

March 10, 2008



# **Bezeq The Israel Telecommunication Corp. Ltd.**

## **Annual Report for 2007\***

**Chapter A: Description of Corporation's Operations**

**Chapter B: Directors Report on the State of the Company's Affairs**

**Chapter C: Financial Statements**

**Chapter D: Additional Details About the Corporation**

The information contained in this annual report constitutes a translation of the annual report published by the Company. The Hebrew version was submitted by the Company to the relevant authorities pursuant to Israeli law, and represents the binding version and the only one having legal effect. This translation was prepared for convenience purposes only.

\* The annual report was prepared in accordance with the Securities Regulations (Periodic and immediate reports), 5730-1970

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**Chapter B – Directors' Report on the State of the Company's Affairs**

**Chapter C – Financial Statements (Restated)**

**Chapter D – Additional Details About the Corporation**



## Chapter A – Description of Corporation’s Operations

In this report, which contains a description of the Corporation’s business operations as at December 31, 2007, the Corporation included forward-looking information, as defined in the Securities Law 5728-1968 (hereinafter: the “Securities Law”) with respect to both itself and the market. 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 Corporation’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 Corporation’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 Corporation, 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 Corporation’s operations, as set out in this report.

“Bezeq” – The Israel Telecommunications Corp. 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”.

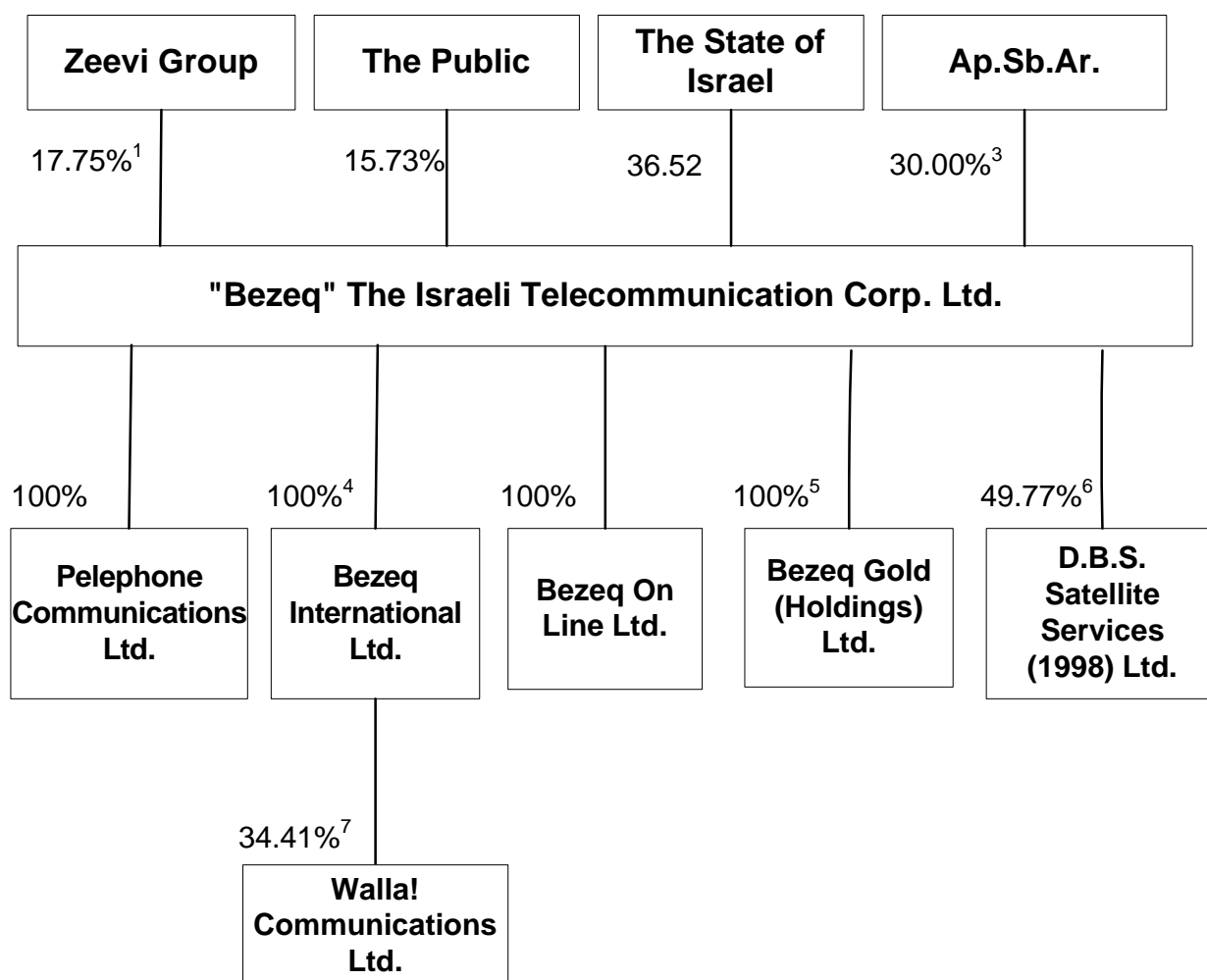
Since the financial statements of the Company for 2006, the Corporation has been reporting in accordance with international accounting standards (IFRS). The date of transition to IFRS was prescribed for January 1, 2005, and as a result, the Corporation has restated its financial statements for 2005 once again, these having been reported in the past in accordance with the accounting rules employed in Israel.

### **1. Description of General Development of Group Operations**

#### **1.1 Group Activity and Description of its Business Development**

- 1.1.1 As of the date of this periodic report, The Bezeq Group is the principal provider of communications services in the State of Israel. The Bezeq Group implements and provides a broad range of telecommunications operations and services, including fixed-line domestic services, cellular services, international communications services, transmission to the public of satellite multi-channel television broadcasts, internet access services, customer call centers, maintenance and development of communications infrastructures, provision of communications services to other communications providers, satellite services, transmission to the public of television and radio broadcasts, provision of services and maintenance of equipment on customer premises (network end point – NEP – services).
- 1.1.2 Both in the global markets and in Israel, the pace of development in the telecommunications sector is rapid. The telecommunications arena 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 is a public company, the shares in which are traded on the Tel Aviv Stock Exchange.
- 1.1.4 As of October 11, 2005, the holder of control of the Company is Ap. Sab. Ar. Holdings Ltd. (hereinafter: “**Ap. Sab. Ar.**”) which holds 30% of the shares in the Company, as well as an option to purchase up to 10.66% of the shares in the Company that are held by the State.

The following is a chart of the structure of shareholdings of the Company, and of the Company's shareholdings of its principle subsidiaries and affiliates, as at the date of publication of this period report:



<sup>1</sup> 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.

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

<sup>3</sup> The shareholders in Ap. Sab. Ar. are: 1. SCG Israel Ventures LLC (capital 45%, voting 40.5%) which is 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.

<sup>4</sup> The operations of the Goldnet Communications Services partnership have been transferred to Bezeq International Ltd. BezeqCall Communications Ltd. has also been merged into Bezeq International Ltd. See sections 1.1.5 and 1.1.6 below.

<sup>5</sup> A company whose only activity is to hold series 5 debentures of the Company (see section 2.13.7 and 2.17.1 below).

<sup>6</sup> 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).

<sup>7</sup> 34.41% as at December 31, 2007 and 33.66% under full dilution. In addition, Walla! approved a plan to issue options to employees. Presuming full exercise of the options, the exercise shares shall constitute approximately 3.71% of the issued and paid-up share capital of Walla! and Bezeq International holdings in Walla! will be 32.41% under full dilution.

The Company's holdings 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 with 122,697,648 options, exercisable for 122,697,648 shares of the Company held by the State. Under an employee option plan (apart from members of senior management), the Company allotted 78,151,368 options, convertible into 78,151,368 shares of the Company<sup>8</sup>, and as part of an issue of options to managers and senior employees of the Group - 40,100,000 options convertible into 40,100,000 shares of the Company<sup>9</sup>.

The following are details of the rates of holdings of the Company under full dilution, presuming exercise of all of the options issued as set out above, and presuming exercise of Ap. Sab. Ar.'s option to purchase approximately 10.66% of the State's shares in the Company as set out in section 1.3 below:

Shareholders	Percentage holdings as at March 26, 2008	Percentage holdings (fully diluted)
Ap. Sab. Ar.	30.00%	38.89%
State of Israel	15.73%	0.97%
Zeevi Group	17.75%	16.98%
The Public	36.52%	43.16%

### 1.1.5 Mergers and Acquisitions

#### A. DBS Satellite Services (1998) Ltd. (hereinafter: "DBS")

On January 2, 2005, the Antitrust Commissioner conditionally approved the merger between the Company and DBS (increase of the Company's holdings in DBS to more than 50%). The merger did not take place within a year of the date of its approval, and required a new consent. On August 2, 2006, the Company and DBS submitted new merger notices to the Antitrust Commissioner (the "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 approximately 49.8% to approximately 58%. On December 31, 2006, the Antitrust Commission gave notice of the Antitrust Commissioner's objection to the merger and on February 18, 2007, the grounds for such objection were given. On May 15, 2007, the Company filed an appeal against the Antitrust Commissioner's decision to object to the merger with DBS. As at the date of publication of this periodic report, the appeal is before the Antitrust Tribunal. With respect to the Company's investment in DBS, see also Note 33 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

#### B. Merger of Bezeq International Ltd. and BezeqCall Communications Ltd.

On February 11, 2007, proceedings were completed regarding merger of the operations of the subsidiary BezeqCall Communications Ltd. (network end point operations) and the subsidiary Bezeq International Ltd. (internet, international calls and integration solutions for business), so that the operations of BezeqCall were transferred to Bezeq International.

#### C. Acquisition of Tadiran-Telecom

In April 2007, an agreement signed by BezeqCall Communications Ltd. (prior to its merger with Bezeq International Ltd.) for the acquisition of all of the operations of Tadiran Telecom Communications Services Israel Limited Partnership was rescinded, in light of the decision of the Antitrust Authority not to approve the deal, and the partnership's subsequent notice of its decision to rescind the agreement.

### 1.1.6 Disposals

#### Satellite Communications Operations

The Company is acting to sell its satellite communications operations (Inmersat and BezeqSat).

<sup>8</sup> Of this amount, 59,574 options were allotted to two employee-directors.

<sup>9</sup> On March 10, 2008, the board of directors of the Company approved an issue of 5,600,000 additional options convertible into 5,600,000 shares of the Company to managers and senior employees of the Group. These options have not yet been issued.

## 1.2 Areas of Operation

The Group has four principal areas of operation. These four areas of activity 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, 2007, included in this periodic report):

### 1.2.1 Fixed-line domestic communications

This segment primarily includes the activity performed by the Company as a domestic carrier, including telephony services, internet access services, transmission services and data communications.

### 1.2.2 Mobile 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. (hereinafter: "Pelephone").

### 1.2.3 International communications, internet services and NEP

International communications services, internet access (ISP) services, and NEP services. These operations are done by Bezeq International Ltd. (hereinafter: "Bezeq International"). Bezeq International also holds 34.41% (33.66% fully diluted<sup>10</sup>) of Walla! Communications Ltd., an Israeli company whose shares are registered for trading on the Tel Aviv Stock Exchange, and which deals in the provision of services in the field of internet, and in the activation of internet portals (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 activity is performed by DBS Satellite Services (1998) Ltd. (hereinafter: "DBS").

Note that in the past, the Company's financial statements contained a sector of operations headed "other" which included the operations of the companies BezeqCall Communications Ltd., which dealt with NEP services, the Goldnet Communications Services Partnership, which dealt with content services for the commercial sector, and Bezeq Online Ltd., which deals with call center services. Due to the merger of BezeqCall Communications' operations (see section 1.1.5 above) and Goldnet into Bezeq International, as of these financial statements, the "other" sector" in the financial statements of the Company mainly includes customer call center services (via the subsidiary Bezeq Online Ltd.), and investment in a venture capital fund. This sector is not substantial, at the Group level.

## 1.3 Investments in Equity and Stock Transactions

1.3.1 In 2005, the State of Israel completed proceedings for the sale of its control core of the Company to Ap. Sab. Ar. In this context, the State sold Ap. Sab. 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. Sab. Ar. options to purchase an additional 10.66% of the share capital of the Company exercisable until the first business day falling at the end of 48 months after October 11, 2005 (the date of completion of acquisition of the Company's shares). As the Company has been informed, under the agreement between the State and Ap. Sab. Ar., Ap. Sab. Ar. shall be entitled to request that the State vote together with it (under the limitations set out in the agreement regarding certain matters) in respect of the 10.66% of the shares in the Company held by the State in respect of which Ap. Sab. Ar. has an option to purchase, and in respect of the 1.01% that will remain in the State's possession during the period commencing on October 11, 2005 (the date of completion of the transaction) and ending at the end of the option exercise period, and in respect of the 4.71% of the Company's shares held by the State and designated for allotment to employees of the Company (see section 2.9.6 below) – for such period or until transfer of title to such shares to the Company's employees, whichever is the earlier.

Note that Ap. Sab. Ar. has undertaken to the Company that during the period of four years following the date of execution of the new collective agreement of December 5, 2006 (see

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<sup>10</sup> See footnote 7 above.



sections 2.9.1 and 17.4(f) below), Ap. Sab. Ar. will not purchase shares in the Company as a result of which purchase Ap. Sab. Ar. shall have a holding of more than ninety percent 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 plan, there are three plans for options for shares of the Company:

- A. An employee option plan of 2005, under 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, under which the Company allotted 78,151,368 options for shares of the Company to its employees.
- C. An option 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 of its affiliates (the general meeting's approval of issue of the options under this plan was given on January 31, 2008). Of this sum, as at the date of this periodic report, 40,100,000 options were allotted.

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

## 1.4 **Payment of dividends**

1.4.1 In 2004 and 2005, the Company did not distribute a dividend to its shareholders.

1.4.2 Pursuant to a resolution of the board of directors dated 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. This resolution substitutes previous resolutions regarding dividend policy.

1.4.3 Below are details of distributions made by the Company during 2006-2007 and up to the date of publication of this Periodic Report:

<b>Date of distribution</b>	<b>Type of distribution</b>	<b>Total amount distributed (NIS millions)</b>	<b>Distributed amount per share (NIS)</b>
16.4.2006	Cash dividend	1200	0.4606446
30.10.2006	Cash dividend	400	0.1535482
9.1.2007	Cash dividend	300	0.1151612
26.2.2007	Cash dividend <sup>11</sup>	1800	0.6909668
15.10.2007	Cash dividend	760	0.2917415

In addition, on March 10, 2008, the board of directors of the Company resolved to recommend that the general meeting of shareholders of the Company pay a cash dividend to the shareholders in the total sum of NIS 679 million (constituting NIS 0.260648 per share).

### 1.4.4 **Distribution of a cash dividend not in accordance with the earnings test**

On December 28, 2006, the general meeting of the shareholders of the Company 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 distribution was subject to the approval of the court, and on December 31, 2006, the Company filed an application in court for approval of the distribution. The court approved the distribution on February 4, 2007, and the distribution was made on February 26, 2007.

1.4.5 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 and not to make a distribution which was not from the accumulated retained earnings of the Company on December 31, 2000 (it was clarified that this would not prevent the distribution of earnings generated after December 31, 2000 in accordance with

<sup>11</sup> Distribution of a cash dividend not in accordance with the earnings test. See section 1.4.4 below.

the Companies Law, 5759-1999). Ap.Sb.Ar. also undertook to operate by virtue of its holdings so that a distribution would not be made from the capital gains deriving from the realization of capital assets paid for in kind, for a period of two years from the date of purchase of the shares being sold (this period ended on October 10, 2007).

## 1.5 Financial Information regarding Areas of Group's Operations

### 1.5.1 2007:

	Domestic fixed-line communication	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 Revenues:							
From externals	5,373	4,380	1,226	1,402	19		12,400
From other areas of corporation's operations	340	304	78	12	46	(780)	
<b>Total</b>	5,713	4,684	1,304	1,414	65	(780)	12,400
Total attributed costs:							
Costs not constituting revenues in another area of operation	4,102	3,712	961	1,225	64		10,064
Costs constituting revenues from other areas of operation	332	168	140	139	1	(780)	
<b>Total</b>	4,434	3,880	1,101	1,364	65	(780)	10,064
Operating profit	1,279	804	203	50	-		2,336
Total identified assets as at December 31, 2007	7,769	4,290	628	1,097	59	229	14,072
Minority percentage in the segment					17.5%		

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

1.5.2 2006:

	Domestic fixed-line communication	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 Revenues:							
From externals	5,514	4,141	1,219	1,339	19		12,232
From other areas of corporation's operations	285	337	82	23	37	(764)	
<b>Total</b>	5,799	4,478	1,301	1,362	56	(764)	12,232
Total attributed costs:							
Costs not constituting revenues in another area of operation	4,689	3,625	1,090	1,209	54		10,667
Costs constituting revenues from other areas of operation	364	161	92	145	2	(764)	
<b>Total</b>	5,053	3,786	1,182	1,354	56	(764)	10,667
Operating profit	746	692	119	8			1,565
Total identified assets as at December 31, 2006	9,837	3,717	631	1,008	47	214	15,454
Minority percentage in the segment							

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

### 1.5.3 Principal results and operational data

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

	2007	2006	2005	Q4 2007	Q3 2007	Q2 2007	Q1 2007	Q4 2006	Q3 2006	Q2 2006	Q1 2006
Revenues	5,713	5,799	5,893	1,453	1,425	1,393	1,442	1,439	1,465	1,440	1,455
Operating profit	1,279	754	919	340	327	243	369	(197)	363	280	308
Depreciation and amortization	941	1,026	1,109	233	236	235	237	251	259	258	258
Investments in plant & equipment and intangibles	504	578		141	149	101	113				
Proceeds of sale of plant & equipment	153	39		23	16	96	18				
Number of active subscriber lines as at the end of the period (thousands)	2,761	2,808	2,848	2,761	2,767	2,778	2,797	2,808	2,813	2,822	2,831
Average monthly revenue per line (NIS)*	84.2	87.0	87.8	83.3	83.6	83.2	86.4	86.2	88.0	86.6	87.3
No. of outgoing usage minutes (millions)	15,254	16,786	18,448	3,738	3,849	3,753	3,914	4,005	4,257	4,202	4,322
No. of incoming usage minutes (millions)	4,426**	3,715	3,051	1,164	1,149	1,069	1,045	990	967	890	868
Number of ADSL subscribers as at the end of the period (thousands)	963	892	800	963	942	924	912	892	867	844	827
Average monthly revenue per ADSL subscriber (NIS)	58.0	57.0	58.6	58.1	58.5	58.1	57.4	57.0	56.6	56.8	57.7

\* Not including revenues from transmission and data communications services, services to communications carriers, contract work and other.

\*\* Most of the increase in incoming minutes flows from an increase in traffic minutes from domestic fixed-line communications providers in competition with Bezeq.

B. Pelephone (NIS millions except where stated)

	2007	2006	2005	Q4 2007	Q3 2007	Q2 2007	Q1 2007	Q4 2006	Q3 2006	Q2 2006	Q1 2006
Revenues	4,684	4,478	4,428	1,182	1,203	1,152	1,147	1,148	1,144	1,097	1,089
Operating Profit	805	701	591	133	219	240	213	157	171	198	175
Depreciation and amortization	478	470	438	125	121	115	117	114	116	120	120
EBITDA	1,283	1,171	1,021	258	340	355	330	271	287	318	295
Net profit	585	486	287	104	154	173	154	125	111	124	126
Cash flow from current operations	1,249	1,324	974	252	392	246	359	294	337	408	285
Investments in plant & equipment and intangibles	381	354	556	120	81	117	63	106	65	84	99
Proceeds of sale of plant & equipment	5	8	4	3	-	-	2	4	1	2	1
Number of subscribers at end of period (in thousands)	2,622	2,427	2,287	2,622	2,560	2,513	2,478	2,427	2,366	2,323	2,306
Average use minutes per subscriber per month (MOU)	354	349	338	358	363	350	344	347	357	346	345
Average monthly revenue per subscriber (NIS) (ARPU)	131	138	138	130	135	129	132	136	142	141	136
Number of 3G subscribers at end of period (in thousands)	749	255	60	749	607	471	358	255	146	115	85
% revenues from value added services and content, of revenues from cellular services	12.7%	10.7%	8.6%	13.6%	12.8%	12.5%	12.0%	11.6%	10.9%	10.3%	10.0%

C. Bezeq International (NIS millions except where stated)

	2007	2006	2005	Q4 2007	Q3 2007	Q2 2007	Q1 2007	Q4 2006	Q3 2006	Q2 2006	Q1 2006
Revenues	1,304	1,021	815	333	326	322	323	265	259	255	242
Operating profit	204	132	93	45	54	54	51	25	36	38	33
Depreciation and amortization	87	81	91	21	21	22	23	26	19	16	20
Net profit	153	96	104	38	39	39	37	20	29	29	18
Cash flow from current operations	95	209	188	30	34	32	(1)	72	55	32	50
Investments in plant & equipment and intangibles*	91	55	63	36	29	18	8	14	14	14	13
Proceeds of sale of plant & equipment	4	-	2	2	2	-	-	-	-	-	-

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

D. DBS (NIS millions except where stated)

	2007	2006	2005	Q4 2007	Q3 2007	Q2 2007	Q1 2007	Q4 2006	Q3 2006	Q2 2006	Q1 2006
Revenues	1,415	1,355	1,222	347	360	354	354	345	340	338	332
Operating profit	56	1	(64)	5	(4)	31	24	10	(11)	7	(5)
Depreciation and amortization	273	293	285	70	66	69	68	72	74	74	73
Net profit (loss)	(118)	(320)	(346)	(75)	70	(65)	(48)	(42)	(97)	(97)	(84)
Cash flow from current operations	250	244	137	76	56	25	93	96	27	75	46
Investments in plant & equipment and intangibles*	255	186	259	81	84	45	45	38	39	55	54
Proceeds of sale of plant & equipment	-	-	1	-	-	-	-	-	-	-	-
Number of subscribers as at the end of the period (thousands)	549	540	521	549	545	543	542	540	539	535	528
Average monthly revenue per subscriber (NIS)	217	212	205	212	220	218	218	214	211	212	211

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

Note to all of section 1.5.3: Note that non-substantial adjustments have been effected with respect to some of the data in previous quarters as a result of measurement changes and credits.

## 1.6 Forecast for Group

Based on current commercial conditions, the assessment is that in 2008, the level of the Group's revenues shall remain stable and shall express an ongoing erosion of fixed-line telephony, together with an increase in the other areas of operation. Furthermore, progress is expected in reduction of costs and increase of profit margins. With respect to the Group's investments in plant and equipment, the assessment is that an increase of approximately 50% is expected, mainly as a result of the investment by Pelephone in the next generation of network infrastructure (HSPA).

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

## 1.7 General Environment and Effect of External Factors on Group Activity

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, whilst exhausting 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 members of the Group, and given the increasing competition on the part of the other communications groups, the Group is having difficulty providing appropriate responses to threats stemming from this sort of competitive structure.

## 2. Fixed-Line Domestic Communications –

### “Bezeq” – The Israel Telecommunications Corp. Limited ( “the Company”)

#### 2.1 General Information on Area of Operations

##### 2.1.1 Area of activity and changes affecting it

The Company has a general license for the provision of fixed-line domestic communications services. In this context, the Company provides telephony services; broadband internet access services (ADSL); household networks and dial-up internet service provider access; transmission services; information and data communications services; IP-VPN services; remote access services; maintenance and development of infrastructure; other operations including set-up and operation of broadcast facilities for radio and television transmissions, laying and maintenance of television cables, satellite and video services, sale of terminal equipment, billing and collection services and other services to other communications providers; IP services; Centrex; access services between users and internet service connection providers (ISPs); the rate of development of the communications industry around the world and in the Israeli economy is very fast. The telecommunications arena is affected by changes in technology, in relation to both the business structure of the industry and the applicable regulations.

##### 2.1.2 Legislative and regulatory restrictions and special constraints

The Company's activity is subject to comprehensive regulation and control that relates, *inter alia*, to matters such as determining and approving the fields of the Company's permitted activity and services, holding and transferring of 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 following: the status of the Company as a licensee, according to the Communications (Telecommunications and Broadcasting) Law, 5742-1982 (hereinafter: 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 4D 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, 2007. The Company's interconnect tariffs were reduced as of June 1, 2007 (see section 2.16.1).

The Company was declared a monopoly in certain fields of activity, and is similarly 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 facilities emitting electromagnetic radiation, which are subject, respectively, to the Wireless Telegraph Ordinance (New Version), 5732-1972 (see section 2.16.8 below) and the Non-Ionized Radiation Law, 5766-2005 (see Section 2.15 below).



### **2.1.3 Changes in the volume of activity and profitability in the field**

See section 1.5.3(a) above.

### **2.1.4 Developments in the market and in customer attributes**

In recent years we have seen growing competition between fixed-line and cellular telephony. If in the past almost all calls were made between two fixed lines, today, in the Company's assessment, more than 60% of calls are made over the cellular networks. As the number of cellular subscribers has grown and reached approximately 9 million subscribers (according to data published by the cellular companies), 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). On the development of competition in the domestic fixed-line communications area, see section 2.6 below.

### **2.1.5 Technological changes that significantly impact on the area of operations**

A. Penetration of high speed 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 services, video transmission services and network services with organizational applications over the internet infrastructure (ERP, CRM, etc.).

The Company estimates that in the coming years the trend of increased bandwidth to the customer home or business will intensify. This will facilitate penetration of applications required for the transmission of a high volume of data at a fast rate as well as voice services that will enable regular phone calls over the Internet and/or IP networks. Regarding competition through the provision of telephony over the Company's broadband network, see Section 2.6.1 below. Given this trend, the Company is adapting its infrastructures enabling it to provide its customers with significant bandwidths that guarantee availability and quality of service.

B. The development of standardization in this area makes it possible to use the infrastructure owned by the former cable companies – now HOT Telecom – which is currently in place in order to provide higher quality telephony services than in the past, as an alternative to the telephone line services that the Company provides to its customers.

C. 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 than with existing technologies.

D. In addition, wireless technology is being developed which opens the gateways for providing 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.

E. Technological developments may enable other operators to build infrastructures 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 the area of operations and changes therein**

A. Regulatory decisions

B. The ability to offer reliable communications 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 light of growing competition and technological changes that are expressed 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 of the activity and changes affecting such**

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 the following factors: 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 carriers or carriers intending to compete with the Company.

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 4D of the Communications Law; its obligation to some of its employees as part of collective bargaining agreements; long-term agreements with infrastructure providers; large investments requiring a long time to ROI; and an obligation to repay long-term loans taken to finance the investments.

#### **2.1.8 Alternatives to and changes in products of area of operations**

In recent years cellular communications services have to a large extent become an alternative to services offered by the Company, both in the area of telephony and in the area of data communications.

Recently we have seen a growing trend of transmission of voice calls over the internet or over public and private IP-based networks, using dedicated software that is provided free of charge or at a discounted price by companies in Israel and abroad. Furthermore, the internet enables e-mail applications and instant messaging, which to a certain extent are also alternatives to telephone calls. Recently, international software and internet companies have redoubled their efforts to integrate telephony services as part of the service packages that they provide to their customers.

In the area of transmission and data communications services, technological advances enable the provision of new services at high transmission rates and low prices.

#### **2.1.9 Structure of competition in the areas of operation and changes therein**

Fixed-line domestic services primarily include telephony services, internet access services, transmission services and data communications.

The area of transmission and data communications, particularly at high baud rates, was opened to competition at the end of 2000.

In the area of broadband internet access, 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 the merger of reach was recently concluded (hereinabove and hereinafter: "Hot" or "Hot Telecom") 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 provide services to everyone. On January 31, 2007, a policy was published regarding the provision of telephony services over broadband access services (by the Company and by HOT). With regard to this matter, see Section 2.6.1 below. Additionally, the Company views cellular

telephony services as alternative services to the telephony services it provides. With regard to this matter, see Section 2.6.4 below.

Competition in the sector is dependent on a variety of factors, including: Development of competition with Hot and 012 Telecom Ltd., provision of licenses to other domestic providers, increased competition with cellular companies; 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, and in the recommendations that the Grunau Commission will formulate in the field of communications in Israel, and the manner of adoption and implementation thereof (see section 2.6 below).

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 services, associated services, and value-added services, internet access services – both dial-up and broadband access to high speed internet, transmission and data communications services over a wide variety of infrastructures for businesses and other communications carriers.

### **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, abbreviated 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.

The Company currently operates approximately 12,000 public telephones around the country that are operated by biodegradable prepaid cards ("Telecard"), billing a Bezeqcard or calling collect. Since phone cards are no longer available for purchase, the Company is working towards finding a substitute that will enable it to continue providing the service. In 2005, draft regulations were compiled, designed to ease the obligation of deployment of public telephones, but 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.

On February 8, 2006, the Company license was amended so that, *inter alia*, commencing February 8, 2007, the Company is required to provide, itself or through another entity acting on its behalf, a telephone number information service of whoever is a subscriber of a fixed-line or cellular operator, excluding unlisted numbers, for the general 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 additional to the Company's 144 service.

On October 15, 2007, the Company filed an application to the Antitrust Authority to exempt it from obtaining approval of an agreement in restraint of trade for the arrangement between the Company and the cellular carriers and domestic fixed-line licensees to operate the information service (144), the unified information service for telephone numbers of the Company and other carriers (1344) and the unified website that provides corresponding services. The application was filed for the sake of caution and in light of a letter from the Antitrust Authority dated September 9, 2007, giving notice that the Antitrust Authority viewed the agreement the subject of the application to be an agreement in restraint of trade.

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 due primarily to the telephony services offered by competing domestic communications carriers 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 access services using ADSL technology.

At the end of 2007, the Company had approximately 963,000 ADSL subscribers (compared with approximately 891,000 subscribers at the end of 2006), amounting to approximately 61% 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 1.5.3(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 infrastructures.

On March 5, 2008, the Company received a letter from the Director General of the Ministry of Communications stating that the Ministry had decided, following examination of the Company's position, to amend the Company's service portfolio regarding "high-speed access service via ISP", 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"). The Ministry accepted the Company's position that it be allowed to continue to offer a combined ADSL and telephone subscriber line in the existing format ("ADSL combined") alongside the ADSL only service. Payment for the ADSL only service will be prescribed by the Company, in accordance with section 17 of the Communications Law (which applies to those of the Company's services which are not under tariff supervision). According to the Ministry's resolution, the amended service portfolio will come into force on May 15, 2008. The above decision by the Ministry might have an adverse effect on the Company and on its tariff structure, and this cannot be assessed at this stage.

### **2.2.4 Transmission and data communications services**

Data communications services are network services for the 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 communications services are provided over established traditional infrastructures such as digital and frame relay lines, as well as over innovative and advanced infrastructures including ATM and IPVPN (Virtual Private Network). The IPVPN infrastructure enables managed communications solutions for businesses by connecting the various branches of the organization. In recent years customers have been switching from data communications solutions provided over older traditional infrastructures to IP-based infrastructures.

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

## 2.2.5 Other services

### A. Services to Communications Carriers

The Company provides services to other communications carriers including the following: cellular operators; international operators; cable broadcasting licenses; the Israel Broadcasting Authority and The Second Authority for Television and Radio; network endpoint operators; ISPs; domestic operators; Palestinian communications providers.

Among the services provided by the Company are infrastructure services, connection to the Company's network, transmission services, billing and collection services, *inter alia* to international carriers, rental of space and provision of services at rented space, and provision of rights to use underwater cables.

### B. Satellite and broadcasting services

The Company provides satellite services via fixed antennas (in the Ella Valley and the Ramla area), mainly including services for international communications: video transmission services and satellite relay broadcasts for foreign broadcasting organizations in Europe and Asia. The Company also operates mobile units for television broadcasts via satellite from time to time.

Likewise, the Company provides users over a broad geographical area around the world with various kinds of mobile satellite communications services (such as: telephony, data communications and facsimile services) by operating a ground station for the provision of Inmarsat services in the Ella Valley. These services are granted by virtue of an agreement with Inmarsat Ltd. (which operates a satellite network that covers most of the world, land, air and sea). For the Company's intentions with respect to these operations, see section 1.1.6 above.

The Company operates and maintains radio networks operated, *inter alia*, by the Israel Broadcasting Authority, Channel 1's television transmitters and those of Educational Television, Channel 2's television transmitters and the transmitters of regional radio stations. The Company is only responsible for operation and maintenance of the transmitters in order to distribute broadcasts of radio and television programs, and not for the content of the broadcasts. In this regard, see also section 2.15.1 below.

### C. Contract work

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

There are agreements for the provision of installation and maintenance services of cable networks for cable television between the Company and two cable television broadcast licensees which were recently merged using the Company's infrastructure, from the starting point of the above licensees' operating point up to the point of delivery at the entrance to subscriber homes (the connection and maintenance from these points up to the subscribers' homes is not within the Company's responsibility). Note that the merged company, Hot Telecom, has taken upon itself all rights and obligations under these agreements.

### D. IP Centrex

The IP Centrex service is a virtual private exchange service. Pursuant to a letter from the Ministry of Communications, the Company has submitted a service portfolio to the Ministry of Communications with respect to this service, which is provided by it.

### 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 back up and survivability of services. The service that is planned follows a large increase in customer demands for DRP sites (disaster recovery program – a program for continuing work in the event of a disaster), and for real back-up of information at all organization levels. The Data Center site is expected to provide the Company's customers with a variety of solutions, including: hosting the organization's central site, taking into account

requirements of survivability, electricity, airconditioning, etc., back-up of the organization's information on a reliable and protected system so that if necessary, it will be possible to restore the required information, remote back-up of organization information, full DRP for the organization's central site, and storage of the organization's important information at a protected underground site.

## 2.3 Breakdown of Revenues 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:

	2007		2006*	
	NIS millions	% of revenues	NIS millions	% of revenues
Telephony	3,905	68	4,148	72
Internet	712	13	608	10
Transmission and data communications	754	13	711	12
Other services	342	6	332	6
Total	5,713	100	5,799	100

\* reclassified.

## 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 impact on 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 61%) and the business sector (approximately 39%). This division is based on revenues.

## 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, separate technical support centers for internet and IT services, support and repair centers for telephone services (166 center), as well as 17 points of sale and service (the Bezeq Store network) around the country.

**2.5.2** The Company primarily markets its services through advertising in the mass media and telesales centers, customer managers and through a system of independent marketers that includes ISPs, DBS, sales centers working by an outsourcing model, D2D and resale systems that operate points of sale in various shopping centers.

## 2.6 Competition

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

The Grunau Commission for formulating recommendations concerning the policy and principles of competition in communications in Israel

In December 2006, the Minister of Communications appointed a public commission, headed by Professor Grunau, to formulate detailed recommendations concerning the policy and principles of competition in communications in Israel. The amended letter of appointment of the Commission, dated February 2007, stated that the Commission is requested to formulate its recommendations, *inter alia*, on the following important issues: The question of the need for separation between the various sectors of operations (transmission / content), the issue of the operations of consolidated 'communications groups' and the rules of structural separation that apply to the Bezeq Group and others; the marketing of service packages and the flexibility of tariffs for Bezeq; the access of competitors to the infrastructure of licensees (Bezeq, the cable companies and others) whilst

examining various models such as unbundling, convergence between mobile and fixed line communications and voice, video and data services. In addition, provision of broadcasts on communications operator platforms such as ADSL, cable, mobile, WIMAX, either under the IPTV method or using other methods; the scope of the universal service obligations imposed upon communications carriers. Likewise, the letter of appointment further provides that the Commission shall be permitted to extend the list of issues, should it find that such are essential for the formulation of its recommendations.

At the beginning of January 2007, the public was invited to present positions on the subject and to comment on the above. The Commission started its work in February 2007. As at the date of publication of this periodic report, it is expected, to the best of the Company's knowledge, that the Commission will submit its recommendations during the course of March 2008.

The Company's initial position was presented in a document filed with the Commission on April 11, 2007. Note that the Company's positions are developing and changing with time.

The Commission's recommendations, which require the consent of the Minister of Communications, are supposed to relate to those issues that are most substantial to the communications market and the Company, and might generate changes in the rules of competition in place to date. The Company estimates that these recommendations, if approved, might have a substantial adverse affect on the Company, however, it is unable now to assess the trends or consequences that might flow from these.

### **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 broad band internet, telephony and cable television, aimed mainly at households. In addition, HOT markets telephony services to business customers. Pursuant to HOT's reports, its telephony service covers approximately 288,000 cable telephone subscribers, as at the end of Q3, 2007.

The Company petitioned the High Court of Justice against the Minister of Communications, in an application for immediate enforcement on HOT of its obligations and commitments under its license, concerning structural separation.

On November 8, 2007, the Company filed an application with the High Court of Justice to amend the petition 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 December 2, 2007, implementation of the number portability program commenced. Number portability increased the level of competition in the domestic field, and with HOT in particular. In this regard, see also section 2.6.6A below.

Following the adoption of the recommendations of the Kroll Commission, which was appointed to set guidelines for competition in the area of fixed-line telecommunications, and the accompanying legislative amendments, as of September 2004, the Minister was entitled to issue special general licenses for the provision of fixed-line domestic 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 to GlobeCall limited partnership (which was merged with Barak and Netvision), Cellcom Fixed-Line Communications Services limited partnership, O12 Telecom Ltd. and Partner Fixed-Line Communication Solutions. The carriers which received such licenses provide services in accordance with their licenses. The subsidiaries Bezeq International Ltd. and Pelephone Communications Ltd. filed applications for such licenses (see sections 3.7.4 and 4.1.2.2 below).

#### **VOB<sup>12</sup>Service Policy**

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). With respect to DBS, the test point will be set one year

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<sup>12</sup> Voice Over Broadband

after the effective date (February 1, 2007), when the possibility of granting it a VOB license will be examined to see if its competitive status has deteriorated, and noting the situation of the competition in fixed-line domestic telephony.

On the matter of the call termination tariff in the network of a VOB operator, it was determined that it will be the same as the payment for call termination in a public telecommunications network of a fixed-line domestic operator (i.e. the same as the payment which the Company receives for terminating a call in its network), for a period of 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 network end point services. In this context, the policy document notes that the Ministry of Communications intends to adapt the network end point 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 substantially harms the Company and its subsidiaries, and their ability to compete. Implementation of ADSL only (see section 2.2.3 above) will increase the attractiveness of the competitors' VOB services.

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(h) below.

On January 31, 2007, the Ministry issued a directive whereby the Company and HOT are required to allow every special general licensee whose license permits it to provide the service, and every licensee for international telecommunication services whose license permits it to provide international services on broadband, access to the public broadband telecommunications network for providing the service. The directive also states that the Company (and HOT) will not demand additional payment from such special operator or international operator beyond the payment for connecting the ISP to the network, nor additional payment from the subscriber beyond the payment for the high-speed internet service.

## **2.6.2 Broadband internet access**

In the field of broadband internet access, competition has been keen since the cable partnerships (now HOT) began competing with the Company in this area 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 an advanced broadband digital network. Over this network, it is possible to provide a wide range of advanced communications services and advanced interactive applications. This network is currently the main universal alternative for competition against the Company in the private sector.

According to reports by HOT, it currently serves more than 590,000 high-speed cable internet customers.

## **2.6.3 Transmission and data communications**

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 transmission and data communications market.

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



operations of Med-1 as aforesaid shall cause harm to the Company's revenues from the transmission services that it provides to Partner.

#### **2.6.4 Competition from the 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 slow-down 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 15% of Israeli households today do not have a fixed line (compared to approximately 5% in 1996).

Cellcom is operating in 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 fixed-line domestic 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 fixed-line domestic services.

#### **2.6.5 VOD<sup>13</sup> Service Policy**

On March 15, 2007, the Ministry of Communications published the final policy paper on the issue of licensing and regulation of on-demand broadcast services (VOD) under which the Communications Law would be amended so as to permit the award of new licenses for these services; likewise, according to the document, DBS is to be permitted to supply VOD services over the Company's ADSL, under restrictions that shall apply with respect to the Company's infrastructure: the Company will be required to allow a VOD licensee and DBS to use the ADSL infrastructure for providing VOD services on equal terms; the Company will be given usage instructions according to Section 5 of the Communications Law; and payment will be equal and transparent, and will include the cost deriving from connection of the service provider to the network.

In July 2007, an amendment of the Communications Law was passed entitling additional content providers other than HOT to provide the service of supplying 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.

#### **2.6.6 Additional factors that may affect competition**

##### **A. Numbering and number portability**

On December 2, 2007, the number portability program began to be implemented, enabling a transfer of customers between the various communications carriers 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, and gives rise to a significant increase in the number of calls made to the Company's service centers.

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<sup>13</sup> Video On Demand services.

As at the end of February 2008, approximately 55,000 lines were ported away from the Company, the majority transferring to HOT. Number portability increased the churn rate of the Company's telephone and internet lines by approximately 4% calculated annually. The increase in the churn rate is expressed mainly in the private sector, and in lower percentages in the business sector. In the Company's assessment, the increased churn rate is likely to continue, due to increased activity by the competitors, and due to the matter's being on the agenda.

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 G1 of the Communications Law, 5742-1982, due to alleged breach of the duty to provide number portability as of September 1, 2006. The Company, Pelephone and Bezeq International responded to the notices of the Ministry of Communications.

B. Other potential competing infrastructures

In addition to the 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 January 31, 2006, the Ministry of Communications published a request to receive public positions regarding the policy of allocation of frequencies to the wireless access network (WiMAX) by February 28, 2006. According to the Ministry, following applications from existing licenses and commercial entities for allocation of frequencies for the purpose of operating a wireless access system in order to provide a variety of fixed-line communications services, the Ministry is considering amending its policy on allocation of frequencies for the purpose of operating wireless access systems, which will enable the provision of fixed-line communications services. The Company submitted its position, is that there is neither room nor need for the allocation of those frequencies, which are a limited national resource, to operators with special licenses who are not obligated to provide universal service. The Company believes, that due mainly to the essential nature of these frequencies for providing services in periphery areas, the top policy priority for their allocation to wireless access systems should be the universal service and the creation of conditions that will enable it to be provided.

On September 24, 2007, the Ministry of Communications published a hearing regarding the policy for allocating frequencies to broadband wireless access networks. According to the Ministry of Communications document, the Minister of Communications intends to publish a policy for allocation of frequencies for a broadband wireless access network (WiMAX) as set out in the draft policy attached to the document. The Company filed its response to the Ministry of Communications on November 19, 2007 to the effect that preference in allocation should be granted to Bezeq due to the universal service obligation by which it is bound, as well as its ability to provide an immediate and continual service over the required frequencies.

C. Advantages and technological developments

Cellular operators and international telecommunications service providers have an advantage when entering the area of provision of fixed-line domestic telecommunications services, given the existence of exchanges, switching equipment and customer base for telecommunications services.

The Company's assessment that real competition will develop in the market, harming market segments, rests on frequent technological developments and breakthroughs in the various fields of communications. 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, and advanced generation wireless infrastructure.

Another competitive factor is the “Bezeq-bypass networks”. There are two main types of bypass networks: (1) those built on the Company’s infrastructure – mainly PTP lines of various kinds and internet infrastructure; (2) those which use other infrastructure, or redirect traffic to them, mainly various kinds of wireless-cellular networks, microwaves, laser, satellite, and cellular adapters. Systems using a combination of both of these types also exist.

The rapid growth in the number of broadband internet subscribers, improved quality of sound and increasing awareness of use of the internet to make cheaper calls negatively affect the number of calls passing through the Company’s network and are causing a decline in its revenues.

#### **2.6.7 The Company’s preparations for and methods of coping with increasing competition**

The Company is coping with competition in fixed-line domestic 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 its subscribers with advanced services and products.
- B. The Company took action 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 an “IPVPN 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 always working 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 use of the fixed-line telephone and to promote the use of other services which increase telephone use, such as numbering services (1-800), 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 heavier 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 principally 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. After execution of the new collective agreement, the Company is acting in order to implement and assimilate the new organizational structure of the Company (see section 2.9.1 below).
- I. The Company is looking into the method in which it will integrate 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 resolutions in this regard will be passed, inter alia, subject to regulatory policy.

- J. During the course of December 2007, the Company launched a new logo and slogan. Part of this process included connecting the Company to the home using the phrase “Bezeq – the best at home”. This included media advertising, billboards and branding of the Company’s assets.

## 2.6.8 **Positive and negative factors that affect the Company’s competitive status**

### **Positive factors**

- A. National deployment of infrastructure via 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 trained 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 and will continue to impede its ability to compete in its areas of activity as competition increases. 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, though 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.

- 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 were supposed, among other things, to offer an immediate alternative to the normal tariffs) are so tied up in bureaucracy that they are frequently pointless.

- C. Obligation of structural separation

Under its license, the Company must 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. At this stage, the format restrictions that apply to the Company do not apply 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 carrier licensees, which can offer their services to the Company’s profit-bearing customers (particularly business customers), which represent a significant source of revenues for the Company.

The Company believes that a fund should be established to finance this universal service, so that a carrier 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. As noted in the preamble to this section 2.6, in December 2006, the Grunau Commission was set up to formulate recommendations regarding policy and rules of competition in the field of communications in Israel, which is to recommend changes in the above.

#### Labor relations

Labor relations in the Company make flexibility of its operations and its ability to deal with competition more difficult (see also section 2.21(d) below).

#### Competition

The extent to which competition impacts on the Company (including positive implications) and on its revenues is dependent on a variety of factors, including the following: the rate at which competition with HOT and other domestic operators develops; increased competition with cellular operators; carriers providing telephony services over broadband infrastructure; the ability to leverage the synergy between companies in the Group and the flexibility the Company will be given to offer joint packages of services and to determine its tariffs; tariff erosion; approvals for new services, and allowing the Company to implement applications, services and transfer of content enabled via advanced technology (such as: IPTV), combination of fixed-line and mobile services; financing of the universal service; changes in licenses; symmetry in structural separation obligations; implementation of economies of scale; the Company's ability to retain and increase its portion in the various areas in communications; number portability. Competition – the extent to which competition affects the Company depends, as aforesaid, on the recommendations of the Grunau Commission on communications in Israel, and on the manner in which such will be adopted and applied, which the Company is still unable to assess.

## **2.7 Property, Plant & 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 Fixed-line domestic 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 network end points 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.

### 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, management of orders of services, management of follow-up of customer complaints, management of sales and customer service processes, 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 communications carriers. This includes the managing of accounts with communications carriers.

#### 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, financial information (including budget and controls), procurement and inventory processes, property, real estate, human resources and wage controls, vehicle fleet, Company projects, etc.

#### D. Cross-organization 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 (email, resolution follow-ups, etc.), knowledge management systems, etc.

The IT system is made up of hardware (physical infrastructure, computers and various other kinds of equipment) and the information system (software, applications, information systems, etc.). The hardware system includes a central computer, a collection of servers, information storage units, a communications network and a collection of terminal stations which serve all of the Company's units. The information structure, which is made up of a collection of information systems, operates in various computing environments, the components of which are linked in many ways.

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.

### 2.7.4 **Real Estate**

#### A. General

The Company's real estate assets come from two sources: Assets transferred to it 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 1,345,000 m<sup>2</sup> of land, of which approximately 365,000 m<sup>2</sup> is built up. Six of these properties are in Israeli settlements in Judea and Samaria, approximately 7,000 m<sup>2</sup> in area, with a total of approximately 500 m<sup>2</sup> being built up.

In addition, the Company has a right to land of approximately 70,000 m<sup>2</sup> in area at Sakia (near Messubim Junction), for the purposes of storage and offices. Recently, a draft contract permitting the Company to plan this land was received from the Israel Lands Administration.

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 m<sup>2</sup> of land, on which about 1,700 m<sup>2</sup> 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 (switchboards, concentration rooms, broadcast sites, etc.) and for other operations (transmitters, warehouses, etc.). 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 130 land assets, with a total area of 70,000 m<sup>2</sup>, of which 65,000 m<sup>2</sup> are built-up, from various lessors.

The Company has easements (rights of way, etc.) over other real estate (i.e. in order 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 m<sup>2</sup>, 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. The Settlement regarding the Land

On March 10, 2004, the Settlement signed by the Company, the Israel Lands Administration (hereinafter: "ILA") and the State 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. Realization of real estate assets

The total assets sold by the Company over the years (both prior to and after the settlement agreement) until December 31, 2007 amounts to approximately 45 properties (in whole or in part), of which some 10 properties were sold during 2007, as set out below.

Further to the renewed examination done by management of the Company with respect to realization 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 board of directors also resolved to postpone improvement operations on the Company's properties at this stage.

During the course of 2007, the Company sold 10 real estate assets in a total area of approximately 25,000 m<sup>2</sup> in land and approximately 13,000 m<sup>2</sup> built-up, for a total sum of \$ 32.1 million (at an average exchange rate of NIS 4.2 to the dollar).

## 2.8 Intangible assets

### 2.8.1. The Company's general license

The Company operates under the terms of a general licenses which, *inter alia*, serves as the foundation for its fixed-line domestic 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 90 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” – The Company's logo (see section 2.6.7 above).

Advertisement of the main trademarks is done 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 in order 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<sup>14</sup>

During 2006 and 2007, the Company worked in coordination with the workers' organization in order 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' 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. Sab. Ar. Holdings Ltd. The main points of the agreement are set out in section 2.17.4 below.

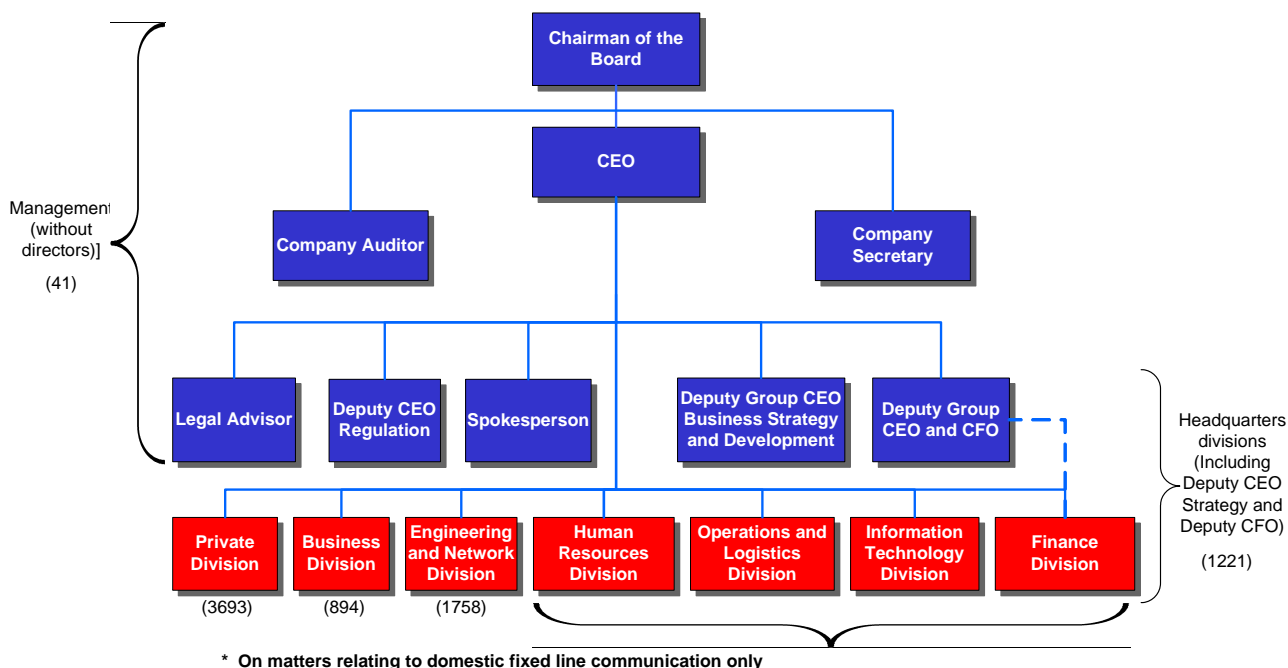
The new collective agreement provides, *inter alia*, that a total organizational change would be made in the Company based, *inter alia*, on a transition from a geographical structure to a functional structure, which would be implemented gradually over two years.

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

As at the date of publication of this periodic report, management of the Company and the employees' representation are formulating an amendment to the new collective agreement, mainly with respect to bringing forward completion of implementation of the organizational structure (with various, insubstantial changes), and with respect to bringing forward retirement dates and changing the mix of those persons who are supposed to retire under the new collective agreement by 2008 (increasing the number of early retirees as opposed to those retiring with severance pay).

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





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 Pelephone 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, 2007	As at December 31, 2006
Senior managers excluded from application of the Company's collective bargaining agreements. Their terms of employment are set in personal agreements.	87	89
Permanent employees employed through collective bargaining agreements.	3,315	3,926
Employees employed through personal contracts that are not part of the collective bargaining agreements.	695	1,116
Employees employed under detailed agreements under collective agreement conditions ("rank rating contracts").	341	279
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").	55	2,241
Employees employed under the special collective agreement of December 5, 2006, hourly.	2,192	376
Employees employed under the special collective agreement of December 5, 2006, monthly.	926	3
Other	3	46
<b>Total</b>	<b>7,614</b>	<b>8,076</b>

Notes: (1) The report as at December 31, 2006 was updated retroactively in accordance with changes in the status of employees, and subtracting employees recruited on January 1, 2007. (2) During the course of 2007, changes were made to employment frameworks (employee subgroup) in accordance with the new collective agreement. 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 do 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. As at December 31, 2007, the number of employees includes 7 employees who have not yet been placed in jobs, and who are not part of the organizational structure set out in section 2.9.1 above.

Note that out of 975 employees who are 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), the following employees have retired:

<b>Period</b>	<b>Retirements during the Period</b>	<b>Aggregate retirements</b>
Up to March 31, 2007	399	399
Up to June 30, 2007	275	674
Up to September 30, 2007	47*	721*
Up to December 31, 2007	171	892

\* Adjusted due to postponement of planned date of retirement of 5 employees.

### **2.9.3 Orientation and retirement of employees from January 1, 2007 through December 31, 2007**

<b>Employment Framework</b>	<b>Intake</b>	<b>Retirement</b>
Senior managers	16	27
Permanent employees	-	783
Employees under other employment arrangements	1,877	1,545
<b>Total</b>	<b><u>1,893</u></b>	<b><u>2,355</u></b>

Note that between January 1, 2008 and February 29, 2008 approximately a further 280 employees retired from the Company (of whom, 44 were permanent employees).

### **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 during 2007 – approximately 43,500. days, or an average of 5 training days per employee. This training activity includes, professional training in the fields of 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 2007 amounted to approximately NIS 6 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 regulations in labor legislation, by the collective bargaining agreements between the Company, the representatives of Company employees and the New General Federation of Labor (hereinafter: "Histadrut") and personal contracts. Additionally, expansion orders to certain general collective bargaining 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 Reward 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, and 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 instalment of the plan. In this regard, see also Note 26 to the Company's financial statements for the year ended December 31, 2007, 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 options<sup>15</sup>) 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 issue of them, 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, 2007, which are included in this periodic report).

#### 2.9.6.3 Option plan to 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 option plan for managers, senior employees at the Company and/or affiliates under which up to 65,000,000 non-negotiable options exercisable for up to 65,000,000 shares of the Company and constituting approximately 2.5% of the issued share capital of the Company, or under full dilution, approximately 2.36% of the share capital, would be allocated.

The options will vest in three equal annual instalments. The vesting dates of each instalment 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, and it reflects 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 general meeting approval.

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 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

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<sup>15</sup> The rest of the options (59574 options) were allotted on January 2, 2008 to two employee directors following approval of the allotment by the general meeting of the shareholders of the Company, 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).

articles of association of the Company. Exercise of the options under the plan is conditional upon obtaining the appropriate consents under the provisions of the Communications (Telecommunications and Broadcasts) (Prescription of Essential Service provided by Bezeq, The Israel Telecommunications Corp. Ltd.) Order, 5757-1997 (the "Telecommunications Order"), or via some other solution that will enable shares in the Company to be allocated in compliance with the provisions of the Telecommunications Order, and such exercise might require amendment of the Telecommunications Order.

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, 40,100,000 options exercisable for up to 40,100,000 shares have been offered under the option plan, including to the CEO of the Company<sup>16</sup>.

The theoretical economic value of all of the options included in the plan, relying on a weighted B&S model, is approximately NIS 187 million, whilst the theoretical economic value of all of the options approved and/or issued (45,700,000 options) is approximately NIS 134 million, in reliance, inter alia, on the share price on the date of issue (for the options approved and/or issued) and on the share price close to the date of approval of the financial statements (for options not yet approved or issued), a risk-free annual interest rate of between 5.11% and 5.24%, the exercise price set out above, an annual standard deviation of between 22.35% and 24.20% and the limitation described above under the Telecommunications Order. The Company has not yet made a decision regarding the exercise price of future options that may be issued, if at all, under the plan.

In this regard, see also Note 26 to the Company's financial statements for the year ended December 31, 2007, 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 directors<sup>17</sup> and 15 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. The conditions of employment of the chairman of the board of directors have not yet been concluded or approved by the competent entities in the Company.

For the management agreement between a management company owned by the shareholders of Ap. Sab. Ar., see section 2.17.5 below and Note 29(e) to the Company's financial statements for the year ending December 31, 2007, 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 prior notice months. The Company also gives options for shares of the Company to members of senior management, in accordance with its discretion (see section 2.9.6 above).

With respect to grants to office-bearers – following the recommendations contained in the report of the external examiner, Dr. Yoram Danziger, dated April 26, 2007 (see section 2.20 below), on May 22, 2007, the board of directors of the Company approved grants to office-bearers for 2006 in the total sum of NIS 1,059,566. In addition, the board of directors at the same meeting approved the award of grants to office-bearers for 2005 in the total sum of NIS 210,000.

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<sup>16</sup> On March 10, 2008, the board of directors of the Company approved an issue of 5,600,000 additional options convertible to 5,600,000 shares of the Company to senior managers of the Group. These options have not yet been issued.

<sup>17</sup> Including two external directors and two directors from among the employees.

In addition, on May 22, 2007, following the consent of the Audit Committee in its meetings of May 15, 2007 and May 22, 2007, the board of directors approved grants to a number of officers. The Company reported these grants in an immediate report on May 22, 2007. Some of the officers repaid the Company the difference (if any) between the grants that they received in the past and the grants approved to them as aforesaid. The total repayment is approximately NIS 590,000 (all of the sums set out above are in gross terms – before tax).

With respect to the grants unlawfully paid to the former CEO of the Company, Mr. Yacov Gelbard, for 2005 and 2006, his undertaking to repay these to Pelephone and the Company, respectively, remains in force. The Company passed a resolution to the effect that if these grants are not repaid to the Company, it shall take such legal steps as are required to collect the debt.

For 2007, payment of grants to members of senior management was approved in the total sum of approximately NIS 4 million. With respect to the CEO and the VP Engineering and Networks, the aforesaid sum also includes grants for the period in which they worked in a subsidiary prior to commencement of employment at the Company.

## 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 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** As at the date of this report, the purchases from no sole supplier to the Company amount to more than 5% of total purchases in any area of operations.

**2.10.3** In the Company's opinion, it is dependent, in the field of public switching equipment, on the Alcatel Group which is represented in Israel by Alcatel Telecom Israel Ltd. In the field of collection systems for business customers the Company is dependent on Amdocs Software Systems and in the field of 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 light of the Company's experience in operating Nortel switches, and in light of the low probability (based on past experience) of faults that the Company is unable to solve by itself, and in light of 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.

## 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 2007:

	Scope of average credit in NIS millions	Average credit days
Customers	918	EOM + 16
Suppliers	346	EOM + 29

## 2.12 Investments

For information on investments in subsidiaries, see Note 33 to the financial statements for the year ended December 31, 2007, 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 2007, the Company is not financed by any short-term credit (less than one year).

The following is a breakdown of the loans from banking and non-banking sources:

Source of financing	Type of currency or linkage	Rate of average interest
Non-banking sources <sup>18</sup>	CPI linked NIS	4.38%
	NIS-Linked Euro <sup>19</sup>	5.14%

### 2.13.2 Restrictions on receipt of credit

A. With respect to limitations on Company loans – see Note 13 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

B. Bank of Israel Restrictions regarding Sole Debtor and Group of Debtors

Directives issued by the Supervisor of Banks in Israel include provisions according to which the liability of an individual borrower or group of borrowers for a banking institution shall not exceed 15% (individual borrowers) and 30% (group of borrowers) of the banking institution's capital. These provisions further stipulate that total liabilities of the banking institution's six largest borrowers and groups of borrowers shall not exceed 135% of the banking institution's capital. These provisions may, from time to time, affect the ability of some banking institutions to issue additional credit to the Company. However, as a rule, the Company does not have difficulty finding sources of finance. 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

During the period between May 27, 2007 and July 16, 2007, the Company raised approximately NIS 1,200 million in a number of fundraising operations by selling 1,070 million par value debentures (series 5) of the Company. These debentures were sold by the subsidiary Bezeq Zahav (Holdings) Ltd. ("**Bezeq Zahav**") and the aforesaid proceeds were transferred to the Company in repayment of a loan granted by the Company to Bezeq Zahav for the purpose of acquiring the above debentures. The fundraising was effected at an average interest rate of 3.71% (the debentures are CPI linked). See also section 2.13.7 below.

### 2.13.4 Credit received after December 31, 2007

The Company has not taken any loans since December 31, 2007.

<sup>18</sup> On August 8, 2007, the Company repaid the principle of the Eurobonds that it issued in 2000, in the total sum of 293 million Euro.

<sup>19</sup> During the month of January 2008, the Company repaid Euro-linked NIS loans and the Company does not now have any loans that are linked to foreign currency.

### 2.13.5 Variable interest

The following table outlines the Company's loans and debentures with variable interest rates (in NIS millions, as at December 31, 2007):

Type of linkage	Change mechanism	Financial scope	Interest range in 2007	Current interest rate
Euro and Euro-linked <sup>20</sup>	Libor – EUR 6M	30	4.05%-5.14%	5.14%

Note: "Interest range" and "current interest rate" are the variable interest rates, not including the spread.

### 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	Rating	Changes in Rating	Type of Credit Rated
Standard & Poors Maalot	AA	May 1, 2007 – Standard & Poors Maalot gives notice that pursuant to disclosures and to the investigation report of the External Examiner (see section 2.20 below) regarding depreciation of plant & equipment at Telephone, no change is expected at this stage in the rating of the Company's undertakings. In this regard, see also section 3.15.6 below.	All series of debentures
Midroog	Aa1	April 11, 2006 – rating taken off the Watch List and left at Aa1. Rating forecast lowered from stable to negative so as to reflect the possibility that a change in ownership of the Company might affect the Company's future commercial and financial profile.	Debenture series 4 and 5
Standard & Poors	BBB+	November 5, 2007 – rating left unchanged: BBB+ with negative rating forecast.	The rating is for the Company
Moody's	Baa1	February 6, 2006 – rating left at Baa1 and held to be stable.	The rating is for the Company

### 2.13.7 Estimate of raising funds in the coming year (2008) and sources of financing

The Company expects to repay some of its loans during 2008. If necessary, the Company will raise additional debt in 2008.

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.

### 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, 2007, 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, 2007, which are included in this periodic report.

<sup>20</sup> See footnote 19 above.

## 2.15 Environmental matters

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

The Law regulates the handling of sources of electromagnetic radiation (hereinafter: "Radiation Source"), the erection and operation of them and supervision of them. *Inter alia*, the Law provides 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. Prior to enactment of the Law, the provisions of the Pharmacists (Radioactive Elements and By-Products) Regulations, 5740-1980 applied to the Company's facilities which emit electromagnetic radiation, and these regulations were not repealed by the Law.

Under the Law, applicants for an operations permit must implement the conditions of grant of the permit as of January 1, 2007, including the conditions regarding presentation of a building permit under the Planning and Building Law.

During the course of 2007, the Company acted to obtain operating permits from the Commissioner for Non-Ionized Radiation at the Ministry of the Environment (the "**Commissioner**"), all in accordance with the Law. Following these operations, the Company received operating permits for communications facilities including for broadcast sites that it operates. With a few exceptions, on the date of filing the application for operating permit under the Radiation Law, there was a valid permit in place under the Pharmacists Regulations. As at the date of publication of this periodic report, the process of issue of the operating permits by the Commissioner is being delayed due to a strike at the Ministry of the Environment.

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. Likewise, the Commissioner may require an affidavit of exemption from a building permit for "wireless access facilities" which have a "class approval" given to the Company by the Commissioner. See also section 2.16.11 below.

The Company has work procedures with respect to 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 approved on October 23, 2007 by the Interior and Environment Committee of the Knesset, and which require the consent of the Ministers prescribe, *inter alia*, 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 prescribed a new method of calculating safety ranges for radiation sources.

**2.15.2** With respect to permits for broadcasting installations that are required by the Planning and Building Law, 5725-1965, see Section 2.16.11 below.

**2.15.3** With regard to claims filed regarding alleged radiation from the Hillel broadcasting station – see Note 17(a)(5) to the financial statements for the year ended December 31, 2007, which are included in this periodic report.

## 2.16 Restrictions on and regulation of Company 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 arrangements under Sections 15 through 17 of the Communications Law apply to Company tariffs.



- A. The tariffs for the Company's supervised services, stipulated in said 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 June 1, 2007, the Communications (Telecommunications and Broadcasts) (Payments for Telecommunications Services) Regulations, 5767-2007 and the Communications (Telecommunications and Broadcasts) (Calculation and Linkage of Payments for Telecommunications Services) (Amendment) Regulations, 5767-2007 came into force. Under these regulations and based on the draft tariff update set out in the Communications (Telecommunications and Broadcasts) (Calculation and Linkage of Payments for Telecommunications Services) Regulations, 5763-2003, the reduction of the Company's supervised tariffs as of June 1, 2007, was at an average rate of approximately 3.13%. This reduction is based on a reduction of approximately 0.1% in the consumer price index less the average rationalization coefficient at a rate of approximately 3.038%. Likewise, the Communications (Telecommunications and Broadcasts) (Payments for Interconnect) (Amendment) Regulations, 5767-2007 came into force on the same date, under which the reduction of interconnect tariffs as of June 1, 2007 was at a rate of approximately 4.01%.

The tariff arrangement set by the latest public commission (the Grunau Commission) commenced in 2003 and was supposed to end at the end of 2007. Despite the fact that no formal notice was received regarding extension of this arrangement, under the Linkage Regulations and the amendment thereof (as set out above), another update of the supervised tariffs is supposed to take place on June 1, 2008, however, as at the date of publication of this periodic report, there is uncertainty as to the performance and force of the update and the Company is unable to assess what the implications of the above might be.

- B. Pursuant to section 15A 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.

In December 2007, five alternative payment baskets were approved for the Company which are relevant to the private sector, and in February 2008, another such payment basket was approved.

- 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, business access, etc.) 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 2.16.2C. below.

- D. On June 7, 2007, the Communications (Telecommunications and Broadcasts) (Payments for Telecommunications Services) (Amendment) Regulations, 5767-2007 were signed under which the criterion for entitlement to reduced usage fees was changed from entitlement under the criterion of reduced use to entitlement granted to a person who receives a pension under the Income Assurance Law, 5741-1980, about whom the National Insurance Office provides the Company with details, and who only has one subscriber telephone line registered in his name, in an apartment that is used for residential purposes only. This change is not expected to have a substantial impact on the Company's income.

## **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 15A 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 fixed-line domestic 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.

With respect to market share – on November 25, 2007, the Ministry gave notice to all domestic licensees of the measurement methods prescribed by the Ministry, under which updates are sent to the licensees in the field of domestic fixed-line telephony. According to the last report provided by the Ministry on February 20, 2008, the Company's market share (in normative revenue terms) is 88.2% of the private sector and 92.6% of the business sector. In the Company's assessment, and presuming that the current trend continues, the Company's market share (in normative revenue terms) will fall below 85% in the private sector only during 2008. With respect to the business sector, the Company is unable to assess when it will reach such a market share. According to the Minister of Communications' policy letter – if and when the Company reaches this market share, it will be able to market joint service bundles as described above.

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

#### Main Points of General License

A. Scope of License and Obligation to provide Service to All (Universal Service Obligation)

The Company is mandated 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<sup>21</sup>, if it has been established that there is a real fear of injury to competition or to the

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<sup>21</sup> Parent company, subsidiary, interested party, affiliated company, related company or partner.

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.

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 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 package of services, in respect of which no tariff is stipulated under Sections 15 or 15A 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 carriers, will be uniform and accordingly inclusive.

With respect to billing by standing order, credit card, prepayment or deposit of a guarantee, it has been prescribed that the Company is not entitled to require that payment necessarily be made in those manners.

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 entering into 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 2.6.6A 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. Interconnectivity and use

Infrastructure services - the Company will supply such services to another licensee such that it will be 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. Arrangements in the field of security

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. Liability 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 guaranty 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 Notes 13(c) and 19(a) to the Company's financial statements for the period ended December 31, 2007, 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.

At the end of 2004, the Ministry of Communications began a process of horizontal amendments of the general licenses, including with respect to the level of service offered to subscribers. The Company had provided its comments on the proposed amendments, but the process is not yet complete.

### **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 (hereinafter: 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 2007 was 2.5% compared with 3% in 2006.

On December 31, 2007, a draft amendment of the Royalty Regulations was submitted for the approval of the Finance Committee of the Knesset by the Ministers of Finance and Communications. The draft added a section exempting a domestic carrier from paying royalties for income from the provision of data communication services, management of a data communications network and PTP lines at high baud rates and certain types of links, where one of the parties is a corporation, as of January 1, 2004. Likewise, the amendment contains a provision regarding deduction of revenues and payments from the basis of royalty-attracting revenues, under which a licensee is not entitled to deduct an income component if such component is not included in the calculation of royalty attracting revenues, and the licensee is not entitled to deduct payments unless they are not ascribed

to income included in the calculation of royalty attracting revenues. The amendment also contains an exemption from payment of royalties for the revenues of international carriers from data communications services, the duty to pay arrearage interest in the event of consolidation, and an amendment of the definition of "licensee" so as to include a broadcast licensee, in order to enable a domestic carrier to deduct its revenues from the provision of transmission services, even when the service is provided to a broadcast licensee.

#### **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. Until the Law was amended in 2001, this Chapter did not distinguish between public and private land, and enabled the Company and the persons it authorized for purposes of providing telecommunications services, to enter any real estate in order to carry out surveys and examinations required for planning a telecommunication installation, and for examining, repairing or making changes thereto or therein. In most cases, prior notice was required to be given to the occupier of the real estate and the latter could appeal to the Court.

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 (hereinafter: "Public Land") and other land (hereinafter: "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.

Deployment of a network on private land requires the consent of the landowner or 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 Nine of the Law, pursuant to his authority to grant immunity to a general license holder.

A Licensee granted immunities according to Chapter Nine of the Law (hereinafter: an "Immune Licensee"), its employees and all persons acting on its behalf shall not bear liability in tort, except:

- (1) For direct damage caused by the restriction or discontinuance of a telecommunications service;
- (2) For damage arising out of an intentional act or gross negligence of the Immune Licensee, its employees or persons acting on its behalf.

Under the Communications Law, an Immune Licensee, its employees and all persons acting on its behalf shall not bear liability for damage caused:

- (1) By 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 to the performance of a telecommunication operation or the provision of a telecommunications service;
- (2) Due to an error in providing a telecommunications service, an error in 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).

#### **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 Ministers' 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, a draft of 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, was provided to the Company and Hot for comment. The Company has provided the Ministry with its response.

#### **2.16.7 Antitrust laws**

A. On June 27, 1995, the Antitrust Commissioner (hereinafter: 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. At the end of 1995, the Company transferred its activity in the field of provision of international telephone services to Bezeq International and as a result, Bezeq International "inherited" the Company's monopolistic position in this market. On April 29, 2001, the Commissioner decided to cancel the declaration of Bezeq International as a monopolist in the field of provision of international telephone services, due to the competition that had emerged in this market.
- C. In light of the changes and developments which have occurred in the communications market overall, and particularly in the field of "basic telephone services", especially in light of the increasing competition in the field of this service compared with the cellular telephone companies, the Company applied to the Commissioner on March 6, 2000, requesting the cancellation of his declaration of the Company as a monopoly in the field of "basic telephone services".

The Company filed an appeal on September 9, 2001 against the Commissioner's decision not to cancel said declaration. Subsequently, the Company consented, at the suggestion of the court (in view of the time elapsed since the appeal, with an accompanying economic opinion, was filed), to withdraw the appeal, and it was struck out on August 2, 2006.

- D. 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 fast access services to subscribers through the access network.
- (2) Provision of fast access services to ISPs through a central public telecommunications network.

- E. 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 said conditions.
- F. In May 2006, the Antitrust Authority wrote to the Company regarding complaints from particular communications carriers regarding acts done, prima facie, by the Company to such carriers, and a complaint of one of the carriers received from the Ministry of Communications. According to such carriers, the aforesaid acts amount to abuse of the Company's monopolistic power. The Company was required to provide the Authority and the Ministry with data and response to the questions set out in the letter, and it provided the requested information.
- G. On May 23, 2006 and thereafter, searches were conducted in the offices of the Company by staff of the Antitrust Authority, and a number of employees of the Company were interrogated with respect to suspicions of abuse of monopolist status and/or unreasonable refusal to supply an asset or service under a monopoly.

Subsequently, the Antitrust Authority gave notice that the investigation of the matter had ended.

- H. 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.

The Company intends to file an appeal against the ruling. With respect to this matter and to the matter of the class action regarding the issue, see Notes 17(a)(12) and 17(c)(1) to the financial statements of the Company for the year ended December 31, 2007, included in this periodic report.

- I. For the application for exemption from approval of an arrangement in restraint of trade regarding telephone number information services, see update to section 2.2.2 above.
- J. 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.
- K. For the Commissioner's objection to the merger of the Company and DBS, see section 1.1.5 above.
- L. The Company has adopted an internal compliance policy (hereinafter: the "Policy") containing internal reporting and internal procedures which essentially ensured that the activity of the Company and its employees would be carried out in accordance with the provisions of the Antitrust Law, 5748-1988 (hereinafter: 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.

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, 2007, to approximately NIS 48 million.

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

#### **2.16.9 Proposed Legislation to Amend the Consumer Protection Law**

In 2005, the Knesset Economics Committee discussed a private member's bill to amend the Consumer Protection Law, which intervenes in the contractual relations between a person dealing in defined deals and the consumer. Under the Bill, a contract will be deemed to provide that it will be rescinded unless the dealer offers the customer to extend the term of the contract and the customer agrees to such. Since then, discussions have been held on the new proposed wording in the Economics Committee of the Knesset.

According to the proposed wording, this provision will not apply to the transactions set out in the Schedule and, under the present wording, fixed line telephony is included in the Schedule. In a similar matter, the Ministry of Communications is also conducting a hearing to amend carrier licenses so that the carriers will be required to give notices to consumers

regarding termination of fixed deals, and the tariffs that will be charged subsequently. On February 10, 2008, the Company gave its comments.

A number of bills to amend the Consumer Protection Law were also placed before the Economics Committee of the Knesset, including with respect to disconnection from ongoing services, visits by technicians, a bill regarding spam mail that requires, with certain exceptions, advance customer consent to being contacted via certain electronic means, including SMS and email, and other proposals which, if accepted, might change the way in which the Company engages with its customers. The Company is unable to assess, at this stage, what amendments will be accepted and what their impact might be.

#### **2.16.10 Arrangements in the field of security**

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. Under this order, an observer is appointed to the meetings of the board of directors of the Company and its committees, with such security vetting and classification as prescribed by the General Security Services.

#### **2.16.11 Establishment of communications installations - National Outline Plan 36**

A. The National Outline Plan for Communications, NOP 36, was 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 (NOP 36A), dealing with the issue of building permits for small and micro-broadcasting installations, was approved by the Government on May 2, 2002.

As at the date of publication of this periodic report, building permits have been issued for most of the small broadcasting installations, in accordance with NOP 36A. The Company is working on taking out building permits, including via legal proceedings, for 7 small broadcasting installations. Due to intensive activities being done at the Company regarding the obtaining of permits, and due to the termination of operation of certain installations, the number and class of sites change from time to time. 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 publication of this periodic report, 10 sites are being dealt with).

- (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 36B

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 36B, 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 36B. Otherwise the building permit shall expire. (2) A permit may be granted for broadcasting installations erected prior to the approval of the NOP 36B at a broadcasting site which existed prior to January 31, 1984, even if the installations do not comply with the provisions of the NOP 36B, provided they meet the safety restrictions specified in NOP 36B.

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 36B, including broadcast installations erected prior to January 31, 1984, which were exempt from the indemnification obligation under previous drafts of NOP 36B. The Company has submitted its objection to the inclusion of said provision in NOP 36B.

D. General

In light of the expected change of classification of broadcast installations based on their safety range as set out above, and in light of the change in the method of calculation of the safety range under new regulations under the Radiation Law that have not yet come into force (see section 2.15.1 above), the Company is reviewing and reclassifying its communications and broadcasting installations and as at the date of publication of this periodic report, it is unable to assess the implications of the change in classification on the licensing status of its installations and the results of such.

- 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.**

**2.16.12 Amendment of section 13 of the Communications Law**

On December 3, 2006, an amendment to the Communications Law was published which, *inter alia*, granted the Minister of Communications power to give instructions to a licensee in the event of a fault or significant break in the provision of communications services, not in circumstances of an emergency.

- 2.16.13** On January 11, 2007, an amendment to the Communications Law was published under the Arrangements Law which contained provisions regarding the expansion of the monetary sanctions on the licensee, *inter alia*.

- 2.16.14** 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 (hereinafter: 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. (hereinafter: "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 2.7.4C 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 Various agreements with DBS and its other shareholders**

- A. Founders' agreement relating to DBS, of December 4, 1998, between the Company, Eurocom Communications Ltd., Lidan Business Enterprises Ltd., and Gilat Communications Ltd., governing the incorporation and management of DBS and the relationship of its shareholders.
- B. An agreement dated December 30, 1998 between the shareholders of DBS, stipulated the establishment of an executive committee and its authorities.
- C. An agreement of November 2001 between the shareholders (with the exception of Gilat Communications Ltd.) and DBS, which amended the dilution formula prescribed in the founders' agreement and determined that the holdings of shareholders 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 between DBS shareholders and DBS determines preference for shareholder loans given as of July 10, 2002 over the loans made prior to that date, and that these loans would bear CPI linkage differentials and annual linked compound interest at a rate of 5.5%, and an amendment to the agreement dated August 6, 2003 which stipulated an interest rate of 11% for new loans granted as of April 27, 2003. Likewise, the agreement relates to the issue of shares and options for shares to shareholders who invest in DBS (for the Company's actions to exercise the options issued to it, see section 1.1.5 above).

### **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, 2007, 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 bargaining agreement executed 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 (i.e., 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 Organization

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 everything 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 on 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) that 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 who is insured under the June 2005 Agreement in respect of whom policies have not been issued by Harel on the date of execution of the amendment of the June 2005 Agreement.

In this regard, see Note 16(g) to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

F. 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. Sab. 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 it until December 31, 2011. The Company has an option to extend the agreement for two more years until December 31, 2013. The retirement chapter of the Agreement shall, in any event, expire on December 31, 2013.

For the amendment of the agreement being formulated between management of the Company and the employee representation, inter alia with respect to bringing forward the date of implementation of the change in the organizational structure and bringing forward employee retirement dates, see section 2.9.1 above.

#### **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. Sab. 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 USD 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. Sab. 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, 2007, included in this periodic report, and sections 1.1.5 and 2.6.1 above.

### **2.19 Goals and Business 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 that 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 provisions a variety of products and services that are tailored for 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.

### Organizational restructuring and implementation at the Company

For the change in the Company's organizational structure, implementation and integration of such, see sections 2.6.7(h) and 2.9.1 above.

## **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 being planned or currently being implemented**

The main projects currently being implemented by the Company include improving IPVPN services and those derived from it within the business sector, as well as upgrading the speed of ADSL-based high speed internet service to private customers. Additional projects include IP Centrex service as a platform for the provision of private virtual exchanges on the Company's private network (see section 2.2.5(d) above). Likewise, the Company has launched a data center service. This project includes a high-standard computing installation which will enable business customers to receive hosting services, computer and server rooms in the installation built especially for this purpose in order to expand the server rooms at a business, or as a back-up for communications infrastructure (see section 2.2.5(e) above).

#### **2.20 Events or Issues not within the Ordinary Course of Business**

- A. On December 5, 2006, a new special 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. Sab. Ar. Holdings Ltd., and prescribing a new organizational structure for the Company. For this, see sections 2.9 and 2.17.4 above.
- B. On July 1, 2007, pursuant to the requirements of the Securities Authority, the Company published an immediate report which included details of the steps taken by the Company following the report of the external examiner, Dr. Yoram Danziger, who was appointed by the board of directors as an external examiner to investigate approval of the plan for options to employees and managers, approval of grants to officers and restatement in the financial statements of Pelephone. This report related, inter alia, to adoption of a new working procedure for the board of directors, and the setting up of committees of the board of directors.

On September 4, 2007, after electing the board of directors of the Company, including a number of new members, it was resolved to set up committees of the board of directors, as well as their substance and composition.

For the application regarding a derivative claim and class action relating to this examination see Notes 17(a)(18) and 17(c)(3) to the financial statements of the Company for the year ended December 31, 2007, which are included in this periodic report.

#### **2.21 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 2.6.6A above) contributes to increased 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.

##### **B. Government supervision and regulation**

The Company is subject to government supervision and regulation that, among other things, 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). Said 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 implication of this mechanism is erosion (in real terms) of the Company's tariffs. 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.

**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 light of the development of communications groups in the field which are not subject to such restrictions on joint operations, the extent to which this risk factor might affect the Company's operations has increased as the competition has developed.

The Antitrust Authority's objection to the merger between the Company and DBS such that the Company's holdings of DBS will increase from approximately 49.8% to approximately 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 the 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, 2007, 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. Therefore the Company is exposed to changes in exchange rates against the shekel. However, due to the currency hedging policy implemented by the Company, exposure has until now been low. The Company has taken and continues to take protective actions against most exposure from exchange rate fluctuations. That said, the Company has not fully neutralized its exposure to exchange rate

fluctuations, by converting its liabilities denominated in foreign currency and/or linked to the consumer price index, to shekel-denominated liabilities.

#### 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, and in the Pharmacists Regulations, and the issue of licensing is governed by NOP 36 (see sections 2.15 and 2.16).

The Company is working to obtain permits to build and operate its various broadcasting installation, 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 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.

**Risk Factor Summary Table**

	Effect of Risk Factor on Company Activity		
	Large effect	Medium effect	Small effect
Macro risks			
Exposure to exchange rate fluctuations and inflation			X
Sector Risks			
Increasing competition	X		
Government supervision and regulation	X		
Tariff supervision	X		
Electromagnetic radiation / licensing of broadcast installations		X	
Frequent technological changes		X	
Special risks faced by the company			
Exposure in legal proceedings		X	
Difficulties in labor relations		X	
Restrictions on relations between the Company and companies in the Bezeq Group	X		

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### **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. 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 as of October 2000. 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 2006-2007:

	<b>2007</b>	<b>2006</b>
Revenues (NIS millions)	4,684	4,478
Operating profit (EBIT) (NIS millions)	805	701
Operating profit before depreciation and amortization (EBITDA) (NIS millions)	1,283	1,171
Number of subscribers at end of period <sup>22</sup> (in thousands)	2,622	2,427
Average minutes of use (MOU) <sup>23</sup> per subscriber per month	354	349
Average monthly revenue per subscriber (NIS) (ARPU) <sup>24</sup>	131	138

<sup>22</sup> Subscriber data relate to active subscribers having received or made at least one call in the past six months.

<sup>23</sup> 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.

### **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 and to increase their segmentation and make special offers to various target groups, providing specific responses to their needs.

### **3.1.5 Technological changes being such as to affect the Company's field of activity**

#### **3.1.5.1 In the cellular industry, there are two main technological tracks:**

- A. The CDMA track, which developed in the 2.5 generation to 1X and in the third generation to EVDO (hereinafter: "CDMA Technology") – Pelephone's network presently operates using this 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 (hereinafter: "UMTS Technology") – the networks of Pelephone's principal competitors in Israel use this technology and Pelephone also plans to use this technology as from 2009 (see section 3.1.5.3. below).

3.1.5.2 In 2004 Pelephone launched 3rd generation 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). 3rd generation services enable transfer 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 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. Ericsson was chosen as the supplier of the system. The new network is expected to begin operating at the beginning of 2009. The investment in the new network will be spread over 4 years with the main part being invested in 2008 (see section 3.9.1.9). The establishment of the new network will enable Pelephone to provide services requiring the rapid transmission of information, may partly solve the problem of wireless disturbances (see section 3.24.2.5) and will enable use of standard terminal equipment supporting UMTS technology which will permit the expansion of roaming services.

The information in this section includes forward-looking information, which is based on Pelephone's assessments that take into consideration past experience, surveys regarding the industry in which Pelephone operates and its plans for the future. Actual results may be significantly different than the assessments described above if one of the factors taken into consideration in these assessments changes. See section 3.24 below regarding risk factors.

3.1.5.4 Pelephone uses frequencies in the range of 850 MHZ in order to operate the CDMA network, and it also has the right to be allocated frequencies in the range of 2100 MHZ (see section 3.10.2 below) which it will use in its UMTS network.

### **3.1.6 Critical success factors and the changes commencing 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.

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<sup>24</sup> 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 subscribers in that month.

- 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 Principal 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 infrastructure, 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 investments.
- 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 operator companies 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 in areas where the local wireless networks have coverage.

### **3.1.9 Structure of competition in the sector 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 behalf<sup>25</sup>). In May 1994, Cellcom Israel Ltd posted the successful bid in an invitation to tender for a second operator for MRT service (hereinafter: "**the second operator**" or "**Cellcom**"). In February 1998, a third operator was selected by invitation to tender – namely Partner Communications Ltd. (hereinafter: "**the third operator**" or "**Partner**"). As of February 2001, MIRS Communications Ltd., (hereinafter: "**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 (see section 3.7 below).

## **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:

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<sup>25</sup> 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.

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

**Advanced services** (hereinafter: “**added value services**”) – Pelephone offers to its customers added value 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 BREW 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, and to read and reply to them, all through their handsets. 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 added value services offered by Pelephone are location-based services. *Inter alia*, these services 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.

**3G services** – 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, Navigator services, based on a high-speed 2.4 MBPS AGPS cellular modem.

At present, some 830,000 subscribers have handsets which enable use of third generation services.

Pelephone began supplying added value services at the end of 2002. In 2005, 2006 and 2007, revenues from added value services amounted to 9%, 11% and 13% respectively of revenues from cellular communications (payments for call minutes, fixed subscription fees, added value services and roaming services).

**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. 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 214 countries around the world. During 2005, Pelephone began supply of dual handsets which support CDMA and GSM technology. The handsets provide an additional solution to roaming services in other countries where the network is not CDMA. In light of the lack of a variety of handsets and support of some of the handsets that Pelephone provides its customers, this solution is a partial solution only and does not address all marketing needs. The establishment of a UMTS network (see section 3.1.5.3. above) will make it possible to increase the variety of handsets and reduce the marketing gap in the area of roaming services.

3.2.1.1 The information in this section includes forward-looking information, which is based on Pelephone’s assessments that take into consideration past experience, surveys regarding the industry in which Pelephone operates and its plans for the future. Actual results may be significantly different than the assessments described above if one of the factors taken into consideration in these assessments changes. See section 3.24 below regarding risk factors.

**Maintenance and repair services** – Pelephone offers its customers ongoing repair service, against a monthly payment that provides warranty for the cellular telephone.

### 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.

### 3.3 **Segmentation of Profitability from Products and Services**

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

	2007	2006
	NIS millions	NIS millions
Revenues from cellular services, sale of terminal equipment and terminal equipment services	4,684	4,478
Percentage of gross profit	29%	27%

### 3.4 **New Products**

In 2007 Pelephone continued to improve and expand its range of added value services and to increase the number of subscribers who use these services.

### 3.5 **Accounts Receivable**

As at the end of 2007, Pelephone had 2.622 million subscribers. Approximately 66% of Pelephone's subscribers are private customers and 34% of Pelephone's subscribers are business customers.

### 3.6 **Marketing, Distribution and Service**

Pelephone's distribution system is based on 26 service and sales centers including laboratories spread around the country, which deal in service and sale to customers, treatment of malfunctions, installation of handsets and customer retention. In addition, 12 service and sales centers provide comprehensive service and instead of repairing the handset the customer receives a substitute handset and the handset is sent for repair. The distribution system is strengthened with stores and stands spread over 89 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 13 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.

### 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. The competition even increased as a result of the entry of number portability into force (see section 3.7.3 below).

To the best of Pelephone's knowledge from the data published by each of the cellular companies in Israel, as at the end of 2007, there are approximately 8.9 million cellular subscribers in Israel: Pelephone has approximately 2.6 million subscribers, Cellcom reported approximately 3.1 million subscribers, Partner reported approximately 2.8 million subscribers and MIRS, approximately 0.4 million subscribers<sup>26</sup>.

**3.7.2** Following a Government decision in 2006, the Ministry of Communications engaged the services of an international consultation firm in order to examine the matter of mobile virtual network operators (MVNO) operating in Israel in the cellular market. A MVNO is a cellular operator that purchases airtime from a regular cellular operator (that owns infrastructure)

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<sup>26</sup> This data relates to active subscribers having received or made at least one call in the past six months. The number of subscribers also relates to subscribers of more than one cellular carrier, or who are in the process of moving between carriers.



according to a business agreement with it. The virtual operator uses the existing cellular networks and sells its services to the public under a separate brand.

Pelephone has expressed its position that in no case is it justified to use regulatory force on the matter of the MVNO and it even backed its position with consultation work. In addition Pelephone, Cellcom and Partner engaged a joint consultation company, at the approval of the Commissioner of Restrictive Trade Practices, in order to obtain consultation on the matter of competition in the cellular market in Israel and the MVNO. In July 2007 a consultation firm that was engaged by the Ministry of Communications submitted to it the final report. In accordance with the report's recommendations, there is no need at this point for any interference of the Ministry of Communications in this matter. The Ministry of Communications did not schedule a hearing on the matter of the MVNO. Furthermore, in the course of the Government's deliberations on the Arrangements Law, the legislation amendments that were proposed in order to create tools that would grant a virtual operator the right to use the MRT network were removed.

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.

The Ministry of Communications has not yet granted any license for MVNO activity in Israel.

- 3.7.3** 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. The licensee is to be required to provide number portability for any subscriber that may request such, and is to do all of the acts required for such purpose without any payment from 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.

In February 2007 the Ministry of Communications requested from the operators information regarding the status of their preparations for number portability, in light of the Ministry's intention to provide a new time schedule for implementation of the number portability plan.

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. Based on Pelephone's estimates, since the beginning of the "Number Portability Program" and up to the date of this report, about 140,000 subscribers changed companies and the net change in Pelephone's subscribers is about 6,000.

- 3.7.4** 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 only once Bezeq's market share of the domestic fixed line telephony industry falls to below a threshold of 85%. 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. Grunau 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 at this stage are operating in the business sector and in the last year have even increased their activity in the area. This constitutes a clear competitive advantage over Pelephone due to the ability of the competitors to offer packages that combine mobile and fixed-line communications.

In September 2007 the Ministry of Communications published a hearing on the policy of allotting frequencies for operating the WiMax technology. 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. The Ministry of Communications has not yet published its policy on the matter.

**3.7.5 Positive and negative factors affecting Pelephone's competitive position**

Positive factors:

- A. The advanced third generation cellular network that supports the download of data at a rate of up to 2.4 Mbps, and provides good network quality.
- 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, and high-quality human resources.
- E. Strong capital structure and positive cash flow.

Negative factors:

- A. As a subsidiary of Bezeq, Pelephone is subject to restrictions on entering into additional fields of activity and on expanding its customer service baskets, which do not apply to the 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.
- D. Two of the leading terminal equipment manufacturers in the world in this industry do not manufacture cellular telephones using CDMA technology for the Israeli market.

### **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 only affect cellular services revenues, but, as stated, the effect is not material.

### **3.9 Property, Plant & 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**

##### **3.9.1.1 Pelephone's infrastructure investments**

Most of the investments in 2003-2007 were used to upgrade the network to CDMA 2000 1XRTT and EVDO technology, using equipment purchased from Nortel and Motorola. In 2006 and 2007, the network capacity was expanded, additional sites were set up (some of them to replace existing sites due to engineering requirements) and the network is underwent adjustments to support number portability.

##### **3.9.1.2 Pelephone presently operates two communications networks using three technologies:**

- 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 fast data communications (up to 144KB).
- B. Digital technology using the EVDO method – see section 3.9.1.6 below.
- C. Analog technology using the NAMPS method (Narrow Band Advanced Mobile Phone System). This is old technology which is not undergoing network development processes, and at present, traffic over it is negligible.

The three technologies operate on the same frequency range allocated to Pelephone.

- 3.9.1.3 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 1,500 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).

- 3.9.1.4 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 in various other countries.
- 3.9.1.5 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.
- 3.9.1.6 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.
- 3.9.1.7 In 2005, Pelephone acquired equipment from Nortel, in a long-term transaction for 2005-2007, for the expansion of its network, including 150 sites and equipment to upgrade the capacity of the network. The value of the transaction was approximately \$ 20 million. This transaction was executed in full.
- 3.9.1.8 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.
- 3.9.1.9 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 UMTS. Ericsson was chosen as the supplier of the system. The new network will be 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 existing 1,500 sites will be converted in order to adapt them to the new frequency and be added the new radio equipment. The network will enable 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 will enable Pelephone to provide services requiring the rapid transmission of information, may partly solve the problem of wireless disturbances (see section 3.24.2.5) and will enable use of standard terminal equipment supporting UMTS technology which will enable the diversification of terminal equipment and the expansion of roaming services.

The information in this section includes forward-looking information, which is based on Pelephone's assessments that take into consideration past experience, surveys regarding the industry in which Pelephone operates and its plans for the future. Actual results may be significantly different than the assessments described above if one of the factors taken into consideration in these assessments changes. See section 3.24 below regarding risk factors.

### **3.9.2 Premises used by Pelephone**

Pelephone is not the owner of 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 3.9.1.3, 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's head offices have been in Givatayim since 1997, and cover a total area of 17,000 sqm. In 2006, Pelephone signed an agreement to extend the lease term until December 31, 2010.
- 3.9.2.3 For the purpose of service and sale operations, Pelephone leases 41 service and sale centers, and 54 points of sale spread out around the country.
- 3.9.2.4 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 pursuant to a license issued to it (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 for Pelephone's activity.

#### **3.10.2 Frequency usage right**

Pelephone uses frequencies in the 850 MHZ range, granted to it by virtue of its license. These frequencies are used by Pelephone mainly for CDMA2000 1XRTT technology and EVDO technology. In addition, Pelephone was granted the right of future allocation and use of frequencies (in the 2100 MHZ ranges) using UMTS technology. In this regard, see Note 18G to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report. In 2008, there are plans to exercise the right for allocation and use of these frequencies as part of the preparations for establishment of the new network.

The information in this section includes forward-looking information, which is based on Pelephone's assessments that take into consideration its plans and expectations regarding their realization. Actual results may be significantly different than the assessments described above if one of the factors taken into consideration in these assessments changes. See section 3.24 below regarding risk factors.

#### **3.10.3 Trademarks**

Pelephone has a number of registered trademarks. The principal ones are: The "Pelephone" trade mark, aimed at the general public and business customers, and the "Esc" trademark, aimed at the young population

#### **3.10.4 Customer Base**

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

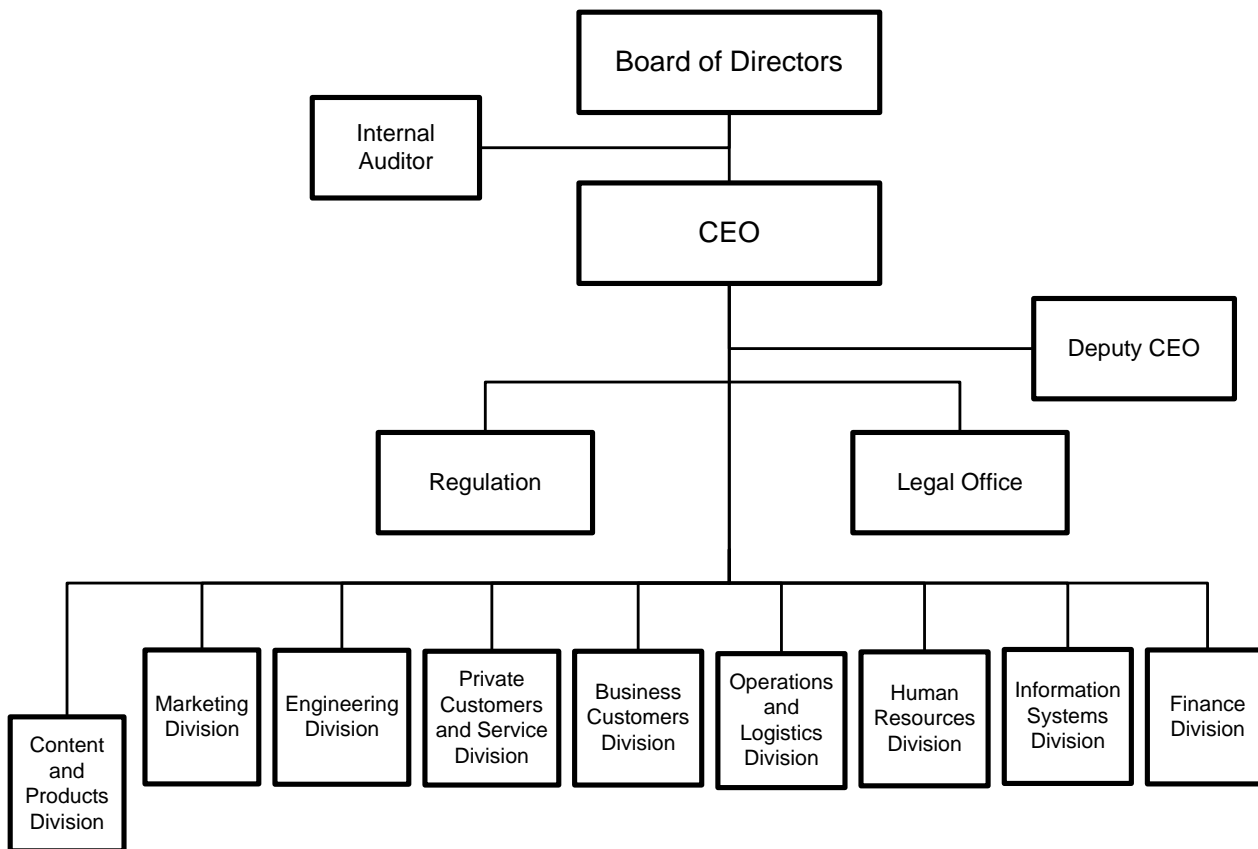
#### **3.10.5 Software, computer systems and databases**

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

### 3.11 Human Resources

#### 3.11.1 Organizational structure

The following is a diagram of Pelephone's organizational structure:



#### 3.11.2 Organizational table

The following details the number of employees<sup>27</sup> in Pelephone in accordance with its organizational structure.

Division	Number of employees	
	31.12.07	31.12.06
Headquarters and management	295	290
Content marketing and products division	102	95
Customer Service and Private Sector Division	2,971	2,427
Business Division	534	438
Operations and Logistics Division	292	306
Engineering and Information Systems Division	617	593
Total	4,811	4,149

<sup>27</sup> The number of employees represents the number of jobs as calculated by Pelephone (total work hours divided by monthly work-hour standard).

### **3.11.3 Changes in the number of employees during 2007**

At the end of 2007, Pelephone's manpower stands at approximately 4,811 employees, compared with approximately 4,149 at the end of 2006. The increase is mainly 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 the field in which he is active. Most training courses take place in the service field, primarily in the service division. Pelephone's total expenses in 2007 and 2006 in respect of instruction and training amount to NIS 10.4 million and NIS 9.3 million, respectively. The employees who work as sales and service representatives and as telephone call center employees have a high churn rate, which requires constant investment in new employees.

### **3.11.5 Employee and Manager Reward Schemes**

It is the practice of Pelephone to award 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 and Employees of the Company and/or Affiliates – see Note 26 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

### **3.11.6 Employment contracts**

All of Pelephone's employees are engaged on the basis of standard personal contracts in accordance with the professions and functions in which they engage.

## **3.12 Products and Suppliers**

### **3.12.1 Terminal equipment suppliers**

The products' inventory of Pelephone includes a range of cellular telephone units and a range of auxiliary accessories (such as: batteries, hands-free kits, earphones, data cables, chargers and so forth). Pelephone also maintains inventory of spare parts for the purpose of supplying 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, the availability of the spare parts and the 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, in order to enable the provision of service to customers as agreed. Replacement of a supplier will involve the addition of exceptional costs as a result of the need to purchase equipment, and will involve a period of re-organizing affairs with the replacement suppliers.

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

Pelephone is presently preparing for the conversion to UMTS technology, and as a part of these preparations it is acting to expand the number of its principal terminal equipment suppliers and suppliers of data transmission equipment.

### **3.12.2 Value Added Service Suppliers**

Pelephone has agreements with content suppliers under which Pelephone receives content such as information services by voice mail, SMS or via 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 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.

## **3.13 Working capital**

### **3.13.1 Stock holding policy**

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

The period over which inventory is held is a consequence of Pelephone's service policy and its sales requirements. The requirements necessitate maintaining an inventory for a period of 3 – 5 inventory months, depending on the type of inventory. As at the end of 2007, the inventory level stands at an amount of approximately NIS 169 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 within a period of 24 hours of the time of the transaction, in accordance with the agreement with customers and in with the conditions thereof, provided that no use has been made of either the product or the accessories to it.

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 Product warranty policy**

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 which regulate issues of 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 spread payments over 36 equal installments. In the past Pelephone's policy was to discount part of the transactions that are paid via 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, in respect of the consumption of MRT services in the preceding month.

As at 2007, total average customer credit less doubtful debts amounts to NIS 1,365 million.

### **3.13.5 Credit from suppliers**

Pelephone receives credit from its suppliers for periods ranging from 30 days to 90 days. As at 2007, total average credit from suppliers and service providers amounts to NIS 542 million. Investment in Investee Companies and in a Partnership.



### 3.14 Investment in Investee Companies and in a Partnership

Until September 30, 2005, Pelephone held 85% of the B-one partnership (hereinafter: the "Partnership"). At the end of the third quarter of 2005, it was decided to transfer the Partnership into the full ownership of Pelephone, and as of the end of 2005, the Partnership has been operating to wind up its business.

### 3.15 Financing

3.15.1 Pelephone's operations are financed by shareholders' equity, bank loans, debentures, discount of credit cards (see section 3.13.4 above) and supplier credit.

The average interest rate in 2007 for undesignated loans was:

	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. As long as 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 that were reviewed by accountants;
- D. Not to mortgage Pelephone's assets 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. Not to provide Pelephone's shareholders or any third party whatsoever with 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. Not to grant Pelephone's shareholders any loan or credit without obtaining the bank's prior written consent to such;
- G. To provide the banks with information, details and various reports;
- H. If Pelephone is in breach of its aforementioned undertakings, then the banks shall be entitled to call for immediate repayment the amounts of the loans extended to it.
- I. 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 favour 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 million 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, 2007, Pelephone is in compliance with its commitments to the banks and to the debenture holders.

In 2007, no new long-term loans were taken.

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, 2007, which are included in this periodic report.

### 3.15.4 Credit limits

Pelephone's credit limits at banks in Israel amount to approximately NIS 2.03 billion as at December 31, 2007. There are no signed agreements with the banks regarding this sum, but rather, there are oral agreements and non-binding written consents. As at December 31, 2007, Pelephone had utilized NIS 452 million of its credit limit at banks.

### 3.15.5 Guarantees and charges

See Notes 13 and 19 to the Company's financial statements for the year ended December 31, 2007, 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). In December 2006, Maalot published a follow-up rating under which Pelephone was rated AA minus yet again.

On May 1, 2007, Maalot, the company that rates all the series of debentures of the Company, announced that following recent discoveries and the report of the external examiner regarding the writing-off of Pelephone's fixed assets, at this stage no change is expected in the rating of Pelephone's liabilities.

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

Pelephone expects to repay a large portion of its loans during 2008, and it plans additional investments in property, plant and equipment (see section 3.9.1.8 above). If necessary, Pelephone will raise new loans from banking corporations and/or by raising capital on the capital market.

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 2007, which are included in this periodic report.

## 3.17 Environmental matters

3.17.1 On January 1, 2007 the Non-Ionized Radiation Law – 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 provided in the law 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 ("additional permit").

The law provides a two-step licensing mechanism, by which 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, the law subjects provision of the permit to performing an assessment of the maximum levels of radiation human beings and the environment are expected to be exposed to from the radiation source once it is operated, including in the event of a malfunction, and to implementing the measures needed in order to limit the levels of exposure of human beings and the environment to the radiation expected from the radiation source once it is operated, including the implementation of technological means that are in use ("**the limiting measures**").

As regards the operation permit, the law subjects provision of the permit to implementation of the limiting measures and to measuring the levels of exposure of human beings and the environment to the radiation created during the operation of the radiation source, with these levels not exceeding the maximum levels of exposure provided by the commissioner in the law. Furthermore, the law also conditions provision of the operation permit on presenting a license according to the **Communications (Telecommunications and Broadcasts) Law 5742-1982** and presenting a license according to the **Planning and Building Law, 5725-1965**, except when a building permit is not required and then the law requires submitting to the local committee a statement in which the applicant specifies the reasons that a building permit is not required for the radiation source. If the engineer of the

local council or the district planner does not object to granting the operation permit within 21 days from the day of submitting the statement, an additional statement shall be submitted by the applicant in which it is stated 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 without a permit, after having been warned in writing by the commissioner according to the law, is a strict liability offense, 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 facility or another requires a building permit, and have objected to granting it an operation permit.

The law even indirectly amends the **Planning and Building Law, 5725-1965** and provides that a condition for granting a building permit to a cellular broadcasting facility is 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 Non-Ionized Radiation Law includes transitional rules regarding ending of radiation permits granted under the Pharmacists Regulations. During 2007, Pelephone made preparations on the basis of an annual plan to renew all the construction and operation permits of the transmission sites according to the Non-Ionized Radiation Law. Renewal of the permits and receipt of new permits pursuant to the Non-Ionized Radiation Law for all the sites was carried out based on the annual plan such that every month some of the radiation permits were renewed. Recently, there have been delays and difficulties with respect to the handling of the renewal and obtaining the construction and operation permits as required by the Non-Ionized Radiation Law, 2006, and the manner of its implementation by the Supervisor of Radiation in the Ministry of the Environment. In addition, in December 2007, the employees of the Ministry of the Environment commenced sanctions that included, among other things, non-acceptance and/or partial treatment and/or providing short-term permits and/or not handling requests for radiation permits or various requests for permits in respect thereof.

The above-mentioned sanctions delayed somewhat treatment of the requests submitted that month. As at the date of this report, requests for new radiation permits have been submitted with respect to all the transmission sites of the Pelephone network and, except for a very small number of requests that were delayed a bit mainly due to the sanctions, all the radiation permits were renewed, some for short periods owing to the sanctions. Regarding certain types of facilities, new class radiation permits were received in accordance with the Non-Ionized Radiation Law. At the end of January 2008, a full strike broke out in the Radiation Department of the Ministry of the Environment. As a result of the strike, the entire treatment of radiation permits stopped and, in this framework, new requests cannot be submitted in respect of new facilities and/or renewal and/or extension of permits and there is a delay in obtaining permits for facilities the construction of which was already approved. Regarding building permits and access facilities – see also Section 3.18.3.3 below.

If the delays and problems are not resolved within a reasonable period of time and permits are not issued for these facilities, it will be necessary to discontinue transmitting from certain facilities to the extent other solutions are not found.

During the year the Minister of the Environment prepared 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 have to be signed also by the Minister of Communications. These regulations have not yet been published. The draft Regulations include instructions that make it difficult to construct wireless access facilities on roofs and roof terraces of apartment buildings (see also section 3.18.1.3. below).

### **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 for the Environment. Pelephone invests on average NIS 4 million per annum in respect of this activity. The Radiation Regulations that have not yet come into effect 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 actions

The Minister of the Environment submitted the Non-Ionized Radiation Regulations – 2007 to the Interior and Environment Committee of the Knesset. The regulations were promulgated and approved by the committee but have not yet come into effect. In accordance with the version of the regulations that was approved by the committee, the regulations 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 facilities 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.

Delays and difficulties in the process of renewing construction and operation permits as required by the Non-Ionized Radiation Law – 2006 and its manner of implementation have been recently imposed by the Commissioner of Radiation in the Ministry of the Environment.

If these difficulties and delays are not resolved within a reasonable period of time and permits are not provided for devices, it will be necessary to stop broadcasting at certain devices if no other solutions are found. If this should happen, meeting the figures specified in Section 3.18.1.3. will be negatively affected.

This information includes forward-looking information that is based on Pelephone's assessments. Actual results may be significantly different from the above assessments if there is a change in any of the factors taken into account in making these assessments.

#### 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 performance of telecommunication activity and the provision of telecommunication services, including the MRT services, 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 field 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 various 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 (hereinafter: "**The Telegraph Ordinance**"), regulates the use of the electromagnetic spectrum, and applies, inter alia, to the use made by Pelephone 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 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, point to point wireless lines, satellite stations etc. For the allocation of radio frequencies to Pelephone, see section 3.10.2 above.

### 3.18.1.3 Facilities emitting electromagnetic radiation

On December 20, 2005 the Knesset passed the Non-Ionized Radiation Law 5766-2006, which applies to the use of facilities that emit electromagnetic radiation, and as from January 1, 2007 regulates radiation licensing. See section 3.17 and section 3.18.3.3.

### 3.18.1.4 The Consumer Protection Law

During the course of its operations, Pelephone is subject to the Consumer Protection Law, 5741-1981 (hereinafter: 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.

## 3.18.2 Controlled tariffs

Payments for interconnections:

The Telecommunications (Payments for Interconnection) Regulations 5760-2000 (hereinafter: the "**Regulations**") prescribe limitations regarding payments to be made or to be received from a domestic carrier or another MRT carrier under the Regulations. In December 2004, the regulations were amended as follows:

- A For the purpose of interconnectivity 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 tariff of NIS 0.32.
  2. As of March 1, 2006, the tariff was reduced to a maximum tariff of NIS 0.29.
  3. As of March 1, 2007, the tariff will be reduced to a maximum tariff of NIS 0.26.
  4. As of March 1, 2008, the tariff will be reduced to a maximum tariff of NIS 0.22.
- B With respect to payments received from an international licensee for completion of traffic on an MRT network, the current tariff of NIS 0.25 for call completion will be reduced, as of March 1, 2008, to a maximum tariff of NIS 0.22.
- C. With respect to payments received from another MRT carrier 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 tariff of NIS 0.025.
- D. The tariffs in paragraphs (A) to (C) above will be revised once a year, commencing March 1, 2006, in accordance with the rate of change of the Consumer Price Index.
- E. For the purpose of calculating payment for airtime and call completion to an MRT network, 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:

Date	Domestic interconnect (per minute tariff)	International interconnect (per minute tariff)	SMS
To Sep 2000	62.0	62.0	
From Oct 2000	54.0	25.0	
From Jan 2002	50.0		
From May 2002	50.0		38.0
From Jan 2003	45.0		

Date	Domestic interconnect (per minute tariff)	International interconnect (per minute tariff)	SMS
From May 2004	45.0		28.5
From Mar 2005	32.0		5.0
From Mar 2006	29.69	25.57	2.56
From Mar 2007	26.59		
From Mar 2008	23.27	23.27	2.71

Note: The tariffs are presented in Agorot and do not include VAT. The tariffs as of March 2008 are adjusted for the CPI known in January 2008.

### 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 6 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 18G to the financial statements of the Company for the year ended December 31, 2007 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, applicable to which (with some changes) are the provisions of the general license awarded to Pelephone by the Ministry of Communications.

The following are the principal provisions of Pelephone's license (hereinafter: in this section "**the licensee**"):

- A Under certain circumstances, the Minister is entitled to modify the conditions of the license, to restrict it or to suspend it, 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 realisation 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 realised 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 interest<sup>28</sup> over

<sup>28</sup> "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.

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, to lease or to 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 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.
- I. The license sets forth the types of payments that the licensee is entitled to collect from its subscribers for cellular services, the mechanisms of setting tariffs, the 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-in centres, the determination of a maximum period for repair of malfunctions, an accounts collection procedure, protection of the privacy of the recipient of the service and so forth.
- K. To secure the licensee's undertakings and also in order to compensate and indemnify the State of Israel in the event that it sustains damage due to acts of the licensee, the licensee must furnish a bank guarantee in the amount of \$ 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:

- A. The Ministry of Communications prescribed, in an amendment to the MRT licenses which came into force on January 7, 2007, that subscribers who are redirected to voice mail shall be given the option of disconnecting without charge, by a preliminary voice message informing the subscriber that he is being transferred to voice mail, the charge being imposed only after that message. Pelephone implemented the amendment on time as prescribed by the Ministry of Communications. According to the data received to date regarding call disconnections by subscribers before reaching voice mail as a result of the preliminary message, substantial harm has been caused to Pelephone's revenues.
- B. 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 the aforesaid license amendment and submitted an economic opinion together with its objection.

On November 27, 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 the said change. The Ministry of Communications has not yet made a decision on the matter.

- C. 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 receive erotic services will be removed by submitting a request in writing 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 was delayed for the time being according to a temporary injunction that was 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.
- D. On April 17, 2007, the Ministry of Communications sent a hearing document to the cellular operators regarding annulment of the clause in the MRT licenses that allows selling plans with billing segments that differ from 12 seconds. In accordance with the document, Pelephone will be able to sell plans with 12 second billing segments only, and as from January 1, 2009, plans with only 1 second billing segments. In August 2007 the Ministry of Communications made its decision on the hearing, by which as from September 4, 2007 the cellular companies are not allowed to sell plans having billing segments longer than 12 seconds. Furthermore, in its decision the Ministry of Communications referred to the amendment to the license from December 2004 and noted that billing according to segments of 1 second as from January 1, 2009 as provided in the regulations (see also Section 3.18.2 of the periodic report) will apply retroactively also to plans that were sold before this date, contrary to the position of Pelephone.
- E. In August 2007 the Economic Committee of the Knesset established a sub-committee for the Economic Committee on the matter of promoting competition in the cellular industry. The sub-committee has chosen to focus on the transparency of the cellular companies' bills.

The committee proposed a number of changes in the present structure of the bill. Furthermore, at the beginning of October 2007 a ministerial committee of the Ministry of Communications was established for the purpose of promoting changes in the bills of the cellular companies in order to increase transparency. The committee is expected to adopt the recommendations of the sub-committee of the Economic Committee and even to recommend additional changes. Pelephone has given its blessing to the plan and is acting to improve its customer bills.

- F. In September 2007 the Ministry of Communications published a hearing to the cellular companies in which it is proposed to amend the MRT licenses so that the maximum period of commitment in subscription plans will be limited to 18-24 months. This hearing is based on the recommendations of the consultation firm that examined the issue of virtual operators for the Ministry of Communications and also examined the level of competition in the Israeli

cellular market. According to the recommendations, the accepted period of commitment in the Israeli market is 36 months and it is longer than the accepted period in similar competitive markets in Europe. Pelephone's position was that the shortening of the commitment period should not in any case be implemented retroactively and that the companies should be allowed to offer a range of plans with various commitment periods in addition to plans with no period of commitment. On January 21, 2008 the Ministry of Communications published a secondary hearing regarding the shortening of the commitment period. In this hearing the Ministry proposed an amendment to the MRT license, by which the maximum commitment period in the agreements with subscribers who are not business subscribers shall be shortened to 18 months and the cellular companies shall be obligated to offer, in addition to the plans including a commitment period, reasonable alternatives from an economic point of view that do not include a commitment period. Pelephone has submitted its remarks and as at the date of publication of this report, a final decision has not yet been received from the Ministry of Communications.

- G. On January 14, 2008 the Ministry of Communications published a hearing on an amendment to the MRT licenses regarding fixed period transactions. In accordance with the proposed amendment, when an agreement is made with customers who are not business customers regarding the provision of a service or basket of services for a fixed period (in the cellular market this means agreements that include a commitment for a tariff plan, for a service, etc., for a fixed period), the licensee is obligated to notify its customers of the last date of the transaction on each bill sent to the customer, and between one and two months before the end of the transaction to notify the customer also by means of a special letter that specifies the terms that will apply when the fixed period transaction ends. In addition to thus notifying the customer, in every fixed period transaction with a customer who is not a business customer, the licensee is required to give notice in advance of the rates that will apply during the transaction. This means that if the rates are expected to be adjusted during the period of the fixed transaction, the customer should be notified in advance, in the agreement, the exact dates of the adjustments and the exact rates after the adjustments. Pelephone has submitted its comments on the hearing and as at the date of publication of this report, a decision has not yet been made.

#### 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, the rate of these royalties amounted to 3% of its revenues subject to royalties. Under the Regulations, the rate of royalties is to be reduced by 0.5% to a rate of 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 2007 that are 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, changes in configuration and changes in existing antenna systems.

Pelephone erects two main types of broadcasting sites under two tracks: Macro sites that require a building permit from planning and building councils and wireless access facilities (hereinafter – access facilities) that are exempt from a building permit in accordance with Section 27 of the Communications Law and Section 266C of the Planning and Building Law 5725-1965 (hereinafter – the exemption provision).

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

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 IDF.

Various parties have criticized NOP 36, following which a proposal for its amendment was prepared. At the end of 2005 the Government of Israel rejected the proposed amendment to NOP 36 that was prepared by the planning administration of the Ministry of the Interior and requested from a committee of director generals to prepare recommendations on the matter and returned NOP 36 for additional deliberation to the national planning and building council.

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 as a condition for issuing a permit for the construction of a cellular broadcasting facility, a local council shall request to receive a deed of indemnity in respect of claims for compensation in respect of loss of value pursuant to Section 197 of the Planning and Building Law, and that the indemnity will be according to the instructions of the national council, which will be in effect until approval of the national outline plan arranging this matter. On January 3, 2006 the national council decided that the local councils are to request full indemnity (100%) from those requesting such a permit. It was also decided to examine the recommendations of the director generals' committee by a committee of editors that shall present its recommendations regarding the need for changing the NOP and its contents. As at the date of this update, Pelephone has deposited with various local councils 170 deeds of indemnity 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. This new version, if it should pass all the necessary proceedings and come into effect, shall 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 aforementioned amendment of NOP 36 is subject to the approval of the national planning and building council and the Government of Israel.

Allegations were raised against the present NOP 36 by which it does not arrange the matter of providing permits to facilities that operate under certain frequencies called "third generation frequencies" that are not included in the list of frequencies attached to NOP 36. The competitors of Pelephone have a large number of sites that broadcast under third generation frequencies and have received building permits according to NOP 36. Pelephone disagrees with these allegations and intends to use the third generation frequencies it acquired from the Ministry of Communications like its competitors. The proposed new version of NOP 36 includes a clarification to 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 and also the coverage, is based partly on its ability to set up cellular sites and to install infrastructure equipment, including broadcasting sites. The difficulties encountered by Pelephone in obtaining the required permits and approvals may

adversely affect the existing infrastructure, the network's performances and the setting-up of any additional cellular sites required by the network.

The inability to resolve these problems on a timely basis is even 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, administrative or other delays occur 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. Applications for the building permits have been submitted by Pelephone with the planning and building authorities, and are at various stages of discussion and approval.

The erection 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 the issuance of demolition orders against sites or the filing of 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 the above mentioned cases to avoid demolition or delay the execution of demolition orders pursuant to arrangements it reached with the planning and building authorities in order to resolve the matter of the deficient licensing. These arrangements have not necessitated 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, like Israel's other MRT operators, 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 at 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 erects broadcasting sites is the access facilities track. The access facilities 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.

Various local authorities have disputed the applicability of the exemption provision to access facilities of a cellular network and to its use. The position of Pelephone regarding the applicability of the exemption was accepted in a number of rulings and decisions of local affairs courts and the use of such facilities and the supporting equipment in them was approved. One verdict in the same instance provided an opposite ruling. Appeals were submitted in respect of some of these decisions and rulings which are pending before the District Court. A petition was submitted to the High Court of Justice against the legality of using the exemption provision for cellular network access facilities, 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. As at the date of this report the Attorney General has not yet provided his opinion on the matter.

Pelephone uses access facilities in order to provide coverage and capacity to highly populated areas. Reducing or preventing use of the access facilities track in a given geographical area may have an adverse effect on service in that area until substitute broadcasting sites can be built. As at the date of this report, Pelephone operates 274 wireless access facilities.

Likewise, Pelephone, like Israel's other MRT operators, provides internal relays inside buildings in order to provide service in the buildings. These relays are small facilities that are attached to external antennas of around 60 cm in length. This antenna enables a broadcast signal to be received from a close 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 of Israel's MRT operators, 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 facilities, on the basis of a clause in the Non-Ionized Radiation Law that conditions the provision of operation permits for access facilities on the approval of the relevant authority. Additional authorities are anticipated to join this objection. As a result of these objections the Ministry of the Environment is refusing to issue operation permits to access facilities that were erected according to the law in these authorities.

Meetings were held in the last month in the Interior and Environment Committee of the Knesset regarding regulations for the Non-Ionized Radiation Law. The regulations provide a set of rules for the erection of sites, such as safety distances, location of the sites, etc. After the committee completes its deliberations and the regulations are approved, the Minister of the Environment and the Minister of Communications are to sign the regulations as final approval. On the matter of access facilities, courts of local affairs recently handed down two additional rulings which recognized the legality of erecting wireless access facilities of cellular networks.

#### **3.18.4 Antitrust**

The document setting out the conditions of the merger between Pelephone and Bezeq sets out various restrictions as to cooperation between the companies. During the course of 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 it 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 edition, in the field of mobile radio telephone (cellular) services.

The approval is in force until October 12, 2010.

ISO 9001 2000 edition consists of 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 and the tendency of its customers in particular, to contract exclusively with suppliers meeting the requirements of 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 added value services, see section 3.12.2 above.

For roaming agreements see section 3.2.1 above.

### **3.21 Legal proceedings**

For legal proceedings, see Note 17 of the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

### **3.22 Goals and Business Strategy**

#### **Pelephone's principal strategic goals are:**

1. Increase revenues and improve profitability;
2. Lead with third generation;
3. Launch an additional UMTS network.
4. Increase its market share in the long term.

In order to achieve its goals, Pelephone operates on a number of principal levels:

#### **1. Increasing customer satisfaction**

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

#### **2. Third generation lead**

Pelephone has set itself a goal of being a third generation leader. In 2007 Pelephone has reached leadership in this area and it presently has the largest number of subscribers with third generation handsets compared to its competitors. This leadership is expressed by an increase in revenue from third generation services and by the number of subscribers who join such services.

This leadership will be preserved by continuing the following actions:

- A. Launching a broad range of third generation handsets.
- B. Setting up a communications structure to cover all content.
- C. Placement of Pelephone as a company that supplies the best 3G cellular entertainment.

#### **3. Continued investment in infrastructure**

Pelephone is in the process of setting up another cellular network using UMTS technology (see section 3.1.5.3 above).

The above information includes forward-looking information, which is based on Pelephone's assessments taking into account past experience, surveys regarding the state of the industry 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 Development outlook for the coming year**

During 2008, a number of factors are expected to affect Pelephone's activities, the principal ones are as follows:

#### **3.23.1 Continued reduction of interconnectivity fees**

As set out in section 3.18.2 above, on March 1, 2008, interconnect fees will drop by another 4 Agorot. This reduction might harm Pelephone's revenues.

#### **3.23.2 Third generation services**

Pelephone expects that during 2008, it will increase the amount of customers that use third generation services, it will increase its range of such services and as a result, Pelephone will continue to increase its revenues in this field.

### **3.23.3 Innovative added value services**

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

### **3.23.4 Number Portability**

Number portability might ease the transition of customers from Pelephone's network to those of its customers. In Pelephone's assessment, when number portability comes into force (see section 3.7.3 above), the transition of customers between cellular carriers will increase and this might have an adverse affect on Pelephone's financial results.

### **3.23.5 Set-up of another cellular network**

During the course of 2008, Pelephone's intends to set up an additional cellular network using UMTS technology (see section 3.1.5.3 above).

The information in this section includes forward-looking information, which is based on Pelephone's assessments taking into account past experience, surveys regarding the state of the industry 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.

## **3.24 Discussion of Risk Factors**

The Israeli market in which Pelephone operates is substantially stable, however, there are risk factors which stem from the macro economic environment, from the unique qualities of the industry in which Pelephone operates, and from risk factors that are unique to the Company.

### **3.24.1 Macro-economic risk factors**

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

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, whilst Pelephone's income is in Shekels. Erosion of the shekel as against the Dollar might harm Pelephone's profits in the event that adjustment of sale prices is not permitted 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. Those of Pelephone's loans and debentures that are linked to the consumer price index bear fixed interest and therefore fluctuations in the interest rate will affect their fair value but not their book value.

### **3.24.2 Industry-based risk factors**

3.24.2.1 Investments in infrastructure and technological changes – The cellular market in Israel and elsewhere is characterized by material capital investments in the deployment of infrastructure and in subscriber equipment. The frequent technological changes in the field of infrastructure and terminal equipment, and also the fierce competition over various market segments, impose a heavy financial burden on the companies operating in the market, which necessitates updating their infrastructure technology from time to time or to penetrate new appliances into the market at heavy cost.

3.24.2.2 Customer credit – Pelephone's sales to its customers are mostly done on credit. Some of this credit is secured using credit insurance which includes policyholder's self participation, 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 large spread of its customers, Pelephone assesses that the extent of its risk of substantial harm to its business results is low.

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, etc. These regulations might, inter alia, make it much more difficult to construct cellular sites, so as to impair network quality, increase the costs of services and marketing, and due to the strong competition it might not be possible to roll those costs in full onto consumers, as a result of which, profits in the industry might be eroded. Furthermore, regulatory interference and the uncertainty it entails may have an adverse effect on the ability of the Company to plan its business conduct.

- 3.24.2.4 Competition – The cellular market in Israel is characterized by a high degree of saturation, strong competition and is exposed to influences as a result of technological and regulatory developments.
- 3.24.2.5 Electromagnetic radiation – Pelephone operates hundreds of transmission facilities and sells terminal equipment that emit electromagnetic radiation (see Section 3.18.1.3 above). Pelephone is taking steps to ensure that the levels of radiation emitted by the aforementioned transmission facilities and terminal equipment do not exceed the levels of radiation permitted in the directives of the Ministry of Environment (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 the Company's services, difficulty in renting sites, claims for bodily 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 insurance policies do not presently cover liability for electromagnetic radiation.
- 3.24.2.6 Site licensing – The erection and operation of cellular antennas are subject to building permits from the various planning and building committees, a process that involves, inter alia, obtaining a number of approvals from Government entities and regulatory bodies. For details of the difficulties encountered by Pelephone in the erection 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 might be caused as a result of 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, various forms of 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 via designated communications lines and via the internet. Pelephone's business is highly dependent upon these systems. Large-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 spread out around the country via network core sites and antenna sites. Pelephone's business is totally dependent upon these systems. Large-scale malicious harm or malfunction might adversely affect Pelephone's business and results.
- 3.24.3.5 Legal proceedings – Pelephone is party to legal proceedings, including class actions, which are liable to result in its being ordered to pay material amounts that cannot presently be estimated, and in respect of most of which no provision has been made in Pelephone's financial statements. Pelephone is exposed to class actions. Class actions may reach high amounts, since approximately one third of the residents of the State 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 recognized as a class action applicable to all or a large proportion of those consumers for legal proceedings to which Pelephone is a party.

3.24.3.6 Frequency restrictions and interruption of use in frequency bands – At present, the volume of vacant frequencies that can be allocated to Pelephone over and above the frequencies it has in the CDMA range is limited. The frequencies range used by Pelephone for operating the CDMA technology network is also used by land based television broadcasts, and part of the range is also used for cellular communications using GSM technology. Due to the use of those frequency ranges, broadcasts by a number of television stations transmitting in the Middle East cause disturbances in the operation of Pelephone’s aforementioned network. In some cases, these disturbances have reached a level that prevents high quality CDMA-technology communication in parts of the Pelephone network. Likewise, in light of the peace agreement with Jordan, Pelephone is precluded from making use of part of the frequency range that is suitable for the CDMA network, since the Jordanians use it for the networks they operate using GSM technology. In addition, in the next few years, digital multi-channel television broadcasts are expected to evolve, transmitting a large number of compressed video channels, and this could aggravate the existing disturbances in the operation of Pelephone’s CDMA 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**

<b>Risk factors</b>	<b>Large</b>	<b>Medium</b>	<b>Small</b>
<b>Macro-economic risk factors:</b>			
Recession		X	
Exposure to changes in the exchange rates, interest rates and inflation.		X	
<b>Industry-based risk factors:</b>			
Investments in infrastructure and technological changes	X		
Customer credit			X
Regulatory developments	X		
Competition	X		
Electromagnetic radiation*			
Site licensing	X		
<b>Pelephone’s Risk Factors:</b>			
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 degree of 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 company, 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"), and integration services offering Bezeq International's business customers comprehensive communication solutions, including data services, web and server hosting, and maintenance services and technical support for networks ("Integration Services").

Bezeq International's data communication services include: point to point (P2P) lines, frame relay, virtual private networks, ATM, ISDN, video conferencing facilities and IP services.

In addition to the services specified in this chapter of the periodic report, since its full merger with BezeqCall Communications Ltd. ("BezeqCall") on 11 February 2007 ("the Date of the Full Merger"), Bezeq International has been providing network end point services ("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 providing installation and maintenance services for these systems.

#### **4.1.2 Legislative and statutory restrictions applicable to Bezeq International**

The communications market in Israel is primarily regulated by the Communications Law (Communication and Broadcasting) 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 Bezeq's international 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 11 July 2007, the Ministerial Committee approved an amendment to the Communications (Telecommunications and Broadcasting) 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 Economics Committee, propose 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 data before it makes any decision in this regard. At this stage, before the bill is passed in the first reading and submitted to the Economic Committee of the Knesset, and 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 Application for a special domestic operator license**

On 16 May 2006, Bezeq International applied to the Ministry of Communications for a general special license to operate Bezeq domestic fixed-line services. Under this license, Bezeq International will provide, inter alia, domestic VOB services (which are an integral part of the product mix of internet providers), and will allow

Bezeq International to continue to provide its customers comprehensive communication solutions (similar to those offered by its competitors, some of which have already received similar licenses) and to compete as equals.

#### 4.1.2.3 Special marketing trial license to provide VOB services

On 6 December 2004, the Ministry of Communications granted Bezeq International a special license to conduct a marketing trial of domestic telephony services using Voice Over Broadband (VOB) technology. The trial allowed Bezeq International to provide full VOB services, for payment, to a maximum of 8,500 lines. The trial license was initially granted for one year, and was extended from time to time, with the last extension valid to 28 February 2007. Following the petition for an interim injunction submitted by Bezeq International against the Minister of Communications, set forth in section 4.19.4 below, on 27 February 2007, the Ministry of Communications notified Bezeq International of the extension of the validity of the marketing trial until the ruling on this injunction.

On 5 September 2007, the Supreme Court ruled to dismiss the petition and allowed the Ministry of Communications' decision to stand. In view of the Supreme Court judgment, the Ministry of Communications instructed Bezeq International to cease the supply of services to its customers and end the trial by 15 October 2007, the date for disconnecting all trial customers.

Under the decision of the Ministry of Communications, Bezeq International shall not be eligible for a permanent domestic operators license until the Company's market share falls below 85%.

#### 4.1.2.4 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 revenues from supply of international call services and P2P lines, less permitted expenses and with the exception of revenues 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.

#### 4.1.2.5 NEP license

On 31 December 2006, the Ministry of Communications approved 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.

### 4.1.3 Main entry and exit barriers

- 4.1.3.1 The main entry barrier in the international call market is the need for 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 time to return.

Furthermore, Bezeq International is committed to provide service to its customers for the period of engagement with them.

#### **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 bear 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 cost of using these services leads to a steady growth in the number of users, and as a result – a decline in the revenues of Bezeq International.

#### **4.1.5 Structure of competition in the sector and changes therein**

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 market volume. 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-Kavei Zahav Ltd. (Internet Zahav), Netvision Ltd., and Xfone Communication Ltd., all of which started 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 above-mentioned expansion of competition had a negative effect on the results of Bezeq International's operation and on its financial condition, but since market prices have not yet stabilized, Bezeq International is unable to estimate, at this stage, the extent of the overall effect on the expansion of competition in the sector.

4.1.5.2 Following the mergers, as of the end of 2007, the consolidated company Netvision Barak 013 operates with one international dialing code. This was also the intention for Smile 012 – the Ministry of Communications allowed continued use of the dialing code 015 until the end of 2008 – meaning one company has two international dialing codes.

4.1.5.3 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.

4.1.5.4 In December 2004, the Ministry of Communications permitted Bezeq International to provide fixed line telephony services over its internet network (VoIP) to 8,500 customers for a trial period of one year (which was extended to the end of August 2006).

On 20 April 2005, the Ministry of Communications gave notice of its intention to amend the main points of the policy it published concerning the license for providing telephony services by broadband access (VOB), in a way that will prevent Bezeq International from providing the service until the market share of the Company in fixed-line domestic telephony in a particular customer segment (business or private) falls below 85% or until another decision is made after examining competition in that field in November 2006 and 2007. This policy amendment, if adopted, is liable to remove Bezeq International from this developing market. This will award its competitors in internet access and international dialing services (most of which have received marketing trial licenses from the Ministry of Communications for providing these services and some are already operating in accordance with it) a clear competitive advantage in that they will be able to offer their customers a total communications solution combining internet access and international telephony and fixed-line domestic

telephony services. On 7 February 2006, the Ministry of Communications held a hearing in which Bezeq International was given an opportunity to make oral claims regarding the introduction of the aforementioned policy amendment. Following the hearing, on 8 February 2006, the Ministry of Communications published a notice of its intention to ease the limitation on Bezeq International and to permit it to act in VOB, under certain restrictive conditions.

On 31 January 2007, the Minister of Communications decided to amend the policy of the Ministry of Communications regarding the licensing of VOB services, pursuant to which Bezeq International would only be granted a license to operate domestic land-line telephony services using VOB technology once the Company's share of the market for domestic land-line telephony dropped below 85%. Following that decision, the Ministry of Communications granted 012 Golden Lines Ltd. a permanent license to provide VOB services as part of its special domestic license, and gave notice of its intention to grant similar licenses to other licensees. On 5 February 2007, Bezeq International petitioned the Supreme Court, sitting as the High Court of Justice, to revoke the Minister's decision, as set out in section 4.19.4 below.

On October 15, 2007, following the judgment of the High Court of Justice, the Ministry of Communications revoked the Bezeq International's license for trials in the field.

The inability of Bezeq International to offer a similar total solution could cause the departure of existing customers in favor of the services of competitors and could present difficulties in attracting new customers. At this stage, Bezeq International is unable to estimate the effects of expected churn on the results of its operations and on its financial situation. In this regard see also section 2.6.1 above.

- 4.1.5.5 Implementation of the numbering plan and number portability could also affect the difficulty of Bezeq International to provide a solution for the needs of its customers, which include ISP and domestic operator packages.

Furthermore, implementation of the numbering plan and number portability (see section 2.6.6 above) could require Bezeq International to make additional investments in infrastructure and equipment.

## **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. In this regard, see also section 2.6.1 above.

### **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 fast 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, including 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 multi 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 will focus on data, server and website 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 communications 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 Revenues

Below are data of Bezeq International's revenues (in NIS millions):

	2007	2006	2005
Total revenues	1,304	1,022	815
Gross profit (%)	34%	35%	35%

### 4.4 New products

Following are descriptions of the principal new products launched in 2007:

- 4.4.1 **Disk-online service** – network backup/storage solutions for private customers for 1, 5, and 10 G volumes
- 4.4.2 **Heritage service** – screening of network content, designated for the religious community
- 4.4.3 **Virtual domain server (VDS)** – offering a virtual server stored and managed at Bezeq International (and not at the customer's premises), with a configuration for a number of virtual server environments on one physical server
- 4.4.4 **eToken** – authentication systems for end users for secure access of employees/external suppliers to the organization; a solution for customers in all segments
- 4.4.5 **SSL VPN** – secure access systems for organizational applications of the organization's external users; a solution for customers in all segments
- 4.4.6 **Applicure** –firewall for application security of websites for server farm customers and onsite solutions

- 4.4.7 **VMWARE** – virtualization solutions for merging servers for business customers at the customer's premises.
- 4.4.8 **Pointsec** – Check Point endpoint security systems (computers and laptops) for business organizations.
- 4.4.9 **F5** – application delivery systems, a solution for balancing loads and accelerating applications for websites and server farms; designated for strategic customers
- 4.4.10 **EMC** – from leading storage solutions manufacturers, designated mainly for the enterprise market
- 4.4.11 **Beyond Security** – automatic scanning system for vulnerability assessment of information security for customers
- 4.4.12 From the date of the full merger, Bezeq International absorbed all the products and services that BezeqCall sold and supplied at that time. In this matter see update to 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 set out below:
  - 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
  - 4.5.2.5 Yes@wow – a joint venture with DBS in which subscribers are recruited for integrated packages comprising internet access, multi-channel television, and company internet access infrastructure (for further details see also section 5.16 below)
- 4.5.3 Bezeq International operates sales channels for the business market, as set out below:
  - 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 portfolio 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 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 A telemeeting center for setting and coordinating meetings with potential customers for SMB and SME customers

- 4.5.3.6 SME sector which concentrates customer managers who recruit and manage medium-sized customers on an ongoing basis
- 4.5.3.7 ENT sector which concentrates customer managers who recruit and manage strategic customers on an ongoing basis

## 4.6 Competition

The main characteristic of market competition is market consolidation, which includes the mergers of Barak - Netvision, Golden Lines - Internet Zahav, and on the other hand, the merger of Bezeq International with BezeqCall.

The domestic carrier is a new issue with customers and will allow for the drafting of agreements with customers with respect to connections to the internet and international calls.

The competition is characterized by eroding tariffs.

### 4.6.1 Voice services

- 4.6.1.1 At the end of 2007 there were four competitors operating in the market: 014 Bezeq International, Netvision 013 Barak, 012 Smile (still operating with two dialing codes – 012 and 015), 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 2007

- 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

This market has three competitors after the mergers: 014 Bezeq International has a market share of 36% and Netvision-Barak and Internet Zahav-Golden Lines share the remainder of the market.

- 4.6.2.1 General characteristics of competition in 2007

- 4.6.2.1.1 Some 72% of Israeli households are connected to the internet, and 95% of these have high-speed 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 and acts to restrict Bezeq International's internet operations, for example the Mega-7 bundle. After Bezeq International's petition to the court, HOT was required to terminate its exclusive cooperation with the competitors, until it acts equally with Bezeq International.

- 4.6.2.2 Main developments in 2007

- 4.6.2.2.1 Continued slowdown 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 (4, 7, 8, 10 Mb)
- 4.6.2.2.3 Continued transition 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, and, in view of the market saturation, emphasis on nurturing customer loyalty
- 4.6.2.2.6 Strengthening sales of bundle and triple packages in the market, meaning infrastructure suppliers affect market behavior

#### **4.6.3 Solutions for the business sector – Bezeq International business**

##### **Characteristics of the business sector in 2007**

From the aspect of customer orientation and with the aim of increasing revenues from business customers, Bezeq International started supplying integration services to businesses in 2007, 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 rest of the 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. The expectation is that Internet Zahav will reinforce its integration solutions in the merged company, and that Netvision will also continue to do so.

##### **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, Telrad, GlobeCall, Gil International and Tel-Yad.

The data communications and IP telephony field is characterized by the entry of new players – IT companies – into the world of voice. These are companies such as Binat, Taldor, Netcom, and IBM. These companies 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 civil year
- 4.7.3 Internet services – best results usually obtained 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 in the summer vacation months).

#### **4.8 Property plant & equipment**

- 4.8.1 In the periodic report for 2005, Bezeq International referred to international communications infrastructure (underwater cables and international switches) which the Company leases (mainly from Mediterranean Nautilus Limited) as plant and equipment. Upon adoption of IFRS, Bezeq International's rights in international infrastructure can no longer be regarded as 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 (which, at this stage, are still being used as a non-substantial component in the Company'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, through which advanced services are provided to its customers.

Bezeq International has long-term lease agreements for the two main structures in which it is based, for average periods of 6 years.

- 4.8.3** On 14 November 2006, Bezeq International signed an agreement with Avnet Choshen Building and Investment Company Ltd. to lease 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 Actcom Active Communications Ltd.**

On 13 December 2006, Bezeq International signed a transaction to acquire 100% of the shares of Actcom Active Communications Ltd., Israel's first internet access service provider, from its two founders. Actcom, whose offices are in Haifa, shall continue to run its business as an independent subsidiary of Bezeq International. On 9 July 2007, the Registrar of Companies approved the full merger of Actcom and Bezeq International Ltd., under the provisions of section 323 of the Companies Law, 5759-1999, such that Bezeq International received Actcom (all of its assets, rights and liabilities) and Actcom was removed from the register.

For the operations of Bezeq International and BezeqCall Communications Ltd. (a wholly-owned subsidiary company of Bezeq engaging in NEP), see the update to section 1.1.5 above.

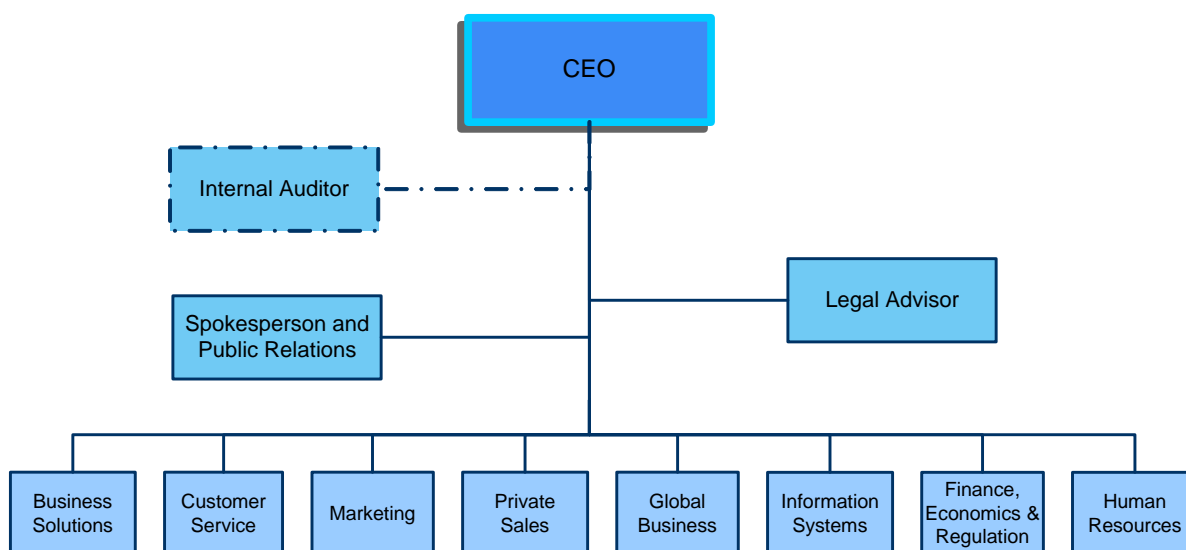
## **4.10 Human resources**

- 4.10.1** On 18 June 2007, the appointment of the deputy CEO as acting CEO of Bezeq International was approved (in place of CEO of Bezeq International, who was appointed acting CEO of the Company). The position of deputy CEO of Bezeq International was cancelled. On 6 November 2007, the acting CEO's appointment as CEO was approved.

- 4.10.2** The number of persons employed by Bezeq International (employees of the Company, employees of human resource firms and outsourcing) is 2,621, of which 883 are headquarters staff.

### 4.10.3 Organizational structure

Below is the organizational structure of Bezeq International:



In 2007, Bezeq International's management resolved, with the consent of the board of directors, to alter the organizational structure of the Company, in the following way:

- A. The organization and methods department will be transferred to the management of the finance department.
- B. Human resources will be separated from the finance department into an independent department under the management of a manager reporting to the CEO of Bezeq International.
- C. The operations division will be merged into the service division, under the management of VP Services.

**4.10.4** Bezeq International has a number of employee groups whose wage structure includes a component of performance-linked commissions and incentives, such as sales employees, telephone sales representatives, and telephone service and support representatives.

**4.10.5** Employees have a leasing arrangement enabling employees to receive vehicles at a cost determined 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.

**4.10.6** 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.

**4.10.7** 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 will be dependent on this provider.

**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. For this purpose, Bezeq International signed a three-year agreement with IBM to provide 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 them 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 an underwater cable running from Israel to Europe. From there onwards, Bezeq International uses other infrastructure for connecting to the rest of the world.

As of the date of full merger, 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 NEP services, Bezeq International makes sales to its customers by payments in many instalments. In this way, Bezeq International gives its customers credit, which they repay in instalments. To reduce the exposure which might stem 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** At 31 December 2007, Bezeq International held 34.41% of the share capital of Walla! Communications Ltd. ("Walla") (33.66% at full dilution). 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. In 2007, Bezeq International and others exercised option warrants of Walla (series 3). In all, Bezeq International exercised 508,979 option warrants (series 3) in 2007, for NIS 916,000, which was set off against the balance of the shareholders' loans provided by Bezeq International to Walla. Following exercise of the option warrants, the Company has a cost surplus of NIS 81,000.

Walla ended 2006 with a net profit of NIS 25.5 million and 2007 with a net profit of NIS 15.1 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 2007, which are included in this periodic report.

**4.14.2** B-Zone partnership – on 23 October 2006, Bezeq International signed 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% in the partnership. The purpose of the partnership is to set up, support and manage wireless browsing networks in public areas, enabling connection to high-speed internet browsing and collecting payment from the end user for permission to

browse the internet ("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. After the establishment of the partnership, the Company signed an agreement with 2+ to provide outsourcing services for the partnership by 2+, whereby 2+ attends to the day-to-day operation and management of the Partnership.

- 4.14.3** On 21 December 2006, Bezeq International signed an agreement with DSNR Communications Ltd. for the establishment of a joint company, under which Bezecom Ltd. was established in January 2007. (Bezecom). Bezecom 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 Bezecom is to provide communication services to end customers around the world, inter alia through a unique communications solution to provide telephony services. Bezecom commenced development operations in March 2007, and in August 2007 commenced its commercial launch.

## **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 – In accordance with 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 telecommunications services. As at the balance sheet date, Bezeq International has provided additional bank guarantees of NIS 10.7 million.

In January 2007, Bezeq International repaid on-call loans provided to BezeqCall by a number of banks, in the amount of NIS 20.3 million.

In 2007, Bezeq International repaid all of BezeqCall's long-term bank loans, in the amount of NIS 47.6 million.

## **4.16 Taxation**

See Note 8 to the Company's financial statements for the year ended 31 December 2007, which are included in this periodic report.

In February 2007, Bezeq International paid income tax down payments for the 2006 tax year, in the amount of NIS 36.3 million.

## **4.17 Bezeq International's operations: restrictions and supervision**

### **4.17.1 Legislative restrictions**

- 4.17.1.1 The Communications (Telecommunications and Broadcasts) Law, 5742-1982 and the general license to provide of 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.

#### 4.17.1.2 Interconnectivity payments

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, the present tariff of NIS 0.25 for completion of a call will be reduced from 1 March 2008 to a maximum tariff of NIS 0.22.

The above-mentioned tariffs, rounded to 12 seconds, will be updated once a year, starting from 1 March 2006, in accordance with the percentage of the change in the CPI.

#### 4.17.1.3 Royalties

For payment of royalties, see sections 4.1.2.4 and 2.16.3 above.

#### 4.17.1.4 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, an agreement was signed by Bezeq International and Kardan Communications Ltd. 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 will provide 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 restructuring 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 effect on the running of Bezeq International's business, nor on its sale of Infonet products.

### 4.19 **Legal proceedings**

**4.19.1** In April 2004, a competing international communications operator filed a claim in the Jerusalem District Court against the State of Israel in the amount of NIS 11.2 million, for damages allegedly caused to it by a violation by the State of Israel of an obligation to place at its disposal part of the total capacity of an underwater cable (which was granted as part of the tender which opened the international communications market to competition in 1995).

In September 2004, the State of Israel filed a statement of defense and third-party notice against Bezeq.

Following negotiations between the parties out of court, they reached a settlement to cancel the claim against payment of sums that are not substantial to Bezeq International.

**4.19.2** 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. According to the plaintiffs, each of the

defendants is infringing the patent which they own and unlawfully enriching themselves at their expense. In the statement of claim, the plaintiffs demand that detailed reports of these revenues stemming from the infringement of the patent be submitted to them and that the full revenues, plus reasonable royalties and punitive compensation, be paid to them under the provisions of the Patents Law.

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 (which it supplied), under the provisions of the agreement between Bezeq International and Tadiran Communications Ltd. dated 13 December 1998 (Alcatel is replacing Tadiran for the purpose of this agreement).

In January 2008, the District Court accepted the joint petition of Bezeq International and the plaintiffs to postpone the determination of the pre-trial date by another two months and to allow the parties to inform the court whether they have reached a compromise or whether a new date for a hearing should be set, and determined that the update notice will be submitted before 20 March 2008.

- 4.19.3** In May 2006, Bezeq International filed an appeal with the Magistrate's Court at Tel Aviv against the Ministry of Communications' decision to impose financial sanctions on the Company in the amount of NIS 1 million for prima facie breach of the provisions of its license regarding erotic services

In January 2007, the court upheld the appeal in part, and the Ministry of Communications was required to refund Bezeq International the amount of NIS 387,000. Bezeq International filed an application for leave to appeal to the Tel Aviv District Court where it petitioned for refund of the rest of the sanction paid by it. On October 15, 2007, the District Court handed down a ruling setting aside the appeal and affirming the ruling of the Local Court.

- 4.19.4** In February 2007, Bezeq International filed a petition with the Supreme Court sitting as the High Court of Justice, to cancel a decision of the Minister of Communications made on 31 January 2007 to amend the policy of the Ministry of Communications regarding licensing of VOB services – under which decision Bezeq International would only be given a license to operate domestic land line telephony services using VOB technology after the Company's market share in domestic land-line telephony falls below 85%. The Supreme Court accepted Bezeq International's application and on 8 July 2007, awarded an interim injunction instructing 012 Telecom to focus its offers of domestic fixed line telephony engagements on their own customers only, by direct mailing and without addressing the public. On 5 September 2007, the Supreme Court ruled to dismiss the petition and allow the decision of the Minister of Communications to stand.

- 4.19.5** On 6 June 2007, HOT Telecom Limited Partnership ("HOT") filed a claim against Bezeq International in the Tel Aviv District Court, under which it sought declaratory relief and an interim injunction under which Bezeq International would not take any steps, directly or indirectly, to obtain confidential information belonging to it, and would not use such information should it be obtained. This was following HOT's investigation that indicated that Bezeq International was allegedly operating unlawfully to obtain the details of customers who had joined as subscribers to its internet access infrastructure services.

Bezeq International filed its response to the application for temporary injunction to the court, in which it alleged that HOT's claims against Bezeq International and its managers regarding the existence of methodical and systematic operations at Bezeq International aimed at unlawfully obtaining information about HOT's customers are insubstantial and that in any event, there is no evidentiary infrastructure for such, and that if any of Bezeq's representatives indeed acted as alleged by HOT, such person acted of their own accord, in absolute contravention of the instructions of Bezeq International.

On 23 July 2007, the Court acceded to HOT's application and awarded an injunction prohibiting Bezeq International and/or any of its employees and/or persons acting on its behalf and/or any of its representatives from contacting the employees of HOT and/or its representatives directly or indirectly to obtain confidential information regarding the identity of its customers, by way of grant of benefits and/or making use of such information that may have reached it. In view of Bezeq International's clear policy, which also existed prior to the filing of this claim, and which prohibits unauthorized receipt and use of such information, it would appear that the injunction granted by the court will not have any implications on Bezeq International's operations or its financial results. As of the date of this report, Bezeq International's response to the principal claim (regarding the declaratory relief) has not yet been submitted; however, at this stage,

given the causes of action and Bezeq International's clear policy regarding the receipt of information relating to customers of infrastructure suppliers, it would appear that the claim will not substantially affect the conduct of Bezeq International's business, or require it to use substantial resources to remove it.

**4.19.6** On 29 July 2007, Bezeq International filed a claim against HOT in the Tel Aviv District Court in the amount of NIS 23.2 million for damages caused to it by HOT since the latter decided, in contravention of the provisions of its license, not to allow Bezeq International to participate in the joint parcels it offers (joint parcels for access services and infrastructure services at an attractive price). The lawsuit was filed following the Ministry of Communications' decision in October 2006 (following Bezeq International's complaints on this matter), according to which HOT is in violation of the terms of its license and therefore is obliged to include the Bezeq International in its combined packages, together with the other internet access service providers in competition with Bezeq International. In the statement of claim, Bezeq International claims loss of profits in the amount of NIS 23.2 million during the two years (2005-2007) in which HOT blatantly refused to cooperate with it. According to Bezeq International, during this period it lost many customers who wanted to benefit from its services but wanted HOT's infrastructure services. Due to HOT's conduct, Bezeq International was in fact obstructed from accessing a whole sector of customers which it could not bring into its services or retain. As of the date of this report, HOT has not yet filed a statement of defense.

**4.19.7** Further to the provisions of the update to section 2.6.6A above, on 27 May 2007, Bezeq International received a letter from the Director General of the Ministry of Communications, in which he notified the Company that he intends to impose a financial sanction of NIS 2,031,750 on the Company for failure to apply and operate the number plan and number portability, from on 1 September 2006.

In response to the Ministry of Communications, Bezeq International contended that as holder of a general license for providing international telecommunications services, it does not allocate numbers to its customers and therefore, in any event, is not part of number portability, which is implemented by domestic and cellular operators. Bezeq International's part in this matter begins and ends with the building of the interfaces required for incoming calls to cellular and/or domestic operators, according to the characterization of the number portability configuration determined by the cellular and domestic operators, and the relevant tests. Bezeq International fulfilled its lawful duty by making appropriate preparation and it was ready, prior to the date set for implementation of the portability plan on 1 September 2006, to do everything necessary for implementation of the plan in the way that would be decided by the domestic operators, and nothing it did would prevent the realization of number portability from any customer whatsoever.

This being the case, the allegations made by Ministry of Communications are groundless, and not only do they contradict the facts of the matter, but also caused anguish to Bezeq International, which invested extensive resources and acted tirelessly to implement what was required of it, by the date and in the manner prescribed by the relevant persons. In view of the above, it is clear that Bezeq International implemented number portability faultlessly, and it should be seen as having been ready to apply number portability in accordance with the provisions of the law and by the date prescribed therein.

**4.19.8** For further legal proceedings, see Note 17 to the Company's financial statements for the year ended 31 December 2007, which are included in this periodic report.

## **4.20 Goals, business strategy and expected development**

**4.20.1** As part of the preparations for 2007, 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 implement a quality merger process with BezeqCall at the employee, processes and customer levels, effecting merger synergy

4.20.1.3 To create loyalty by improving customer satisfaction and experience for Bezeq International customers

4.20.1.4 To continue to attract excellent employees

4.20.1.5 To improve effectiveness and efficiency of cross-organizational work processes



4.20.1.6 To time investments as a tool for retaining the stability and growth of Bezeq International

#### **4.20.2 Bezeq International's goals for 2008**

4.20.2.1 To reinforce customer loyalty by improving customer satisfaction and experience

4.20.2.2 To establish leadership in the customer's perception and the market share in the internet sector

4.20.2.3 To maintain its status as an international call provider

4.20.2.4 To realize the potential in the business segment, while constructing an organizational infrastructure that supports solutions for business customers

4.20.2.5 To develop the Company's potential in international markets

4.20.2.6 To adapt the Company's budget structure to the new market

4.20.2.7 To realize synergies from the mergers

4.20.2.8 To empower and develop the Company's human capital

4.20.2.9 To establish and realize the potential of the technology system and adapt it to the Company's business requirements

**4.20.3** 2007 was characterized by continued growth and increases in Bezeq International's revenues and operating profits.

**4.20.4** In 2007, Bezeq International increased the range of communications solutions that it provides to its commercial customers. During the year, Bezeq International completed all of the procedures for the merger with BezeqCall. Bezeq International views this field as having growth potential and plans to further establish its status in this area.

**4.20.5** The year 2007 was characterized by a continued increase of Bezeq International's operations in supply of internet access services in general, and broadband internet in particular, including a range of added value services and Datacom operations to international customers. In this way, Bezeq International continued to reduce its reliance on revenues from international outgoing call services.

**4.20.6** In 2007, Bezeq International improved its market position in all the areas of its operations.

**4.20.7** In 2007, Bezeq International continued to invest in its customer service system, which provides service and technical support to its business and private customers.

**4.20.8** The above information is forward-looking and as such is not certain and may not become reality, in full or 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 estimates 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 become reality at all or may become reality 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 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 services to customers worldwide and collects the payments to which it is entitled in foreign currency, mainly in US dollars. On the other hand, Bezeq International uses services from suppliers throughout the world and pays them for these services in foreign currency, mainly in US dollars. Changes in the exchange rates of the currencies in which Bezeq International operates against the shekel expose it to exchange rate differentials which are liable to harm its profitability by increasing finance expenses as well as its

cash flow. 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 above.
- 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.

### Summary of risk factors

	Effect of risk factor on Bezeq International's operation		
	Major effect	Moderate effect	Minor effect
<b>Macro risks</b>			
Exposure to changes in the currency exchange rate.		X	
<b>Sector risks</b>			
Increasing competition		X	
Investments in infrastructure and technological changes		X	
Government supervision and regulation	X		
<b>Special risks for Bezeq International</b>			
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 Area of Operations**

DBS, known also by the trading name of “yes”, provides multi-channel broadcast services to subscribers via satellite. DBS was founded on December 2, 1998, and has been providing this service since July 2000.

This service allows for 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 stems from subscription fees and additional payments made by viewers.

As at December 31, 2007, DBS had 549,252 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 and changes in area of operations**

The area of broadcasts is regulated and operations in the area are effected via 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 (hereinafter: the “Council”).

Multi-channel television broadcasts have been offered in Israel since the mid-1990s, via companies which supplied cable television broadcasts. Those companies operated first under regional franchises on conditions of exclusivity, which were granted to them, and since 2002 they operated by virtue of long-term broadcast licenses which replaced the franchises. In November 1999, these companies were declared to have a monopoly in the field of multi-channel television broadcasts in the areas of the franchises in which they operated at the time, by virtue of the Antitrust Law, 5748-1988. As of the end of 2003, the cable corporations worked jointly in a number of 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 television services by cable 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 free distribution of certain television channels via a digital terrestrial broadcast system, see section 5.1.3.3.

To the best of DBS’s knowledge, the Ministry of Finance is working on publication of a tender for the set-up and operation of a system for terrestrial distribution of digital radio broadcasts. This distribution system might also constitute infrastructure for providing television services to mobile terminal handsets, which will constitute a rival service to the services provided by DBS. As at the date of publication of this periodic report, the tender has not yet been published.

#### **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 by virtue of the provisions of the law and pursuant to the Telecommunications (Proceedings and Conditions for the Grant of a Satellite Broadcasting License) Regulations 5758-1998 (hereinafter: the “Broadcast License”).

The broadcast license granted to DBS is in force 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' 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 Developments in markets 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 The offering to consumers of a "total bundle of services" which includes, in addition to multi-channel television services, internet connection infrastructure (at high speeds) as well as fixed-line telephony services (a bundle which contains these three services is also called "triple play"), and there is increasing demand for purchase of such communications service bundles. This trend follows the combined offer of television services with internet connection services that had been employed previously.
- 5.1.3.2 The offer of advanced television services with added content, including VOD, PVR and HD (see section 5.1.4 above).
- 5.1.3.3 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.

- 5.1.3.4 In addition, in August 2005, the government resolved to require the Minister of Communications and the Minister of Finance to do all of the acts required in order to enable the public, no later than January 1, 2007, to purchase a basic television services package from the multi-channel television companies (the cable and satellite companies) including connection to the distribution infrastructure of DBS's broadcasts, and reception of the television channels of the Broadcast Authority (Channel 1 and Channel 33), the commercial television channels (Channel 2 and Channel 10), the Knesset Channel (Channel 99), the Educational Channel (Channel 23) and the designated channels, without the consumer being required to purchase any other services from the multi-channel television companies. To the best of DBS's knowledge, as at the date of this report, the government is not promoting legislation to implement this decision. In addition, a number of private member's bills have been submitted to require the broadcast companies to offer a basic television service package. Likewise, this issue is one of the matters being discussed by the Grunau Commission (see section 5.1.3 below), although it is not certain whether the Commission will submit recommendations on this matter. In DBS's estimation, requiring it to offer a basic services package might harm its revenues.
- 5.1.3.5 In February 2007, the Minister of Communications appointed a Commission to formulate detailed recommendations regarding policy and rules of competition in the field of communications in Israel, headed by Prof. Reuven Grunau, with the aim of advising the Minister of Communications as to how to adapt the policy derived from the regulation targets to the new circumstances of the market. Among the matters on the agenda of the Commission was a series of issues that have direct relevance to DBS's operations, including questions regarding structural separation and the rules of structural separation that apply to the Company, the marketing of service bundles, formats for regulating the transition of content players on other platforms, including platforms with the potential to compete with DBS, such as unbundling issues, IPTV (see section 5.1.4 below) and others. The Commission has stated that it reserves the right to deal with such other issues as it may see fit, and therefore, it may deal with other matters affecting DBS's operations. In March 2007, DBS submitted its position to the Commission. In January 2008, the Commission informed DBS that it was considering recommending that the Minister of Communications require DBS and the cable companies to transmit a reduced basic broadcast package to their subscribers at a significantly cheaper price than the basic package price. DBS expressed its objection to this recommendation and to the fact that the Commission is discussing the issue. In the opinion of management of DBS, in light of the issues that the Commission is due to discuss, its decisions, if passed and adopted by regulators or in legislation, might have a significant effect on DBS's revenues.

#### **5.1.4 Technological changes that significantly impact on the area of operations**

- 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 (hereinafter: "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 5.6.5F below).
- 5.1.4.2 Around the world, video over broadband content transfer services 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.

- 5.1.4.3 Use of decoders which are able to record content broadcast on various channels onto a hard disk, known as personal video records (hereinafter: "PVRs"). The PVRs sold by DBS interface with DBS's electronic broadcasting timetable and enable the receipt of special services regarding the content that is broadcast, including ordering recordings in advance, recording series and suspending live broadcasts. DBS provides its subscribers with PVR decoders known by the brand name of "yesMax". Launch of PVRs to DBS subscribers is, in DBS's assessment, a partial response to the lack of VOD services to its subscribers.
- 5.1.4.4 At the end of 2007, high resolution television broadcasts were launched in Israel, known as High Definition TV (HDTV). These broadcasts, which are supplied as at the date of this report in a small number of channels, enable higher quality viewing. In DBS's opinion, even though at the date of this report this is a relatively limited service, the development of this service might substantially affect the field of broadcasting.

#### **5.1.5 Critical success factors in the 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 5.6.5F 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 5.6.5F below).
- 5.1.5.4 Differentiation at the customer service level provided to DBS subscribers, which constitutes a material success factor in DBS' ability to retain customers in a competitive market.

#### **5.1.6 Principal entry and exit barriers**

- 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.
- 5.1.6.2 Recently, some of these entry barriers started to wear away as a result of regulatory changes (such as DTT – see section 5.1.3.3 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).
- 5.1.6.3 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 Alternatives to and changes in products of area of operations**

With respect to multi-channel television broadcasts, the following principal services can be classified as alternative 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 commercial Channel 3 ("Channel 10 Israel"), the Knesset channel, Channel 23 belonging to Educational Television, the Music Channel ("Music 24"), the Russian-language channel ("Israel Plus"), and the Shopping Channel. In addition, many foreign channels that can be received in Israel via relatively cheap terminal equipment are another alternative product to DBS's services.

For the set-up of a digital terrestrial transmission system for distribution of various channels and bills to expand the channels broadcast over such system, see section 5.1.3 above.

5.1.7.2 Access to video content over broadband, including internet (see section 5.1.4.2 above).

5.1.7.3 DVD libraries.

#### **5.1.8 Structure of competition in the areas of operation 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 5.6.4.1 below) does not offer a similar package, is a principal component differentiating the offer to potential subscribers.

DBS, by cooperating with the Company, sells a service package that includes the multi-channel television services provided by it, and the Company's high-speed internet infrastructure, thereby providing a partial response to the 'triple' service package sold by the cable company (for this cooperation, see section 5.6.5G below).

## **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 sells its subscribers decoders which are essential for receiving its broadcasts, some of which also act as PVRs (see section 5.1.4.3 above). In December 2007, DBS began also selling HD broadcasts, and decoders intended to receive such broadcasts (see section 5.16 below).

### 5.3 Revenues and Profitability of Products and Services

Following is a table containing a breakdown of DBS' revenues (in NIS millions):

	2007	2006
Revenues	1,415	1,356
Gross profit	298	216

### 5.4 New Products

**5.4.1** DBS is working on launching **VOD services** for its subscribers. Following a legislative amendment in 2007, DBS is permitted to launch these services via DSL infrastructure, however, the launch is subject to obtaining a suitable license and to arriving at 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 the same time, DBS is looking into other alternatives to launching VOD services in other formats – see section 5.6.5F below.

**5.4.2 High Definition TV (HDTV)** – at the end of 2007, DBD launched high definition broadcasts and began selling a decoder that enables reception of broadcasts in this format.

**5.4.3 Content viewing on a website** – in August 2007, DBS launched a content site on the internet in cooperation with Walla! Communications Ltd., which permits the viewing of various forms of content.

### 5.5 Marketing and Distribution

The marketing of DBS's services is by way of publication in the various media. DBS's sales operations are effected over three main distribution channels:

**5.5.1** Sales people in the field working to recruit subscribers.

**5.5.2** Telephone service center receiving telephone enquiries from customers wishing to receive DBS services.

**5.5.3** External resellers of telecommunications services under contracts with DBS. DBS has some dependence 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, 2007, to the best of its knowledge, at around 37% 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 2006 and 2007 there was a relatively slow increment in the number of DBS subscribers, as set out below.

	<b>2006</b>	<b>2007</b>
Increase in number of subscribers	18,887	9,694
Rate of growth	3.6%	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 In the estimation of DBS management, 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 has also recently begun marketing HD services (see section 5.4.2 above).
- B. DBS's broadcasts are transmitted via satellite, and therefore the broadcasts can also be received in remote or isolated areas in which there is no access to cable infrastructure.
- 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' 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 since 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.
- 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, there are regulatory restrictions imposed upon the Company with respect to the 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.
- 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 IPTV services in Israel as being a factor that might adversely affect its competitive standing in the broadcast field, including 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. PVRs – 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.
- F. VOD – whilst 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.

In light of the abovementioned infrastructure inferiority, DBS applied to make use of the high-speed bi-directional infrastructure (digital subscriber line – DSL) owned by the Company and to provide its subscribers with VOD services over such infrastructure.

In July 2007, the Communications (Telecommunications and Broadcasts) (Amendment No. 37) Law, 5767-2007 was enacted. Inter alia, this law authorizes the Minister of Communications to grant a satellite broadcast licensee permission to supply broadcasts on demand (VOD) to all or any of its subscribers, after consulting with the Council and taking into account the considerations set out in the Communications Law, if he finds that there is difficulty transmitting VOD broadcasts via satellite in a scope and format similar to those broadcast by the general cable broadcast licensee. However, commercial launch of VOD services by DBS requires the receipt of a license from the Ministry of Communications, that the subscriber be connected to the DSL network and receipt of the consent of the Company to provision of the service under conditions that will make it possible for DBS to supply the service to its subscribers, conditions which, at present, have not yet been fulfilled. DBS is also looking into other alternatives to providing VOD services.

- G. “Bundle of services” – as set out in section 5.1.3.1 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.

As a result, DBS currently sells a service package, together with the Company, which includes broadcasts and infrastructure to connect to high-speed internet services. However, 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.

- H. As part of DBS’s efforts to provide a response to the bundle of services marketed by the cable company, DBS has worked to obtain a license to provide telephony services via broadband access – Voice over Broadband (hereinafter: “**VOB**”). In January 2007, the Minister of Communications published the Ministry of Communications policy regarding the grant of licenses for the supply of VOB services, in which it was prescribed, *inter alia*, that DBS is not entitled, at this stage, to receive a license to supply VOB services until the Company’s market share in the field of domestic fixed-line telephony fell below 85% (subject to a check point at the end of one year). DBS is looking into the possibility of selling VOB services provided by a third party.

## 5.7 Property Plant & Equipment

DBS broadcasts to its subscribers via an engineering setup which contains a ground broadcasting center located in Kfar Saba broadcasting to the satellite the content received at the center via optical fibers, cassettes and direct reception from the satellites, a secondary broadcasting site situated close to the Re’em Junction, 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.

### 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 9,701 sqm, alongside which there is a parking lot and adjacent facilities: An area of approximately 7,715 sqm (in which the broadcast center is situated) are leased by a third party, in accordance with a memorandum of understanding dated May 1999. This lease ends in November 2009, and DBS has an option to extend the

term of the lease by 10 more years under the same conditions. DBS has a right of first refusal to purchase the premises from the lessor, should such be put up for sale; an area of approximately 1,994 sqm in another adjacent building is leased by a third party, the term of which lease ends in July 2008.

In addition, DBS runs two operational centers, one being in the Neshar Industrial Zone (some 1,522 sqm in area, which is leased by a third party until May 2008) and the second in the Industrial Zone at Kanot (some 1,487 sqm in area, which is leased to a third party until July 2011), and these are used as technical service and sale centers for subscribers in the north and south of the country; in addition, nation-wide telephone service centers operate from them. DBS also runs two employee recruitment centers.

### **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 January 2009, 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.
- 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 July 2008. 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 December 31, 2007, which are included in this periodic report.

### **5.8.4 Software**

See Note 3 to the Company's financial statements for the year ended December 31, 2007, 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 done 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 uses 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.

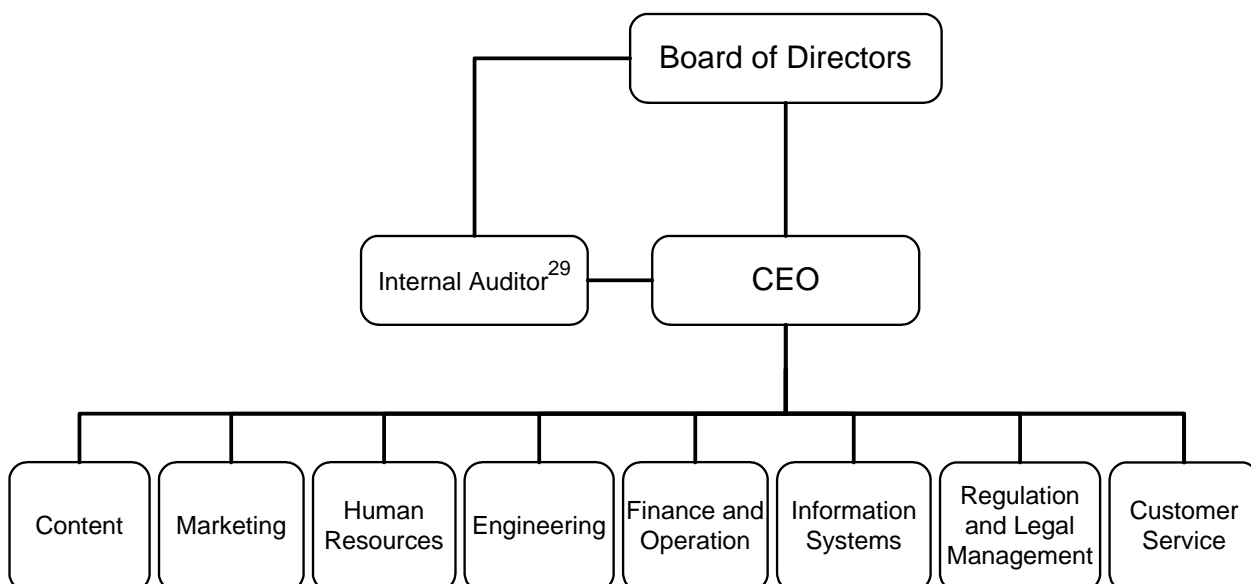
**5.9.3** At present, the trend of transmitting content over non-television media creates some uncertainty as to the payment of royalties for such transfer, inter alia due to the fact that to the best of DBS's knowledge, some of the authors are not represented by the aforesaid organizations with respect 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 8 departments, each one headed by a VP who is a member of management of DBS. 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:



#### 5.10.2 **DBS personnel by division**

Division	Number of Employees	
	As at December 31, 2006	As at December 31, 2007
Marketing Department	22	27
Sales Department	283	295
Customer Service	1,016	1,116
Content Department	53	60
Engineering Department	72	78
Finance and Operations Department	100	106
Human Resources Department <sup>30</sup>	13	39
Regulation and Legal Administration Department	2	2
Information Systems Department	55	65
Management	3	3
<b>Total</b>	<b>1,619</b>	<b>1,971</b>

#### 5.10.3 **Training and development of human capital**

DBS provides regular training for its customer service, technical service and sales personnel, via its training center.

DBS trains some 1,000 employees every year.

#### 5.10.4 **Employee remuneration schemes**

For options to officers at DBS, see also Note 26 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

##### Bonuses and Nature of Employment Agreements

<sup>29</sup> The auditor is an external auditor

<sup>30</sup> In January 2007, the training sections of the Company's various departments was unified into central administration as part of the Human Resources Department.

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 to the best of DBS's knowledge, this application is in the process of approval.

## **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 two owners 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 5.20 below).

As at the date of this report, DBS pays the current rental on space segments on the Amos 1 satellite, and makes partial payments on account of the rental debt for previous periods the time for payment thereof to the Israel Aviation Industry has passed (due to assignment of the right to receive rental from HLL to the IAI). 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 5.18.8 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). 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 alternative supplied to DBS' broadcasting and encryption system, which might cause DBS to lose revenues. For a description of DBS's contracts with decoder suppliers, see section 5.16.1 below.

D. 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, 2007, customer credit amounted to approximately NIS 145,524,000 net.

### 5.12.2 Supplier credit

The average supplier credit period in 2007 was 123 days.

### 5.12.3 Deficit in working capital

As at December 31, 2007, DBS's deficit in working capital amounted to NIS 1,326,750,000.

## 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%.

#### 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%.

The loans provided to DBS by institutional bodies in December 2006 and June 2007 were linked to the consumer price index and bore interest at an annual rate of 8% (these loans were fully repaid in August 2007).

Debentures (series A) of DBS (see section 5.13.8 below) are linked to the consumer price index and as at the date of this report, bear annual interest at a rate of 7.9%.

#### 5.13.1.3 Banks

Short-term credit – the average interest rate for this credit for 2007 was 6.248%.

Long-term credit – there are two types of loans:

- A. Loans based on prime interest rates where the average interest rate for 2007 was 6.577%.
- B. CPI linked loans, the average interest rate for which was 6.58%.



### **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 (hereinafter: 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, the bank credit limit was increased (in this section: the "**additional credit**"). Under the amending document, the additional credit is intended to be repaid by the end of 2008, in the installments set out in the amending document, however, in the event of injection of shareholders' equity into DBS by its shareholders, or external credit (in such sum and on such conditions as require receipt of the banks' consent under the financing agreement) before the date of repayment of the additional credit, DBS is required to repay the additional credit early, in the amount of the sum injected. It was further agreed that the rate of interest for the bank credit would be increased pending full payment of the additional credit.

During 2006, DBS began gradual repayment of the bank credit that it had taken, until full repayment in 2013.

In July 2007, the financing 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, 2007, which are included in this periodic report.

### **5.13.3** In addition to the above-mentioned 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 the Company, 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).

**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 (see Note 19 to the Company's financial statements for the year ended December 31, 2007, which are included in this Periodic Report), 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 5.11.1B 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, and non-payment of the debt, as a breach by DBS of the financing agreement, provided that by December 31, 2008, 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 2008, DBS made a request of the banks to plan and adjust the financial commitment targets for 2008 so as to match its budget. During March 2008, consent was received from the banks to amend these commitment targets.

In the assessment of DBS' 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, 2007, DBS was in compliance with the financial commitments under the financing agreement (following relief that it received from the banks in March 2008) with respect to the targets of a number of financial commitments as at December 31, 2007. In light of the fact that this relief was given after the balance sheet date, the loans from the banks are presented as part of short term liabilities.

**5.13.7 Credit amounts received in 2007**

In 2007, DBS received a bridging loan in the sum (principal) of NIS 50 million from a number of related institutional bodies who had provided it with a previous loan in December 2006. The loan (including the bridging loan) was paid back in full in August 2007.

For the loan received by DBS as part of a private placement of debentures, see section 5.13.8 below.

**5.13.8 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. (hereinafter: "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%. On the other hand, if the Debentures are not listed for trading on the Stock Exchange by July 31, 2008, the annual interest rate paid on them shall increase 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). 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 to 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. (hereinafter: 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) (hereinafter: 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 (hereinafter: the "**Banks' 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 proportionate share of the proceeds, equal to its proportionate 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.

Since issues of debentures by DBS require the consent of the banks, the banks' consent to the issue has been obtained, subject to the conditions set out in the deed of consent of the banks, including conditions regarding the division of guarantees between the Trustee and the banks, and the division of receipts of the exercise thereof, if exercised. The consideration for the issue of the Debentures has been used by DBS in partial repayment of the long-term bank credit, for early repayment of the loan taken by DBS from a number of related institutional entities in 2006 (including a bridging loan provided by such entity to DBS in June 2007) in the total sum (principal) of NIS 100 million, and shall be used for DBS's current operations.

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 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 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, 2007, which are included in this periodic report.

#### **5.13.9 The Corporation's credit facility**

DBS's credit line is approximately NIS 974 million. As at December 31, 2007, DBS had used approximately NIS 933 million of this line of credit.

For the position taken by the Ministry of Communications regarding limitations on provision of shareholders loans by the Company to DBS, see Note 33 to the Company's financial statements for the year ended December 31, 2007, included in this periodic report.

### **5.14 Taxation**

See Note 8 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

Assessments were issued to DBS for 2000-2004, under which the losses for tax purposes carried forward to subsequent years were reduced by 21 million, pre-business expenses from 2000 will amount to NIS 83 million and will be recognized over 10 years, and expenses in the sum of NIS 162 million recognized in previous years will be deferred to subsequent years.

During the report year, DBS reached an arrangement with the Taxation Authority with respect to deduction assessments for 2002-2004.

### **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 a 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 by virtue of the Communications Law and the regulations promulgated pursuant thereto. The Telecommunications (Proceedings and Conditions for Grant of Satellite Broadcasting License) Regulations, 5758-1998 (hereinafter: 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.

The Telecommunications (Television Broadcasts via Satellite) (License Fee and Royalties) Regulations, 5759-1999 (hereinafter: 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 2008 (inclusive), each year DBS shall invest in local productions an amount which is not less than 8% of its revenues from subscriber fees. Pursuant to the Council's confirmation, DBS was in compliance with its original production obligation for 2006 (including the proportionate part 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.

#### **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 licensee'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 or in any percentage resulting in a person becoming an interested party or controlling party of the licensee requires approval from the Minister of Communications, after consultation with the Council (this provision does not apply to a change which does not exceed 15% of the holding of the means of control in a company whose shares are listed on the Stock Exchange, provided that it is not a change in the control thereof, all in relation to those shares that are listed on the Stock Exchange); 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 contains terms governing the establishment and operation of a satellite broadcasting system; terms governing subscriber services, among them the duty of the Council and the Uniform Contracts Tribunal to approve subscriber agreements, the duty to connect applicants and ban on stipulating conditions, the duty to maintain the service throughout the year, prohibition on discrimination between subscribers, except for the offering of various tariffs to subscriber types which are reasonably differentiated, the establishment of a subscriber service center; establishment of an ongoing setup for the supply and maintenance of terminal equipment and protection of subscriber privacy; terms concerning the provision or disconnection of service and terms linked with the oversight of the operations of the broadcasting licensee and the duty to submit reports to the Ministry of Communications; conditions regarding whether the terminal equipment installed by DBS complies with standards.

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. DBS must give notice to its subscribers of termination of any special offer under which they joined DBS, at least 14 days in advance.

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. Under the provisions of the law, DBS currently 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. As at the date of this report, no fixed payment has yet been prescribed for the transmission of those special channels. 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.

To the best of DBS's knowledge, the Council is considering publishing tenders for the grant of licenses to additional special channels – both an Arabic language channel and a heritage channel.

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). As at the date of this report, this restriction is being kept with respect to DBS's channels.

In 2001, the Ministry of Communications issued administrative orders regulating the method of transferring subscribers from the services of the cable company to DBS and vice versa, and use of the infrastructure installed in the subscriber's home (the "administrative orders"). The administrative orders also provide an obligation to pay a monthly fee for infrastructure owned by the other multi-channel television provider.

Since entry into force of the administrative orders, the cable company has made claims against DBS to the effect that it is in breach of the administrative orders. DBS for its part has made claims to both the Ministry of Communications and to the cable company regarding breach of the administrative orders by the cable company.

In 2004, the Ministry of Communications gave notice to DBS that in light of the extent of its breaches of the administrative orders, it intended to issue a demand to DBS to pay financial sanctions for some of the breaches that it had committed, in the sum total of approximately NIS 1.4 million. DBS objected to the imposition of the aforesaid financial sanctions, and to date no such letter of demand has been received.

On August 15, 2005, the Ministry of Communications gave notice to DBS and the cable company that in light of their many breaches of the administrative orders, it has examined the issue and is currently considering repealing them *inter alia* in light of the mechanism for purchasing wiring set out in the Communications Law, which enables a subscriber to purchase the wiring in his home for NIS 120. On November 2, 2005, DBS submitted its position to the Ministry of Communications to the effect that the administrative orders should remain in force, whilst repealing the prior notice obligations set out therein which require the giving of notice to the party whose subscribers are disconnecting from their service. DBS also claimed that the statutory provision affording title to the multi-channel television provider over the infrastructure installed by it in the subscriber's home should also be repealed. DBS claimed that at least, if this provision is to remain, then the proper interpretation of it ought not be to give the cable company title to the wiring installed by them in private homes. DBS also claimed that the sum prescribed in the law as the consideration payable for purchase of the wiring (NIS 120) is baseless and that should such prescription remain in force, it should be substantially reduced. DBS further claimed that the arrangement being considered by the Ministry of Communications is deficient and contains many defects which will prevent proper transfer of subscribers under it, and will prejudice competition. As at the date of this report, the results of the hearing have not yet been reported.

At the beginning of 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. (hereinafter: "ADB") and Eurocom Marketing (1986) Ltd. (hereinafter in this section: "Eurocom") in which Eurocom Communications Ltd., an interested party in DBS, is also an interested party (hereinafter: 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. In 2007, DBS purchased decoders from Eurocom in the total sum of approximately NIS 33.6 million. As at the date of these statements, DBS has ordered more decoders under the ADB agreement. Following the assignment of ADB's rights and obligations under the ADB Agreement to another corporation, Advanced Digital Broadcast S.A., it was agreed at the beginning of 2008 that an addendum would be drafted to the ADB Agreement, governing such assignment and making certain amendments to the ADB Agreement. In addition, at the beginning of 2008, Yes obtained an understanding to extend the term of liability with respect to a particular series of decoders. As at the date of this report, these arrangements have not yet been signed.

In 2007, DBS purchased decoders from ADB which enable viewing using HD technology. DBS has also recently ordered PVR decoders which will enable viewing HD broadcasts.

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, see section 5.18.7 below.

Purchase of PVR decoders – in July 2004, DBS entered into a contract with UEC Technologies (Pty) Limited (hereinafter: “UEC”) for the development, manufacture and supply of PVR decoders. The agreement is for 5 years, automatically renewing for additional terms of one year each, unless one of the parties gives notice otherwise. UEC supplies the Company with support services, including a local repairs laboratory, with respect to reasonable changes, as may be made from time to time, in development of the software, for no additional consideration, but subject to an agreed ceiling of changes each year, the warranty term for the decoders so supplied being 24 months with the exception of the device's hard disk which has a 15 month warranty, special provisions having been made with respect to substantial system failure.

## **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. (hereinafter: “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 (hereinafter: the “First Space Agreement”). The lease period determined in the First Space Agreement will conclude on June 30, 2009 (in relation to the period from January 1, 2009 – subject to the purchase by DBS of insurance cover as defined in the agreement) or upon the end of the life of the Amos I satellite, the earlier of the two, and if DBS continues to use the space segments after the end of the lease period, it shall continue to pay the leasing fees. DBS has undertaken to lease at least 8 space segments on the satellite. According to information provided to DBS by Israel Aviation Industries (IAI), the Amos 1 satellite is not expected to stop operations before June 2008, the estimated time of termination of operations is during September 2008. These assessments by IAI are forward-looking information based, to the best of DBS's knowledge, on calculations that IAI has done, in accordance with various technical parameters. However, technical failures and other events might also affect the life-span of the satellite.

The rental set out in the First Space Agreement is made up of annual rental for each space segment which DBS uses.

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.

As at the date of publication of this periodic report, DBS has not completed the reduction of its past debt as required under the amendment to the agreement of May 2003.

### **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 (hereinafter: 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. The Second Space Agreement stipulates that at the end of the First Space Agreement the leased capacity on Amos 1 will be transferred to Amos 2 or to another suitable subsequent satellite.

Pursuant to the Second Space Agreement, the lease period for the space segments on Amos 2 is for 12 years from the date on which the satellite is stationed in space (which took place during April 2004) or until the end of the satellite's life, 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 satellite. 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.

As at the date of this report, DBS leases 7 space segments on the Amos 1 satellite, due to a technical restriction which prevented leasing of the eighth segment for a very long period, which required DBS to implement alternative permanent solutions. DBS held negotiations with IAI regarding the obligation to lease the eighth segment, and the cost thereof. In fact, as at the date of the report, IAI is not charging DBS for lease of the eighth segment. As at the date of this report, DBS is also leasing 6 space segments on the Amos 2 satellite. The rental in 2007 for the First Space Agreement and the Second Space Agreement amounted to approximately NIS 108,987,000. For the financial dispute with HLL see section 5.11.1B above.

### **5.16.3 Information and encryption system development agreement**

In October 2000, DBS signed an agreement with NDS Limited (hereinafter: "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. 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 and VOD services. DBS is paying for NDS's services and products based mainly on the number of decoders that it uses and the number of its active subscribers. In March 2004, DBS signed an additional agreement with NDS whereby NDS provides DBS with services linked to the integration and assimilation of interactive applications into DBS subscriber services, the granting of usage licenses for these applications and the development of future interactive technological services.

### **5.16.4 Telephone Call Center Service Agreement**

DBS operates some of its telephone call centers via Bezeq Online Ltd. (hereinafter: "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. Under the agreement, DBS purchases call center services from Bezeq Online. The agreement is for a period of 3 years, and is automatically extended annually for a further period of one year, unless one of the parties gives notice otherwise.

Pursuant to the agreement, Bezeq Online itself operates a sales center, employs staff which serve as service representatives at the call center operated by DBS, and supplies technical support and maintenance services to certain of DBS's systems. In consideration for Bezeq Online's services, consideration is paid based on the cost of employment of the employees at the call centers, and various additional costs set out in the agreement.

#### **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, 2007, 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 5.13.8 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 do 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 5.13.8 above.

#### **5.16.7 Agreements with DBS shareholders – see section 5.13.3F above**

#### **5.16.8 Agreements with Institutional Bodies**

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 year ended December 31, 2007. 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** DBS purchases annual internet access packages at high baud rates based on DSL infrastructure, and sells these packages to its subscribers non-exclusively (see section 5.6.5 above).

**5.17.2** DBS has a joint venture with Bezeq International Ltd., a subsidiary of the Company, for the supply of a basket of services including multi-channel television services (supplied by DBS), infrastructure connection to the internet and internet access services (supplied by Bezeq International Ltd.). The joint venture operates under the brand name "yes-Wow". Since 2005, the joint venture has been operating to retain customers only, and no marketing or sales efforts have been made.

Under the venture, each party bears its own expenses (i.e. Bezeq International Ltd. re all matters relating to internet access services and DBS regarding all matters relating to multi-channel television services).

**5.17.3** DBS and Microsoft Israel Ltd. (hereinafter: "Microsoft") are setting up a marketing and technical joint venture with respect to a media center system which is a system that includes software components and mostly also content which enables the viewing, on television screens, of video content transmitted to the viewer via the internet, and content saved at the viewer's home. As part of this joint venture, the media center will interface with DBS's website and it shall be possible to view DBS's contents as transmitted using Broadband TV technology.

**5.17.4** For the joint venture between DBS and Walla! Communications Ltd. with respect to the website, see section 5.4.3 above.

## **5.18 Legal Proceedings**

**5.18.1** On July 6, 2005, DBS submitted a statement of claim in the District Court at Tel Aviv against Pace Micro Technology Plc., in which DBS requested that the court require the defendant to pay the direct costs that DBS incurred in order to fix defective decoders of a particular model assembled and/or manufactured by the defendant and supplied to DBS in 2000-2001. Under the statement of claim, the decoders suffered from three serial hardware faults which were under the defendant's liability and which caused DBS severe damages, mainly due to the need to repair them and to bear the costs involved in such. The claim is for the sum of approximately NIS 31.4 million, and is based on various causes of action including breach of framework agreement by the defendant, negligence against DBS and breach of the provisions of law, DBS retaining its right to sue for additional damages. On July 15, 2007, a statement of defense was filed by the defendant together with a statement of counter-claim against DBS and Eurocom Digital Communications Ltd. (in this section: "Eurocom"), jointly and severally, relating to a monetary claim in the sum of NIS 42,640,000. Under the statement of defense and statement of counter claim, the defendant claims that the liability for the faults in the decoders does not fall on it but rather, falls on DBS and/or on Eurocom Communications, due, in its view, inter alia to the fact that the decoders were not properly characterized by the counter defendants, were not properly checked by the counter defendants and the decoders, at least in part, had not been properly installed on the premises of DBS's subscribers by DBS or contractors working for it. In light of these and other claims, according to the statement of counter-claim, the defendant suffered, in its view, various kinds of damage relating to the need to repair the decoders even after the warranty period under the contract, to provide spare parts, to provide human resources services and various payments that the defendant alleges to have made to Eurocom

Communications. Alternatively, the defendant claims loss expenses and loss of profits caused to it, it alleges, due to the acts and omissions of DBS and/or Eurocom, in the sum of USD 15,000,000. For fee purposes, the claim was set at the sum of NIS 42,640,000. Pursuant to a ruling of the court, as amended at the defendant's request (to which DBS did not object), all of the preliminary proceedings are to be completed within 30 days of the date of submission of the last pleadings. Pursuant to procedural agreements between the parties, DBS was required to submit its pleadings by November 23, 2007 (in accordance with an extension given to Eurocom), and the statement of response from the defendant to the statement of counter defense by DBS is to be filed 45 days after the filing of such statement of defense. On November 1, 2007, DBS filed an application for an order to amend the statement of defense and statement of counter claim filed by the defendant, due to failure to comply with the Civil Procedure Regulations. At the same time, DBS also filed an application to postpone the date of submission of the statement of response and statement of defense in the counter claim by DBS pending ruling on the application to award the aforesaid order. On November 18, 2007, the defendant filed an application to strike out the claim, alleging that the fee paid in the file was insufficient due to the contradictions that the defendant claimed were in the statement of claim. On December 9, 2007, DBS filed an objection to the application to strike, and later, pursuant to the ruling of the court, the state attorney's office response to the application was also filed, leaving the ruling to the court's discretion. Rulings have not yet been handed down in these applications. A hearing (pre-trial) in this file has been set down for July 2008).

- 5.18.2** In May 2007, a claim filed against DBS in the District Court at Haifa by Al Jazeera Satellite Network Co., which included a monetary claim in the sum of NIS 3,000,000 (for fee purposes) and an application for an injunction to prevent DBS from broadcasting or making use of the channel produced by the plaintiff, was withdrawn by consent. The claim was struck out in accordance with a memorandum of understanding under which the channel would continue to be broadcast on the conditions agreed upon by the parties.
- 5.18.3** In September 2007, a petition by DBS against the Minister of Communications regarding decisions of Ministers of Communications dated December 31, 2004 and February 14, 2005 relating to the amount of money injected into DBS by its shareholders and external financiers was struck out in limine for want of clean hands.
- 5.18.4** On November 6, 2006, an application was filed with the District Court at Tel Aviv to approve a class action against DBS. The claim and the application stated that DBS had not, as it were, returned the full sums owing to the Applicant and to other subscribers who chose to terminate their contract with it, out of the deposit given by them as security in return for terminal equipment lent to subscribers. The Applicant did not set out the total damage of the members of the group, on the grounds that such data was in the possession of DBS. In her view, the damage caused to her as at the date of filing of the claim is NIS 546.74 and she assesses the cumulative damage of members of the group at more than NIS 16 million. Under the procedural arrangement reached by the parties, DBS filed its response to the application for approval on February 13, 2007, and the applicant's response was given on October 15, 2007. The Attorney-General's position has not yet been submitted. On October 21, 2007, the applicant filed an application to summon witnesses, which was accepted by the court on October 22, 2007 ex parte. On October 25, 2007, DBS filed an urgent application to cancel the ruling handed down ex parte and on October 28, 2007, the court decided to stay the aforesaid ruling. On December 24, 2007, a pre-trial hearing was held at the end of which, an evidence session was set down for March 24, 2008, for the cross-examination of the persons giving affidavits. During the pre-trial session, the court proposed that the parties consider the option of a settlement.
- 5.18.5** 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 Samaria [sic – it's 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 done 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.

**5.18.6** On December 3, 2002, an application to approve the filing of 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+ (hereinafter – the ‘approval application’). 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 the said 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. The settlement left the issue of costs and attorneys’ fees to the discretion of the court and these were ruled in favor of the plaintiff. On November 30, 2006, two opinions were filed with the court on behalf of the plaintiffs: One related to the value of the benefit granted to subscribers of the cable and satellite companies under the settlement; and the other related to the rate of the fees of the attorney representing the class plaintiff. According to the first opinion, the value of the benefit granted to the subscribers of both of these companies under the settlement is between NIS 90 and 97 million, the value of the benefit to DBS’s subscribers alone being between NIS 28 and 30 million. Under the second opinion, the remuneration to the class plaintiff should be the equivalent of approximately 6% of the value of the benefit, and the costs of counsel must be equal to approximately 12.5% of the value of the benefit. On January 4, 2007, DBS and the cable companies filed an expert opinion on their behalf with the court, with respect to the value of the benefit granted under the settlement, and an application for an order regarding the methods of filing evidence containing commercial secrets, to which a confidential affidavit by the producers of the Sports Channels was attached, setting out the structure of the costs of the Sport 5+ Channel. According to this opinion, the remuneration to the class plaintiff and the fees of his attorneys should be derived from the benefit value of NIS 4.6 million or less. On February 28, 2007, the ruling of the court was published to the effect that the value of the benefit was assessed at \$ 10,000,000 and costs were ruled to counsel for the plaintiff in the sum of 6% of the sum of the benefit, or a total sum of NIS 2,514,000 plus VAT, and remuneration to the plaintiffs in the sum of NIS 400,000 (including VAT). DBS and the cable companies decided that the division between the parties would be 70% and 30%, and accordingly, on April 26, 2007, DBS’s share (30% of the total sum) was transferred to counsel for the class plaintiff. 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 September 3, 2007, a preliminary hearing took place on the appeals in the Supreme Court. The Court made various proposals for concluding the matter in a settlement, but these were not accepted by the class plaintiffs. On September 18, 2007, a ruling was handed down instructing the filing of the parties’ closing statements in writing. The appellants are to file their written closing statements in the appeal by March 27, 2008, and the closing statements in response in the appeal and closing statements in the counter-appeal are to be filed by June 26, 2008. The Company will file closing statements in writing in the appeal and in the counter appeal by May 29, 2008, and closing statement sin response in the counter appeal by July 10, 2008. The date of the hearing of the appeals has been set down for August 7, 2008. On November 20, 2007, DBS and the plaintiffs filed notice of consent regarding the broadcast of alternative content in lieu of the content referred to in section 13.1.2 of the settlement agreement between them of November 9, 2006, but prohibiting broadcast of it on the sports channel, Channel 5. According to the notice, the parties have agreed that in lieu of each cycle in which such game will not be broadcast, two games will be broadcast live on Channel 5 in a different cycle, without this being at the expense of other games which the channel is required to broadcast as part of its regulatory obligations, including games of senior teams in the Spanish league. This notice was submitted for the sake of caution only, since prima facie, the honorable Court already

acceded to this on November 18, 2007, apparently as part of approval of an identical arrangement between the Plaintiffs and the cable companies in Civil File 2474/02 Tomer Rotem & 6 Ors v. Matav Cable Communications Systems Ltd. & Ors. On December 27, 2007, DBS filed an application to approve the notice regarding the substitute content. On February 20, 2008, the court approved the notice regarding the substitute content.

- 5.18.7** Proceedings regarding deficit demand from the Customs Department: In December 2006, a deficit demand was sent to Eurocom Digital Communications Ltd. (in this section: "Eurocom Communications") from the Customs Department, for payment of purchase tax and VAT (including linkage differentials, interest and fines) in the sum total of approximately NIS 10 million, for decoders purchased by DBS from Eurocom Communications, and imported by it for DBS, smart cards belonging to DBS having arrived with such decoders. Eurocom Communications and DBS have mounted objection proceedings against the deficit demand, the dispute dealing with the proper classification of the smart cards for the purposes of purchase tax. DBS has provided the sureties required by the Customs Department for assurance of the taxes in dispute and DBS and Eurocom Communications have agreed that DBS will bear any payments required under the deficit demand, if any. In the opinion of DBS's and Eurocom Communications' legal advisers, there is a reasonable chance of no effective debt in respect of the sum of approximately NIS 5 million out of the deficit demand, which is in respect of VAT, and there is a reasonable chance of subtraction or cancellation of the linkage differentials, interest and fines included in the deficit demand. In November 2007, a written objection to the deficit demand was filed. As at the date of this report, a decision has not yet been made with respect to the objection to the deficit demand.
- 5.18.8** Arbitration with HLL Communications - in February 2008, a settlement was signed between DBS and HLL Communications Ltd. (hereinafter: HLL) which is an interested party in DBS to terminate the arbitration proceedings that had been taking place between the parties with respect to the sum of the monthly payment owing to HLL for the lease of space segments on the Amos 2 satellite under the agreement between the parties (see section 5.16.2 above).
- 5.18.9** 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. (hereinafter: "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 (hereinafter: the "approval application"). 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 exercise 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. The remedies sought in the application with respect to the class action are the following alternative remedies: (a) restitution of the cost of all of the pizzas and/or the value of all vouchers from the date on which the conditions of the vouchers changes until the end of the period set out in the vouchers, to every customer who joined the campaign. The rate of restitution sought shall be calculated at the price of one family pizza according to Pizza Meter's price list, i.e. NIS 48 (in the applicant's personal claim, he seeks restitution of NIS 1,824 under this head of damage). (b) Payment of the cost of delivery for all vouchers, from the date on which the conditions of the vouchers changed until the end of the period set out in the vouchers, to every customer who joined the campaign, calculating in accordance with the cost a tripartite delivery (delivery to the customer's home to take the voucher, delivery to the Pizza Meter branch to get the pizza and delivery back to the customer's home, within a period of no more than one hour after the time of ordering), i.e., NIS 60 per delivery (in his personal claim, the applicant seeks restitution of the sum of NIS 2,280 under this head of damage). 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. Following termination of the campaign by Pizza Meter, on September 20, 2007, the applicant filed an application to amend the application for approval (the "amendment application") in order to approve the addition of these new facts, and noted that this was a litigant's admission on the part of the respondents regarding the

blatant breach of their undertakings. In October 2007, DBS wrote to all of its subscribers via a yes-mail notice, offering them, ex gratia, another benefit in lieu of the campaign vouchers. In this letter, DBS offered its subscribers two alternative benefits for them to choose from: (1) vouchers to purchase pizzas from Domino's Pizza; or (2) an offer to receive a yesMax decoder for two years, for no payment. On December 24, 2007, the applicant filed an "amended application for approval" after the court had acceded to the second amendment application. On March 2, 2008, DBS's response to the application for approval was filed. In this response, the applicant's allegations were dismissed outright, and it was noted, inter alia, that DBS's letter to all of its customers regarding substitute benefits made the application for approval baseless, both theoretically and factually.

**5.18.10** For additional legal proceedings see Note 17 to the Company's financial statements for the year ended December 31, 2007, 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, the option of marketing a total service package alongside television services and internet browsing packages together with telephony services, either by obtaining a license to provide VOB services or by marketing the telephony services of a third party, and 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 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 launch of VOD and telephony services depend, in addition to the above, on obtaining the statutory and regulatory consents required for such purpose (see section 5.6.5 above), and for VOD services, on the Company's agreement to provide such under conditions that will enable the service to be provided, from DBS's point of view, on the availability of Bezeq's DSL network and on the ability to provide the service at a quality level for DBS's subscribers (see section 5.6.5F 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 Extraordinary Event in DBS's Business**

On September 5, 2007, non-continuous disruptions began to occur in DBS's broadcasts, which occurred on a variety of waves, power and scope which caused disruptions, at various strengths, to the quality and availability of DBS's broadcasts, mainly in the north of the country and along the coast. The disruptions to broadcasting also gave rise to extraordinary loads on DBS's customer service center, which caused difficulties in receiving service. In order to locate the source of the disruptions, DBS set up teams to locate and pinpoint the disruptions, with the cooperation of specialists in this area, and with the assistance of various governmental bodies as well. To the best of DBS's knowledge, and as informed to it by government bodies following the location operations, the source of the disruptions was external, was not within DBS's control and was not related to it. The disruptions ceased on October 9, 2007 and have not occurred since, as at the date of



publication of this report. To the best of DBS's knowledge, the disruptions were caused due to broadcasting operations in the frequency range in which DBS's broadcasts are transmitted from the satellites that it uses to the dishes in subscribers' homes. Therefore, despite the fact that the disruptions have stopped as at the date of this report, there is no certainty that a disrupting transmission of this kind may not occur again in the future.

The frequency range in which DBS operates as aforesaid was permitted for its use under a license granted to DBS by the Ministry of Communications prior to its commencing commercial operations (see section 5.8.1.4 above), in respect of which DBS paid and continues to pay appropriate fees. In this regard, in October 2007, the Government resolved as follows:

- A. Further to the operations done by the Ministry of Communications, the Ministry of Defense and the Foreign Ministry to cease the disruptions to reception of the broadcasts of YES, to appoint an inter-ministerial committee headed by the Director General of the Ministry of Communications, and with the participation of a representative of the Foreign Ministry, a representative of the Ministry of Defense, a representative of the Ministry of Finance and a representative of the Ministry of Justice, to examine all of the aspects and issues arising with respect to these disruptions, and in broader contexts as well.
- B. To instruct the relevant government ministries to give the matter appropriate priority. The team to be appointed as set out in section A above shall place special emphasis on the issues arising in the field of mass communications in cases of emergency.
- C. The team shall provide the Government with an interim report by mid November 2007."

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.

## **5.21 Discussion of Risk Factors**

The following are the threats, weaknesses and risk factors of DBS (hereinafter: 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 affect irrespective of the reasonableness of its coming about.

### **5.21.1 Macro risks**

- 5.21.1.1 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; the loans taken out by DBS from banks are, as at the date of this report, at variable interest rates and therefore, sharp rises in interest rates might have a substantial affect on the business results of DBS.
- 5.21.1.2 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.
- 5.21.1.3 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.

### **5.21.2 Sector Risks**

- 5.21.2.1 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 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.

- 5.21.2.2 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' operations and could substantially harm its financial results.
- 5.21.2.3 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 be 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.
- 5.21.2.4 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.
- 5.21.2.5 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. For the terrestrial distribution system see section 5.1.3.3 above. For digital radio broadcasts see section 5.1.1 above.
- 5.21.2.6 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.
- 5.21.2.7 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.
- 5.21.2.8 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.

### **5.21.3 Special risks to DBS**

- 5.21.3.1 Need for receiving consents 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.
- 5.21.3.2 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.

- 5.21.3.3 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 section 5.6.4.2A above.
- 5.21.3.4 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.
- 5.21.3.5 Failure and damage to satellite – DBS broadcasts through space segments on the Amos 1 and Amos 2 satellites stationed in identical points in space. 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 failure 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. DBS has no insurance for loss of revenues caused due to satellite malfunction. The Amos 1 satellite is expected to end its life during the second half of 2008 (see section 5.16.2 above). In addition, during the first half of 2008, HLL might launch another satellite (Amos 3) which shall be situated in the same position in space. A failure of launch or of properly placing Amos 3 will significantly increase the risk involved in harm to the Amos 2 satellite.

The aforesaid is forward looking information, which is based, to the best of DBS's knowledge, on calculations by the IAI. However, technical malfunctions and other events may change the lifespan of the Amos 1 satellite (see section 5.16.2 above).

- 5.21.3.6 Dependence on the holders of rights in space segments – DBS is dependent upon HLL and the IAI as holders of the rights in space segments (the IAI with respect to Amos 1, which is owned and operated by it, and HLL with respect to Amos 2, which is owned by it). Since these two satellites are in an identical part of space, if DBS is unable to lease the space segments of one of the rights holders and it is only possible to lease the space segments of the other supplier, DBS estimates that its business results will not be substantially affected. However, after the end of the lifespan of the Amos 1 satellite, DBS will be very substantially dependent upon HLL as the exclusive holder of rights and the sole supplier of space segments used by DBS.

The above is forward-looking information, based on the assessments of management of DBS regarding the availability of space segments on the remaining satellite, and on exercise of DBS's right to back-up with the supplier. However, failure by the supplier to meet such back-up obligations might cause substantial harm to DBS's business results.

- 5.21.3.7 Dependence on software, equipment, content, infrastructure and service suppliers – DBS depends upon the Company, which enables DBS to purchase internet packages which constitute a very important component of the package sold to DBS's subscribers. If the Company does not supply DBS with the services, DBS's ability to compete will suffer; in addition DBS is dependent upon certain software, equipment, content and service providers and failure to receive the products or services provided by them might harm DBS's ability to function or its rate of growth.

- 5.21.3.8 Dependence on use of internal wiring – DBS depends on the use of internal wiring in subscriber homes, which is owned by the cable company, 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.
- 5.21.3.9 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. As at the date of these reports, DBS broadcasts from both of the broadcast centers at once, some channels being broadcast from one center and DBS's home channels being broadcast only from Kfar Saba, and being stored at the broadcast center at Kfar Saba only. Should one of the broadcasting centers be damaged, DBS will transfer most of its broadcasts through the other broadcasting center, however, as at the date of these reports, in the event of harm to its broadcasting center at Kfar Saba, DBS will have a limited ability to transmit DBS's home channels via the other broadcasting center. DBS is working to improve the survivability of its home channel broadcasts from the secondary broadcast center (including with respect to the option of storing and encrypting such content).
- 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.
- 5.21.3.10 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.
- 5.21.3.11 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.
- 5.21.3.12 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.
- 5.21.3.13 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.
- 5.21.3.14 Exposure to payments of stamp duty - DBS might be required to pay stamp duty on agreements which it signed before stamp duty was repealed. DBS has made an appropriate provision in its financial statements.
- 5.21.3.15 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.

5.21.3.16 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.

5.21.3.17 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.

5.21.3.18 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. (For the disturbance that took place in September – October 2007 and the government decision in that matter, see section 5.20).

5.21.4 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		
	Large	Medium	Small
<b>Macro risk</b>			
Financial risks		X	
Security situation			X
Recession			X
<b>Industry Risk</b>			
Dependence on licenses		X	
Changes in regulation	X		
Strong competition	X		
Development of new technology	X		
Tariff control			X
Piracy			X
Exposure to claims for broadcasting infringing content			X
<b>Special Risk</b>			
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	

	Level of Effect		
	Large	Medium	Small
Restrictions due to structure of ownership	X		
Need for sufficient cash flows	X		
Satellite malfunction		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		
Technical inferiority and inability to offer combined services		X	
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

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Bezeq – The Israel Telecommunication Corp. Ltd.

Names and titles of signatories:

Shlomo Rodav – Chairman of the Board

Avi Gabbay, CEO