisfaction and maximize revenue, Pelephone acts to prioritize migration of customers from CDMA to HSPA/UMTS.

4. Continued investment in infrastructure

Pelephone acts constantly to improve cellular service so that it can offer its customers the most advanced services, high speed access, high reception quality and full national deployment. The above information contains forward-looking information, which is based on Pelephone's assessments taking into account past experience, surveys regarding the state of the sector in which Pelephone operates, and its own future plans. Actual results might be substantially different from the assessments set out above, if there is any change in any of the factors taken into account in making these assessments. For risk factors, see section 3.24 below.

3.23 Outlook for Development in 2009

In 2009, a number of negative and positive factors are expected to affect Pelephone's activities, the main ones being:

3.23.1 Launching of the HSPA/MTS network

1. Launching of the HSPA/UMTS network allows Pelephone to expand the range of terminal equipment available to its customers, with popular brands such as Nokia and Sony Ericsson, which will contribute to the application to other target populations.
2. Launching the HSPA/UMTS network will allow Pelephone to expand roaming services and accordingly, increase revenue from this sector.

3.23.2 Third generation services

Pelephone expects that during 2009, it will increase the number of customers using 3G and the range of such services, resulting in continued increase its revenue in this sector.

3.23.3 Innovative value added services

In 2008, Pelephone is expected to continue to improve its existing services and to widen its range of advanced value added services, which will help improve brand perception and increase revenue from existing customers.

3.23.4 Regulation

In 2009, Pelephone expects revenue to be adversely affected by regulation of policy, license amendments, consumer legislation and various administration provisions that are expected to come into effect during the year, including the transition to charging by second, the ban on price increases in a fixed transaction and the introduction of MVNO. See section 3.18.3.1 above.

The above information contains forward-looking information, which is based on Pelephone's assessments taking into account past experience, surveys regarding the state of the sector in which Pelephone operates, and its own future plans. Actual results might be substantially different from the assessments set out above, if there is any change in any of the factors taken into account in making these assessments. For risk factors, see section 3.24 below.

- ### **3.23.5**
- Recession – an economic recession in Israel might bring about a reduction in private consumption in general and consumption of cellular services in particular, some of which are considered luxuries. See section 3.24.1.1 below.

3.24 Risk Factors

The Israeli market in which Pelephone operates is stable by nature, however, there are risk factors deriving from the macro-economic environment, the unique qualities of the sector in which Pelephone operates, and risk factors that are unique to the Company.

3.24.1 Macro-economic risks

3.24.1.1 In 2008, the crisis in the credit market has sent global markets into a recession and credit crunch. It is expected that the impact of the process will continue to be felt in 2009 and possibly even later, and it is possible that there will be a transition from growth to recession. The local market is also expected to experience a significant slump together with a deterioration in business operations and central economic parameters, which could have an adverse effect on its operations in 2009.

The possible effect of changes in the economic environment include the following:

1. A slowdown in the acquisition of new subscribers, abandonment of existing subscribers
2. A decline in revenue as a result of the decline in use, erosion of tariffs and reduction in the number of users in other services
3. Changes to the exchange rate which will impact the profitability of the sale of end equipment and financing costs
4. Collapse of suppliers

This information contains forward-looking statements, based on Pelephone's assessments. Actual results may differ materially from these assessments if there is a change in any of the factors taken into account in these assessments.

3.24.1.2 Exposure to fluctuations in exchange rates, interest rates and inflation – Pelephone is exposed to risks caused by fluctuations in exchange rates, since most purchases of terminal equipment, accessories, spare parts and infrastructure are in US dollars, while Pelephone's income is in NIS. Erosion of the shekel as against the dollar might have an adverse effect on Pelephone's profits if sale prices cannot be adjusted in the short term. Accordingly, Pelephone invests a considerable share of its cash balances in deposits that are exposed to changes in real yields as a result of inflation rate fluctuations. Pelephone's CPI-linked loans and debentures bear fixed interest and therefore fluctuations in the interest rate will affect their fair value but not their book value.

3.24.2 Sector risks

3.24.2.1 Investments in infrastructure and technological changes – The cellular market in Israel and other countries is characterized by material capital investments in the deployment of infrastructure and in subscriber equipment. The frequent technological changes in infrastructure and terminal equipment and the fierce competition in various market segments impose a heavy financial burden on the companies operating in the market, requiring them to update their infrastructure technology from time to time or to introduce new devices into the market at heavy cost.

3.24.2.2 Customer credit – Pelephone's sales to its customers are mostly credit-based. Some of this credit is secured using credit insurance which includes policyholder's deductibles, and some is secured by sureties provided by customers. The other part of this credit, which is not covered by either insurance or sureties, is exposed to risk. Due to the wide distribution of its customers, Pelephone assesses that there is a low risk of substantial harm to its business results.

3.24.2.3 Regulatory developments – In the area of Pelephone's operations, there is a trend to legislate and impose standards on issues such as the environment, increased competition, tariffs, product liability and the methods used for repairing products. These regulations might, inter alia, make it much more difficult to construct cellular sites, impairing network quality, and increase the costs of services and marketing. Due to the strong competition, it might not be possible to

roll those costs in full onto consumers, which could erode profits in the sector. Furthermore, regulatory intervention and the uncertainty it entails may have an adverse effect on the Pelephone's ability to plan its business conduct.

- 3.24.2.4 Competition – The cellular market in Israel is characterized by a high degree of saturation and strong competition, and is exposed to influences due to technological and regulatory developments.
- 3.24.2.5 Electromagnetic radiation – Pelephone operates hundreds of transmission facilities and sells terminal equipment that emits electromagnetic radiation (see section 3.17 above). Pelephone is taking steps to ensure that the levels of radiation emitted by these transmission facilities and terminal equipment do not exceed the levels of radiation permitted in the directives of the Ministry of Environment Protection (levels adopted in accordance with international standards). Even though Pelephone acts according to the directives of the Ministry of Environment, if health risks are found to exist or if the transmission sites or terminal equipment are found to emit more radiation than that allowed in radiation standards, which constitutes a risk to health, the effect could be negative following a reduction in the use of Pelephone's services, difficulty in renting sites, claims for physical and property damages of substantial amounts and attempts to exercise the deeds of indemnity that were deposited with the planning authorities with respect to section 197 of the Planning and Building Law. Pelephone's third-party liability policy does not currently cover electromagnetic radiation.
- 3.24.2.6 Site licensing – The establishment and operation of cellular antennas are subject to building permits from the various planning and building committees, a process that involves, inter alia, a number of approvals from State entities and regulatory bodies. For details of the difficulties encountered by Pelephone in the establishment and licensing of sites, see section 3.18.3.3 above. These difficulties may impair the quality of the existing network and even more the deployment of the new network.

3.24.3 Pelephone's risk factors:

- 3.24.3.1 Terminal equipment quality – Pelephone might be exposed to losses in the event of malfunctions in the terminal equipment that it sells, including indirect damages that could result from such malfunctions.
- 3.24.3.2 Property risks and liabilities – Pelephone is exposed to various property risks and liabilities. Pelephone employs the services of an expert external insurance consultant in this field. Pelephone has insurance policies which cover the usual risks to which Pelephone is exposed within the limits of the conditions of such policies, such as various forms of property insurance and liability insurance, loss of profits, third party liability insurance and officers' insurance.
- 3.24.3.3 Serious malfunctions in information systems – Pelephone's information systems are networked throughout the country through designated communications lines and through the internet. Pelephone's business is highly dependent upon these systems. Wide-scale malicious harm or malfunction might adversely affect Pelephone's business and results.
- 3.24.3.4 Serious malfunctions in the communications network – Pelephone's communications network is deployed around the country through network core sites and antenna sites. Pelephone's business is totally dependent upon these systems. Wide scale malicious harm or malfunction might adversely affect Pelephone's business and results.
- 3.24.3.5 Damage by natural or other disasters, war, damage to the switching farm and/or servers used by Pelephone for its core activities could have an adverse effect on Pelephone's business and its results.
- 3.24.3.6 Legal proceedings – Pelephone is party to legal proceedings, including class actions, which are liable to result in its being charged for material amounts that cannot presently be estimated and generally no provision has been made in Pelephone's financial statements for these proceedings. Class actions may reach high amounts, since approximately one third of the residents of Israel are Pelephone consumers, and a claim relating to a small amount of damage to a single consumer may grow into a material claim against Pelephone if certified as

a class action applicable to all or a large proportion of those consumers for legal proceedings to which Pelephone is a party.

3.24.3.7 Pelephone uses two frequency ranges: 850 MHz and 2100 MHz. These frequencies are exposed to interruptions and could impair service quality of networks operated by Pelephone. The factors that could cause interruption include the fact that the 850 MHz frequency is also used for cable television broadcasts, television stations broadcasting in the Middle East (mainly in Cyprus) on the same frequency causing interruption in the Pelephone's EVDO/XRTT1 network. In addition, in view of the peace treaty with Jordan, Pelephone is precluded from using part of the frequency range that is suitable for the CDMA network, which is used by Jordan operators. In addition, development of digital multi-channel television broadcasts could aggravate the disturbances in this network.

The following are the risk factors as described above, and their effect in the opinion of management, on the results of its business:

Effect of risk factor on all of Pelephone's activity			
Risk factors	Major	Moderate	Minor
Macro-economic risk factors			
Economic recession		X	
Exposure to changes in the exchange rates, interest rates and inflation		X	
Sector risk			
Investments in infrastructure and technological changes	X		
Customer credit			X
Regulatory developments	X		
Competition	X		
Electromagnetic radiation*			
Site licensing	X		
Pelephone's risk factors:			
Quality of terminal equipment		X	
Property risks and liabilities			X
Serious malfunctions in information systems	X		
Serious malfunctions in the communications network	X		
Legal proceedings		X	
Restrictions applicable to frequencies and disturbance in use of frequency range		X	

* Pelephone is unable to assess the effect of this risk factor on its operations.

4. International communications and internet services – Bezeq International Ltd. (Bezeq International)

4.1 General

4.1.1 Structure and changes to area of operations

Bezeq International, a wholly-owned Bezeq subsidiary, supplies direct dialing telephone services to 240 destinations all over the world. Bezeq International's telephone services, similar to services of other international operators competing in the market, are primarily based on the Company's domestic network and on the cellular network for connecting the subscriber to the international exchange.

In addition to international call services (Voice Services), Bezeq International supplies data communication services (Data Services), ISP (Internet Services), value added services, telephony routing services between foreign international communication operators and server and web hosting services (Hosting Services). Bezeq International also supplies integration services offering business customers comprehensive communication solutions, including data services, web and server hosting, and maintenance services and technical support for networks (Integration Services). Since its full merger with BezeqCall Communications Ltd. (BezeqCall) on February 11, 2007, (the date of the full merger), the Company also supplies NEP services, including data communications infrastructure services, passive infrastructure installation services and low voltage systems, sale of exchange systems including IP telephony communications systems, and installation and maintenance services for these systems. Bezeq International's data communication services include P2P lines, frame relay, virtual, ATM, ISDN, private networks, video conferencing facilities and IP services.

4.1.2 Legislative and statutory restrictions applicable to Bezeq International

The communications market in Israel is primarily regulated by the Communications (Telecommunications and Broadcasts) Law, 5742-1982 (the Communications Law). See section 4.17 below.

4.1.2.1 General license

Bezeq International operates in compliance with a general license for supply of voice, data and internet services (in this chapter: the License), which is valid until 2022. The provisions of the license regulate, inter alia, the method for determining tariffs charged by Bezeq International for its services, their update and collecting the payments for these services.

On July 11, 2007, the Ministerial Committee approved an amendment to the Communications (Telecommunications and Broadcasts) Law, 5742-1982, which is parallel to the Limitation of Access to Adult Internet Sites Bill, 5766-2006, of Knesset Member Amnon Cohen, and submitted it to the Economic Committee of the Knesset. The bill, which was discussed by the Economic Committee, proposes restricting access to sites that contain pornographic content, gambling, or violence, inter alia by imposing an obligation on internet service providers, including Bezeq International, to activate mechanisms that oversee access to such sites. Due to the many questions raised in the Committee relating to the constitutionality of the amendment, as well as to the technical aspects involved in its implementation, the Committee requested that the Ministry of Communications present it with information before it makes any decision in this regard. At this stage, before completion of the hearing in the Economic Committee of the Knesset, it is not possible to assess the implications of this law, if and when it is passed, on the commercial operations of Bezeq International.

4.1.2.2 Special general domestic operator license

On February 8, 2009, the Minister of Communications granted a special general license for the supply of domestic communication services to BIP Communication Solutions (S.R), a company owned by the Bezeq International.

Granting the license was made possible in view of the VoB policy document, which states, inter alia, that Bezeq International can receive a VoB license once the Company's share of the domestic telephony market falls below 85%.

The license allows Bezeq International to deliver domestic telephony services over broadband (VoB) to private customers only. However, once Bezeq's market share of the business sector falls below 85%, the Bezeq International can also provide these services to business customers.

4.1.2.3 Royalties

Under its license and the Telecommunications (Royalties) Regulations 5761-2001, Bezeq International pays the State of Israel royalties of 3.5% per year, out of most of its revenue from the supply of international call services and P2P lines, less permitted expenses and with the exception of revenue from customers determined in these regulations.

In the past, Bezeq International carried out an examination, which uncovered that the calculation method for royalties due by Bezeq International is incorrect and that it paid excessive royalties in previous years. Accordingly, Bezeq International updated payment of the royalties it transferred. On the publication date of the periodic report, there is a dispute between Bezeq International and the Ministry of Communications in respect of this update.

In the matter of the percentage of the royalties, in August 2006 the Ministry of Communications and the Ministry of Finances approved the Telecommunications (Royalties) (Amendment) Regulations 5766-2006 so that the royalty rate was reduced from 3.5% to 3%, as of January 2006. The amendment also determined that the royalty rate would be gradually reduced, so that in 2007, the rate would be 2.5%, in 2008 it would be 2%, in 2009 it would be 1.5%, and from 1 January 2010 it would be 1%. In this regard see also section 2.16.3 above.

4.1.2.4 NEP license

On December 31, 2006, the Ministry of Communications approved the transfer of BezeqCall's NEP license to Bezeq International. As of the date of the full merger, Bezeq International has been providing NEP services under this license.

4.1.2.5 Gronau Committee report

For recommendations of the Gronau Committee and their adoption by the Minister of Communications, see section 2.6 above.

Bezeq International estimates that the Minister's decision will not have an effect on the company's business operation in the near future and in any event, it is unable, at this stage, to estimate the possible long-term effect. The Minister determined that implementation of the changes in the company's field of operations requires the completion of a lengthy procedure to prepare regulatory infrastructure, the nature of which is uncertain at this stage, as well as the creation of new market arrangements on this infrastructure, and it is uncertain if or when they will materialize.

4.1.2.6 Amendment to the general license – sale of service bundles

On July 3, 2008, Bezeq International received a letter from the Director General of the Ministry of Communications, regarding an amendment to the general license for the sale of service bundles, which includes the services of Bezeq International and Bezeq. The letter included draft amendments to the general licenses of Bezeq International and Bezeq. In its response to this letter and in the framework of the hearing held at the Ministry of Communications on July 20, 2008, Bezeq International informed the Ministry of Communications that it objects to the amendment of its general license, in the proposed wording, because on the one hand, this amendment will not ease the restrictions imposed on Bezeq International and Bezeq for the sale of joint service bundles, and on the other hand, the proposed amendment will have an adverse effect on its current situation and discriminates against the company in comparison to the competitors. In the course of this hearing, further amendments were made to the draft amendments to the licenses of Bezeq International and the Bezeq, and again, this was not to the satisfaction of Bezeq International. On February 11,

2009, another hearing was held with the Director General of the Ministry of Communications. In this hearing, Bezeq International was assured that the Ministry of Communications would consider cancelling or updating the proposed amendment, to avoid discriminating against Bezeq International opposite the competitors.

4.1.3 Main entry and exit barriers

- 4.1.3.1 The main entry barrier in the international call market is the requirement of a license under the Communications Law and investments in infrastructure, which are affected by frequent technological changes. However, change in the licensing policy, as set forth below, and expansion of the use of VoIP technology in this field, significantly reduces the effect of these barriers.
- 4.1.3.2 The main entry barrier into the data and internet services market stems from investments in infrastructure (international capacity, access to the internet network and broad service network).
- 4.1.3.3 The main exit barriers for these markets stem from long-term agreements with infrastructure suppliers and from investments that require a long periods of time to provide returns. Furthermore, Bezeq International is committed to providing service to its customers during the period of their contract .

4.1.4 Substitutes for Bezeq International products

Some service providers in the international call market do not have a license (illegal operators) and therefore do not adhere to the restrictions imposed on Bezeq International by virtue of the license and the provisions of the law. Furthermore, use of VoIP technology enables transfer of international calls over the internet, for other users of this technology, as well as for TDM network users, through the use of software products and services of communication providers abroad. The attractive costs of using these services lead to a steady growth in the number of users, and as a result – a decline in the revenue of Bezeq International.

4.1.5 Structure of competition and changes in the sector

- 4.1.5.1 In the first year of its operation, from June 1996 to July 1997, Bezeq International was the exclusive provider of international telephony services in Israel. In July 1997, two other international operators entered the market: Barak I.T.C. (1995) – International Telecommunications Services Company Ltd. and 012 Golden Lines Ltd. This led to a sharp fall in the prices of international calls and extensive growth in the capacity of the market. In April 2004, the Communications (Telecommunications and Broadcasts) (Procedures and Conditions for the Receipt of a General License for International Telecommunications Services) Regulations 5764-2004, came into effect. On the publication date of this report, the Ministry of Communications has granted general licenses to provide international telecommunications services to three more operators: Internet Gold-Golden Lines Ltd. (Internet Gold), NetVision Ltd. and Xfone Communication Ltd., all of which commenced operations by the end of 2004. The expansion of competition led to an additional fall in the prices of international calls, although, unlike 1997 when competition began, the volume of international traffic did not undergo a significant increase, since prior to the expansion of competition, call prices did not constitute a factor preventing the public from using the service. The expansion of competition had an adverse effect on the results of Bezeq International's operation and on its financial condition.
- 4.1.5.2 In 2007, Barak merged with NetVision, forming NetVision 013 Barak and Internet Gold merged with Golden Lines, forming 012 Smile.
- 4.1.5.3 In September 2008, Partner Communications Ltd. (Partner) announced its intention to offer internet and IP-based content and telephony services, and as such will compete in Bezeq International's markets. Partner chose to soft launch internet, VoB and content services in the fourth quarter of 2008 and started to offer these products to the public on January 1, 2009. Bezeq International is adjusting its work plans accordingly.

- 4.1.5.4 As at the date of the periodic report, licenses for providing internet services have been granted to some 70 companies, among them five of the aforementioned international operator licensees.

4.2 Products and Services

Below are details of the principal products and services provided by Bezeq International.

4.2.1 Voice services

In the voice services sector, Bezeq International provides international direct dialing (IDD) services to business and private customers; toll-free number services for business customers overseas; telephone card services enabling prepaid and postpaid dialing, mainly from overseas to Israel, for business and private customers; and the 1809 service for dialing from Israel to other countries by dialing 1809.

4.2.2 Internet services

In the internet services sector, Bezeq International provides internet access services for private and business customers, including terminal equipment and support, with an emphasis on broadband internet based on ADSL or cable infrastructures; hosting services – site storage and server services in a designated installation for business and private customers, including value-added services (such as monitoring and control); information security services, services securing customers' internet and LAN connections using the required terminal equipment or software, including monitoring; data services with international data communication IP solutions for business customers, including global deployment if necessary; and wireless (WIFI) access – fast wireless access solutions for private and business customers, including in various public locations (hotspots).

4.2.3 International data services

Supply of international data communication solutions for business customers, includes customized global deployment.

The customer is able to choose from a range of advanced data communication methods:

- DIA is a reliable and scalable P2P public IP platform manufactured by BT Infonet. The service allows global internet access (ISP) through one internet provider, and is designed as an optimum solution for the current requirements in business VPN connectivity.
- iWorks is a global offnet internet service that complements DIA, supplied as a one-stop-shop service through Bezeq International. The service provides full connectivity to public internet, through local providers in each country.
- IP VPN secure service enables transfer of multiple applications on a consolidated network, including data applications, real time and mission critical.
- Bezeq International supplies a range of private P2P services through optic cables running from Israel to Europe, for which the company has long-term leasing rights.

4.2.4 PBX services

Following the merger with BezeqCall, Bezeq International markets and maintains communication systems in the Israeli market, exchanges, telephony networks and IP communications. As part of the service contracts, Bezeq International supplies direct maintenance of a range of exchange manufacturers. The services are given to gateways, exchanges and network end points (NEP) designated for use with both internal and external lines.

4.2.5 Integration services

In the third quarter of 2005, Bezeq International set up an integration and new business division that focuses on data, server and web hosting, and total integration solutions for businesses.

- 4.2.6 In the NEP services sector, Bezeq International provides sale, installation, and maintenance of exchange systems, installation and maintenance of data communication infrastructure, installation and maintenance services for passive infrastructure and low-voltage systems, with emphasis on integrative solutions tailored to business and institutional customers on their premises.

4.3 Revenue

Bezeq International's revenue (in NIS millions):

	2008	2007	2006
Total revenue	1,306	1,304	1,021
Gross profit (%)	40%	34%	35%

4.4 New Products

4.4.1 In January 2009, Bezeq International launched its new server farm, which is the most advanced in Israel. The server farm, which is in addition to the company's existing server farms (IDC), is expected to host thousands of servers. Establishment of the server farm is part of Bezeq International's strategy to strengthen its position in the corporate sector, and in particular, among small and medium business that prefer outsourcing their IT management. The new server farm is a green farm, based on energy-saving infrastructure. The server farm uses Bezeq International's advantages as a leading internet provider in Israel and is connected directly to the backbone of the company in Big 10 connection. This allows customers to benefit from maximum flexibility in their broadband management and from a wide range of advanced services, including server hosting and management, virtual services and a range of managed services such as backup, information security, firewalls, tracking, statistical construction, international traffic, burstable bandwidth and FTP services.

Principal new products launched in 2008:

4.4.2 SIM 014: an international SIM for dialing from cellular handsets when abroad, with the benefit of saving tens of percent compared to special offers for calls from abroad offered by the cellular companies. SIM 014 services are carried out through automatic callback and also provide the following services:

- Voice mail
- SMS
- SIM 014 online support

4.4.3 Eset: a security package installed on the customer's PC, supplying comprehensive security including antivirus, anti-spam, spyware and firewall. Eset also provides offline protection and is updated automatically.

4.4.4 iKeeper version 6: screening of websites with inappropriate content classified by content – gambling, porn, sport, chat and email. The new version (from December 22, 2008) includes shopping, violence, social networks, blogs and forums.

4.4.5 @my: a service allowing customers to select a unique email suffix to replace the regular suffix

4.4.6 Safeweb: a network service that screens inappropriate content and sites. The services screens content and websites whenever the customer is online and is not dependent on the customer's screening settings.

4.4.7 Juniper SSG: a series of unified threat management products providing a comprehensive protection solution for customers on the organizational gateway level

4.4.8 Check Point UTM-1 270 / 570 / 3070: a series of unified threat management products providing comprehensive protection for customers on the organizational gateway level

4.4.9 Check Point Power 1: a series of high performance hardware-based network firewalls

4.4.10 From the date of the full merger, Bezeq International absorbed all the products and services that BezeqCall sold and supplied at that time. For further details, see the update in section 4.2 above - Products and services.

4.5 Marketing, distribution and service

4.5.1 The marketing department coordinates all the operations for a number of permanent suppliers, among them advertising companies representing Bezeq International, which are used by Bezeq International to remain in contact with the advertising media (television,

internet, radio and the daily national press), production and post-production companies (this changes depending on the requirements of each campaign), design and printing companies, and sales promotion and PR companies. Bezeq International believes that the loss of contact with any of its permanent advertising or marketing suppliers will have no significant effect on its marketing and distribution channels.

4.5.2 Bezeq International operates sales channels for the private market, as follows:

- 4.5.2.1 Recruitment center for internet and incoming voice call services providing solutions for demand, and recruitment center for internet and outgoing voice calls based on various files.
- 4.5.2.2 Retention center for internet and incoming voice call services providing solutions for customers wishing to leave Bezeq International and retention center for internet and outgoing voice call services which handles existing customers proactively.
- 4.5.2.3 National direct sales setup conducting door-to-door operations, operating points of sale and managing customers.
- 4.5.2.4 Distribution channel setup including external centers and field systems for resellers and dealers.

4.5.3 Bezeq International operates sales channels for the corporate market, as follows:

- 4.5.3.1 New customer recruitment center – for SMB customers under the ingoing and outgoing call model, using files.
- 4.5.3.2 Increased existing customer volume center – for SMB customers under the ingoing and outgoing call model, using files.
- 4.5.3.3 Customer retention center, which handles the heaviest customers in the SMB sector, retains them and increases revenues from them. This center also acts as a second line regarding customer retention matters.
- 4.5.3.4 National direct sales setup conducting door-to-door operations, operating distributors and recruiting SMB customers.
- 4.5.3.5 Telemeeting center for setting and coordinating meetings with potential SMB and SME customers.
- 4.5.3.6 SME sector, which coordinates customer managers who recruit and manage medium-sized customers on an ongoing basis.
- 4.5.3.7 ENT sector, which coordinates customer managers who recruit and manage strategic customers on an ongoing basis.

4.6 Competition

The main characteristic of market competition in 2008 was the entry of new players into ISP and VoB, following the market consolidation in 2007, which included the mergers of Barak - NetVision, Golden Lines – Internet Gold, and on the other hand, the merger of Bezeq International with BezeqCall. The competition is characterized by eroding tariffs.

4.6.1 Voice services

- 4.6.1.1 At the end of 2008 there were four competitors operating in the market: 014 Bezeq International, NetVision 013 Barak, 012 Smile and 018 Xfone. In Bezeq International's estimation, its market share in the outgoing calls sector is 36%.
- 4.6.1.2 General characteristics of competition in 2008
 - 4.6.1.2.1 About 50% of households make international calls at least once a month.
 - 4.6.1.2.2 The various sectors are extremely important (emphasis on immigrants originating from the former USSR) and marketing operations are designed accordingly.
 - 4.6.1.2.3 The product is a commodity.
 - 4.6.1.2.4 The market is a price market.

- 4.6.1.2.5 There is low consumer involvement due to the low costs.
- 4.6.1.2.6 Fierce competition and penetration of VoIP technology increase competition for customers.

4.6.2 Internet services

There are a number of competitors in this market, including Bezeq International, 013 NetVision, 012 Smile, Partner (as described in section 4.1.5.3) and two minor niche players. In Bezeq International's estimation, its market share in the internet service sector is 36%.

4.6.2.1 General characteristics of competition in 2008

- 4.6.2.1.1 Some 73% of Israeli households are connected to the internet and 95% of these have broadband connections.
- 4.6.2.1.2 There are two alternatives for customers in the market: ADSL, the leading Bezeq infrastructure, and HOT infrastructure.
- 4.6.2.1.3 HOT frequently cooperates with Bezeq International's direct competitors. HOT acts to restrict Bezeq International's internet operations.

4.6.2.2 Main developments in 2008

- 4.6.2.2.1 Continued slow-down in the growth rate of high-speed internet compared with previous years.
- 4.6.2.2.2 Launch of high speed services by infrastructure companies (M 4, 7, 8, 10, 12).
- 4.6.2.2.3 Continued migration of customers to higher speeds.
- 4.6.2.2.4 Purchase of value added services.
- 4.6.2.2.5 Continued importance of price for the customer. At the same time, and in view of the market saturation, emphasis is placed on strengthening customer loyalty.
- 4.6.2.2.6 Strengthening sales of bundles and triple play in the market, meaning infrastructure suppliers influence market behavior.
- 4.6.2.2.7 In 2009, Bezeq's ADSL network will be upgraded to NGN, with national deployment and high speed access of up to 50 MB.

4.6.3 Solutions for the business sector – Bezeq International Business

Characteristics of the business sector in 2008

From the aspect of customer orientation and with the aim of increasing revenues from business customers, Bezeq International continues to supply integration services to businesses, providing full solutions in areas such as system, networking, IT, hosting, voice, data, ISP and wireless.

There is a full solution model for the customer, without relying on external suppliers, and the customer has one contact person with responsibility for the process (one supplier, one responsibility).

With the introduction of integration solutions, Bezeq International is facing new competitors in this field, such as Binat, Taldor, and IBM.

The other companies that are in competition with Bezeq International, and which, as well as the Bezeq Group fall into two main communications groups, are also trying to reinforce this field and competition is expected from that direction as well.

4.6.4 NEP services

The traditional field of telephone exchanges is characterized by a large number of competitors and by fierce competition, which has given rise to an erosion of service prices. The most prominent competitors are Tadiran, Eurocom, GlobeCall and Tel-Yad.

The data communications and IP telephony sector is characterized by the entry of new players – IT companies – into the world of voice. These are companies such as Binat, Teldor, Netcom, and IBM, which are substantially different from traditional NEP companies

and are on a higher technological level. Telecommunication companies are also conglomerating and new operators, are entering the market, with the intention of providing customers with total communications solutions, such as telephony, transmission, data communications, internet, and information security.

4.7 Seasonality

In general, the revenues and profitability of Bezeq International are affected in a minor way by the seasons and holidays. There are seasonal fluctuations in the following services:

- 4.7.1** Voice services for the business sector – decrease in August and during the Passover / Tabernacle holidays
- 4.7.2** Voice services for the private sector – increase in the summer months and towards the end of the Gregorian year.
- 4.7.3** Internet services – best results usually achieved in the fourth quarter
- 4.7.4** Internet services for the business sector – a decrease in the summer months owing to the closure of educational institutions (customers in this sector are not billed for the internet services to which they subscribe during the summer vacation).

4.8 Property, plant and equipment

4.8.1 In the past, Bezeq International referred to international communications infrastructure (underwater cables and international switches) which Bezeq International leases (mainly from Mediterranean Nautilus Limited) as property, plant and equipment. Upon adoption of IFRS, the rights of Bezeq International in international infrastructure can no longer be regarded as property, plant and equipment. For reference to Bezeq International's contract with the infrastructure supplier Mediterranean Nautilus, see section 4.11.5 below.

4.8.2 Towards the end of 2004, Bezeq International signed an agreement with Veraz, to purchase SoftSwitch switches, which, during the course of 2005, replaced the Alcatel S-12 voice switches (at this stage, these switches are still being used as a non-substantial component in Bezeq International's voice service systems). These switches are used to route Bezeq International's voice traffic. The value-added services, including dialing cards, are based on an intelligent network (IN), which was also replaced in 2005 as part of the upgrade of its voice setup.

Bezeq International's technological infrastructures, which support voice, data and internet setups, are deployed in four sites to provide services with high survivability. In 2005, Bezeq International set up another site in London, England to supply advanced services to its customers.

Bezeq International has a long-term lease of the two main structures in which it is based, for average periods of 6 years.

4.8.3 On November 14, 2006, Bezeq International signed an agreement with Avnet Choshen Building and Investment Company Ltd. to lease approximately 7,000 sq m for eight years and four months, from April 2007 to July 2015, with an option to extend the lease term for two years each time, up to an additional eight years.

4.9 Intangible assets

4.9.1 License to provide Bezeq International services

Bezeq International operates within the framework of a general license for the provision of international telecommunications services, under the Communication Law, which anchors the right of Bezeq International to provide internet services. The license constitutes the basis for Bezeq International's operations.

4.9.2 Acquisition of Gil A.R. Telecom Systems

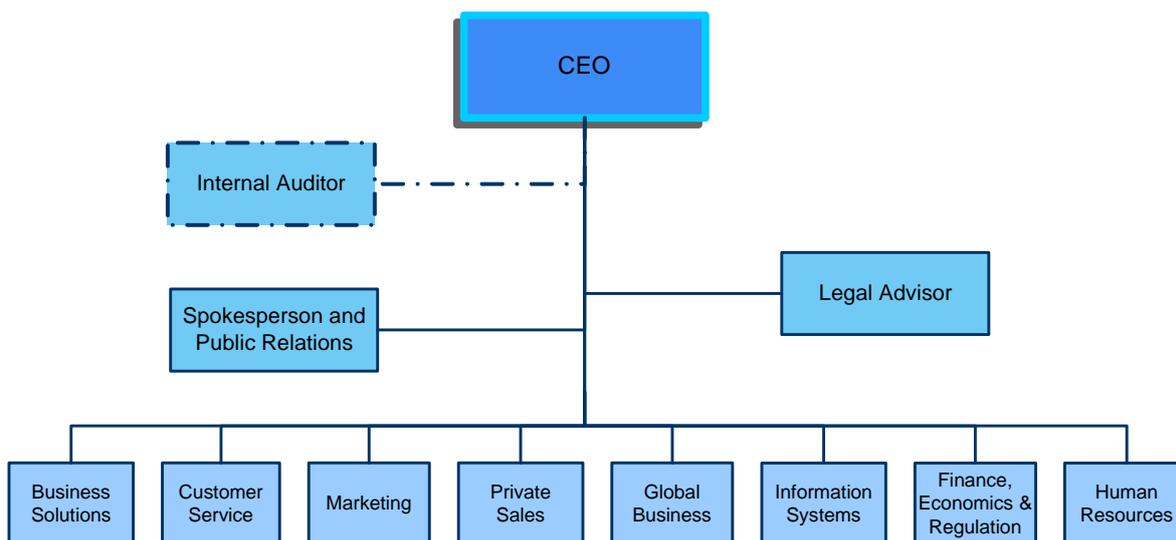
On March 23, 2008, Bezeq International signed an agreement with Gil A.R. Telecom Systems (Gil A.R.). Under this agreement, Bezeq International purchased from Gil A.R. all sales, rental and service operations of Avaya Office telecommunication and exchange products.

4.10 Human resources

4.10.1 The number of persons employed by Bezeq International (employees of the company, employees of human resource firms and outsourcing) is 2,325, of which 900 are permanent employees.

4.10.2 Organizational structure

Below is the organizational structure of Bezeq International:



4.10.3 Bezeq International has a number of employee groups whose wage structure includes a component of performance-linked commissions and incentives. These groups include sales employees, telephone sales representatives, and telephone service and support representatives.

4.10.4 Employees have a leasing arrangement enabling employees to receive vehicles at a fixed cost in accordance with the terms of an agreement between Bezeq International and a leasing company. Employees also have an arrangement for pension and health insurance that is fully subsidized by the company.

4.10.5 Bezeq International invests resources in professional training in accordance with the type of employee and the field in which he or she operates, such as technological training and qualification, manager development courses and more.

4.10.6 All of Bezeq International's employees have standard personal contracts based on their professions and positions.

4.11 Suppliers

4.11.1 In February 2005, Bezeq International signed an agreement with SigValue to purchase an intelligent network system, the cost of which is not material. Bezeq International is dependent on this supplier for some of its services based on the intelligent network.

4.11.2 Bezeq International has an agreement with Tadiran Information Systems Ltd. (which was acquired by IBM) which is implemented by IBM Global Services (Israel) Ltd. (IBM) for the maintenance and development of service absorption and pricing and billing systems. Bezeq International is dependent on this service from IBM.

4.11.3 In 2004, Bezeq International set up a contact center (a system integrating switchboard, collaborative system comprising computer, switchboard and interactive voice response). This setup is used by Bezeq International's service, support and sales centers, and is based on Avaya technology. Bezeq International has an agreement with IBM for ongoing support and maintenance.

4.11.4 Bezeq International has financial relations with some 100 foreign operators in approximately 240 destinations worldwide. The substantial foreign operators in terms of

size and cost of traffic passing through these operators include British Telecom, Rostelecom, Paltel, and AT&T.

4.11.5 Bezeq International is dependent upon international communications infrastructure provider Mediterranean Nautilus Limited, which supplies it with most of the international communications infrastructure that it requires through a seabed cable running from Israel to Europe. From there onwards, Bezeq International uses other infrastructure for connecting to the rest of the world.

4.11.6 All of the rights and obligations of BezeqCall under joint venture, marketing and sale agreements to which BezeqCall has been a party, were transferred to Bezeq International, giving it the right to market and supply installation, support and maintenance for equipment sold as part of NEP services. The most significant agreements are with LG, Nortel, Cisco, and Tadiran.

4.12 Working Capital

Bezeq International's cash item includes bank deposits for immediate withdrawal as well as fixed-term deposits on which there are no usage restrictions and whose repayment date, on their investment date, does not exceed three months.

4.13 Credit Policies

4.13.1 Credit to customers

4.13.1.1 Most of Bezeq International's customers have credit terms of EOM + 45.

4.13.1.2 Equipment sold to internet customers is usually billed in 24 installments.

As part of the NEP services, Bezeq International makes sales to its customers through payments in many installments. In this way, Bezeq International gives its customers credit, which they repay in installments. To reduce the exposure which might derive from long-term credit to its customers, Bezeq International checks their financial resilience, sets ceilings for the maximum credit available to customers and registers a charge over the equipment sold, pending full repayment of the credit.

4.13.2 Credit from suppliers

Bezeq International receives credit from its suppliers for 30 to 120 days (usually 90 days).

4.14 Investments

4.14.1 On December 31, 2008, Bezeq International held 34.25% (32.42% after full dilution as at December 31, 2008) of the share capital of Walla! Communications Ltd. (Walla). Walla is an Israeli company whose shares are listed on the Tel Aviv Stock Exchange. Walla provides internet services and is an internet portal provider.

Walla ended 2006 with a net profit of approximately NIS 15.1 million and 2007 with a net profit of approximately NIS 17.4 million.

For additional details regarding Bezeq International's investment in Walla, see Note 12 to the company's financial statements for the year ended 31 December 2008, which are included in this periodic report.

4.14.2 B-Zone Partnership: On October 23, 2006, Bezeq International entered into an agreement with 2+ (Two Plus) Wireless Solutions Ltd. (2+) for the establishment of a general partnership called B-Zone (the Partnership). Each party holds 50% of the partnership. The purpose of the partnership is to set up, support and manage wireless browsing networks in public areas, enabling high-speed internet connection and collecting payment from the end-user for internet access (the Area of Operations). Under the agreement, each of the partners transferred its operations in the partners' area of operations to the partnership, effective from the date of commencement of the partnership's operations. After the partnership was set up, it signed an agreement with 2+ to provide outsourcing services for the partnership, whereby 2+ attends to the day-to-day operation and management of the partnership.

4.14.3 On December 21, 2006, Bezeq International signed an agreement with DSNR Communications Ltd. for the establishment of a joint company, under which Bezeqcom Ltd. was established in January 2007 (Bezeqcom). Bezeqcom was set up as part of the expansion

of Bezeq International's global operations, together with the DSNR Group, which specializes in online marketing. The purpose of Bezeq International is to provide communication services to end-users worldwide, inter alia through a unique communications solution to provide telephony services.

4.15 Financing

- 4.15.1** As of the date of the periodic report, the Company has no liabilities to banks and is not using its approved credit line.
- 4.15.2** The source of Bezeq International's finance in the past two years has been a positive cash flow from current operations.
- 4.15.3** Bank guarantees: Pursuant to the requirements of the Ministry of Communications, Bezeq International provided a bank guarantee of NIS 9.4 million and NIS 1.4 million to fulfill all of the conditions of the license to provide international communication services. As at the balance sheet date, Bezeq International has provided additional bank guarantees of approximately NIS 20.1 million.

4.16 Taxation

See Note 8 to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

4.17 Restrictions and Supervision of Operations

4.17.1 Legislative restrictions

The Communications (Telecommunications and Broadcasts) Law, 5742-1982 and the general license to provide international telecommunications services:

Under the Communications Law, implementation of telecommunications operations and provision of telecommunications services, including international telecommunications services and internet access services, require a license from the Minister of Communications. The Minister is authorized to amend the terms of the license, add to them or detract from them, while taking into consideration, inter alia, the government's telecommunications policy, interests of the public, compliance of the licensee to provision of services, contribution of the license to competition in the telecommunications industry, and the level of service therein.

The law authorizes the Director General of the Ministry of Communications to impose financial sanctions for violations of the provisions of the law and of orders and directives issued by virtue thereof, and for violation of the license terms.

A recently introduced amendment to the provisions of the Communications Law permits the Minister of Communications to prescribe telecommunications services that do not require a license. Pursuant to his declarations, the Ministry of Communications intends to exempt the supply of internet access services.

In view of these provisions of the Communications Law, all Bezeq International's telecommunications services are provided by virtue of the provisions of the licenses granted to it and pursuant to the terms therein, as set forth in Section 4.1.2 above.

4.17.2 Payment for interconnection

The Telecommunications (Interconnect Fees) Regulations, 5760-2000 (the Regulations) regulate the payments made to the domestic operator or the cellular operator.

With regard to payments to be made by Bezeq International, as an international licensee, for the completion of traffic on a cellular network, on March 1, 2008, the present tariff of NIS 0.25 for completion of a call was reduced to a maximum tariff of NIS 0.22.

These tariffs are updated once a year, in accordance with the percentage of the change in the CPI.

4.17.3 Royalties

For payment of royalties, see sections 2.16.3 and 4.1.2.3 above.

4.17.4 Standards

Bezeq International holds ISO 9001:2000 certification for quality management systems and ISO 7799 certification for information security management systems issued by the Israel Standards Institute.

4.18 Joint venture agreements

In June 2003, Bezeq International signed an agreement with Infonet Corporation (Infonet) for the distribution of Infonet's data communications services. Infonet is a network connecting many sites worldwide and provides for the efficient transfer of data between these sites. In December 2003, Bezeq International and Kardan Communications Ltd. signed an agreement for the acquisition of the operation of Infonet Israel Ltd., the Israeli representative of Infonet which provides international data communication and IP services on the Infonet network in Israel. The customer files were transferred to Bezeq International, which received the equipment and rights to provide Infonet services in Israel, and it provides technical support to all Infonet's global customers requiring services in Israel. This acquisition process enables Bezeq International to serve as a franchisee and strategic partner of Infonet in Israel and provide its customers with an expanded deployment of global communication networks and access to a wider range of advanced, high-quality communication services.

In the first quarter of 2005, Infonet was acquired by BT, resulting in reorganization under which the infrastructure used by the companies to provide their services to Israel was unified. At this stage, neither the acquisition nor the restructuring have had any affect on the running of Bezeq International's business, nor on its sale of Infonet products.

4.19 Legal Proceedings

4.19.1 In January 2005, a claim for NIS 10 million was filed in the District Court in Tel Aviv against Bezeq International, two other international operators, and another company, alleging that a patent for a prepaid telephone system had been infringed by persons alleging that they are the inventors and owners of this patent. In the statement of claim, the plaintiffs demand payment of the full revenues deriving from infringement of the patent plus reasonable royalties and punitive compensation.

In April 2005, Alcatel took over management of the defense in this case, on behalf of Bezeq International, for one of the systems which are the subject of the claim (supplied by Tadiran Communications Ltd.). Against another supplier of systems the subject of the claim - SigValue Technologies Ltd. (SigValue), the Company submitted notice to a third party.

The option of a settlement is being examined.

4.19.2 On November 2, 2008, a claim and application for certification as a class action was filed against the Company at the Tel Aviv District Court, alleging that the Company charged customers using the SIM-014 service with VAT, contrary to the publications and explanations that the price paid for the service includes VAT.

4.19.3 On December 31, 2008, a claim and application for certification as a class action was filed against Bezeq International at the Tel Aviv District Court, in respect of alleged unlawful connection to Bezeq International's Call for a Shekel service. The applicant is demanding a refund for the amounts charged by Bezeq International for this service, on behalf of all customers who were included in the programs specified in the claim, without their explicit consent, in a cumulative amount of NIS 15.834 million plus VAT.

4.19.4 Further to the provisions of the update to section 2.6.6(A) above, on May 27, 2007, Bezeq International received a letter from the Director General of the Ministry of Communications, giving notice to Bezeq International that he intended to impose a financial sanction upon it in the sum of NIS 2,031,750 for failure to implement and operate the number portability plan, commencing on September 1, 2006.

In its response, Bezeq International claimed that as holder of a general license for the provision of international telecommunications services, it does not allocate numbers to its customers and therefore, in any event, is not part of number portability, which is effected by domestic and cellular operators. Additionally, Bezeq International has implemented number portability faultlessly, and that it should be deemed as prepared for number portability, in accordance with the provisions of the law and on the date set out in such provisions

Bezeq International repeated its position in its response to the Director of Supervision and Compliance at the Ministry of Communications, on November 20, 2008, who asked for information about Bezeq International's actual preparation for the implementation of the portability plan.

- 4.19.5** For additional legal proceedings, see Note 17 to the Company's financial statements for the year ended 31 December 2008, which are included in this periodic report.

4.20 Goals, Business Strategy and Expected Development

- 4.20.1** As part of the preparations for 2008, Bezeq International set itself a number of key goals outlining the nature of its operations and reflecting the strategy which it adopted during the year.

4.20.1.1 To retain global leadership in ISP.

4.20.1.2 To create loyalty by improving customer satisfaction and experience for Bezeq International customers.

4.20.1.3 To continue to attract excellent employees.

4.20.1.4 To improve effectiveness and efficiency of cross-organizational work processes.

4.20.1.5 To time investments as a tool for retaining the stability and growth of Bezeq International.

4.20.2 Bezeq International's goals for 2009

4.20.2.1 To leverage changes in the market and continue quantitative and perceptual leadership.

4.20.2.2 To expand the range of telecommunication services and solutions.

4.20.2.3 To create differentiation and adapt the service experience to customer requirements.

4.20.2.4 To empower and develop the company's human resources.

- 4.20.3** 2008 was characterized by continued growth and increases in Bezeq International's revenues and operating profits.

- 4.20.4** Bezeq International's revenues and operating profits continued to grow in 2008. In 2008, Bezeq International increased the range of communications solutions that it provides to its commercial customers. Bezeq International views this field as having growth potential and plans to further establish its status in this sector.

- 4.20.5** In 2008, Bezeq International improved its market position in all the areas of its operations.

- 4.20.6** In 2008, Bezeq International continued to invest in its customer service system, which provides service and technical support to its business and private customers.

- 4.20.7** The above statements contain forward-looking information that is not certain and may not materialize, in full in part. The forward-looking information is based on information that Bezeq International currently has as at the date of publication of this report, and contains assessments made by Bezeq International, its work assumptions or intentions, as at the date of publication of this report. The actual results could be significantly different from the results that are estimated or implied from this information.

The forecast of Bezeq International's management is based on forecasts related to the continued recovery in the Israeli market, continued penetration of broadband technology and continued growth in the number of internet users. The above forecast may not materialize at all or may materialize in part only, owing to a slump in the Israeli economy which will reduce purchasing power in Israel, regulatory changes liable to harm the ability of Bezeq International to provide solutions to existing or changing market requirements, and all the other risk factors listed below.

4.21 Risk Factors

A. Changes in exchange rates

The main currency used by Bezeq International is the new Israeli shekel, which is also its reporting currency. There is a special risk in the nature of Bezeq International's international

transactions: most of its operations (sales) derive from customers in Israel. In addition, Bezeq International provides its services to customers all over the world and collects payments from them in foreign currency, mostly the US dollar. On the other hand, Bezeq International consumes services from suppliers outside Israel and pays for these services in foreign currency, mostly the US dollar. The changes in the exchanges rates of the currencies in which Bezeq International operates opposite the Israeli shekel expose the company to exchange rate differences on the gap created, which could have an adverse effect on its cash flow as well as on its profitability by increasing finance expenses. To protect itself against currency exposure, Bezeq International enters into hedging transactions and purchases other financial instruments.

B. Competition

For the effect of the competition on Bezeq International's businesses, see section 4.6. above.

C. Investments in infrastructures, technological changes and dependence on suppliers

See Section 4.11.

D. Government supervision and regulation

For the application of the provisions of the law and licensing policy and their effect on Bezeq International, see sections 4.1.2 and 4.1.3.1 above.

E. Legal proceedings

Bezeq International is a party to legal proceedings, including class actions, which could result in its being required to pay substantial sums. A provision has been made in Bezeq International's financial statements for the proceedings, which, according to the assessment of the company's legal counsel, could require the use of Bezeq International's financial resources. For legal proceedings to which Bezeq International is a party, see section 4.19 above.

F. Global economic crisis

In the present quarter, the global economic crisis has sent global markets into a recession and credit crunch. It is expected that this will continue in 2009 and possibly even later, and there will be a transition from growth to recession. The local market is also expected to experience a significant slump, together with a deterioration in business operations and central economic parameters. Management believes that these events could affect the operations and business results of Bezeq International, however the company cannot, at this stage, estimate the extent of the impact on its business results. Bezeq International is adjusting its work plans accordingly.

This information contains forward-looking statements, based on the assessments of the company. The actual results may differ materially from these assessments if there is a change in any of the factors taken into account in these assessments.

Summary of risk factors

	Effect of risk factor on Bezeq International's operation		
	Major	Moderate	Minor
Macro risks			
Exposure to changes in the currency exchange rate			X
Sector risks			
Increasing competition		X	
Investments in infrastructure and technological changes		X	
Government supervision and regulation	X		
Special risks for Bezeq International			
Exposure in legal proceedings		X	
Dependence on suppliers			X

5. Multi-Channel Television – D.B.S. Satellite Services (1998) Ltd. (DBS)

5.1 General Information on the Area of Operations

DBS, known also by its trade name YES, provides multi-channel satellite broadcast services to subscribers. DBS was founded on December 2, 1998, and has been providing this service since July 2000.

This service enables the provision of multi-channel encoded digital television broadcasts and value-added services to subscribers who receive the broadcast at home via a small antenna dish from which broadcasts are transmitted to a domestic decoder in the subscriber's home and connected to the television set.

Most of DBS's income derives from subscription fees and additional payments made by viewers.

As at December 31, 2008, DBS had 559,613 subscribers.

DBS is the only company currently operating in the satellite multi-channel television broadcasting sector, even though neither the law nor the license awarded to it grant it exclusivity.

5.1.1 Structure of area of operations and changes therein

The area of broadcasts is regulated and operations in the area are effected with various broadcast licenses. The heavy regulation of the field of broadcasting includes the obligation to receive a license, the obligation to operate in accordance with the relevant provisions of the Communications Law, the provisions of the various licenses and the conditions thereof, and constant supervision of the Ministry of Communications and the Cable and Satellite Broadcast Council (the Council).

Multi-channel television broadcasts have been offered in Israel since the mid-1990s by companies supplying cable television broadcasts. These companies operated first under regional franchises under exclusivity conditions which were granted to them, and since 2002 they have operated by virtue of long-term broadcast licenses which replaced the franchises. In November 1999, these companies were declared to have a monopoly, under the Antitrust Law, 5748-1988, in the field of multi-channel television broadcasts in the regional franchises in which they operated at the time. As of the end of 2003, the cable corporations have worked jointly in several areas of operations under the brand name HOT. In December 2006, the cable corporations merged into a single merged cable company, HOT Cable Communications Systems Ltd., which supplies cable television services to all of the subscribers of the cable corporations that were merged into it (the Cable Company). The cable company holds all of the rights in a limited partnership which owns the cable network infrastructure, including the terminal equipment and broadcast centers, and which, to the best of DBS's knowledge, provides communications services, internet access and telephony services

For the all-in-one services package offered to subscribers, which includes, in addition to the multi-channel television services, infrastructure for internet access (high speed broadband) as well as fixed-line telephony services (the package, which includes these three services, is also known as Triple Play), see section 5.1.8 below.

For proposed advanced television services with added features, including VOD, PVR and HD, see sections 5.1.4 and 5.2 below.

For streaming of video content over the internet, see section 5.1.4 below.

In February 2009, the Finance Ministry published a tender for the establishment and operation of terrestrial distribution system for digital radio broadcasts (see section 5.1.3.1 below). DBS estimates that said distribution system may in the future also serve as infrastructure for providing television services to mobile end devices which will compete with the services provided by DBS.

5.1.2 Statutory restrictions and special constraints

The Communications Law requires that a broadcasting license be obtained in order to transmit satellite television broadcasts to the public. In January 1999 DBS received the above-mentioned broadcasting license under the provisions of the law and pursuant to the

Telecommunications (Proceedings and Conditions for the Grant of a Satellite Broadcasting License) Regulations 5758-1998 (the Broadcast License).

The Broadcast License granted to DBS is valid until 2014. At the end of that period, the Broadcast License shall be renewable for additional periods of six years each, subject to the conditions of the license.

For additional licenses granted to DBS, see Section 5.8.1 below.

Operations in the field of broadcasting and other fields of communications are subject to licensing, supervision and the policy decisions of the Ministry of Communications, in aspects defined in the Law and the communications licenses (which relate, mainly, to matters relating to competition, consumers, and technical and engineering aspects). In recent years, due to the process of closer connections between the field of broadcasting and other fields of communications, and particularly due to the operations of cable companies and entities related to it in the field of telephony and internet, the field of broadcasts is substantially influenced by the policy and supervision of the Ministry of Communications in various areas that relate to or touch the field of broadcasting.

DBS's and the cable company's broadcasting operations are also under the constant supervision of the Council. The Council sets policy and makes rules regarding the content of broadcasts, the duty regarding original Israeli productions, the division of content into genres, broadcasting ethics, consumer protection and other matters in the area of broadcasting policy. The Council is also responsible for enforcing the various statutes relating to the field of broadcasting, for approving the channels that DBS wishes to broadcast, or to cease broadcasting, and is also authorized to amend the broadcast licenses of DBS and the cable company under the conditions set out therein.

The Council has authority in the field of consumer protection, so that the setting of price lists, updating of price lists and offers to customers require its consent or the giving of prior notice (on the issue of DBS's activities being subject to legislation and to the supervision of the Ministry of Communications and the Council, see also section 5.15 below).

Changes may be made to the identity and nature of the persons supervising the operations of the players in the field of licensing and supervision of the field of broadcasting (including DBS's operations), at the initiative of the government.

In 2005, the government resolved to consolidate the Council's activities with those of the Second Television and Radio Authority and the Public Broadcast Regulation Administration into a unified commercial broadcasting authority. This decision was anchored in a government bill, but to the best of DBS's knowledge, the bill has not been discussed. In addition, to the best of DBS's knowledge, in the past, the government examined setting up a communications authority which would replace the Ministry of Communications and the authorities described in section 5.1.1 above, and which would have all of the powers of such authorities, despite the abovementioned delay.

5.1.3 Market developments in the area of operations

In recent years, a number of trends have arisen in the broadcasting industry, which have affected competition in it:

5.1.3.1 Pursuant to an amendment to the Second Television and Radio Authority Law, 5750-1990 of February 2008, the Second Television and Radio Authority is required to set up a system whereby the television channels of the Israel Broadcasting Authority (Channel 1 and Channel 33), the commercial television channels (Channel 2 and Channel 10) and the Knesset Channel (Channel 99) would be distributed to the public freely, nationwide, via a terrestrial transmission service using digital technology, backed-up by a digital satellite system (known as DTT). This distribution system will be a partial substitute for DBS's transmissions which, in DBS's assessment, is likely to cause substantial harm to its revenues. In January 2008, a private member's bill was submitted to the effect that the DTT system will also include the transmission of two special channels broadcast as at the date of this report (a Russian language channel – Channel 9 – and the Music 24 Channel), and the Educational Television channel. Increasing or varying the number of channels distributed via the distribution system is expected, in DBS's assessment, to increase the extent to which the system will substitute for DBS's services, and therefore, might bring about an increase in the harm caused to DBS's revenues.

The private bill on the matter of the inclusion of the two special channels and the Educational Television channel in the DTT was passed in its preliminary reading in the Knesset. Several private bills were also submitted on the subject of including additional channels to the bundle of channels designated for broadcasting via the DTT system and to the best of DBS' knowledge they are in the initial stages of legislation.

To the best of DBS's knowledge, the Second Authority for Television has chosen the winner of the tender that it published for the supply of broadcasting equipment which will serve for the establishment of the distribution system. According to a Second Authority announcement, the distribution system is expected to commence operating in the third quarter of 2009.

- 5.1.3.2 In August 2008, the Government decided, inter alia, that the Communications Law will be amended as such that as of March 1, 2011 DBS and the cable companies will be obligated to allow any subscriber to connect to a basic package including Channel 1, Channel 33, Channel 2, Channel 10 and the Knesset Channel (in this section - the Basic Package) against payment for the connection to the broadcasting center, which will be calculated on the basis of subscriber connection costs plus reasonable profit; to allow any subscriber to purchase any other broadcast whereby the tariff for the acquisition of several broadcasts shall not be set in a manner that will be conditional as aforesaid; to set a price that will be paid by the owners of the channels in the basic package to the cable companies and to DBS for transferring their broadcasts and this on the basis of usage cost plus reasonable profit; DBS and the cable companies will be entitled to broadcast commercials as of April 1, 2010 when the Commission will establish rules with respect to maximum broadcast time for the various types of channels for a period of three years, which will enable the gradual broadcast of commercials; an order will be legislated with respect to the broadcast of joint channels in the format set forth in section 6(20)1 of the Law, which will expire. In addition, the Government decided to instruct the Commission to examine cancellation of the restrictions applicable to the special license holders for cable broadcasts that do not exist for DBS and the cable companies and the establishment of an inter-ministerial committee headed by a representative of the Ministry of Communications to examine the method of arrangements in the commercial television broadcast sector.

In October 2008, the Government published the Settlements in the State Economy (Legislative Amendments for Achieving Budget Goals and Economic Policies for Fiscal Year 2009) Bill 5768-2008, in order to anchor the aforesaid principles of the Government decision in legislature.

In DBS's estimation, requiring it to offer a basic services package might harm its revenues.

- 5.1.3.3 For the recommendations of the Gronau Committee and their adoption by the Minister of Communications, see section 2.6 above. As described in that section, on August 13, 2008, the Minister published his decision to adopt the Gronau Commission's recommendations (subject to a few changes and conditions. Nonetheless, the Minister decided that since the Commission focused on Bezeq's area of operations and analysis of the broadcasting sector was not discussed in full, a commission will be set up to formulate recommendations and policy with respect to rules of competition in the multi-channel and commercial television sector. To date, this commission has not yet been established.
- 5.1.3.4 In November 2008 the Council resolved to institute a new policy with respect to multi-channel television sports broadcasts from June 2009. According to the decision, content protection for the basic sports channel (Channel 5) and Channel 5+ broadcasts and restrictions were imposed on live broadcasts on the pay-for sports channels. DBS estimates that the foresaid decision is liable to harm DBS revenue from its pay-for sports channels.
- 5.1.3.5 In September 2008, the Council announced a hearing with respect to granting of special license to broadcast a movie and series channel on DBS and the cable companies. According to the hearing, the Council is considering that the actual granting of the aforesaid license and its terms and conditions, whatever they may

be, will limit the ownership of the licensee to a number of special licenses and obligating holders of more than one special license to invest in original productions. DBS objected to the actual hearing regarding the granting of new licenses before the issue of transmission fees to be paid by the special license holders is settled. Furthermore, DBS submitted its responses to the hearing, according to which the granting of special broadcast licenses for movie and series channels should not be permitted or the restriction regarding the maximum number of licenses granted to a single organization should be changed. DBS also requested to equate the license holders' obligation to pay royalties, as aforesaid, to its own commitments and to obligate an organization holding more than one license with a higher obligation to produce original productions than that imposed on DBS.

- 5.1.3.6 In September 2008, in accordance with the government's decision noted in section 5.1.3.2, an inter-ministerial committee headed by the Ministry of Communications CEO was set up to examine the method for settling the commercial television broadcasts area of operations, including changing the current franchise system, pursuant to the Second Television and Radio Authority Law, 5750-1990, to a licensing system (the Second Authority and the Second Authority Law) for the licensing regime. In March 2009, the committee's recommendations were sent to the Minister of Communications. The recommendations stipulated, inter alia, that as of 2012: (1) the franchise regime based on the Second Authority be changed to a licensing regime for key channel broadcasts; (2) the DTT system be expanded so as to also enable transfer of any key licensed broadcast; (3) commercials be permitted for license holders for multi-channel broadcasts; (4) license holders for multi-channel broadcasts be obligated that the narrow package offers include the basic package (as defined in section 5.1.3.2 above) and broadcasts of a new license holder for key channel broadcasts. Furthermore, the narrow package will include the special licensed broadcasts for cable broadcasts and licensed broadcasts for special channels subject to the payment of transfer fees by the license holders; (5) license holders for multi-channel broadcasts will be exempt from payment of royalties to the State. The Commission also recommended the establishment of a national communications network which will unite the activities of the Broadcasting Corporation and the Second Authority. If the Commission's recommendations will be adopted, they are liable on the one hand to lead to a reduction in DBS expenses due to the payment of royalties and an increase in its revenue as a result of the permit to broadcast commercials and on the other to harm its revenue due to the obligation to offer a narrow package and as a result of the expansion of the DTT system. As at the date of this periodic report, the Minister of Communication's decision with respect to adopting the Commission's recommendations has not yet been published. Furthermore, the recommendations require legislative amendments and their application therefore depends on the formulation of legislation and the wording of the legislation that will be formulated, if at all.
- 5.1.3.7 In respect of the Company's appeal of the Antitrust Commissioner's decision to dismiss the application submitted by the Company and DBS for approval of the merger between the two companies by increasing the Company's holdings in DBS to 58.4%, see section 1.1.5 above. If the Company provides notice of its agreement to the foregoing merger conditions, this will have impact on the broadcasting market.

5.1.4 Technological changes that materially impact the area of operation

- 5.1.4.1 Technological developments and changes which have taken place in the field of digital broadcasting enable the provision of personal television services, which include bi-directional services that enable reciprocal communications between the individual subscriber and the service provider, and immediate provision of the service individually selected by the subscriber. The principal service in this field at present (even in Israel) is the provision of television services upon the immediate demand of subscribers, also known as Video on Demand (VOD services) As at the date of this report, VOD services are only provided by the cable company and this has a substantial effect on competition in the field of broadcasting (in this regard, see section 5.6.5 below.

- 5.1.4.2 Around the world, transfer services of video content over broadband have developed, whether in closed / managed systems or over the public internet, and these are known as IPTV (Internet Protocol Television). These services and abilities enable the consumer to watch video content (either by transferring content to all users or by transferring individually upon demand), the content sometimes being viewed via a personal computer and at other times via the television. In Israel, this service has not yet been developed in a closed network, and broadband infrastructure owners might act to launch such services in the future, and entry of another service provider into this field might adversely affect the players in the field of broadcasts. However, as at the date of this report, video content is being transferred over the internet (in both local sites designed for Israeli audiences and foreign sites, and via file sharing software), and the development of this trend might substantially affect the field of broadcasts, which is currently based on special infrastructure, and might enable the supply of varied video content without needing a special infrastructure system For DBS's option to use the internet to transfer video content to its subscribers see section 5.4 below.

5.1.5 Critical success factors in area of operations and changes therein

DBS regards the following factors as critical to the success of its operations:

- 5.1.5.1 Differentiation, innovation and originality in the content, branding and packaging of its broadcasts compared with the broadcasting content of its competitor, the cable company. These factors are reflected in the purchase and production of content, which includes current movies, documentary programs and many series containing unique and innovative characteristics, as well as in the production and purchase of original Israeli programming. For such purpose, ongoing investment is required in the area of production and purchase of the content of broadcasts supplied to DBS customers.
- 5.1.5.2 The ability to offer subscribers personal television services, and in particular, VOD services and PVR machines (see section 5.6.5(F) below).
- 5.1.5.3 The ability to offer a bundle of communications services including television services and other services such as telephone services and internet services (see section 5.6.5(G) below).
- 5.1.5.4 Differentiation at the customer service level provided to DBS subscribers, which constitutes a material success factor in DBS's ability to retain customers in a competitive market.

5.1.6 Main entry and exit barriers for the area of operations

- 5.1.6.1 The main entry barriers into the area of operations are: (a) the need for appropriate licenses under the Communications Law; (b) the immense investments required to be made by carriers in the area of operations, including for the purpose of setting up appropriate infrastructure and purchasing and producing content; (c) the limited size of the broadcast market which reduces the size advantage characteristic of the broadcast field around the world; (d) saturation of the broadcast market.

Recently, some of these entry barriers started to wear away as a result of regulatory changes (such as DTT – see section 5.1.3.1 above) and as a result of technological developments enabling the transfer of content over alternative infrastructure (such as IPTV – see section 5.1.4.2 above).

- 5.1.6.2 The principal exit barriers are: (a) the regulatory barrier – termination of operations under the broadcast license depends on a decision of the Minister of Communications to cancel the license prior to the end of the license term, under the conditions set out in the license, including arrangements for ensuring the continuation of broadcasts and services and reduction of harm to subscribers. The licensee is required to continue providing the services under the broadcast license until the date prescribed by the Minister or until completion of such arrangements as the Minister may instruct, whichever is the later; (b) long-term contracts with important suppliers.

5.1.7 Substitutes and changes in products in the sector

With respect to multi-channel television broadcasts, the following principal services can be classified as substitute products:

- 5.1.7.1 The variety of territorial channels and other channels broadcast for free to the Israeli public. These channels include Channel 1 (belonging to the Israel Broadcasting Authority), Channel 2, the third commercial Channel (Israel Channel 10), the Knesset channel. In addition, many foreign channels that can be received in Israel via relatively inexpensive end equipment are another substitute product to DBS's services.
- 5.1.7.2 The DTT system, see section 5.1.3.1 above, when it is established, will become an alternative service to multi-channel broadcasts.
- 5.1.7.3 Access to video content via broadband infrastructure, including the internet (see section 5.1.4.2 above).
- 5.1.7.4 Partner Ltd, a cellular operator in Israel, recently launched a new venture which is in principle its entry to the internet access sector (ISP service), the VoIP service sector and the content and broadcasts (particularly VOD) sector. The content services are at this stage provided via the PC and are expected later on to also be provided via the television screen with the aid of end equipment which will also allow reception of the DTT channels.

To the best of DBS knowledge, Cellcom Israel Ltd, a cellular operator in Israel, is also considering launching a venture that will include the transfer of video content.

DBS estimates that content services via the television screen, as aforesaid, provided by the cellular companies or either of them, will become a substitute service to the multi-channel television market.

In recent months, DBS applied to the Ministry of Communications and the Council several times demanding the cessation of all aforesaid actions taken by the cellular companies prior to the matter being examined by the Ministry and until equal opportunity policies with respect to all multi-channel television broadcasts are set, in a way that will also obligate the cellular companies to obtain broadcasting licenses and to comply with their terms and conditions, and if necessary, to amend the Law for this purpose. The Minister of Communications and the Council Chair have not yet responded to the fundamental issue of these requests with the exception of a notice to DBS that it has requested clarifications from the cellular companies with respect to their activities in the broadcasting area of operation.

- 5.1.7.5 DVD libraries

5.1.8 Competitive environment and changes therein

The concentrated and complex ownership structure in the areas of content, communications and infrastructure in Israel is likely to cause groups throughout the chain of production, packaging and supply of content to move into positions of control. The cable company which, together with the corporations related to it, has a broad deployment of advanced broadband infrastructure, markets and sells a package of services including multi-channel television services, high-speed internet infrastructure, and fixed-line telephony. Sale of a service package containing the above three kinds of communications services (known as triple play) whilst DBS, which does not have the infrastructure for providing telephony and high-speed internet access services, and is prevented from offering such a package together with the Company (see section 5.6.4.2 below) does not offer a similar package, is a principal component differentiating the offer to potential subscribers.

5.2 Products and Services

DBS's broadcasts provide its subscribers with a wide variety of channels: Around 160 different video channels (of which 30 are pay per view channels) and another 20 radio channels, 30 music channels and 20 information channels (including portals), and interactive services.

The broadcasts include a basic package which each subscriber is required to purchase as well as additional channels chosen by the subscriber, whether as a package or whether as a single channel, based on plans defined from time to time by DBS, with the approval of the Council and pursuant to the terms of the broadcasting license.

The main channel packages marketed by DBS in addition to the basic package are the movie package, the entertainment package, the children's package, the music package and the sport package and the science and nature package. These channel packages appeal to different target populations depending on their viewing habits and preferences.

As part of its operations, DBS also allows its subscribers to purchase movies and programs on a pay-per-view basis, from a list of movies and programs which is updated from time to time.

DBS is looking into the possibility of obtaining approval to launch VOD services (see section 5.6.5F below).

DBS markets decoders, called personal video recorders, with the capacity to record content broadcast on the various channels on a hard disk, known by the brand name yesMax (PVR Decoders). The PVR decoders interface with the DBS electronic broadcasts and enable receipt of special services, including booking recordings in advance, recording series and pausing live broadcasts. The PVR decoders also enable viewing of the content stored in the decoder memory and which are updated from time to time by DBS. Marketing of PVR decoders among DBS subscribers constitutes, in DBS's estimation, a partial solution for the lack of VOD services.

At the end of 2007, high definition television (HDTV) broadcasts, which can be received through special decoders, were launched in Israel. These broadcasts which, as at the date of this report, are provided for a limited number of channels, allow superior quality viewing. DBS estimates that although, at the date of this report, this service is relatively limited, the development of this service may have significant impact on the broadcasting area of operations.

Content viewing on a website – in August 2007, DBS launched a content site on the internet in cooperation with Walla! Communications Ltd., which allows viewing of various forms of content

5.3 Revenue and Profitability of Products and Services

Following is a table containing a breakdown of DBS's revenue (in NIS millions):

	2008	2007
Revenue	1,513	1,415
Gross profit	422	298

5.4 New Products

VOD services – subsequent to a legislative amendment in 2007, DBS is permitted to launch broadcasts via broadband infrastructure providing service quality similar to digital broadcasts (Managed Network), however such launch is subject to obtaining an appropriate license and reaching a commercial and technological agreement with the owner of the infrastructure (the Company). To the best of DBS's knowledge, launching this to all of its subscribers will also involve an upgrade of the Company's infrastructure.

At present, DBS is working on launching VOD services over the internet (the non-managed network). This method is limited regarding the type of decoders through which the service may be received and with respect to the availability of services due to restrictions connected to the broadband internet infrastructure required.

5.5 Marketing and Distribution

Marketing of DBS services is by way of publication in the various media. DBS's sales operations are carried out via three main distribution channels:

5.5.1 Field sales people working to recruit subscribers.

5.5.2 Service Call centers that receive telephone enquiries from customers wishing to receive DBS services or additional services, as well as telemarketing campaigns to potential subscribers.

5.5.3 External resellers under contract with DBS. DBS is somewhat dependent on an external reseller who works to recruit subscribers among one of DBS's target groups.

The distribution channels, except for the external resellers, are operated by DBS employees.

5.6 Competition

5.6.1 Competitors in the broadcasting market

DBS is in principal direct competition, as set out in section 5.1.1 above, with the cable company.

DBS estimates its share of the multi-channel television market as at December 31, 2008, to the best of its knowledge, at around 38% of total subscribers.

5.6.2 Broadcasting characteristics of the competitors

DBS's competitor is the cable company. For the operations of the cable company see section 5.1.1 above.

DBS transmits its broadcasts using only a digital method, by means of tiering at various price levels, while the cable company transmits its broadcasts to most of its subscribers using a digital broadcasting method and the above-mentioned tiering, while for the remainder they use an analog broadcasting method, which allows for lower-quality viewing, does not enable display of an electronic broadcast timetable and requires purchase of a uniform channel package without the option of choosing broadcast segments (for further implications of this difference, see section 5.6.4 below).

5.6.3 Characteristics of the current competition

After DBS achieved high rates of growth in subscribers during the first years of its operations, inter alia due to temporary regulatory concessions given to it and a considerable technological gap, together with high churn rates amongst subscribers of the cable company, in 2007 and 2008 there was a relatively slow increment in the number of DBS subscribers, as set out below.

	2008	2007
Increase in number of subscribers	10,400	9,694
Rate of growth	1.9%	1.8%

At present, competition in the field of broadcasts is focused on broadcast content, on the proposed channel packages, on the price of channels and packages, on the field of service, and on the offer of additional services, including VOD services that are provided by the cable company, PVR decoders and HD broadcasts. Competition is also characterized by offers of other communications services as part of the service package (see section 5.6.5G below).

5.6.4 Positive and negative factors regarding the competition

5.6.4.1 DBS management estimates that DBS has competitive edges, the principal ones being:

- A. DBS makes use of advanced digital technology, which contributes to picture and sound quality; enables a fast and convenient user interface for subscribers when watching broadcasts; enables translation of the broadcast content into foreign languages and the additional of dubbing into other languages (such as into Russian) at the subscriber's election (in most of the Company's home channels); and enables the user to choose a language interface from four options (Hebrew, English, Arabic and Russian). In addition, DBS transmits wide screen broadcasts in a variety of channels which allows subscribers to watch broadcasts in wide screen format (which is similar to the format used in cinemas) on television sets. DBS broadcasts a number of channels using sound technology known as Dolby Digital (which is only supported by some of the decoders). DBS markets HD services (see section 5.2 above).

- B. DBS's broadcasts are transmitted via satellite, and therefore the broadcasts can also be received in remote or isolated areas where there is no access to cable infrastructure. The infrastructure available to DBS also enables transmission of the content outside to the borders of the State of Israel. As of the date of this report, DBS does not broadcast outside of the borders of the State.
 - C. The quality and variety of content broadcast by DBS to its subscribers.
 - D. The level, quality and availability of DBS's customer service system, both telephone service and technical service.
 - E. Accessibility and fast installation of equipment for receiving DBS broadcasts for customers living in buildings that are not connected to multi-channel television infrastructure in remote or isolated areas.
- 5.6.4.2 However, DBS's competitive operations suffer from inferiority or from factors that adversely affect it, in a number of areas, the main ones being:
- A. Inferiority of infrastructure with respect to the option of offering 'personal television' services such as VOD (see section 5.6.5F below).
 - B. Some of the cable company's customers are customers of analog cable systems (see section 5.6.2 above). Insofar as such customers wish to switch to the digital system, the cable company has much greater access to them. The analog broadcasting system allows its subscribers to receive lower-cost broadcasts without using a digital decoder.
 - C. The directives issued by the administration of the Ministry of Communications, relating to the bi-directional transfer of subscribers between DBS and the cable company and use of the infrastructure installed in the homes of subscribers, require 36 hours' notice before disconnection of an existing subscriber of the cable company (and vice versa in the case of disconnection of an existing DBS subscriber). The cable company can exploit this time frame to make special offers to existing subscribers about to leave it for DBS, in order to retain their custom. In addition, where the internal wiring infrastructure is owned by the cable company, the administrative orders stipulate that payment must be made thereof (and vice versa). However, as at the date of this report, neither the cable company nor DBS is in full compliance with the administrative order. For this and the hearing being conducted by the Ministry of Communications with respect to internal wiring see section 5.15.3 below.
 - D. DBS has infrastructure inferiority which does not permit it to transmit telephone and internet services over its infrastructure, as opposed to the cable company whose infrastructure enables the provision of such services. This inferiority is even greater given the regulatory restrictions imposed on DBS and on the Company, which restrict DBS's ability to offer telephony services using the Company's infrastructure, and the lack of any realistic ability to market the telephony services of the cable companies. For information regarding the hearing on the matter of the restrictions on offering services together with the Company's services, see section 5.6.5G below.
 - E. Regulatory restrictions of structural separation, including restrictions in the field of joint marketing of products and services, between the Company and its subsidiaries and certain affiliates, including DBS, restrict DBS's operations. So long as these restrictions remain in force, and at the same time, there are no other similar restrictions on the cable company (and corporations related to it in the field of telephony and internet) harm DBS's ability to offer a bundle of services at a competitive price. In addition, existing regulatory restrictions are applicable to the Company with respect to injection of funds into DBS. Since the Company is a shareholder of DBS, DBS is subject to the restriction on obtaining a license to supply telephony services itself over broadband internet (VOB), whilst telephony services are offered to subscribers of the cable company. For information regarding the hearing on the matter of the restrictions on offering services together with the Company's services, see section 5.6.5G below.

- F. DBS has significant expenses involved in leasing space segments, which are necessary for the purpose of providing DBS's broadcasts.
- G. DBS views the development of the capacity to transmit video content via the internet, including IPTV services in Israel as being a factor that might adversely affect its competitive standing in the broadcast field, including as a result of the entry of additional competitors into the field of multi-channel broadcasts.

5.6.5 Principal methods for coping with competition

The following are the main methods used by DBS to deal with competition in the field of broadcasts:

- A. Content – DBS acts to purchase, produce and broadcast high-quality, innovative and varied content, creating differentiation of its content;
- B. Branding – cultivation, promotion and differentiation of the YES brand;
- C. Service – DBS emphasized its customer service and technical service systems;
- D. Technology – continuing investments in technological capabilities and quality of DBS's broadcasts; emphasizing technological innovation;
- E. PVR decoders – since DBS views the supply of “personal” television broadcasts as an integral part of the services provided by those operating in the broadcasting market in this modern era, and a significant component of the total bundle of services offered to subscribers. At the beginning of 2005, DBS launched PVR decoders under the brand name yesMax. In 2007, DBS significantly increased the rate of penetration of PVR decoders among its subscribers. To the best of DBS's knowledge, the cable company also sells PVR decoders to its subscribers, although at significantly lower penetration rates. The cable company recently announced that it intends launching PVR services via the cable network and without the need for a special decoder.
- F. VOD – while the cable company commenced providing VOD services to its subscribers at the beginning of 2005, as at the date of this report, DBS has not yet launched such services. DBS is looking into the possibility of obtaining approval to launch VOD services (see section 5.4 below).
- G. Services bundle – as set out in section 5.1.8 above, a trend has developed in the field of broadcasts of offering a bundle of communications services as a marketing measure to recruit customers and to retain them, and there is an increasing demand on the part of consumers and potential consumers to receive a total bundle of services enabling them to receive multi-channel television services, high-speed internet connection infrastructure services and fixed line telephony services from one source at lower prices than the prices paid for purchase of each of these services separately.

Until April 2008, DBS, together with the Company, marketed a service package including DBS broadcasts and infrastructure to connect to high-speed internet services. As of April 2008, DBS ceased marketing said service package to its subscribers and began marketing the Company's special offers for infrastructure to connect to high-speed internet service, so that the subscribers' service contract for the said infrastructure is with the Company only.

Due to regulatory restrictions imposed upon the Company with respect to structural separation between it and its subsidiaries and certain related companies, including DBS, contrary to the cable company, which sells its subscribers a triple bundle of services, under which it can also reduce the prices for the bundle of services, DBS is unable to offer a similar bundle at a competitive price.

Letters from the Ministry of Communications to DBS show that the Ministry of Communications is of the opinion that DBS is not permitted to market the Company's telephony services, and this is contrary to DBS's view.

In July 2008, the Communications Ministry informed DBS that it was considering amending the Company's license and as a supplementary amendment, also amending DBS's license so as to enable offering a service package based on the following principles:

1. The services package will be divisible – so that it will be possible to acquire any of the services offered in the service package separately at the price at which it is offered in the services package.
2. Services packages not offered by the cable company may not be offered.
3. Approval to market a services package will be granted on the basis of DBS's prior application to the Communications Ministry.
4. The provisions refer to services offered by DBS together with any of the Company's services.

In reply to the letter dated July 2008, DBS objects to the proposed amendment to its license. Furthermore, DBS claims in its response that granting the option to market a divisible services market does not provide a real solution for the services basket offered by the competition and that the amendment should be applicable only on the Company's telephony services and not on other services, such as internet infrastructure services. DBS also claims that the supervisory mechanism for offering a services package should be changed so that the Ministry of Communications will not require the obligation to obtain a permit in advance, but only the obligation to report and that the offered services package, which will include the Company's services, should not be limited to those also offered by the cable company.

In January 2009, the Ministry of Communications gave notice to DBS regarding certain changes to the license amendments under consideration. As part of the amendments, it will be permitted to offer any services package which another corporate group in Israel is able to offer (even if not offered in practice), benefits were granted for service packages that include broadcast and internet infrastructure services only; the services package approval mechanism and its amendments were set by the Ministry of Communications. In February 2009, DBS reiterated its objection to license amendments, its request to enable it to market a non-divisible services package and its objection to the supervisory mechanism that is under consideration by the Ministry of Communications, as well as any restriction relating to marketing television services together with the Company's internet browsing infrastructure services.

5.7 Property Plant and Equipment

DBS broadcasts to its subscribers via an engineering setup which contains a ground broadcasting center located in Kfar Saba as well as a secondary broadcasting site situated close to the Re'em Junction, broadcasting to the satellite the content received at the broadcasting centers via optical fibers, cassettes and direct satellite reception from the leased space segments on the Amos 1 and Amos 2 satellites (for lease conditions see section 5.16.2 below) and receiver dishes and decoders located in subscriber homes, enabling receipt of the satellite broadcasts and decoding in accordance with the broadcasting package purchased by the subscriber.

As of the date of the periodic report, DBS broadcasts various channels from any broadcasting center. Most house channels are broadcast from the broadcasting center in Kfar Saba and the other from the broadcasting center at Re'em. Furthermore, DBS maintains digital archives at the broadcasting centers for storing content for broadcasting.

5.7.1 Rental of structures

DBS's principal offices, including its management offices, the broadcast center and other operations departments, are in three buildings in the Eastern Industrial Zone at Kfar Saba, in an area covering approximately 10,330 sq m, alongside which there is a parking lot and adjacent facilities: An area of 8,335 sq m (which also contains the broadcasting center) is rented from a third party. The said rental period will expire in October 2014, and DBS has an option to extend the contract for a further five years, and this with a price increase of 5%. DBS has been given first-refusal rights to purchase the property from the landlord, should it be placed for sale. Another 1,994 sq m are in an adjacent building is leased from a third party. This rental period expires in July 2010.

In addition, DBS runs three operational centers, one being in the Neshet Industrial Zone (some 1,612 sq m in area, which is leased from a third party until May 2011), the second is located in the Industrial Zone at Kanot (some 1,487 sq m in area, which is leased from a third party until July 2011), and the third in Beer Sheva, some 1,100 sq m in area, which is

leased until October 2012, (with two options to extend rental; the first – for an extension of three years until October 2015 and the second – for an extension of five years until October 2020), which are used as technical service, telephone service and sales centers for subscribers. DBS also runs two employee recruitment centers. In addition to the three operational centers, DBS also runs a 1,540 sq m logistics warehouse located at Airport City, which is leased from a third party until May 2013 (with an option to extend the rental until May 2015).

5.7.2 Terminal equipment

DBS installs a receiver dish and other terminal equipment in subscriber homes, among them, decoders used as a receiving and decoding unit for the reception signals, which constitute an infrastructure to the subscriber's television screen (including PVR decoders and HD decoders) as well as smart cards used to decode the encrypted broadcasts, which are transmitted via the encryption system of NDS company (see section 5.16.3 below).

Some decoders are leased to subscribers in return for a fixed leasing fee paid during the broadcast reception period and some are lent to subscribers (some of these loans are made in return for a deposit which is reduced over the subscription period). A small number of the decoders are sold to subscribers and owned by them.

5.7.3 Broadcast equipment

In addition, DBS's plant and equipment also includes the broadcast and reception equipment at the central broadcasting center at Kfar Saba, which includes the reception systems at the broadcast centers, the compression, encryption, playing and uplink systems, and the compression systems at the secondary broadcast center at Reem Junction.

5.8 Intangible Assets

5.8.1 Licenses

DBS owns the following main licenses:

- 5.8.1.1 Broadcasting license valid until January 2014 – this license is material to DBS's operations and constitutes the regulatory permit for its broadcasting operations (for the conditions of this license, see section 5.15.2 below).
- 5.8.1.2 License for satellite television broadcasts in the Judea and Samaria region valid until 2010, and by virtue of this license whose provisions are similar to those of DBS's main broadcasting license, DBS broadcasts to the Judea and Samaria region. In February 2009, DBS applied to the Civil Administration for an extension of the license until 2014.
- 5.8.1.3 License to perform uplink operations (transfer of broadcasts from DBS's broadcasting center to the broadcasting satellite and implementation of set and ancillary operation activities), which is valid until January 2014 or until the end of DBS's broadcast license, whichever is the earlier. This license is material to DBS's operations and constitutes the regulatory permit for the transmission of broadcasting messages from the broadcasting center to the broadcasting satellites and from them to subscriber homes.
- 5.8.1.4 License for the provision of uplink/downlink services to other communication licensees which is valid until October 2013. As at the date of publication of this report, DBS does not use this license.

5.8.2 Trademarks

DBS owns a variety of trademarks designed to protect its various brands and services and also a number of trademarks which are in the process of being registered on the Register of Trademarks. The main registered trademarks relate to the protection of its trading name (Yes), its key content channel names, the channel packages it markets and its unique terminal equipment which it installs in subscriber homes.

5.8.3 Costs of acquisition of subscribers.

See Note 3 to the Company's financial statements for the year ended 31 December 2008, which are included in this periodic report.

5.8.4 Software

See Note 3 to the Company's financial statements for the year ended 31 December 2008, which are included in this periodic report.

5.9 Broadcasting Rights

5.9.1 DBS holds the broadcast rights of television content purchased from the owners of intellectual property rights in such content. Sometimes, DBS purchases the right to sell these content broadcast rights to third parties together with the rights themselves, for the purpose of broadcasting the content again. As at the date of this report, revenues from these sales do not amount to a significant percentage of DBS's revenues.

5.9.2 The broadcast of content in which DBS owns broadcast rights involves the payment of royalties to the owners of intellectual property – i.e., copyright and performers rights in sound recordings for actual broadcasting, including under the Copyright Law, 5768-2007 and the Performers and Broadcasters Rights Law, 5744-1984. Payment of royalties as aforesaid is performed via a number of organizations that operate in Israel, which collect the royalties owing to the owners of the intellectual property rights and in return provide the broadcasting entities with blanket licenses. For some of these licenses which represent principal royalty payments, the final sum owing from DBS for use under the license is prescribed in accordance with the final sum paid by the cable company to the licensee for every subscriber, either in the case of an agreement between them and the licensee or in the event of a judicial ruling on a dispute between the parties, the consideration owing from DBS being no less, in any event, than that paid currently under the license. Payments by DBS under these licenses are based mainly on a fixed payment and sometimes on various pricing methods, including those that depend on the number of subscribers as aforesaid.

5.9.3 At present, the trend of transmitting content over non-television media creates some uncertainty as to the payment of royalties for such transfer, inter alia due to the fact that to the best of DBS's knowledge, some of the authors are not represented by the aforesaid organizations with respect to such media.

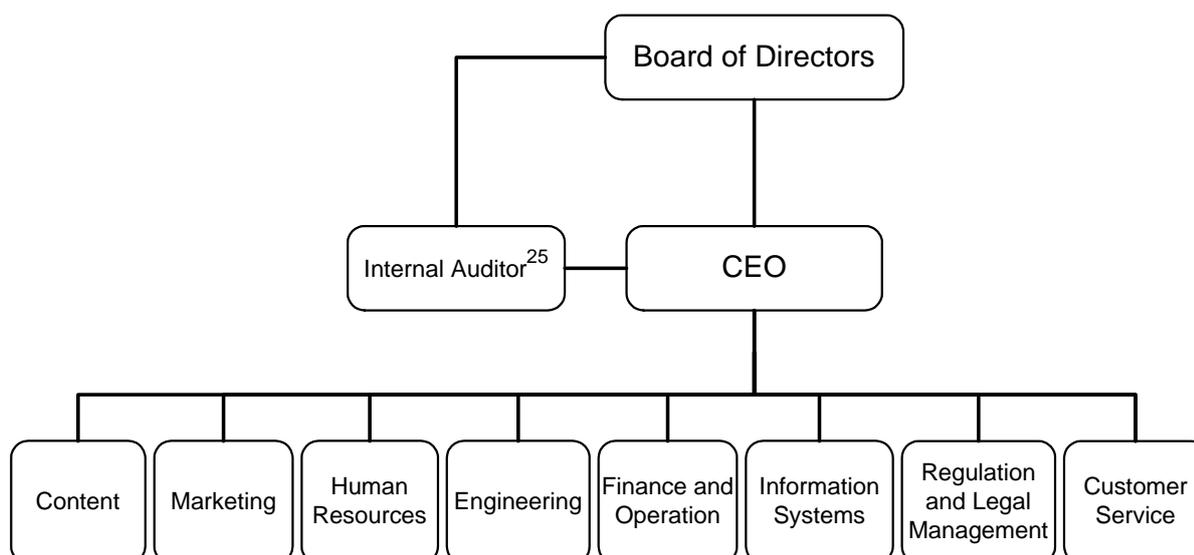
5.9.4 DBS participates, fully or partially, in investment in original productions that it broadcasts. In consideration for its investment, DBS is usually entitled, in addition to the right to broadcast the content as part of its transmissions, to rights in such content, in the percentages set out in agreements with the producers. Sometimes, DBS is also entitled to give permits to use rights and to participate in revenues flowing from additional uses of content over and above broadcast by DBS.

5.10 Human Resources

5.10.1 Organizational structure

DBS has eight departments, each one headed by a VP who is a member of DBS's management. DBS's departments are: marketing, customers (including recruitment of customers and service), content, engineering, finance and operations, human resources, regulation and legal administration, and information systems:

²⁵ The auditor is an external auditor



5.10.2 DBS personnel by division

Division	Number of Employees	
	As at December 31, 2008	As at December 31, 2007
Marketing Department	31	31
Customer Service	1,584 ²⁶	1,506
Content Department	65	64
Engineering Department	82	80
Finance and Operations Department	110	108
Human resource department	40	40
Regulation and Legal Administration Department	3	2
Information Systems Department	77	66
Management and Spokesperson	7	3
Total	1,999	1,900

5.10.3 Training and development of human resources

DBS provides regular training for its customer service, technical service and sales personnel, via its training center.

DBS trains its employees on an ongoing basis and also carries out manager training and support on an ongoing basis.

5.10.4 Employee remuneration schemes

- A. For options to officers at DBS, see also Note 26H to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.
- B. In September 2008, 4,250,000 Company options were allocated to the CEO of DBS, which may be exercised to ordinary shares of the Company at the exercise price of NIS 5.239352 per option (which was coordinated according to the Company's distribution of dividends as of allocation date). The options will vest in three equal annual portions, whereby the vested options will be exercisable for up to 5 years from

²⁶ The increase in the number of employees in this department stems in part from the employment of employees for the customer service center in Beer Sheva, who in the past were employed by Bezeq On-line Ltd, which provided DBS with these call center services (see section 5.16.4 below).

the vesting date of the third option part. This allocation was made after the Antitrust Commissioner confirmed that she does not object to it and after the allocation was approved by DBS and the Company. The fair value of the options on the allocation date was NIS 10,280,000.

- C. An existing annual grant plan is in place for the CEO of DBS for 2009-2010, based on the rate for meeting of certain goals as defined in the plan. An annual grant plan also exists for other officeholders. Furthermore, annual grants are given to other DBS employees from time to time at DBS discretion.

5.10.5 Bonuses and nature of employment agreements

DBS employees are employed under personal employment agreements, on the basis of a monthly salary or an hourly salary (usually service representatives and telephone sales representatives). The salaries of sales personnel, service personnel and collection employees are comprised of a base salary and commissions / bonuses based on performance. The employment agreements are usually for a non-specific period, and each party may terminate the agreement by prior notice in accordance with the agreement or the law.

DBS employs people at the telephone service call center on weekly days of rest and on days of rest prescribed by the State. In March 2007, DBS filed an application for a permit for such employment for 2007. The permit has not yet been received. DBS has also filed such an application for 2008 and approval was received for 2008 and 2009.

5.11 Raw Materials and Suppliers

5.11.1 Main raw materials

The main raw materials used by DBS for its broadcasting operations are:

A. Television content

The broadcasting rights purchased by DBS are presented in DBS's books on the basis of their cost, where the broadcasting usage rights relating to the screening of movies and television programs includes payments made to rights providers pursuant to the agreements with them.

The broadcasting rights are amortized in accordance with their purchase agreements, on the basis of the actual content screening (where the part which is not amortized by the end of the agreement period is amortized in full on the basis of the agreement period) or in equal parts on the basis of the rights agreement period.

The costs of original productions made for DBS which, under purchase agreements, may be broadcast a number of times or which may be sold to third parties are deemed to be part of DBS's broadcast rights inventory, and the cost of them is amortized over the period of their expected use, or in accordance with the estimated number of future screenings of such programs, but in any event, are amortized in full upon expiration of the broadcast rights under the contract.

In view of the proliferation of content providers from which DBS purchases broadcasting rights, DBS does not have a main provider and is not materially dependent on one single content provider. However, in the Israeli sport broadcasting sector there is dependence, as at the date of this report, on the purchase of broadcasting rights for local sport channels from these two content providers.

B. Space segments

DBS leases rights to satellite space segments via which DBS broadcasts from the satellites to the reception dishes installed in subscriber homes. The space segments are leased by means of long-term agreements with the owner of the rights to the space segments (see section 5.16.2 below).

DBS is dependent on the continuing regular availability of the space segments (see section 5.16.2 below).

Through July 2008, DBS leased space segments from another owner of rights on Amos 1 satellite of the Israel Aircrafts Industries Ltd. (see section 5.16.2 below). As of the reporting date, DBS is makes partial payments on account of the rental debt for

the lease period that terminated on Amos 1 satellite, and which payment was overdue. Due to arrears in payments by DBS set out in the above agreement, DBS is negotiating with the IAI due to the latter's demand to repay the entire debt. For the settlement agreement with HLL regarding the amount of the annual rental payments owing to HLL for lease of the space segments on the Amos 2 satellite, see section 5.18.7 below.

C. Digital decoders

DBS purchases digital decoders for the purpose of receiving and decoding its encrypted broadcasts at customer homes. DBS is dependent upon the suppliers from whom the decoders are purchased, including PVR decoders (ADB via Eurocom – see section 5.16.1 below, and UEC). With respect to the acquisition of decoders and their maintenance, replacement of a decoder supplier with another supplier does not in itself entail substantial additional costs, but the replacement would require a significant preparation period to adapt the decoders of the other supplier to DBS's broadcasting and encryption system, which might cause DBS to lose revenues. Maintenance of decoders which is not carried out by the specific supplier from whom they are purchased may involve additional costs and maintenance complications. For a description of DBS's contracts with decoder suppliers, see section 5.16.1 below.

Operating and encryption systems

DBS purchases from NDS services linked to the operating systems of its broadcasting setup and encryption means (see section 5.16.3 below) as well as hardware for these services. DBS is dependent upon the regular provision of these services.

5.12 Working Capital

5.12.1 Customers

DBS collects subscriber fees from its customers at the end of each calendar month for the previous completed calendar month. As at December 31, 2008, customer credit amounted to approximately NIS 152,876,000 net.

5.12.2 Supplier credit

The average supplier credit period in 2008 was 111 days.

5.12.3 Deficit in working capital

As at December 31, 2008, DBS's deficit in working capital amounted to NIS 1,329,796,000.

5.13 Financing

5.13.1 Average interest rate for loans

5.13.1.1 Shareholders

The loans granted to DBS by its shareholders (among them the Company) are divided into three types:

- A. CPI-linked non -interest bearing loans.
- B. CPI-linked loans bearing annual interest of 5.5%.
- C. CPI-linked loans bearing annual interest of 11%.

These loans were included in the financial statements of DBS at their discounted value based on the interest rate of 11.64%-15.63%, constituting the fair value for July 2007. The current finance expenses in the financial statements are recorded in accordance with these rates, with the addition of linkage to the index. For further information, see Note 13E to the Company's financial statements for the year ended December 31, 2008, included in this periodic report.

5.13.1.2 Institutional bodies

The loans provided to DBS by institutional bodies in 2005 (see section 5.16.8 below) are linked to the consumer price index and bears interest at an annual rate of 11%.

Debentures (Series A) of DBS are linked to the consumer price index and as at the date of this report, bear annual interest at a rate of 8.4% (see section 5.13.7 below).

5.13.1.3 Banks

Short-term credit – the average interest rate for this credit for 2008 was 6.68%.

Long-term credit –

- Loans based on prime interest rates where the average interest rate for 2008 was 6.577%.
- On December 31, 2008, DBS long-term bank loans were extended for a further period of two years at fixed annual interest rate of 5.52%.

5.13.2 Credit restrictions applicable to corporations

Under a financing agreement between DBS and a consortium of banks that provided DBS with banking finance, as re-expressed in August 2003 and amended from time to time (the Finance Agreement and the Banks, respectively), DBS must comply with all the following financial criteria:

- A. Minimum overall income
- B. Minimum operating surplus
- C. Minimum operating surplus less DBS investment in decoders and modems
- D. Maximum and minimum supplier credit
- E. Minimum targets for coverage of the bank debt and debt balances
- F. Maximum overall finance requirements
- G. Maximum churn rate

The values for compliance with the financial criteria are variable and are measured quarterly (except for a different measure of the criterion of the maximum subscriber churn rate). Non-compliance grants the banks the right to demand early repayment of the loans and the right not to provide DBS with the balance of any unused credit line. During 2005, the banks completed providing the entire credit limit to which DBS was entitled under the financing agreement (apart from the sum of approximately half a million shekels) in return for the provision of shareholders' loans by the shareholders of DBS in the rates required under the financing agreement (apart from shareholders loans which the banks waived under the amendment to the financing agreement dated December 2005, as replaced in the schedule to the financing agreement dated May 2006) (in this section: the Amending Document)). Under the amending document, the banks confirmed that actual investments by shareholders in DBS by the end of 2005, despite certain deficits therein compared with the values prescribed in advance in the financing agreement do not constitute a breach of the financing agreement. Under the amending document, additional bank credit was granted, which was paid up by the end of 2008.

During 2006, DBS began gradual repayment of the bank credit that it had taken, until full repayment in 2013.

In July 2007, the finance agreement was amended via an addendum to it. Under this addendum, inter alia, the financial target conditions that DBS is required to comply with as of Q2 of 2007 and until 2013 (the date of full repayment of the bank credit) were amended. The amendment also prescribed a mechanism for determining the rate of receipts of issues of debentures (series A) of DBS, including future extensions of the series, if any, to be used for repayment of the bank credit. In this regard, see also Note 13 to the Company's financial statements for the period ended December 31, 2008, which are included in this periodic report and section 5.13.7 below.

5.13.3 In addition to the abovementioned financial commitments, pursuant to the finance agreement additional restrictions anchored therein apply to DBS, the main ones being:

- A. Restrictions related to compliance with its business plan, update of such plan and dealing in operations that are not an integral part of its current operations.

- B. Restrictions on the assumption of third-party liabilities, including the receiving and granting of credit.
- C. Restrictions on the distribution of profits and payment of management fees or similar payments to shareholders.
- D. Restrictions on the creation of pledges and sale of certain assets without consent from the banks.
- E. Restrictions on DBS's transactions with interested parties, changes of ownership in DBS, the purchase of securities in any corporation and the offering of its securities to the public (including the issue of debentures).
- F. Restrictions with respect to the shareholders loans provided to DBS by its shareholders, including the inferiority thereof to the bank credit (and debentures that are to be issued to the public, if any), and restrictions relating to the repayment thereof prior to repayment of the bank credit in full, except with respect to shareholders' loans provided by the shareholders of DBS after April 1, 2004, which DBS may repay on account thereof prior to repayment of the full bank credit, on the conditions set out in the financing agreement (DBS and the banks have agreed that they will view the loans received by DBS from institutional bodies in 2005 (see section 5.16.8 below) as being part of the aforesaid shareholders' loans, and accordingly, DBS may repay them under certain restrictions as set out in the financing agreement, prior to full repayment of the bank credit).
- G. Restrictions with respect to the issue of shares of other securities of DBS without the consent of the banks, with the exception of issue of securities to shareholders of DBS permitted subject to the conditions set out in the financing agreement.

DBS is bound by mandatory repayment of sums that it receives with respect to the placements of shares or debentures to the public, sale or transfer of property and certain cash surpluses of DBS, on the conditions and at the rates set out in the financing agreement. DBS may, voluntarily, effect early repayment sums received with respect to placements of shares or debentures to the public, which may remain after the aforesaid mandatory repayment, on such conditions and at such rates as are set out in the financing agreement.

The financing agreement also sets out provisions regarding various reports which DBS is required to provide to the banks, including with respect to examination of its compliance with financial conditions.

The financing agreement sets out a list of events which amount to breach thereof, and which entitle the banks, under the conditions set out in the financing agreement, to make the bank credit immediately repayable.

5.13.4 DBS has taken a floating charge in favor of the banks, and has taken out fixed charges in favor of the banks over its rights under substantial agreements to which it is a party, over its unissued registered capital, over its goodwill, over certain intellectual property rights, and over the insurance rights to which it is entitled under the insurance policies issued to it (the charge does not apply to DBS's rights under its broadcast license). These charges were taken at equal rank, *pari-passu*, with similar charges created by DBS in favor of the holders of its Debentures (Series A) (see section 5.13.7 below).

5.13.5 The shareholders of DBS, with the exception of the Company, have charged the DBS shares that they hold in favor of the banks, in assurance of the sums that the banks provided and will provide to DBS. Most of the shareholders also charged their rights to repayment of the shareholders' loans granted to DBS in favor of the banks and confirmed to the banks that pending repayment of the full bank credit, the shareholders' loans would be inferior to the bank credit, that they would not effect dispossession of them and that they would not require that they be paid back nor any security in assurance of them. In view of the restrictions on the Company's ability to charge its assets as a result of the negative pledge created by the Company in favor of its creditors, on November 23, 2000 the Company gave a guarantee of DBS's debts to the banks, provided that the amount which the banks receive in repayment by the Company of its guarantee does not exceed the value of its shares in DBS on the date on which the banks realize the shares which the other shareholders charged in their favor. The Company also gave an undertaking to sell its shares if the shares charged by the banks are sold. Pursuant to a deed of amendment of the guarantee of May 2, 2002, the Company consented that in the event of realization of

the collateral given by the other shareholders the Company would waive repayment of the shareholders' loans it granted to DBS. The Company also consented that its guarantee would also apply, mutatis mutandis, to the options allotted to DBS and to the right to receive them.

The shareholders in DBS with the exception of Gilat DBS Ltd., gave an undertaking to the banks inter alia not to oppose the sale or other realization of their shares in DBS, which had been pledged or in respect of which a guarantee had been given (by the Company), so that the bank could make the sale without disturbance in the form of a friendly liquidation.

- 5.13.6** As at the date of this report, DBS is not in compliance with all of its undertakings under the financing agreement to take out insurance with respect to its operations and assets, including with respect to the duty to take out satellite failure insurance for the satellites on which DBS leases space segments for the purpose of its broadcasts. DBS is negotiating with the banks for relief with respect to its insurance undertakings, which will enable it to comply with these undertakings.

In addition, arrears in DBS's payments to the Israel Aviation Industry (as set out in section 5.11.1 B above), constitutes a prima facie breach of the financing agreement, however, the banks have allowed DBS not to deem the demand by IAI for repayment of the debt owing to it (as stipulated in section 5.11.1 B above), and non-payment of the debt, as a breach by DBS of the financing agreement, provided that by December 31, 2009, the parties reach a written arrangement regarding repayment of such debt, and that during the period prior to the aforesaid date, IAI does not institute any measures for collecting its debt as aforesaid.

In light of the forecasts of DBS management regarding the business results for 2009, DBS made a request of the banks to plan and adjust the financial commitment targets for 2009 so as to match its budget. During March 2009, consent was received from the banks to amend these commitment targets.

In the assessment of DBS's management, the sources of funding available to it will be sufficient for its needs for activities in the coming year, in accordance with the cash flow forecasts approved by the board of directors of DBS. If additional sources are required in order to meet the needs of operations for the coming year, DBS shall adapt its operations so as not to require additional sources above those available to it.

As at December 31, 2008, DBS was in compliance with the financial covenants under the financing agreement (following relief that it received from the banks in March 2009) with respect to the target of one of the covenants as at December 31, 2008. In light of the fact that this relief and commitment target amendment for 2009 were given after the balance sheet date, the loans from the banks are presented as part of short term liabilities.

5.13.7 Private issue of debentures

In July 2007, DBS raised the sum of approximately NIS 620 million as part of a private issue to institutional investors of registered Debentures (Series A) which were listed on TACT Institutional at TASE (the Debentures). For the purpose of this issue, the Debentures were rated by Maalot the Israel Securities Rating Company Ltd. which, to the best of DBS's knowledge, has changed its name to Standard & Poors Maalot Ltd. (Maalot) as BBB- / stable.

The Debentures are to be repaid in eight annual principal payments, in the months of July 2010-2017, the principal payments in each of the years 2010-2013 being at a rate of 8% of the par value of the Debentures, and the principal payments in the rest of the years 2014-2017 being at a rate of 17% of the par value of the Debentures. The Debentures are linked to the consumer price index as of the index for the month of June 2007, and bear annual linked interest at a rate of 7.9% per annum (subject to various possible adjustments in accordance with the conditions of the Debentures) which shall be paid in half-yearly installments in the months of January through July of each of the years 2009-2017. DBS has not undertaken to list the Debentures for trading on TASE, however, in the event of listing of the Debentures for trading on TASE, the annual interest to be paid on them as of such date shall be reduced to 7.4%. Since the Debentures were not listed for trading on the Stock Exchange by July 31, 2008, the annual interest rate paid on them increased, in accordance with the terms and conditions of the debentures as of July 31, 2008, to 8.4% for so long as such listing does not take place (and in the event of later listing, the interest rate will be decreased from that point to 7.4% as aforesaid). Under the terms of the Debentures, if the rating of the Debentures falls by two rating points without the

Debentures being listed for trading, then the annual interest rate shall be increased by half a percent, but to a rate no higher than 8% until the original rating is regained or the Debentures are listed for trading (in which case, the interest rate will again be decreased as referred to above). In addition, if DBS does not comply with the financial commitments set out in the financing agreement between it and the banks, and as a condition of the banks' waiver of such breach, DBS shall undertake to pay the banks a supplement on the bank credit margin to the banks, and if at that time the Debentures are not listed for trading, then so long as it pays the banks the supplement on the bank credit margin as aforesaid and the Debentures are not listed for trading, DBS shall pay the debenture holders an annual interest supplement in the same amount.

Additional provisions have also been made in the Debentures, including with respect to payments related to them, dates of payment, and the method of convening of general meetings of Debenture holders.

With respect to the issue of the Debentures, DBS and Hermetic Trusts (1975) Ltd. (the Trustee) executed a deed of trust in July 2007 (for the main points of the deed of trust, see section 5.16.6 below).

The Debentures are secured by a first degree floating charge, unlimited as to sum, over all of DBS's assets (apart from exceptions stemming from the provisions of the Communications Law) created by DBS in favor of the Trustee, including a condition restricting the creation of additional charges (apart from charges and actions during the ordinary course of business and charges and actions permitted under the deed of trust) and a first degree fixed charge, unlimited as to sum, over the rights and assets of DBS, charged by it in favor of the banks (apart from exceptions stemming from the provisions of the Communications Law) (the Trustee's Guarantees). The Trustee's Guarantees are ranked first and equal (*pari passu*) to the floating charges and fixed charge created by DBS in favor of the banks, in assurance of the bank credit (the Bank Guarantees), without taking into account the dates of creation of the various guarantees and/or the dates of registration of such with the Companies Registrar and/or the Registrar of Pledges. The creation of other charges by DBS in favor of the banks shall be subject to the consent of the Trustee, unless such charges are also registered in favor of the Trustee. In the event of exercise of the Trustee's Guarantees and/or the Banks' Guarantees and/or exercise of the assets the subject of such guarantees, including by the holders of other securities who may be given a charge over such assets, the proceeds of exercise shall be distributed *pro rata* between the Trustee, the Banks and the aforesaid holders, and each chargee shall receive its *pro rata* share of the proceeds, equal to its *pro rata* share of the debt to it (as defined in the deed of trust) divided by the total debt secured by such assets.

For the purpose of rating the debentures, DBS has undertaken to Maalot (and to it alone) that it shall not make payment on account of the shareholders loan prior to the end of the life of the Debentures.

In October 2007, Maalot gave notice that the rating of the Debenture is on the watch list due to interferences in DBS's transmissions (see section 5.20.3.18 below), due, in its opinion, to the fact that such disturbances caused higher expenses than expected, to deviations from DBS's business plan and to the filing of a number of lawsuits against it. In February 2008, Maalot informed DBS that DBS had been taken off the above watchlist, and that the debentures were rated at stable / BBB-, *inter alia* because DBS was able to maintain its subscriber base and to meet the subscription target that it had set for itself prior to the disturbances. On August 2008, Maalot announced the validation of the existing rating.

On October 21, 2007, DBS received a letter from the Trustee of the Debentures stating that following interruptions in transmissions and various items published regarding that, including regarding a reduction in the number of DBS subscribers, and regarding the compensation that DBS would grant its subscribers, it wished to receive various documents and certificates from DBS in order to clarify whether the aforesaid events and their long-term impacts might harm DBS's undertakings to the debenture holders. In the assessment of management of DBS, based on conversations with the Trustee, in light of its being taken off the watch list, the Trustee is not expected to require further particulars beyond the ordinary reporting requirements under the deed of trust.

For further details about this placement, see Note 13 to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

5.13.8 The Corporation's credit facility

DBS's line of credit is NIS 960 million. As at December 31, 2008, DBS had used approximately NIS 881 of this line of credit. For further details see Note 13 to the Company's financial statements for the period ended December 31, 2008 which is included in this periodic report.

For the position taken by the Ministry of Communications regarding limitations on provision of shareholders loans by the Company to DBS, see section 5.6.4.2 below and Note 33 to the Company's financial statements for the period ended December 31, 2008, included in this periodic report.

5.14 Taxation

See Note 8 to the Company's financial statements for the period ended 31 December 2008, which are included in this periodic report

5.15 Restrictions on and Supervision of the Corporation

5.15.1 Subjection of activities to specific laws

DBS's operations are regulated by and subject to a special extensive system of laws (from primary legislation to administrative directives and Council decisions). The above legislation, secondary legislation, resolutions of the Council and administrative directives have substantial impact on DBS and its operations. Likewise, legislation and secondary legislation in the field of communications in general has a substantial impact on DBS.

Restrictions are applicable to DBS under the Communications Law and the regulations promulgated pursuant thereto. The Telecommunications (Proceedings and Conditions for Grant of Satellite Broadcasting License) Regulations, 5758-1998 (the License Regulations), determine the processes and conditions for receipt of a broadcasting license, and also various restrictions applicable to a licensee during the term of the license. The License Regulations prescribe, inter alia, suitability conditions for a satellite broadcasting licensee, relating to the direct or indirect holdings of the broadcasting licensee and the interested parties therein, in cable broadcasting franchisees, in franchisees pursuant to the Second Authority for Television and Radio Law, 5750-1990, and in proprietors of daily newspapers.

In October 2008, the Ministry of Communications informed DBS that due to the fact that Bank Leumi Ltd (hereinafter, in this section: Bank Leumi) is part of the consortium of banks in whose favor some of the DBS shareholders attached the DBS share capital held by them on the one hand and on the other hand Bank Leumi's holding in part of the share capital of Keshet Broadcasting Ltd., the concession holder in accordance with the Second Authority for Television and Radio, 5750-1990. As of October 31, 2008 on which the transfer provisions set forth in the Regulations for the granting of a license expired with respect to a parallel holding as aforesaid at a rate exceeding 25% of the concession holder's equity, and one of the qualifying restrictions set forth in the Regulations for granting licenses, in the opinion of the Ministry of Communication, will be applicable with regard to DBS (also see section 5.15.2 above). The permission to surpass expiry of the transfer provision as aforesaid, was given to DBS by Bank Leumi and by the Ministry of Communication, which formulated an agreement between them, according to which the Ministry of Communication shall not deem the attachment of DBS shares in favor of Bank Leumi as non-compliance with the aforesaid restrictions, subject to the split of the attachment deed of the attached DBS shares (or most of them), so that only the appropriate portion of DBS shares attached to all the banks will be attached to Bank Leumi for a defined period which as not yet been agreed upon. To the best of DBS's knowledge, a detailed settlement has not yet been signed between Bank Leumi and the Ministry of Communication. The Communications Ministry informed DBS that the matter was sent for assessment by the Attorney General.

The Telecommunications (Television Broadcasts via Satellite) (License Fee and Royalties) Regulations, 5759-1999 (the Royalty Regulations) as amended in August 2006, provide the

rate of royalties and the broadcast license fees to be paid by a licensee for satellite broadcasts to the State. Under those regulations, DBS owes royalties in a rate of 3.5% of its revenues from the provision of broadcasting services in the years 2004 and 2005, in the rate of 3% for 2006 and in a rate of 2.5% for 2007. The royalty rate will be 2% in 2008, 1.5% in 2009 and 1% from 2010 onwards. In February 2008, an agreement was signed between DBS and the State regarding the spreading of payment royalty sums under which DBS undertakes that the sum of royalties for the period commencing in July 2007 and ending in September 2008 (but not more than the sum set out in the Agreement), plus interest differentials, would be paid in 11 monthly installments commencing in February 2009.

Under Section 6WW of the Communications Law, the license may prescribe the maximum prices that a subscriber may be billed. As at the date of this report, no such prices have been prescribed.

In accordance with the requirements of the broadcasting license and regulations determined by the Council, from 2004 to 2009 (inclusive), each year DBS shall invest in local productions an amount which is not less than 8% of its revenue from subscriber fees. Pursuant to the Council's confirmation, DBS was in compliance with its original production obligation for 2007 (including the proportionate share of completing past debts) apart from non-substantial deviations in the sub-division into various kinds.

Under the requirements of the law and the license, DBS is required to allow independent channel producers under section 6EEE of the Communications Law to make use of its infrastructure in order to distribute transmissions to its subscribers, in return for payment to be set out in an agreement, and in the absence of any agreement, in consideration for payment to be prescribed by the Minister, upon consultation with the Council. For further information relating to the hearing announced by the Ministry of Communications with regard to transmission fees to be paid by independent channel producers as aforesaid, see section 5.15.3 below.

In January 2009, the amendment to the Consumer Protection Law, on the issue of fixed transactions, came into effect. This amendment stipulates, inter alia, the obligation to give notice of the termination of the transaction period and obligates receipt of the customer's agreement to extend the contract beyond the fixed transaction period.

5.15.2 Operations subject to broadcasting license

DBS's operations are subject to the provisions of its broadcasting license. The Communications Law, the License Regulations and the broadcast license stipulate a number of grounds on the basis of which the Minister of Communications can terminate, restrict or make the broadcasting license conditional, after consultation with the Council and the granting of a hearing to the broadcasting licensee, among them, violation of the provisions of the law or rules and regulations pursuant thereto, a material violation of the terms of the broadcasting license or a non-material violation which was not amended after a warning from the Minister or the Council, the cessation of broadcasts for an unreasonable period of time or the total cessation of broadcasts for 14 consecutive days, noncompliance of the licensee with the restrictions determined in relation thereto in the License Regulations, and the appointment of a receiver or temporary liquidator for the licensee or the issuing of a liquidation order, all pertaining to the licensee.

The Minister of Communications, in consultation with the Council, and after granting the broadcasting licensee an opportunity to make its arguments and considering the harm to its rights, may change the terms of the broadcasting license, inter alia, for the purpose of the goals stipulated in the license. In addition, the Council alone has concurrent authority to amend the broadcasting license, provided that the broadcast licensee is first of all given an opportunity to make claims.

5.15.3 Principal restrictions by virtue of the law and broadcasting license

The Communications Law and Broadcasting Regulations stipulated the following principal general conditions: The broadcasting license may not be transferred or attached. Encumbrance of the broadcasting license, insofar as it may be encumbered under the law, requires prior written approval from the Minister of Communications; transfer, encumbrance or attachment of any of the assets of the broadcasting license from August 2001 onwards, which were not granted advance permission in the license, require approval from the Minister of Communications, except for encumbrance of an asset in favor of a banking

corporation (in this respect DBS received the consent of the Ministry of Communications for a charge that DBS sought to create inter alia over the "license assets" in favor of the trustee for the debenture holders); an encumbrance placed on any of the broadcasting license's assets shall only be exercised in the manner prescribed by the Minister of Communications; DBS's broadcasts to be in accordance with the broadcast license and their scope subject to the provisions of the law; a change, directly or indirectly, in control or holding of the means of control in a percentage of 10% or more and changes in a holding of the means of control in any percentage resulting in a person becoming a controlling party of the licensee (as defined in the Regulations for the granting of a license) requires prior written approval from the Minister of Communications, after consultation with the Council. In the event that the change in the holding of the means of control does not exceed 15% of the holding of the means of control in a company whose shares are listed on the Stock Exchange, the said approval is not required with respect to the shares that are listed on the Stock Exchange and their attached rights, provided that it is not a change in the control thereof and a report has been delivered as set forth in the license. Reporting requirements were stipulated concerning holders of the means of control and restriction on encumbrance of the means of control; cross-ownership in the licensee is prohibited as set forth in the License Regulations; competition pertaining to the provision of broadcasts and services shall not be prejudiced, including terminal equipment or other telecommunications services, by any agreement, arrangement or understanding to which the broadcasting licensee, any body in which the broadcasting licensee, an officer of the broadcasting licensee, or any owner of a right in a company owning a broadcasting license (and also an officer of the owner of a right therein) are parties, unless approved in advance and in writing by the Council; advertising broadcasts are prohibited (this prohibition also applies to the cable companies) except for the transmission of foreign channels containing advertisements which are not aimed primarily at Israel and except for sponsorships and service broadcasts, under restrictions prescribed by the Council.

The broadcasting license also stipulates conditions for the establishment of a satellite broadcasting system and its operation; conditions relating to subscriber services, including the obligation to receive approval of the subscription contract from the Council and the Court for standardized contracts; the obligation to connect applicants and the prohibition of preconditions; the obligation to provide the services throughout the year; prohibition on discriminating among subscribers, with the exception of offering different rates for types of subscribers reasonably categorize; maintaining a subscriber service center, maintaining a supply and maintenance system and ongoing maintenance of terminal equipment and subscriber privacy; conditions relating to provision or disconnection of services and conditions relating to supervision of the operations of the owner of a broadcasting license and the obligation to submit reports to the Ministry of Communications, and conditions relating to the compliance of the terminal equipment installed by DBS to the standard.

The broadcasting license stipulates provisions regarding the types of payments that the broadcasting licensee may collect from its subscribers. The licensee is under an obligation to give notice in writing to the chairman of the Council of any change in the price list approved by the Council immediately upon publication of such or upon notice of a change to subscribers, whichever is the earlier, and the chairman may, if he is of the opinion that such change might cause harm to competition, misleading of the public, discrimination among subscribers, unfair competition, or that it does not comply with the provisions of the law, the regulations, the rules, the license or the Council's policy, instruct the licensee not to change the price list or given notice that he intends to place the change before the Council for discussion. If the chairman does not give the licensee notice as aforesaid prior to the date of commencement of the change, the change shall come into force. With respect to reductions, discounts and promotions (for a restricted period), DBS is required to notify the chair of the Council no later than the date of publication or commencement, whichever is the earlier, and the chair may intervene if he finds them to be misleading to the public or as drawing distinctions between subscribers.

The broadcasting license sets out a number of provisions that relate to the content of DBS's broadcasts, including approval of the channels broadcast by DBS and amendments in respect of them by the Council (including the content of DBS's basic package), approval of the electronic program guide (EPG) which is part of DBS's digital service to its subscribers and approval of pay per view broadcasts.

DBS is also required to transmit the television and radio (FM) channels broadcast nationally in Israel including the educational television channel and must carry broadcasts

to its subscribers. At present, DBS transmits the broadcasts of two special channels, the Music Channel (Music 24) and a Russian language channel (Israel Plus), in consideration for a payment which the Minister is required to prescribe. DBS as the aforesaid special channels are in legal proceedings with respect to the debt for the transmission fee that DBS is claiming from the channels, including with respect to the Minister's power to require them to pay such a transmission fee. In February 2008, the Ministry of Communications informed DBS that it intended to announce a hearing with regard to the transmission fees to be paid by independent channel producers, including must carry broadcasts, to DBS for transmitting the broadcasts over its infrastructure. The Ministry attached to its letter, a draft economic opinion prepared by the Ministry according to which transmission fees will include a fixed component of NIS 1.2 million and a component dependant on the number of subscribers to the channel producer, which will not exceed one million shekel in any case. As at the report date, the hearing has yet to be published.

In February 2008, the Council published a decision, according to which it is considering to re-examine the advertising terms for a special news channel which will be broadcast as part of the cable company and DBS broadcasts and the integration of commercials in its broadcasting. During 2008, the Council published its intention to publish a tender for a special Arabic channel. For this purpose the Council announced a public hearing in which it wished to examine a few benefits in the area of original productions and news production in Arabic as well as changes in the identity of entities which may compete for ownership of the channel. As of the date of this report, the two aforesaid tenders have not yet been published.

Pursuant to a decision of the Council dated March 2006, DBS, including its shareholders, are entitled to own up to 30% of the local channels broadcast in DBS's broadcasts (compared with a 20% restriction that applies to the cable company).

In 2001, the Ministry of Communications issued administrative directives which regulate how a subscriber switches from the services of the cable companies to DBS and vice versa, and the use of infrastructures in the subscriber's home. The directives also prescribe a duty to pay monthly usage fees for infrastructure owned by another multi-channel television service provider. Since the administrative directives were issued, DBS and the cable companies have submitted mutual complaints of violation of the directives by the other party, and voluminous correspondence has been exchanged between DBS and the Ministry of Communications on the matter. In August 2005, the Ministry of Communications notified DBS and the cable companies that in view of their numerous violations of the administrative directives, it had re-examined the matter and was now considering their cancellation, inter alia, in view of the mechanism for purchasing the wiring prescribed in the Communications Law, which enables a subscriber to purchase the wiring in his home for NIS 120.

In November 2005, DBS submitted its position to the Ministry of Communications, stating that the administrative directives should remain in place, while cancelling the early notice prescribed in them, which requires that notice be given to a party whose subscribers disconnect from its services. DBS also contended that the provisions of the law granting ownership of infrastructure to the multi-channel television provider that installs it in the homes of its subscribers, should be rescinded. At the very least, contended DBS, if the directive remains in place, its proper interpretation should not grant the cable companies ownership of the wiring they installed in private houses. DBS also stated that the amount prescribed in the law as the consideration to be paid for purchasing the wiring (NIS 120), is baseless and that if the directive is retained, the amount should be considerably reduced.

In March 2006, the cable company gave notice to the director general of the Ministry of Communications that in light of DBS's breaches of the administrative order, it was ceasing to accept disconnection notices sent to it by DBS, and indeed, the cable company ceased accepting any notices under the administrative order, including connection plans and termination notices. DBS dismissed the claims made by the cable company and argued that by refusing to receive notices from DBS, not only was the cable company in breach of the administrative order, it was also in breach of its license and of the agreements via which it had contracted with its customers, since it continued charging subscribers a subscription fee despite knowing that such subscribers had disconnected from their broadcasts. DBS also demanded that the Ministry of Communications order the cable company to stop charging subscribers immediately upon receipt of notice of disconnection.

As at the present date, the Ministry of Communications has not yet commented on the issue, and the cable company continues not to accept notices from DBS.

In the assessment of management of DBS, if the administrative order is cancelled, without an appropriate alternative arrangement enabling one supplier to make use of the infrastructure of the other in subscriber homes, this will constitute a substantial barrier to the transition of subscribers between the various suppliers.

5.16 Substantial Agreements

Following is a summary description of the principal agreements likely to be considered as material agreements not in the normal course of business of DBS which have been signed and/or are valid in the period of the periodic report:

5.16.1 Agreements for the purchase of decoders

In August 2000 DBS signed an agreement for the purchase of decoders with Advanced Digital Broadcast Ltd. (ADB) and Eurocom Marketing (1986) Ltd. (hereinafter in this section: Eurocom) in which Mr. Shaul Elovitch, an interested party in DBS, is also an interested party (the ADB Agreement). Under the ADB Agreement, DBS purchased a minimum number of decoders from ADB and is also entitled to purchase additional decoders from time to time in accordance with a purchase order which DBS is to send to Eurocom. DBS is also responsible for the converters and support service thereof via Eurocom. Following the assignment of ADB's rights and obligations under the ADB Agreement to another corporation, Advanced Digital Broadcast S.A., an addendum to the ADB Agreement was signed in April 2008, governing such assignment and making certain amendments to the ADB Agreement. In April 2008, an agreement was signed to extend the warranty period for a certain series of decoders.

In 2007 and 2008, DBS purchased decoders from ADB which enable viewing using HD technology. DBS also ordered PVR decoders which will enable viewing HD broadcasts.

In 2008, DBS purchased decoders from Eurocom for approximately NIS 32 million.

For the legal proceedings regarding the deficit demand from the Customs Department of the Taxation Authority for decoders purchased by DBS from Eurocom and smart cards imported by Eurocom for DBS, which were resolved in the reporting year, see section 5.18.5 below.

Purchase of PVR decoders – in July 2004, DBS entered into a contract with UEC Technologies (Pty) Limited (UEC) for the development, manufacture and supply of PVR decoders. The agreement is for 5 years and is automatically renewed for additional terms of one year each, unless one of the parties gives notice otherwise. DBS was also awarded a warranty period and support services for the decoders, including a local repair laboratory.

5.16.2 Space segment lease agreements

First space agreement

In order to transmit the satellite broadcasts DBS signed an agreement in April 1999 with the HLL Communications Ltd. (HLL), in which there is an interested party which is also an interested party in DBS, and with Israel Aircraft Industries for the leasing of space segments in the Amos 1 satellite as amended in May 2003 (the First Space Agreement). The lease period for Amos 1 satellite terminated in June 2008.

For information relating to lease fee debts for Amos 1 satellite see section 5.11.1 above.

The First Space Agreement regulated mechanisms guaranteeing reserve and backup in the event of satellite faults. Inter alia, it was prescribed that the satellite's reserve transponder used as backup for the satellite's entire capacity would serve as reserve capacity for DBS if the reserve transponder were used to restore any satellite capacity. HLL undertook to make available one space segment within six months and within a further three months another reserve space segment which would be used as reserve capacity for the satellite's entire capacity. In the event of a fault contemporaneous with another capacity DBS has priority for the restoration of the capacity that it has leased.

Second space agreement

In May 2000, DBS signed another agreement with HLL to lease space segments on the Amos 2 satellite, as amended in May 2003 (the second space agreement), whereby DBS is to lease no fewer than 12 space segments on the two satellites (of which 8 on Amos 1) from HLL, and one year later, shall lease two additional segments on Amos 2 on the same polarity, so there will be no need to adjust DBS's receiver dishes. According to the second space agreement, the capacity that was leased on Amos 1 was transferred to Amos 2 and to Amos 3, whose positioning in space was completed in July 2008.

Pursuant to the second space agreement, the lease period for the space segments on Amos 2 and Amos 3 is for 12 years from the date on which Amos 2 was positioned in space (which took place during April 2004) or until the end of the life of Amos 2, the earlier of the two. The consideration for the lease determined in the second space agreement consists of annual lease fees to be paid in monthly installments, the amount of which depends on the total number of segments which DBS, its shareholders and lessors affiliated with it and/or with its shareholders, as defined in the second space agreement will lease on the Amos 2 and Amos 3 satellites. The second space agreement brings together space segments which are to be used as reserve capacity for the leased capacity on Amos 2, and alternative capacity if the leased capacity becomes unusable, and awards DBS the right of first refusal to lease other space segments on Amos 2 under the terms specified in the agreement.

HLL has undertaken to act to extend the lease period for the space segments beyond the current lease period, and for this purpose to endeavor to station a subsequent satellite in a suitable position, with similar technical characteristics, so that it will not be necessary to make changes to the receiver systems of DBS subscribers, under the conditions determined in the agreement, until December 31, 2013, provided that an appropriate agreement for the continuation of the satellite's life is signed by the parties, as shall be determined in said agreement, pursuant to which DBS will lease at least 14 space segments in consideration of annual leasing fees under similar commercial conditions.

In February 2008, an amendment to the second space agreement was signed between DBS and HLL, according to which, inter alia:

1. DBS will lease 13 space segments instead of 14 from HLL.
2. DBS will terminate the lease of the 13 space segments by the signing of another agreement between the parties, in accordance with the mechanism set forth in the agreement.
3. A mechanism was set up for partial backup on Amos 3 in the event of non-accessibility of space segments on the Amos 2 satellite.

As at the date of this report, DBS is leasing ten space segments on the Amos 2 satellite and two space segments on Amos 3. The leasing fee in 2008 amounted to approximately NIS 78 million.

5.16.3 Information and encryption system development agreement

In October 2000, DBS signed an agreement with NDS Limited (NDS) for the development, licensing, supply, training, assimilation and maintenance of software and equipment for encryption, broadcasting, compression operations and ancillary operations required for DBS's multi-channel, broadcasting system, including development of a smart card inserted into a special decoder drive, by means of which the subscriber's viewing options can be controlled. The smart card may be updated using a satellite broadcasting signal. NDS undertook to adapt its equipment and services to the decoders purchased by DBS in accordance with the provisions of the agreement. NDS also undertook to provide DBS with support services and provide a warranty for its products. Pursuant to the agreement DBS may order and pay for additional broadcasting equipment and software and also make modification to the existing ones under the conditions set forth in the agreement. The provisions of the agreement were applied in January 2006, mutatis mutandis, to the advanced (second generation) version of the smart card. In addition, DBS has also entered into a number of agreements with NDS for the development and implementation of a system of applications to enable DBS to offer its subscribers interactive services via yesMax decoders and VOD services. DBS is paying for NDS services and products based mainly on the number of decoders that it uses and the number of its active subscribers.

5.16.4 Telephone call center service agreement

DBS operates one of its telephone call centers via Bezeq Online Ltd. (Bezeq Online), a wholly owned subsidiary of the Company, which employs staff who serve as service representatives for DBS, under an agreement of June 2001, which is in force until the end of 2010.

Until the end of 2008, Bezeq Online provided services, as aforesaid, with respect to an additional telephone call service center.

5.16.5 Finance agreement with the banks

For a summary of the main points of the agreement, see section 5.13 above and Note 13 to the Company's financial statements for the year ended December 31, 2008, which are included in this periodic report.

5.16.6 Deed of trust relating to debentures (Series A)

With respect to the issue of the Debentures (Series A) of DBS, a deed of trust was signed in July 2007 between DBS and the Trustee. The deed makes various provisions regarding the relationship between DBS and the holders of the Debentures (via the Trustee) including with respect to the possibility that DBS might increase the Debenture series and issue additional debentures and/or securities. A restriction is also prescribed depending on DBS's EBITDA with respect to DBS's right to register first degree charges in favor of the holders of additional securities as aforesaid, and/or allow them to participate in charges in favor of the Trustee, without requiring the Trustee's consent.

The deed of trust sets out various events, the occurrence of which requires the Trustee to convene a meeting of holders of the Debentures, in which, if the event has not yet been dealt with, the holders may decide, in a resolution requiring a 75% majority of the Debenture holders represented at the vote, to make the Debentures immediately repayable (in which case, the Trustee must exercise the securities granted to it) the events including: Non-payment of a sum owed by DBS on time after a warning period; appointment of a temporary liquidator, temporary or permanent receiver to DBS and/or over all or most of DBS's assets, the passing of a winding up resolution by DBS (except for winding up for the purpose of merger with another company and/or a restructuring of DBS), institution of proceedings against DBS under section 350 of the Companies Law or grant of an order under such provision, and the imposition of attachment orders or certain acts in execution of judgment, not cancelled within the periods set out in the deed; exercise of the banks' guarantees (as defined in section 5.13.7 below) or exercise of charges over most of DBS's assets by third parties; the making of another series of debentures issued by DBS immediately repayable, if the balance to be paid out is greater than the sum set out in the deed; termination of DBS' business or an intention so to do, and the creation of circumstances giving rise to a real probability that DBS will cease paying its debts or running its business; cessation of rating of the Debentures by any rating company for the period and under the conditions set out in the deed (so long as DBS is not a reporting corporation under the Securities Law); and if DBS breaches or does not fulfill any substantial condition or undertaking included in the Debenture or the deed of trust (except for non-payment as aforesaid) which the Trustee may deem to be harmful to the rights of the holders of the Debentures, and such breach is not remedied within the warning period set out in the deed.

DBS has also undertaken, under the deed of trust to carry out various acts and to issue various documents and consents to the Trustee and/or provide access to DBS' information and documents, in the events and under the conditions set out in the deed of trust.

For the principal conditions of the Debentures and the securities created by DBS under the deed of trust, see section 5.13.7 above.

5.16.7 Agreements with DBS shareholders

- A. The founders agreement dated December 4, 1998 between the Company, Eurocom Communications Ltd (whose holding was later transferred to Eurocom DBS Ltd), Lidan – Business Ventures Ltd (whose holdings in DBS were later transferred to Lidan Investment Agencies (1994) Ltd) and Gilat Communications Ltd. (whose DBS holdings

were later transferred to Gilat DBS Ltd), which regulates the establishment of DBS, its administration and the relationships between the shareholders²⁷.

- B. An agreement dated December 30, 1998 between DBS shareholders and DBS regulates, inter alia, the setting up of an executive committee and its authority.
- C. An agreement dated November 2001 between the DBS shareholders²⁸ and DBS, modified the dilution formula set forth in the founders agreement and stipulated that the DBS shareholders' holdings will be adjusted to their pro rata share of investments in DBS, so that for the purpose of dilution, the investments (made by way of shareholders loans) would bear, as of the date fixed in the agreement, CPI linkage differentials and annual cumulative linked interest rate of 5.5% from the date of the establishment of DBS.
- D. An agreement dated December 30, 2002 as amended on August 8, 2003, between DBS shareholders and DBS, prioritizes shareholders loans granted subsequent to July 10, 2002 over earlier loans. The agreement also prescribed that these loans will bear CPI linkage differentials and annual accrued linked interest rate of 5.5%, whereby a loan extended on April 27, 2003 will bear CPI linkage differentials and annual accrued linked interest rate of 11%. Furthermore, the agreement prescribed a mechanism for the allocation of shares or options for shareholders who will invest in DBS, so that their holdings in DBS will reflect their adjusted investments in it. The agreement also prescribed the information rights as prescribed for the shareholders who are not interested parties.

5.16.8 Agreements with institutional organizations

According to agreements of March and April 2005, loans were provided to DBS by a number of institutional bodies, in the total sum (principal) of NIS 100 million, linked to the CPI and bearing interest at an annual rate of 11%, the date of repayment of which is December 31, 2013. This credit was taken on inferior terms with respect to payment, compared with the bank credit, with exceptions similar to those that apply to shareholders' loans provided by the shareholders of DBS. After April 1, 2004, these loans were received under three different loan agreements between DBS, the Company and each of the institutional bodies, and in assurance of repayment of the 2005 institutional loans, the Company gave an undertaking to pay sums on account of the loans the amount of which is to be set based on the formula set out in the agreements (which is conditional, inter alia, on the value of DBS's debts), as set out in Note 13 to the financial statements of the Company for the period ended December 31, 2008, which includes this periodic report. The lenders, the Company and the banks agreed that in the event of exercise of the Company's guarantee to the banks (see section 5.13.5 above), the lenders shall be entitled (each pro rata their share) to a proportionate share of the exercise receipts, at the rate set out in the agreements.

5.17 Joint Venture Agreements

- 5.17.1** For further information relating to joint ventures with the Company regarding acquisition and marketing of internet connection infrastructure see section 5.6.5 G above.
- 5.17.2** In 2008 DBS and Bezeq International Ltd. decided to terminate their joint venture for the supply of a services package that includes multi-channel television services (supplied by DBS), internet infrastructure connection and internet access services (supplied by Bezeq International Ltd.). The joint venture operates under the brand name yes-Wow! Termination of the joint venture is expected to take effect by the end of 2009.
- 5.17.3** Under the venture, each party bears its own expenses (i.e. Bezeq International Ltd. regarding all matters relating to internet access services and DBS regarding all matters relating to multi-channel television services).
- 5.17.4** For the joint venture between DBS and Walla! Communications Ltd. with respect to the website, see section 5.2 above.

²⁷ DBS is not a party to this agreement.

²⁸ Gilat DBS Ltd. did not sign this agreement, however did not dispute it and signed at a later stage on an amendment to this agreement.

5.18 Legal Proceedings

- 5.18.1** On November 6, 2006, a claim and application for certification as a class action was filed against DBS, alleging that DBS did not refund the full amount of the deposit due to the applicant and other subscribers who chose to terminate their agreement with DBS. The deposit was paid to DBS as collateral for terminal equipment loaned to the subscribers. The applicant did not specify the total amount of the damage to the members of the group, alleging that this information is available to DBS, and she estimates that the cumulative damage to all members of the group is over NIS 16 million.
- 5.18.2** On January 5, 2005, DBS filed a claim in the Local Court at Tel Aviv against a company and two of its subscribers following information that it had received that the broadcasts of channels 5+ and Tchelet, originally produced by it, were being transmitted on the internal cable network of the town of Efrata in Judea, and were being received in all of the homes of that town that were connected to such cable network. Investigations by DBS showed that the channels' transmissions were being received via two decoders which contained DBS smart cards, and that those decoders were decoders that had been given to the defendants. It also became apparent that transmission of the broadcasts of the channels in the town was being performed via the broadcast center operated by the defendants in the town. DBS demanded to charge the defendants to pay compensation in the sum of NIS 2,000,000 for filing fee purposes, and in addition, DBS petitioned for a declaratory order to the effect that the defendants had breached DBS's rights under the Copyright Ordinance. Since liquidation orders and receivership orders were issued against the two defendants in the file, and in light of information regarding the poor financial situation of the remaining defendant in the file, DBS decided to withdraw the claim. On August 9, 2006, DBS filed a debt claim in the sum of NIS 27,200,000 to the Official Receiver for the debt of one of the defendants. On July 19, 2007, DBS submitted closing statements in the debt claim to the special manager appointed by the Official Receiver.
- 5.18.3** On December 3, 2002, a claim and application for certification as a class action was filed with the District Court against DBS, the Cable and Satellite Broadcasts Council and the Ministry of Communications with respect to the broadcasts of the sports channel 5+. According to the applicants, the broadcast of channel 5+ contravenes the conditions set out in the Council's approval of broadcast of it, and divest channel 5 of content, in contravention of the provisions of these conditions. On November 9, 2006, a settlement was signed between the plaintiffs and DBS, under which DBS undertook to broadcast various sports transmissions as part of Channel 5, for one full season of the relevant sporting areas, during the years 2006/2007, and other sporting areas during 2007/2008. The settlement was filed with the court on November 11, 2006. This is subsequent to a similar settlement signed between the plaintiffs and the cable company. Subsequent to the opinions submitted by the parties, on February 28, 2007, the ruling of the court was published to the effect that the value of the benefit was assessed at \$ 10 million and costs were ruled to counsel for the plaintiff in the amount of NIS 2.5 million, and remuneration to the plaintiffs in the sum of NIS 400,000. DBS and the cable companies decided that the division between the parties would be 30-70%, and accordingly, on April 26, 2007, DBS's share (30% of the total sum) was transferred to counsel for the class plaintiffs. On April 16, 2007, the class plaintiffs filed an appeal to the Supreme Court against the sum set as remuneration to the plaintiffs, and an application to increase such sum. On May 16, 2007, DBS together with the cable companies filed a counter appeal regarding the valuation of the benefit (and accordingly, regarding the fees of counsel for the plaintiffs), and regarding the plaintiff's remuneration. On February 20, 2008, the court ratified the announcement of the parties in respect of broadcasting alternative content instead of the content described in section 131.1.2 of the settlement agreement of November 9, 2006, however prohibited its broadcast on Channel 5. The parties filed their closing statements for the appeal and counter appeal. The date for the hearing was set for June 17, 2009.
- 5.18.4** On July 11, 2007, an application was filed with the District Court at Tel Aviv to approve the filing of a class action against DBS and against Pizza Meter Co. Ltd., which was later substituted under the amended application of the applicant with Pizza Meter Holdings Ltd. (Pizza Meter) with respect to a campaign by DBS under which subscribers who joined the campaign were entitled to 52 vouchers for a family pizza from Pizza Meter for one year. According to the applicant, in May 2007, there was a change in the policy for exercising these vouchers, mainly in that delivery services were no longer provided, and this made it impossible to use the vouchers, in contravention of the conditions promised to subscribers when they joined the campaign. The applicant seeks to sue DBS on grounds of breach of

contractual obligation, breach of duty of good faith in entering into a contract, unjust enrichment, misleading conduct and unfair trading due to false description. On September 2, 2007, Pizza Meter gave notice to DBS of termination of exercise of the campaign vouchers by it as of September 6, 2007, following transfer of title to and all of the rights in the Pizza Meter brand from Pizza Meter Holdings Ltd. to Pizza Meter Israel – Management (2005) Ltd. DBS contacted all of its customers who had not yet reached the end of the campaign period, offering them compensation, even though it was Pizza Meter that breached the commitment. On December 4, 2007, the applicant filed a revised application for certification. On March 2, 2008, DBS filed its response to the application for certification and on April 27, 2008, the applicant filed the response. In the absence of a response by Pizza Meter, the applicant filed an application for a ruling against Pizza Meter in the absence of a defense.

Closed legal proceedings

- 5.18.5** In December 2006, Eurocom Digital Communications Ltd. (Eurocom Communications) received a deficit demand from the Customs Department for payment of purchase tax and VAT (including linkage differentials, interest and fines) in the amount of NIS 10 million for PVR decoders that DBS purchased from Eurocom and which Eurocom imported for DBS. Smart cards belonging to DBS arrived in the same shipment. In July 2008, Eurocom Communications and DBS signed a settlement agreement with the Customs Department, ending the dispute in relation to the deficit demand.
- 5.18.6** In April 2008, the application for certification as a class action against DBS, filed with the Tel Aviv District Court with regard to the disruptions in DBS broadcasts which occurred in September 2007 was dismissed following an understanding reached with another application for certification as a class action regarding the conduct of the proceedings filed by him alone, as described in Note 17 A (44) to the Company's financial statements for the year ended December 31, 2008, included in this periodic report.
- 5.18.7** In February 2008, DBS signed a settlement agreement with HLL to terminate the arbitration procedure between the parties in relation to the amount of monthly payment due to HLL for leasing space segments on the Amos 2 satellite under the agreement between the parties (see section 5.16.2 above).

For additional details regarding the legal proceedings, see Note 17 to the company's financial statements for the year ended 31 December 2008, which are included in this periodic report.

5.19 Goals and Business Strategy

- 5.19.1** DBS's goals are to continue the trend of increasing DBS's revenues, by continuing a gradual increase in the number of DBS subscribers, and by continuing the increase in average revenue per subscriber (ARPU).
- 5.19.2** In order to achieve these goals, DBS intends to invest considerable efforts in the field of marketing and sales and in appropriate marketing strategies, which are intended for the continued recruitment of subscribers, via DBS's sales system, to continue its efforts to create differentiation and innovation in the content of its broadcasts and increasing such compared with those of the cable company and by increasing the content purchased by each subscriber; to continue expanding DBS's added value services, and to continue investing in customer services and in retention of existing customers and to increase revenues from them. These efforts include DBS's striving to increase penetration of PVR decoders among its subscribers so as to increase DBS's revenues and its subscribers' loyalty to DBS's services, and to obtain the required permits for marketing a total service package alongside television services and internet browsing packages together with telephony services. DBS is working on launching VOD services.
- 5.19.3** DBS's goals with respect to increasing the number of subscribers and the ARPU are based on forecasts by management of DBS, based on the current trend in the broadcast market and on DBS's presumptions regarding competition in the field of broadcasts and regulations, which apply and which shall apply to DBS's operations and the restrictions imposed upon DBS and its operations, taking into account the restrictions applying to and that shall apply to the Company, which affect DBS. However, the forecasts of management of DBS might not come to fruition due to changes in demand in the broadcast market, due

to increased competition in this field, due to the entry of additional entities into the broadcasting field or alternative fields and due to regulatory restrictions imposed or which might be imposed on DBS or on its joint ventures with the Company (see section 5.6.5 above). Realization of DBS's goals with respect to the marketing of services packages as aforesaid are also dependent upon obtaining the statutory and regulatory consents required for such purpose (see section 5.6.5 above). With respect to the launch of the VOD services, these are dependent upon the availability of the types of decoders via which this service can be received (see section 5.4 above). Increasing the penetration rates of PVRs depends also on the availability of such decoders and the dates of supply of them by the manufacturer.

5.20 Risk Factors

The following are the threats, weaknesses and risk factors of DBS (the Risks) deriving from its general environment, from the industry and from the special nature of its operations. It should be emphasized that the risks set out below are rated according to various levels of reasonableness of occurrence, and the reasonableness of the occurrence of some of them, in DBS's assessment, would be very low. However, each risk has an effect irrespective of the reasonableness of its coming about.

5.20.1 Macro risks

5.20.1.1 Financial risks – a substantial part of DBS' expenses and investments are linked to fluctuations in the exchange rate of the US dollar. Therefore, strong fluctuations in the exchange rate will have a substantial effect on the business results of DBS. In addition, loans taken out by DBS from banks, from its shareholders and from institutional entities are partly linked to the consumer price index and therefore sharp rises in inflation might have a substantial affect on DBS's business results.

5.20.1.2 Recession – an economic recession, increase in unemployment rates and a decrease in disposable income might bring about a decrease in the number of DBS' subscribers, a decrease in DBS' revenues and harm to its business results.

The current economic recession, which includes, inter alia, by increased unemployment and reduced available income, together with the accelerated competition, is liable to lead to the aforesaid damages. Furthermore, if the economic slump leads to harming the operations or termination of the operations of significant suppliers, it is possible that this will have a negative impact on DBS's operations.

5.20.1.3 Security situation – a continued unstable security situation in most of Israel, which disrupts the day-to-day lives of residents, might bring about a downturn in DBS's business results.

5.20.2 Sector risks

5.20.2.1 Dependence on licenses – DBS provides multi-channel television broadcasts in accordance with a broadcast license and via other licenses. Breach of the provisions of the licenses as well as the provisions of the law under which the licenses are issued, are likely to bring about, subject to the conditions set out for such in the licenses, the cancellation amendment or suspension of the licenses and as a result of such, substantial harm to DBS's ability to continue operating in the field, and to imposition of monetary sanctions on DBS.

5.20.2.2 Changes in regulation – DBS's operations and broadcasts are subject to a licensing system, oversight and approvals from various regulatory bodies, and consequently DBS is likely to be influenced and restricted by considerations of the policy dictated by these entities and by changes in communications legislation; the content of DBS's broadcasts is subject to special legislative arrangements, to supervision by the Council and to the obtaining of consents from the Council and the Ministry of Communications. A very high level of regulatory intervention and changes in regulation have an effect on DBS's operations and could substantially harm its financial results.

5.20.2.3 Strong competition – the field of broadcasts is characterized by a very high penetration rate and very strong competition, which requires DBS to

constantly and continually investing in recruiting and retaining customers; and dealing with high transfer rates of customers between DBS and the cable company. The offer of a bundle of services containing multi-channel television, internet and telephony, which are not offered in this format by DBS, also increases the ability of the cable company to compete. Non-provision of VOD services by DBS when the cable company does offer such services to its customers also harms DBS's ability to compete. For further information regarding potential new competitors and alternative services to the broadcasting market see section 5.6 above.

- 5.20.2.4 Development of new technology – there is a risk in the development of new technology which will prevail over existing technology and turn the existing technology into old technology, and as a result a need for large monetary investments in order to retain competitive standing or alternatively in the event of development of new technologies that enable entry into the field of multi-channel broadcasts without making heavy financial investments, the entry barriers into the field might be lowered and this will constitute a threat to DBS's competitive status. For IPTV technology see section 5.1.4.2 above.
- 5.20.2.5 Setting up alternative infrastructure to that of multi-channel broadcasts – amendments to legislation and regulations might enable the setting up of infrastructure or systems for provision of television services that might constitute a substitute for DBS's services and harming its financial results. For the terrestrial distribution system see section 5.1.3.1 above. For digital radio broadcasts see section 5.1.1 above.
- 5.20.2.6 Types of payments and supervision of tariffs – DBS's license provides the kinds of payments that DBS is permitted to collect. In addition, the Council has the power not to approve amendments to the price list or campaigns or discounts initiated by DBS. These restrictions affect DBS's ability to conduct its own commercial prices policy.
- 5.20.2.7 Piracy – DBS is exposed to attempted pirated connection by viewers wishing to receive DBS broadcasts without paying a subscription fee. DBS assesses this phenomenon as being marginal only.
- 5.20.2.8 Exposure to claims regarding broadcast of content that breaches legal provisions – DBS is exposed to claims regarding broadcast of content that breaches legal provisions, including breach of intellectual property rights, damage to privacy, damage to good name, broadcast of prohibited content, etc. Its agreements with content suppliers and program producers usually include an undertaking by the supplier / producer to indemnify DBS in the event of contact that infringes the provisions of the agreement and the law.

5.20.3 Special risks to DBS

- 5.20.3.1 Need for receiving approval from financing banks for the performance of operations by DBS – the doing of operations and certain proceedings are dependent upon the receipt of the prior consent of the banks. This restriction might hinder DBS's operations.
- 5.20.3.2 Exposure to the provision of immediately repayable credit as a result of non-compliance with loan agreements – failure by DBS to comply with the provisions of the financing agreement or with the provisions of the deed of trust signed with the trustee for the debenture holders might, in accordance with and subject to the provisions of each of the aforesaid agreements respectively, give the relevant lenders grounds for making all of the credit provided to DBS immediately repayable and the exercise of the securities provided by DBS and its shareholders to the banks. Exercise of such securities by the banks constitutes grounds for making the debentures immediately repayable, however, making the debentures immediately repayable constitutes grounds for making the bank credit immediately repayable.
- 5.20.3.3 Restrictions that are the result of the ownership structure – restrictions imposed upon the Company restrict it from providing sources of finance to DBS and from cooperating for the purpose of offering a communications service bundle. These

restrictions substantially affect DBS's commercial situation and its ability to compete – see sections 5.1.2 and 5.1.3.7 above.

- 5.20.3.4 Maintenance of sufficient cash flow – DBS is required to maintain cash flows sufficient for compliance with its business plan and with payment of the credit that it took. Failure to pay such credit on time constitutes grounds for making the bank credit and debentures immediately repayable in accordance with and subject to the provisions and restrictions of the financing agreement and the deed of trust, accordingly.
- 5.20.3.5 Malfunction and damage to satellite – DBS broadcasts through space segments on the Amos 1 and Amos 2 satellites stationed in identical points in space. Operational malfunction or damage to one of the satellites is liable to disrupt and reduce the scope of DBS broadcasts, and such disruption and reductions are expected to be more significant in the event of a failure on Amos 2 satellite. Nonetheless, the duplication of the satellites by means of which broadcasts are transmitted to subscribers enables a significant reduction of the risk entailed by damage to one of them, and improves the survival ability of the broadcast. If there is a malfunction in one of the satellites, it will be possible to move most of the channels broadcast by DBS via the existing space segments on the other satellite, and perhaps even via additional segments on the satellite that might be made available for DBS's use, but not all the channels broadcast. DBS has no insurance for loss of revenues caused due to satellite malfunction.
- 5.20.3.6 Dependence on the holders of rights in space segments – DBS is very substantially dependent upon HLL as the exclusive holder of rights and the sole supplier of space segments used by DBS.
- 5.20.3.7 Dependence on software, equipment, content, infrastructure and service providers – DBS is dependent upon certain software, equipment, content and services providers, including broadcast distribution services, and failure to receive the products or services provided by them might harm DBS's ability to function or its rate of growth.
- 5.20.3.8 Dependence on use of internal wiring – DBS depends on the use of internal wiring in some of the subscriber homes, which is owned by the cable companies, and the use of which is effected in accordance with the administrative order. As set out in section 5.15.3 above, in 2005, the Ministry of Communications gave notice that it was considering canceling the administrative order. If the administrative order is cancelled, without an appropriate alternative arrangement enabling one supplier to make use of the infrastructure of the other in subscriber homes, this will constitute a substantial barrier to the recruitment of subscribers to DBS.
- 5.20.3.9 Harm to broadcast centers – harm to a broadcast center might cause a significant difficulty for continued broadcasts, however, the splitting of broadcasts into two broadcast centers (Kfar Saba and Reem Junction) significantly reduces the risk involved in harm to one of them and improves the possibility that most of the broadcasts will survive. In the event of damage to one of the broadcasting centers, DBS can continue broadcasting the primary channels from another broadcasting center (while the Kfar Saba center is able to broadcast the greatest number of channels). All the broadcasting centers have the identical encryption system and therefore, backup is also available for the encryption system in the event of damage to one of the broadcasting centers.
- DBS's assessment as set out in this paragraph is forward-looking information. This assessment is based on the provision of back-up services from the supplier with whom DBS has contracted, in the event of harm to the broadcast center at Kfar Saba. This assessment might not be realized or might be partially realized or otherwise, if DBS is not permitted to receive such back-up services.
- 5.20.3.10 Malfunction of DBS computer systems – a significant malfunction in DBS central computer systems is liable to harm its operational capacity. DBS has a remote backup site which is intended for activation and provision of partial computer services within a few hours in the event of malfunction, and however, certain

DBS operational capacities will not be able to be executed without the proper running of the central computer systems.

- 5.20.3.11 Technical inferiority and the inability to offer combined services – DBS's technology is technically inferior to that of its competitors. This technical inferiority prevents DBS from providing telephony services, internet and various interactive services, including VOD, over its infrastructure, and requires it to purchase these services or to enter into joint venture agreements in order to provide such services to its customers.
- 5.20.3.12 Inability to offer a combined analog and digital package – DBS provides its customers with digital decoders only, whilst the cable company can provide both analog and digital decoders. The offer of two kinds of decoders makes the cost of equipment cheaper for subscribers, and improves the cable company's ability to compete.
- 5.20.3.13 Defects in the encryption system – DBS's broadcasts are based on the encryption of broadcasts transmitted via satellites and encoded via smart cards that are installed in the decoders in subscribers' homes. Defects in the encryption system or breach of it might enable broadcasts to be viewed without payment being made to DBS, thereby causing a reduction in revenues and a breach of the agreements between DBS and its content suppliers.
- 5.20.3.14 Exposure due to broadcast of channels without an agreement – DBS broadcasts approximately 10 channels to its subscribers which are broadcast from their broadcast origin as unencrypted satellite broadcasts, and which can be received in Israel (even without a decoder) without any agreement with the owners of the broadcast rights. DBS makes an effort to regulate contracts with owners of broadcasting rights.
- 5.20.3.15 Exposure to class actions – given the large number of its subscribers, DBS is exposed to class actions and the more subscribers, the greater the exposure to class actions in significant sums. For applications pending against DBS for approval of claims as class actions see section 5.18 above.
- 5.20.3.16 Compliance with conditions and instructions of the Ministry of the Environment regarding the broadcast center – in the event of failure to comply with the conditions and instructions of the Ministry of the Environment with respect to the broadcast center, DBS is exposed to the sanctions set out in the law.
- 5.20.3.17 Secondary allocation of frequency range – the frequency range used by DBS to transmit its broadcasts from the broadcast satellites to the satellite dishes installed at subscribers' homes, and allocated in accordance with a license by the Ministry of Communications is defined as the frequency range allocated under secondary allocation, such that there is an Israeli entity which is permitted to make primary authorized use of the frequency range. If the owner of the primary allocation uses the frequency range on an ongoing and significant basis, disruptions may occur to the quality and/or availability of DBS's broadcasts to its subscribers which might cause harm to the financial results of DBS. As at the date of this report, to the best of DBS's knowledge, the owner of the primary allocation has not made use of these frequencies in such a way as to cause significant and/or ongoing disruptions to DBS's broadcasts. Since DBS's broadcasts are wireless transmissions from the broadcast satellites on which DBS leases space segments, to the satellite dishes in subscribers' homes, the broadcast of wireless signals in the same frequency range might cause disruptions to the quality and/or availability of the broadcasts provided by DBS to its subscribers and harm to its financial results.
- 5.20.3.18 Disturbances to broadcasts – since DBS's broadcasts are wireless transmissions from broadcast centers to broadcast satellites and from those to the reception dishes in subscriber homes, the broadcast of wireless signals in the same frequency range, and extreme weather conditions of heavy rain, hail or snow, might cause disruptions to the quality and/or availability of the broadcasts provided by DBS to its subscribers and may cause harm to its financial results.

During the period September 5 to October 9 2007, non-continuous disruptions were found in DBS's broadcasts, which occurred at various strengths and scope and which caused disruptions to the quality and availability of DBS's broadcasts, mainly in the north of the country and along the coast. To the best of DBS's knowledge, and as it was informed by government entities following the actions taken to locate the problem, the source of the disruptions was an external element which executed broadcasting activities in the range of frequencies in which DBS transmits its broadcasts.

In this regard, in October 2007, the government decided to appoint an inter-ministerial team to examine all of the aspects and issues arising with respect to said disruptions, and in broader contexts as well. As of the date of this report, the team's conclusions have not yet been published.

Despite the fact that the disruptions to its broadcasts had been caused by external entities and not by DBS's own act or omission, DBS had opened all of the channels marketed by it (with the exception of erotic channels and pay per view movie channels) to all of its subscribers for free, for a period of three months from the middle of October 2007 until January 15, 2008, and subscribers who, under their contracts, pay a separate fee to purchase "premium" channels will be credited for such payment. This compensation and the other expenses and damages caused to DBS with respect to these disruptions caused harm to DBS's financial results.

5.20.4 The following table sets out the risk factors based on their nature and ranking according their effect in the opinion of DBS's board of management. Note that DBS's assessments below regarding the level of exposure of DBS to a risk factor reflects the level of impact of such risk factor presuming realization of the risk factor, and this shall not amount to an assessment nor shall it give any weighting to the chances of the realization of such factor. Likewise, the order of appearance of the risk factors above and below is not necessarily based on the risk involved in each risk factor, or the probability of its occurrence:

	Level of Effect		
	Major	Moderate	Minor
Macro risk			
Financial risks		X	
Security situation			X
Recession			X
Sector risk			
Dependence on licenses		X	
Changes in regulation	X		
Fierce competition	X		
Development of new technology	X		
Tariff control			X
Piracy			X
Exposure to claims for broadcasting infringing content			X
Specific risk			
Need for approval for company operations from financing banks			X
Exposure to bank credit becoming immediately repayable due to non compliance with financing agreements		X	
Restrictions due to structure of ownership	X		
Need for sufficient cash flows	X		
Satellite malfunction and damage	X		
Dependence upon space segment supplier	X		
Dependence on suppliers of content, equipment and infrastructure	X		
Dependence on suppliers of essential content		X	
Damage to broadcast centers	X		
Malfunction of computer systems			X
Technical inferiority and inability to offer combined services		X	

	Level of Effect		
	Major	Moderate	Minor
Inability to offer combined analog and digital packages			X
Encryption system	X		
Exposure regarding broadcast of channels without agreement			X
Stamp duty			X
Legal Proceedings		X	
Compliance with environmental restrictions			X
Secondary allocation of frequencies			X
Disruptions of broadcasts	X		

Date

Bezeq – The Israel Telecommunication Corp. Ltd

Names and titles of signatories:

Shlomo Rodav, Chairman of the Board

Avi Gabbay, CEO