

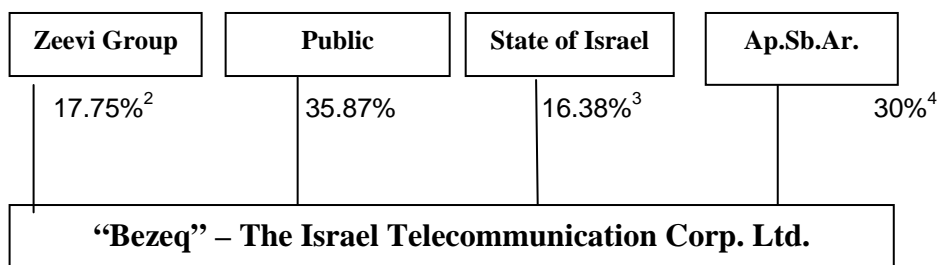
UPDATE OF CHAPTER A (DESCRIPTION OF COMPANY OPERATIONS)¹
TO THE PERIODIC REPORT FOR 2004 ("THE PERIODIC REPORT")
OF "BEZEQ" – THE ISRAEL TELECOMMUNICATIONS CORP. LTD.
(HEREINAFTER: "THE COMPANY")

1. DESCRIPTION OF GENERAL DEVELOPMENT OF GROUP OPERATIONS

Section 1.1 – Group Activity and Description of its Business Development

In the matter of the diagram of the structure of holdings of the Company set out in section 1.1.3 to the Periodic Report – following completion of the sale of 30% of the State's holdings in the Company to Ap.Sb.Ar. Holdings Ltd. ("**Ap.Sb.Ar.**") on October 11, 2005, Ap.Sb.Ar. 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 held by the State. The remainder of the State's holdings after completion of the above sale (prior to exercise of the aforesaid option and prior to exercise of employee profit options as set out in the update to section 2.9 below amounts to 16.38%. For this, and for the voting rights of Ap.Sb.Ar. by virtue of the State's shares in the Company, see section 1.3 below.

The following is an up-to-date diagram of the shareholdings in the Company:



In the matter of section 1.1.5 to the Periodic Report regarding the merger of the Company with DBS Satellite Services (1998) Ltd. (hereinafter: ("**DBS**") – on October 11, 2005, a hearing was held in relation to petitions filed by DBS and the Company in the High Court of Justice, against the jurisdiction of the Minister of Communications to intervene regarding the injection of funds to DBS by its shareholders, including the Company and external entities – the cable companies were joined as respondents to the petitions. As at the date of publication of these reports, the decision of the High Court of Justice has not yet been handed down.

In the matter of the Antitrust Commissioner's conditional approval of the merger and the appeals filed by the Company and DBS – the Company applied to expunge the

¹ The update is pursuant to Article 39A of the Securities Regulations (Periodic and Immediate Reports), 5730-1970, and includes material changes or innovations that have occurred in the corporation in any matter which must be described in the Periodic Report. The update relates to the section numbers used in Chapter A (Description of Company Operations) in the Company's Periodic Report for 2004.

² 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.

³ For the option given to Ap.Sb.Ar. to purchase up to 10.66% of the State's shares, see update to section 1.3 below; for employee options, see update to section 2.9(d) below.

⁴ The shareholders of Ap.Sb.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.

appeal that it filed, *inter alia* for the reason that the condition limiting the injection of funds by the Company into DBS was due to expire. DBS also filed an application to expunge the appeal that it filed, for the same reasons, and on September 19, 2005, the appeals were expunged. The cable companies also filed an appeal against the merger. This appeal is pending following dismissal, on July 25, 2005, of the Company's and DBS's applications to strike it out *in limine*, and has been set down for preliminary hearing on December 1, 2005.

For a detailed description of developments in this matter, see also Note 4 to the financial statements of the Company for the period ended September 30, 2005.

Section 1.3 – Investments in Equity and Stock Transactions

Further to the provisions of sections 1.3.4 and 2.20 to the Periodic Report, regarding the process of privatization of the Company – the State chose Ap.Sb.Ar., which offered NIS 4,237,000,000 for 30% of the share capital of the Company and options to purchase an additional 10.66% of the shares of the Company, as the preferred bidder. Transfer of the State's holdings to Ap.Sb.Ar. required the receipt of consents under all laws, including the consent of the Prime Minister and the Minister of Communications, under the Communications (Telecommunications and Broadcasts) Law, 5742-1982 (the "**Communications Law**") and the Telecommunications (Prescription of Essential Service Provided by Bezeq – the Israel Telecommunications Corp. Ltd.) Order, 5757-1997 (the "**Telecommunications Order**"), and the consent of the Antitrust Commissioner under the Antitrust Law, 5748-1988.

Following the "industrial espionage" incident (see in this regard section 2.20(b) below) and disputes that have arisen between the State and Ap.Sb.Ar. regarding the effect of that incident on the Bezeq Group, on July 7, 2005, the Parties reached an agreement regarding various demands made by Ap.Sb.Ar. as conditions of completion of the transaction. Based on a notice from the Government Companies Authority, this agreement has implications on the exercise price of the options received by Ap.Sb.Ar., to the extent that such might relate to and result from the above incident, plus the accrual of interest on the transaction price up to completion of it. For this matter, see the Company's Immediate Reports dated July 10, 2005 and July 14, 2005.

On October 11, 2005, (subsequent to all of the consents required by law having been received) the aforesaid transaction was completed, under which the State sold Ap.Sb.Ar., off the Stock Exchange, 781,513,683 of the shares in the Company held by the State (constituting approximately 30% of the shares in the Company), and options to purchase 277,697,862 shares in the Company held by the State (constituting approximately 10.66% of the shares in the Company), all under the conditions set out in the agreement for sale of the State's holdings in the Company, between the State of Israel and Ap.Sb.Ar. (and parties with an interest in it) dated as above.

In consideration for the shares and options as aforesaid, the total sum of NIS 4,246,286,575 was paid by Ap.Sb.Ar.

Ap.Sb.Ar.'s shares in the Company are to be held in trust by Romema Investment Company Ltd.

According to information provided to the Company:

- a. Pursuant to the agreement with the State, Ap.Sb.Ar. purchased 30% of the State's shares in the Company and an option for the purchase of up to 277,697,862 of the State's shares in the Company (constituting approximately 10.66% of the share capital of the Company), on the conditions set out in the above agreement, as set out in the Company's immediate reports dated July 14, 2005 and October 16, 2005. The option is

exercisable up until the first day of business 48 months after October 11, 2005 (the date of completion of purchase of the Company's shares).

- b. Pursuant to this agreement, Ap.Sb.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.Sb.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 update to section 2.9(d) below) – for such period or until transfer of title to such shares to the Company's employees, whichever is the earlier.

As a result of completion of the transaction, the Company was released from certain limitations that had been imposed upon it as a company controlled by the State of Israel, including cancellation and/or amendment of some of the provisions of its bylaws, which were similar to certain provisions of the Government Companies Law, 5735-1975. Likewise, the bylaws of the wholly owned subsidiaries of the Company have been amended such that, *inter alia*, the provisions regarding the number of members of the board of directors, proceedings for appointment of them, and provisions regarding the composition of committees of the board of directors were amended, and provisions relating to the Government Companies law (in the bylaws of former government subsidiaries) were deleted. Further to such, the directors of the Company's subsidiaries were replaced such that directors were appointed from the ranks of senior management of the Group, subject to the rules of structural separation in the Group.

Section 1.4 – Distribution of Dividends

Further to Section 1.4.4 to the Periodic Report in the matter of an undertaking by the buyer of the controlling interest in the Company to act by virtue of his holdings in relation to distribution, it was clarified to the participants in the privatization proceeding by the Director General of the Government Companies Authority, in a letter dated April 19, 2005, that the position of the Government Companies Authority is that no restrictions will be imposed on the buyer of the controlling interest preventing him from initiating and implementing a distribution with the approval of a court in accordance with Section 303 of the Companies Law, 5759-1999 (reduction of capital). In addition, the Company received a copy of a letter which was sent to the Director General of the Government Companies Authority on April 17, 2005 by the Chairman of the Company Workers Organization, in which the Chairman of the organization informs that participants that the Company Workers Organization sees a distribution pursuant to Section 303 of the Companies Law as contrary to the arrangements with the Company employees and that any attempt to reduce the capital will meet the strong opposition of the employees.

Agreements in this regard might be obtained with the Workers Organization - in this regard, see section 2.9(d) below.

Section 1.6 – General Environment and Influence of External Factors on Group Operations

The relations between the Company and its subsidiaries are strictly limited, which make it very difficult for the Group to manage the high level of competition in the field of communications. Similar limitations do not apply to entities in competition with the Company. Thus, for instance, on July 7, 2005, an unconditional merger was approved by the Antitrust Commissioner between Discount Investment Company Ltd. ("DIC") and Cellcom Israel Ltd. ("Cellcom"), which, when implemented, will make DIC the holder of the controlling interest in Cellcom. In the Company's opinion, approval of the merger unconditionally gives rise to an asymmetrical situation in which the Bezeq Group is under severe limitations, whilst the DIC Group, which also holds other communications companies, is not under similar limitations.

2. **FIXED-LINE DOMESTIC COMMUNICATIONS –
“BEZEQ” – THE ISRAEL TELECOMMUNICATIONS CORP. LIMITED (“THE
COMPANY”)**

Section 2.1 – General information on areas of operation

In the matter of section 2.1.2 of the Period Report – limitations of legislation and delegated legislation, and special obligations – see update to section 2.16.1 below regarding the update of the Company’s tariffs.

Section 2.2 – Products and Services

In the matter of Section 2.2.2 to the Periodic Report – Telephony, on April 21, 2005, the Company received a letter from the Director General of the Ministry of Communications, stating that after examining the various considerations and data submitted to the Ministry, the Minister is considering refusing to give her approval (contrary to the approval in principle given to the Company by the former Minister) to cease the provision of the Bezeqcard service. The Company has objected to the change in the Ministry of Communications' position, having already prepared to terminate the service, based on the approval in principle which had been given to it previously. However, in light of the Ministry of Communications request not to terminate the service until the final decision of the Minister of Communications is obtained, the service has not been terminated. On June 7, 2005, the Minister passed a decision to the effect that the Company would not be given consent to stop providing the “Bezeqcard” service. As at the date of publication of this Report, the Company is acting to reactivate the service, in an orderly and proper manner.

On July 10, 2005, the Ministry of Communications issued a paper on telephone number information services, in an era of multiple communications providers, for public comment. The Ministry gave notice that it intends to examine the need to amend the current arrangement for provision of information services, and that it would consider, *inter alia*, obliging each cellular operator to provide an information service to its subscribers, at no cost, for all cellular subscribers in Israel, as a substitute for the current arrangement. The position of the public has been requested, *inter alia*, with respect to activation of a uniform information call center for all telephone numbers in Israel, or a separate call center for each operator, or for each level of communications (fixed-line, mobile), and activation of the center by communications operators only or by other operators. In a letter of response dated August 9, 2005, the Company submitted its comments on this matter, to the effect that, *inter alia*, these are auxiliary services to the basic service, and in an area in which the services provided are at a high level, and which already embodies the advantages of competition, regulatory intervention is likely to be harmful.

In the matter of Section 2.2.3 to the Periodic Report – Internet access services, as at September 30, 2005, the Company's ADSL subscribers number approximately 771,000 (compared with about 650,000 subscribers at the end of 2004).

Section 2.6 – Competition

a. **Ministry of Communications document – Clarification for participants in the privatization proceeding of the Company**

On April 6, 2005, a letter was sent to the Director General of the Government Companies Authority by the Director General of the Ministry of Communications, containing clarification for the entities which took part in the privatization process of the Company. The document contains explanations of the main questions raised by the entities which took part in the privatization proceeding, based on the present policy of the Ministry for promoting competition in communications and provisions of the law and existing

licenses, and notes that they should not be cause for expectation or reliance on the part of the participants.

The main points of the clarifications in the document appear in an immediate report of the Company dated April 11, 2005. As the Company noted in that report, it believes that the clarifications in the Ministry of Communications Clarification Document do not significantly reduce the regulatory uncertainty in which the Group and the Company operate. Furthermore, the document contains general explanations about future operations regarding which the Company is unable to make any assessment at this stage as to when or if they will occur, and therefore the Company is unable to assess their implications on the operations of the Company and the subsidiaries of the Group and on the results of those operations.

On this matter, see also Note 1C(1) to the financial statements of the Company for the period ended September 30, 2005.

b. Interconnect fees

On the matter of the arrangement whereby interconnect fees will not be paid for terminating a call between the networks of the Company and the cable companies ("HOT") described in Section 2.6.1 to the Periodic report – on April 14, 2005, the Company withdrew its petition to the High Court of Justice. On this matter, see also Note 1C(4) to the financial statements of the Company for the period ended September 30, 2005.

c. Competition with “Hot-Telecom”

Competition with HOT is increasing, and is expressed, *inter alia*, in offers by HOT which combine broadband internet, telephony and cable television, aimed mainly at households. In addition, HOT offers telephony services to business customers. According to advertisements in the media, HOT's telephony service has several tens of thousands of customers.

d. VOB Service Policy⁵

Further to Section 2.6.1 to the Periodic Report, on April 20, 2005, the Ministry of Communications notified, *inter alia*, the Company and its subsidiaries that in completing preparation of the policy and following study of the remarks submitted in response to their enquiries, it is considering making an amendment to the policy paper so that the Company or a subsidiary of the Company will be able to provide VOB services after the Company's market share in fixed-line domestic telephony in a particular customer segment falls below 85%. In addition, the Ministry intends to set two review dates, in November 2006 and November 2007, to look into the possibility of permitting the Company or a subsidiary of the Company to provide VOB services even if the Company has not lost 15% of that market share, noting the developments in competition in the field of telephony.

The Company views this amendment as a possible worsening of its position, and of its subsidiaries, and has given notice to the Ministry of Communications that the amendment that it is considering, as set out above, contravenes the policy principles document. On May 25, 2005, the Company once again contacted the Ministry of Communications, asking for an oral hearing before the Minister of Communications. In its letter, the Company once again clarified, *inter alia*, that it should not be denied the ability to provide VOB services, and that such denial would contradict the license and the law, would be unprecedented anywhere in the world, and would severely harm the Company and its customers;

⁵ Voice Over Broadband

The Company is preparing for a hearing at the Ministry of Communications.

According to its press release, Golden Lines applied to the Ministry of Communications for a special general license for the provision of telephony services on broadband infrastructure. The Company wrote to the Ministry of Communications in this regard, informing it that a special general license should not be given to Golden Lines until the hearing proceeding has ended. As at the date of publication of these Reports, the Ministry of Communications has not replied to the Company.

See also, updates to sections 3.7 and 4.6 below.

e. Marketing trial for payment for VOIP services

On the matter of licenses for a marketing trial for payment for VOIP services as described in Section 2.6.1 to the Periodic Report – after a joint discussion at the Ministry of Communications with the Company and the operators who wish to offer this service, the Ministry issued an administrative instruction for the operation of dialing directions and numbering ranges allocated for the use of a licensee for a marketing trial in the Company's network. In another letter from the Ministry of Communications, it was clarified that the Company will not bear "expenses in kind" of the trial, and that if additional payment is determined as part of the VOB policy, that payment will apply retroactively also for the trial period. As at the date of publication of these Reports, dialing directions have been opened to two licensees (one of which is the subsidiary Bezeq International Ltd.) and the Company is in advanced negotiations with other trial licensees for connecting them to the Company's network.

The Company has applied to the Ministry of Communications with respect to the grant of a marketing trial license for the provision of VOIP services to Cellcom, and has applied for suspension of such at least until the completion of the hearing proceedings and the setting of policy. As at the date of publication of these Reports, the Ministry of Communications has not responded to the Company.

f. Numbering and number portability

1. Further to Section 2.6.5(a) to the Periodic Report, on March 29, 2005, the Economic Policy for Fiscal 2005 (Legislative Amendments) Law, 5765-2004 was passed by the Knesset, including, *inter alia*, an amendment to the Communications (Telecommunications and Broadcasting) Law, 5742-1982 (hereinafter: the "**Communications Law**"), whereby the Minister of Communications will prepare a numbering program for the matter of number portability with regard to a holder of a general license (including a special general license) for fixed-line domestic communication, and with regard to the holder of a general license for the provision of cellular services, and will instruct them concerning its implementation and operation by September 1, 2006 (if the Ministers of Communications and Finance see that there is a real need, and for special reasons, they may postpone, in an order and with the approval of the Knesset Economics Committee, the implementation and operation of the program for a period not exceeding three months).

Notwithstanding the Company's opinion, and to the best of its knowledge, and that of the other licensees, it is not possible to comply with the timetables set out in the draft provided to the licensees including the Company, the Ministry signed a numbering plan for implementation of number portability on August 22, 2005. In this regard, see the Company's immediate report dated August 24, 2005, and Note 1C(5) to the financial statements of the Company for the period ended on September 30, 2005.

As the Company noted in its reports and in detailed letters that it sent to the Ministry of Communications, it will not be possible to meet the timetables set out for implementation of the plan (the signed numbering plan only extended the internal dates – the milestones for planning and installing means for activating number portability – by three months, however the timetable for implementation of number portability flowing from the Law remains as it was). Apart from that, implementation of the plan is likely to require the Company to effect significant investments, which is likely to adversely affect the Company's ability to compete, as well as that of some of the companies in the Group. In the immediate report published by the Company, the Company noted that it was studying the signed plan in comparison with the draft plan and that it intended to continue with its efforts, *inter alia*, to convince the Ministry regarding the need to prescribe more reasonable timetables.

On August 31, 2005, the Company wrote to the Minister of Communications and gave notice, once again, that it was preparing to implement number portability and investment of the necessary resources, however, that the dates for such were not realistic and that the Company would not be able to comply with them. The Company once again asked to be summoned to a hearing in order for it to present the activities that have been undertaken and the reasons for not being able to comply with the timetable to the Ministries of Communications and Finance.

As the Company further noted in an immediate report on March 23, 2005, the implementation of number portability will necessitate considerable financial investment in replacing software and hardware versions in the Company's switching system. In addition, substantial financial investments will also be required in the Company's information systems, which could also lead to postponement of the Company's development plans in this area. The activation of number portability also involves costs for joint registration and administration with relevant operators. These are costs that cannot yet be fully estimated. In addition to the aforementioned expected costs, the implementation of number portability, which will facilitate customer transition from the Company's network to the networks of its competitors, is liable to adversely influence the Company's ability to compete.

2. On October 16, 2005, the Company was given a permit to operate a national area code with the prefix 076. Operation of a national area code will enable the Company to allocate national numbers, which is likely to facilitate the provision of national services.

g. Other potential competing infrastructure

Further to the provisions of section 2.6.5(b) to the Periodic Report – certain municipalities are trying to create an alternative to the laying of infrastructure lines by communications licensees, via the infrastructure of such municipalities.

h. The Company's commitments with business customers

Further to Section 2.6.6(G) to the Periodic Report – on March 28, 2005, the High Court of Justice decided to leave in place the interim order for staying cancellation of the agreements between the Company and business customers pending hearing of the case set down for July 4, 2005. However, the Court also determined in its decision that there is no impediment to the Ministry of Communications calling NIS 8 million of the bank guarantee out of the guarantee given to the Ministry by the Company. As at the date of publication of this report, the Ministry of Communications has not taken any

action relating to foreclosure of the guarantee. "Hot-Telecom" has been joined as a respondent in the petition. Hearing of the petition has been set down for November 17, 2005.

Section 2.9 – Human resources

a. Labor dispute and its subsequent clarification on the matter of the retirement of the remaining transferred employees by 2011

As reported by the Company on April 5, 2005, and April 14, 2004, in immediate reports, on April 5, 2005, the Company received notice of a possible strike at the Company starting on April 21, 2005 ("the Labor Dispute"). After talks between the Government Companies Authority, the Company and the workers' representatives which ended on April 13, 2005, in an exchange of letters between the parties, the Labor Dispute was brought to an end. The main points in the correspondence were these:

- "(1) It is possible that after sale of the State's holdings in the Company, the Company will request negotiations with the workers' organization in accordance with Section 4A of the Special Collective Agreement (Amendment) dated March 18, 2004, which provides that: 'Immediately after signing this Agreement, the parties will start intensive negotiations to arrange the retirement of the remaining transferred employees by 2011 on the one hand, and the demands of the Company's Management for organizational and other changes, on the other hand.'
- (2) The Government Companies Authority clarified that if after sale of the State's holdings in the Company an agreement as referred to above is made, no additional approvals will be required from the Government Companies Authority and the Supervisor of Wages at the Ministry of Finance for extension of the validity of the retirement agreement. The Government Companies Authority also clarified that to the extent that its approval is required for the agreement, the sale of the State's holdings will replace the approval.
- (3) The correspondence will be presented to the participants in the proceeding for the sale of the State's holdings in the Company. "

In the opinion of the Company as at the date of publication of these reports, the above will not change the existing agreements. Furthermore, the aforementioned clarification will not influence the financial statements of the Company. The correspondence was shown to the participants in the proceeding for the sale of the State's holdings in the Company.

- b. In the matter of a one-time bonus to Company employees in the amount of half of the amount of the salary reduction in accordance with the Economic Plan Law and a collective agreement for encouraging economic growth in respect of the period from August 28, 2004, to the date of transfer of the State's holdings to the buyer of the controlling interest in the Company – see update to Section 2.17(b)(2) below and note 1D to the financials statements of the Company for the period ended September 30, 2005.
- c. Section 2.9.5 – the nature of employment agreements at the Company and rationalization programs – following the change in control at the Company, the Company applied to the Ministry of Finance requesting that he ask the Finance Committee of the Knesset to approve an exemption for the Company from the provisions of section 29 of the Budget Foundations Law, following the notice of the (previous) Minister of Finance of his intentions to do so. As the Company has been informed, on November 6, 2005, the Minister of Finance contacted the Chairman of the Finance Committee of the Knesset, asking him to put approval of the Company's exemption from the provisions of section 29(a) of

the Budget Foundations Law on the Committee's agenda, When such exemption is received, the Company shall not be linked to the public sector with respect to the employment of workers. The Company intends to adopt a wage policy suited to its ability and performance.

- d. Section 2.9.6 – employee remuneration schemes – on November 15, 2005 the Company published an outline for 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. On this matter, see also Note 1(g) to the financial statements of the Company for the period ended September 30, 2005.
- e. Section 2.9.7 – officers and senior management employees at the Company – following the change in control of the Company and the termination of office of directors who had acted at the Company prior to the transfer of control (with the exception of external directors), remuneration is no longer paid to directors in accordance with the Government Companies Regulations. As at the date of publication of these Reports, no resolution has yet been passed regarding remuneration to new directors.

Upon completion of the transaction for sale of the State's shares in the Company to Ap.Sb.Ar. (see section 1.3 above), all of the directors acting on behalf of the State resigned from the Board of Directors of the Company, and the appointments of new directors whose election had been approved previously by the general meeting of the shareholders came into force. The external directors who had been acting in the Company prior to completion of the transaction continue to act on the board of directors. There were also changes to management of the Company, which the Company reported in its immediate reports of October 12, 2005, October 27, 2005 and November 1, 2005.

- f. Note that even before completion of the transfer of the State's holdings in the Company to Ap.Sb.Ar., a document of principles was signed between Ap.Sb.Ar. and the workers' organization in preparation for a future agreement between the Company and the workers' organization, which was given to the Company just prior to the date of publication of these Reports, and which contains reference to changes in the organizational structure of the Company relating to retirement and/or firing of employees, reduction of capital whilst maintaining the Company's financial strength, and employee remuneration. As at the date of publication of these Reports, negotiations have not yet begun.

Section 2.10 – Raw Materials and Suppliers, Purchase of Equipment and Suppliers

On the matter of Section 2.10.2 to the Periodic Report – the framework agreement with Supplier D for the purchase and maintenance of transmission equipment has been extended by one year until the end of March 2006.

Section 2.12 – Investments

For sale of the Company's holdings in XPERT Integrated Systems Ltd. see Note 4(c) to the Company's financial statements for the period ended September 30, 2005.

Section 2.13 – Finance

- a. **Section 2.13.4 – Credit received after December 31, 2004**

On April 4, 2005, the Company issued, by way of a private placement to institutional investors, NIS 286,967,000 par value of debentures (Series 5).

The proceeds from the issuance amounted to NIS 315,663,700, where the purchase price for NIS 1 par value is 110 points and reflects a yield of 4.46% (the Company received the proceeds on April 4, 2005). The debentures were listed for trading on the Tel Aviv Stock Exchange and their terms are the same as those of the debentures from the same series which are in circulation (registered debentures, repayable in six equal annual installments in each of the years 2011 to 2016, bearing interest of 5.3% p.a. and not secured by any charge).

In addition, (1) on June 30, 2005, the subsidiary Bezeq Gold (Holdings) Ltd. ("**Bezeq Gold**") sold 100,000,000 par value debentures (series 4) of the Company on the Tel Aviv Stock Exchange. The proceeds, in the sum of NIS 105,160,000, were transferred to the Company in payment of the balance of the loan granted by the Company to Bezeq Gold for the purpose of acquisition of the debentures (series 4). (2) On August 17, 2005, Bezeq Gold sold 100,000,000 par value debentures (series 5) of the Company on the Tel Aviv Stock Exchange. The proceeds, in the sum of NIS 110,950,000, were transferred to the Company in (partial) repayment of the loan granted by the Company to Bezeq Gold for the purpose of acquisition of the debentures (series 5).

b. Section 2.13.6 – Credit rating

1. Moody's rating for eurobonds – On March 7, 2005, the rating forecast was changed from A3 (Stable) to A3 (Negative). The change reflected the uncertainty arising from the expected continuation of the privatization of the Company and the possibility that the new holder of control at the Company (after the privatization is completed) will change the financial strategy of the Company. See the Company's immediate report dated March 8, 2005. Following the notice of sale of the State's Holdings in the Company to Ap.Sb.Ar. Co. (see update to Section 1.3 above), Moody's gave notice, on May 10, 2005, that it had placed on review the possibility of reducing the rating of the bonds. Examination of the rating will focus on the uncertainties expected to be derived from purchase of the State's Holdings in the Company by Ap.Sb.Ar. and the fact that changes might take place in the Company's financial policy and strategy. See the Company's immediate report dated May 11, 2005. On October 11, 2005, following completion of the sale of the State's holdings in the Company to Ap.Sb.Ar. (see update to section 1.3 above), Moody's gave notice of a reduction of the Company's credit rating to Baa1, and the rating was kept on review for another possible reduction. See the Company's immediate report dated October 12, 2005.
2. Midroog rating for debentures series (4) and (5) – On March 24, 2005 the rating forecast was changed from Aa1 (Watch List) to Aa1 (Negative). The negative rating horizon was given because of the transfer of control from the State into private hands. See the Company's immediate reports dated March 27, 2005, and March 28, 2005. Following the notice of sale of the State's Holdings in the Company to Ap.Sb.Ar. Co., Midroog gave notice, on May 16, 2005, that it was transferring rating of the Company's debt to watch list, for the purpose of examining the possibility of reducing the rating. In Midroog's assessment, sale of the core of control of the Company could have a substantial influence on its business strategy and business and financial profile. See the Company's immediate report dated May 16, 2005.
3. Maalot rating for all series of the Company's debentures – On March 28, 2005, the rating AA was given (no change in the rating). See details of principal considerations for rating in the Company's immediate report dated March 28, 2005. Following the notice of sale of the State's Holdings in the Company to Ap.Sb.Ar. Co., Maalot gave notice on May 10, 2005, that the rating of the Company's undertakings was in the process of review (watch list), under which it would look into the effect of

transfer of control of the Company and the business and financial strategies implemented by the purchaser of the core of control of the Company on the Company's rating, and it would publish its conclusions at the end of such review. See the Company's immediate report dated May 11, 2005.

4. Standard & Poors Rating for Eurobonds – following the notice of sale of the State's Holdings in the Company to Ap.Sb.Ar. Co., S&P gave notice on May 10, 2005 that it had placed the Company on Creditwatch, with negative implications to the debentures rated by it at A-. As a result of the expected change in ownership of the Company, S&P expects a basic change in the Company's financial policy and capital structure. See the Company's immediate report dated May 11, 2005. On October 11, 2005, following completion of the sale of the State's holdings in the Company to Ap.Sb.Ar. (see update to section 1.3 above), Standard & Poors gave notice of a reduction of the Company's credit rating to BBB, and that the rating was to remain on creditwatch with negative implications. See the Company's immediate report dated October 12, 2005.

Section 2.14 – Taxation

On taxation, see Notes 2B and 11 to the financial statements of the Company for the period ended September 30, 2005.

Section 2.15 – Environmental protection

- a. On the matter of the Non-Ionized Radiation Bill distributed by the Ministry of the Environment – the revised version of the Bill – the transitional period has been extended from nine months to one year. On June 22, 2005, the aforesaid Bill was published after passing First Reading. A draft is being formulated by a joint interior and environment committee of the Knesset in view of a second and third reading, unifying a number of draft private members' bills in this regard with the government Bill.
- b. On the matter of permits for communications installations under the Planning and Construction law – see the update to Section 2.16 (sub-section g.) below.

Section 2.16 – Limitation and regulation of Company activities

- a. On the matter of number portability, see the update of Section 2.6(f) above.
- b. On the matter of Section 2.16.1 to the Periodic Report concerning regulation of Company tariffs, and Section 2.16.3 to the Periodic Report concerning royalties – on March 29, 2005 the Knesset approved the amendments to the Communications Law described in those sections, as part of the Economic Policy Bill. In addition, on May 31, 2005, an order was published under which the Supervision of Commodities and Services Law is not to apply to telecommunications services for which payment of a fee has been set under section 15(c) of the Communications Law.
- c. Further to Section 2.16.1 to the Periodic Report concerning the regulation of Company tariffs, as the Company reported on May 30, 2005, commencing on June 1, 2005, the Company reduced its regulated tariffs prescribed under section 15(a) of the Communications Law, by an average rate of approximately 2.2%, based on a tariff update formula prescribed in regulations in place at that time. The regulations also contain an amendment of the method of calculation set out below. The aforesaid reduction is based on a change of some 1.2% in the consumer price index and the average rationalization coefficient at a rate of approximately 3.4%. It should be noted that the update includes, *inter alia*, a reduction of approximately 3.2% in call tariffs and an increase of approximately 1.2% in fixed fees. Note that interconnect tariffs were reduced by 3.2% as of September 1, 2005.

On the matter of amendment of the calculation method, as the Company reported in an immediate report dated May 5, 2005, as part of the Ministry of Communications' handling of the annual update of the Company's tariffs, it became apparent to professional staff at the Ministry that it was necessary to amend the method of calculation set out in the regulations in such a way as to enable more precise measurement of the data used for calculating the annual rationalization coefficient.

As the Company reported, according to initial estimates, the immediate affect of the aforesaid amendment would give rise to a reduction in its income in the sum of approximately NIS 30 million per annum in each year of the current tariff arrangement (up to the end of 2007). Apart from the aforementioned, the effect of this amendment, as of the amendment in June 2006, might considerably increase the reduction in the Company's revenues to the extent that the change in the calculation formula will bring about an increase in the tariff reduction coefficient in the coming tariff updates as well, from June 2006 until the end of the arrangement period.

Following reduction of the rate of VAT to 16.5% in September 2005, the Company's tariffs were updated accordingly. Later on, some of the Company's tariffs were amended (and published in the tariff regulations) in force as of November 1, 2005, in order to retain "rounded off" tariffs for these services, including the new rate of VAT.

- d. Regarding Section 2.16.2 – the main points of the amended license/tariffs – following the Company's notice of its intention to demand the participation in payment of a commission by subscribers who pay through the Postal Bank, the Ministry announced that it is considering amendment of the Company's license so that it will determine that the Company must enable a range of means of payment of its bills, including through the Postal Bank. The Ministry also stated that its position is that the Company may not collect such a commission. The Company responded that the proposed amendment of the license and the position of the Ministry of the matter are beyond its authority and unreasonable. Attempts to speak with the Ministry of Communications in this matter have been fruitless, and as at the date of publication of these reports, the Company does not require that subscribers paying via the Postal Bank participate in payment of the commission to that Bank.
- e. Further to Section 2.16.2 to the Periodic Report concerning the general license of the Company:
 - (1) On July 14, 2005, the Company's general license and the licenses of other operators were amended. The amendment to the license prescribed that the Company must act in accordance with the Israeli Standard regarding reliability of bills and due disclosure in telephone accounts. In addition, provisions that are different from those in the aforesaid standard were prescribed regarding rounding off of sums in bills. Under the amendment, the provisions of the standard regarding due disclosure in telephone bills will come into force by October 14, 2005, whilst provisions relating to reliability of billing will come into force by January 14, 2006. The Company's license was amended in this manner, despite the fact that the Company expressed its opinion to the Ministry that there is no room or justification for the standard in its proposed format, and certainly not for changing it, by adopting it in the license, into a binding standard, bypassing the statutory mechanism set out in the Standards Law. Likewise, the Company clarified that implementation of the standard involves investment of considerable resources, technical difficulties and the effecting of broad based changes to core systems, which cannot be done at the same time as implementation of the number portability program, and that it needs a longer period of time to implement the standard. The

Company is prepared to implement the standard in accordance with the amendment of its license, however, at the same time, it contacted the Ministry of Communications and gave notice to it that it would not be able to meet the dates set out for implementation of the standard under the amendment of the license, and asked that the matter be presented to the Ministry in order that the Company's request for a longer preparation period may be re-examined. On October 16, 2005, the Director General of the Ministry of Communications gave notice to the aforesaid licensees that due to the consumer importance of the issue, there will be no delays in implementing due disclosure, but the Company's position is as above.

- (2) On June 8, 2005, the Ministry of Communications provided a draft appendix to the general licenses to the cellular licensees, HOT and the Company, for remarks, regarding replacement of the "erotic services" appendix with "adult services". Under the draft appendix, a variety of services that are not appropriate for minors, due to their nature and substance, will be regulated by way of use of access code 1919, instead of what the Ministry sees as the restricted arrangement of "erotic services". The proposed amendment extends the content that may be offered via the aforesaid prefix to all "adult services" such as introductions, chats, matchmaking, etc., and prescribes clear rules for "reliable identification" of an adult prior to removal of the block. The Company, without going into the main body of the matter, asked that the requirement to play a voice message to all subscribers blocked from the service not apply to a licensee which does not itself produce the service, since the technology by which the Company currently provides access to the service, and which was adopted based on the previous amendment to the license, does not enable this.

f. On the matter of section 2.16.3 to the Periodic Report concerning royalties –

- (1) On May 2, 2005, the Company received a copy of a letter dated April 20, 2005 sent by the Director General of the Ministry of Communications and the Deputy Supervisor of Budgets at the Ministry of Finance to the Director General of the Government Companies Authority, setting out the position of the Ministries of Communications and Finance on the matter of the obligation of the holders of international telecommunications licenses and of fixed-line domestic telecommunications licenses to pay royalties. According to the letter, following the recommendations of the committee for formulating policy and rules for opening fixed-line communications to competition, against the background of the proceeding for sale of the State's Holdings in the Company and as part of the preparations for the implementation of the number portability service throughout the entire telecommunications sector, the Telecommunications (Royalties) Regulations are to be amended by the Ministries and brought for the approval of the Minister of Communications, the Minister of Finance and the Knesset Finance Committee, as required by law, so that commencing January 1, 2006, a reduction of 0.5% will be made each year in the rate of the royalties paid by those licensees until reaching a rate of 1% in 2010.
- (2) Concerning the dispute between the Company and the Ministry of Communications regarding the payment of royalties for revenue from interconnections from cellular subscribers to subscribers of the Company during the period between April 1999 and the end of 2000, on July 25, 2005, the Company received a letter from the Director General of the Ministry of Communications demanding that the Company pay the above royalty debt in dispute in the sum of approximately NIS 17 million. The Company replied to the Ministry of Communications that it was taking the legal position and that Ministry

had not given reasons for its decision and had not referred to claims and data recently presented by the Company to professional staff at the Ministry. The Company also sought to hold urgent talks with the Director General of the Ministry of Communications in this matter, and to postpone the demand for payment until such talks could take place. On this matter, see also Note 6A(14) to the financial statements of the Company for the period ended September 30, 2005.

- g. Concerning Section 2.16.10(b) to the Periodic Report regarding permits for communications installations under the Planning and Building Law, including permits of the Commissioner for Radiation:
- (1) Due to intensive activities being carried out 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. As at the date of publication of these reports, the Company is dealing with the issue of permits from the relevant licensing authorities, with respect to 26 other small broadcast installations only.
 - (2) For the amendment to NOP 36A – see update to Section 3.18(c) below.

Section 2.17 – Material agreements

- a. Regarding Section 2.17.2 (deed of trust for debentures (series 5) dated May 24, 2004, and an addendum to that deed dated December 6, 2004) – on March 30, 2005, an additional addendum to the deed of trust was signed between the Company and the Mizrahi Bank Nominee Company Ltd. in respect of an issue of NIS 286,967,000 par value of debentures from the same series. See the update to Section 2.13 above and the Company's immediate report dated March 30, 2005.
- b. Regarding Section 2.17.7 to the Periodic Report –
- (1) On April 17, 2005, a special collective agreement was signed between the Company, the Workers Committee 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 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).

As a result of the contract with Harel, the Company reduced its provision for early retirement, after performing adjustments that also stem from an updated estimate of the total retirement liabilities of NIS 90 million in its financial statements for the period ended June 30, 2005.

On this matter, see also Note 5A to the financial statements of the Company for the period ended September 30, 2005.

- (2) On May 3, 2005, a special collective agreement was executed between the Company, the employee representation and the General Trade Union regarding payment of a one-time grant in the sum of part of the amount of reduction of salaries under the Israeli Economy (Recovery Program) Law and under the collective agreement for encouragement of economic growth immediately after completion of sale of the State's holdings in the Company. See also update to Section 2.9 above (sub-section (b)).

Section 2.18 – Legal proceedings

For updates on the subject of legal proceedings, see Note 6 to the financial statements of the Company for the period ended September 30, 2005, and section 1.1 above.

Section 2.20 – Event or matter outside the normal course of business

- a. Regarding the proceeding for privatization of the Company and completion of transfer of the State's holdings in the Company to Ap.Sb.Ar., see the update to Section 1.3 above.
- b. **The “Industrial Espionage” Incident**

On May 29, 2005, the media published that the Israel Police Force was conducting an enquiry regarding “industrial espionage” via computer systems in which, according to such publications, the subsidiaries of the Company – Pelephone, Bezeq International and DBS – were also involved. As a result, senior employees of those subsidiaries were called in for inquiry and/or to give evidence.

Pelephone notified, in response to the aforesaid publications, that neither it nor its employees had any connection to the obtaining of information by unlawful means, that it and its employees were surprised by the publications and that they would cooperate with the Police in order to clarify the facts in the incident.

In November 2005, a claim was filed with the District Court at Tel Aviv against Pelephone, and against Civil Intelligence "(Modi'in Ezrahi)", for grant of an order to report, together with an application for the splitting of remedies. The cause of action revolved around claims whereby, Pelephone allegedly ordered commercial information regarding the plaintiff's business, and that such information was supplied by Civil Intelligence, in violation of a number of statutory provisions, and as part of the Trojan Horse incident. At this stage, Pelephone is unable to assess the chances or consequences of this claim. See also Note 6A(26)(c) to the financial statements of the Company for the period ended September 30, 2005.

Bezeq International gave notice, in response to the summons to investigation of its employees, that it would give the Police all assistance required, and that it would not have assisted or touched material obtained in unlawful ways. Concerning Bezeq International in this affair, see also Section 4.1 below.

DBS gave notice in response to the aforesaid publications that if offenses were committed against the law, they were committed in express contravention of its instructions and that it had not sufficed with entry into an oral contract with the investigation company, but rather, had had the investigation company sign an unequivocal undertaking to act only in accordance with the law, and the investigation company had undertaken that it and all those taking part in the agreement with it would act in accordance

with the law. It should be noted that the cable companies filed a claim against DBS in which they requested an order declaring that the cable companies were the owners of all of the secret materials obtained, allegedly, by DBS unlawfully, and orders instructing DBS to avoid any use of such materials. In a hearing which took place on July 7, 2005, an order was given with the consent of the Parties, to the effect that DBS would not make use of the documents and information relating to the cable companies allegedly transferred to it from the investigation companies. Regarding DBS in this incident, see also Note 6A(26)(a) to the financial statements of the Company for the period ended September 30, 2005.

It should be noted that a number of senior employees of the Company were summoned, immediately upon publication of the incident, to give evidence to the Police regarding confidential documents of the Company which were found in the possession of competitors, and to evaluate the level of damage expected to be incurred by the Company as a result of such. The Company examined this issue and took immediate action with the aim of reducing the risk of information being taken out of the Company, as far as possible.

On the implications of this incident on the privatization of the Company, see the update to Section 1.3 above.

3. CELLULAR – PELEPHONE COMMUNICATIONS LTD. (“PELEPHONE”)

Section 3.1 – General information on areas of operation

On the matter of the “industrial espionage” incident, see Section 2.20(b) above.

On Section 3.1.5.2 – the PTT (Push To Talk) service was launched at the beginning of 2005, at a reduced level, and as of July 2005, the service can be marketed in full without limitation. MIRS applied to the Ministry of Communications and petitioned the High Court of Justice requesting that the Ministry of Communications extend the period in which the marking limitation applies to the other cellular companies. During the course of the hearing held in the High Court of Justice, the State gave notice that it intended to reject MIRS’s application and that a notice in writing would be sent out to the parties involved.

Section 3.2 – Products and Services

Regarding section 3.2.2 – during 2005, Pelephone began supply of dual handsets which support CDMA and GSM technology. The handsets will provide an additional solution to roaming services in other countries where the network is not CDMA.

Section 3.7 – Competition

On the matter of number portability, see the update of Section 2.6(f) above. Implementation of the number portability plan will impose costs on Pelephone, the complexity, scope and implications of which cannot yet be assessed. As at the date of these Reports, Pelephone, and to the best of Pelephone’s knowledge, the other cellular companies as well, are not in compliance with the timetables, and notices in this regard have been given to the Ministry of Communications from all of the companies. However, the Ministry of Communications has not given notice of any change in the timetables.

Regarding section 3.7.2, the Ministry of Communications some time ago gave notice, as part of a process of final formulation of its policy regarding the field of licensing of supply of telephony services by way of a broad band access service (VOB), of its intention not to permit the companies in the Bezeq Group (including Pelephone) to take part in this field so long as the Company’s portion of the fixed-line domestic telephony field in the segment of certain customers does not fall below a given threshold, or earlier taking into account the situation of competition in the field, after an

examination to take place at examination stations on the timeline and on prescribed dates. 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 with the Company. Pelephone is waiting to present its arguments in a hearing before the Ministry of Communications. Pelephone has submitted an application to the Ministry of Communications for the effecting of a marketing trial of VOIP technology, and in response, the Ministry noted that it could grant Pelephone a license for such trial subject to conditions, that main ones of which would be a provision in the license that if at the end of the hearing the policy document is amended, such that Pelephone is prohibited from providing VOB services, the trial license shall expire. On this matter see also section 2.6(d) and (e) above.

Section 3.11 – Human resources

For changes to the Board of Directors following the change in control of the Company, see section 1.3 above. Following the appointment of the CEO of Pelephone as CEO of the Company, changes were also made to management of Pelephone.

The Terminal Equipment Services Division has been brought in under the Operations Division.

Section 3.14 – Investment in Subsidiaries and Partnerships

At the end of the third quarter, it was resolved to wind up the B-One partnership. As of the fourth quarter, Pelephone has taken over management of the undertakings given by the partnership. (see Note 4(d) to the Company's financial statements for the period ended September 30, 2005).

Section 3.15 – Finance

On June 29, 2005, Pelephone issued NIS 333 million par value debentures by way of private placement, in return for their par value (see Note 1E(4) of the Company's financial statements for the period ended September 30, 2005).

Section 3.18 – Restriction and control of Pelephone's actions

- a. Regarding the matter of number portability – see the update of Section 3.7 above.
- b. Regarding section 3.18.2 to the Periodic Report (regulated tariffs) – in partial compensation for reduction of the tariffs referred to in that section, Pelephone raised the outgoing call tariff from the Pelephone network and the SMS tariff for outgoing messages from the Pelephone network during the course of the year.

In recent months, a hearing was held in writing and orally regarding the interconnect tariffs for all cellular carriers, and as at the date of publications of these reports, Pelephone is waiting for a decision to be made by the Ministries of Finance and Communications.

- c. Regarding Section 3.18.3.3 – set up of communications installations – NOP 36 – on July 24, 2005, the Government of Israel decided to temporarily postpone approval of the resolution of the National Planning and Building Council regarding amendment of National Outline Plan 36A dealing with the set-up of small and minor broadcast installations. The amendment revolved around expansion of the discretion of local committees, provision of objection rights to the public and requiring companies to deposit undertakings to indemnify the planning committees for claims of devaluation of land. The cellular companies' portion of this indemnification was budgeted at 80% of the value of the devaluation and the balance is supposed to be borne by the local committees. The aforesaid postponement is intended to enable the committee of CEOs that was set up, to submit its conclusions within three months. Approval of the amendment as placed before the Government will have severe implications on

the ability of the cellular companies (including Pelephone) to develop their networks, and the existence of an indemnification obligation will impose an inestimably heavy economic burden on them. The committee is supposed to be finishing its work and submitting its recommendations for government approval in the next few days. To the best of Pelephone's knowledge, the committee's recommendations are, in principle: Creating a distinction between small and large sites, the licensing process for small sites being either via an exemption from license track or a fast licensing track, whilst for large sites, a complex licensing process will be required, including giving the public the opportunity to express its objections. Likewise, there will be a distinction between small and large sites with respect to indemnification. There shall be no indemnification requirement for sites that are exempt from licensing, whilst for medium-sized sites there will be an indemnification requirement, the division of the onus still being in discussion. Likewise, implementation of the committee's recommendations requires an amendment to the Planning and Building Law, and therefore, it is not possible to estimate the timing of the end of this process. The committee intends to recommend an arrangement to apply in the intervening period. On the matter of the petition filed in the High Court of Justice in this matter against the Government, Pelephone and others, see Note 6A(19) to the financial statements of the Company for the period ended September 30, 2005.

Section 3.19 – Legal proceedings

For updates on the subject of legal proceedings, see Notes 6A(7), 6A(17) through 6A(21) and 6A(26)(c) to the financial statements of the Company for the period ended September 30, 2005.

Section 3.21 – Expected developments in the coming year.

For the tender of the "Yoter" Soldiers' Welfare Association and the IDF tender in section 3.21.3 of the Periodic Report, competing cellular companies won those tenders.

4. INTERNATIONAL COMMUNICATIONS AND INTERNET SERVICES – BEZEQ INTERNATIONAL LTD. ("BEZEQ INTERNATIONAL")

Section 4.1 – General

On the matter of the "industrial espionage" affair – On May 31 2005, three employees of Bezeq International were called in for questioning as part of the police investigation into industrial espionage by computerized means (a Trojan horse program). After being questioned, the employees were released with restrictions. Up to the date of publication of the interim financial statements, no proceedings have been instituted against Bezeq International and/or its employees relating to the above investigation. On this matter, see also Note 2.20(b) above and Note 6A(26)(b) to the financial statements of the Company for the period ended September 30, 2005.

For Section 4.1.2.2 to the Periodic Report regarding royalties – see the update of Section 2.16(f) above concerning a letter of the Director General of the Ministry of Communications and the Deputy Director of Budgets at the Ministry of Finance dated April 20, 2005, in the matter of the expected gradual reduction in the percentage of royalties.

Section 4.2 – Products and Services

During the third quarter of 2005, Bezeq International set up an Integration and New Business Department, whose operations shall focus on the fields of data, hosting (of servers and websites), and total integration solutions for businesses.

Section 4.4 – New products

New products launched in 2005:

- a. Hosted Exchange services – A managed e-mail service. The service is based on a model of providing remote managed solutions on the broadband infrastructure, which reduces a business's costs compared with the alternative of purchasing a server and licenses.
- b. Mobile Max services – This service enables convenient use of dialing from abroad to Israel from supporting cellular handsets, using a Bezeq International phone card.
- c. Call Back service – A phone card service from abroad to Israel which enables the direction of a call to be reversed (Israel – abroad), thereby reducing costs.

Section 4.6 – Competition

On April 20, 2005, the Ministry of Communications gave notice of its intention to amend the main points of the policy it published concerning the licensing of the provision of telephony services by means of broadband access (VOB – Voice Over Broadband), in a way that will prevent Bezeq International (a subsidiary of the Company) from providing VOB services 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 in November 2007. This policy amendment, if adopted, is liable to oust Bezeq International from this developing market, thereby awarding 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 access to the Internet, international telephony and fixed-line domestic telephony services. The inability of Bezeq International to offer a similar solution is liable to cause turnover among its customers and to make it difficult for Bezeq International to recruit new customers. Bezeq International is unable, at this stage, to estimate the effects of the above on the results of its operations and its financial condition. On this matter, see also the update of Section 2.6(d) above.

Implementation of the numbering plan and number portability (as detailed in the update to Section 2.6 above, sub-section F) is liable to compel Bezeq International to make additional investments in infrastructure and equipment. Bezeq International cannot, at this stage, estimate the total extent of such investments.

Section 4.10 – Human resources

For changes to the Board of Directors, see section 1.3 above.

Section 4.17 – Limitation and regulation of Bezeq International activities

Regarding section 4.17.1.3 to the Periodic Report regarding royalties – see update to sections 2.16 and 4.1 above.

Section 4.19 – Legal proceedings

- a. With regard to the claim of an equipment supplier which was filed on November 24, 1998, in the Tel Aviv District Court against Bezeq International and the Company, as described in Section 4.19.1 to the Periodic Report, the Court recommended to the parties, in a pre-trial hearing on March 2, 2005, to make a further attempt at mediation and to notify it of their decision. The file is in the evidence stage at present.
- b. With regard to the claim filed on April 4, 2004, in the District Court at Jerusalem by a competing international communications operator, as described in section 4.19.2 to the Periodic Report, a pre-trial hearing of the action was held on April 10, 2005, in which the Court recommended to the parties to apply for a mediation proceeding. The plaintiff and the State of Israel

consented to the mediation proceeding. On April 17, 2005, Bezeq International and the Company gave notice that they do not consent to a mediation proceeding. The matter is in preliminary proceedings.

- c. With regard to the claim filed on January 2, 2005, by persons alleging to be the inventors and patentees of a prepaid telephone system, as described in Section 4.19.3 to the Periodic Report, after Alcatel Telecom Israel Ltd. ("Alcatel") contacted Bezeq International on April 20, 2005, Alcatel took over management of the defense in the case on behalf of Bezeq International in connection with one of the systems which are the subject of the claim (which it supplied), pursuant to the provisions of the agreement between Bezeq International and Tadiran Communications Ltd. dated December 13, 1998 (Alcatel replaced Tadiran for the matter of this agreement). On July 17, 2005, statements of defense on behalf of Bezeq International and a third party notice, against supply of an additional system operated by Bezeq International and used for the supply of the services under the Claim. On September 30, 2005, a statement of defense was filed by another system supplier. The statement of defense filed by such supplier claimed, *inter alia*, that the systems supplied to the Company do not infringe the patent under the claim, and that the respondent supplier does not owe the Company anything based on the provisions of the Law and the agreements between the Parties.
- d. On February 27, 2005, Bezeq International's general license for the provision of international telecommunications services (the "license") was amended by the addition of an appendix which dealt with access to erotic services (services offered via a telecommunications installation containing messages with sexual content) via the international dialing services supplied by Bezeq International. Under the provisions of this amendment (clause 58A of the license, Bezeq International must block outgoing call access to any telephone number dialed without a dialing prefix prescribed by the Ministry of Communications for an erotic service (1919 prefix), to the extent that the Ministry of Communications has given it notice, or it has become aware in some other way, that an erotic service is being offered via such number. In reliance upon the findings of the Supervision Report, which the Director General of the Ministry of Communications views as arousing a real suspicion that Bezeq International is in breach of the abovementioned conditions of its license, the Director General of the Ministry of Communications gave notice to Bezeq International that he was considering imposing a financial sanction upon Bezeq International, in the sum of NIS 2,257,500, based on the right afforded to him under the Communications (Telecommunications and Broadcasts) Law, 5742-1982 (the "Law"), in the event of breach of a condition of the license. Pursuant to the provisions of the Law, Bezeq International was given an opportunity of making claims in writing, in response to the charges of the Ministry, by September 6, 2005. In its Supervision Report, the Ministry of Communications raises suspicions that Bezeq International entered into an agreement with a foreign carrier to the effect that it would transfer traffic to such carrier to fictitious destinations outside of Israel, intended, in effect, for the providers of erotic services operating in Israel, and that such operator would redirect such traffic to Israel via Bezeq International's international telecommunications system; such that the profits from these calls would be divided up between Bezeq International and the aforesaid foreign carrier. More seriously, at the center of its conclusions in the Supervision Report, the Ministry of Communications alleges that it can be held, in reliance upon the findings of its investigations, that: "Bezeq International was an active party to the provision of erotic services via its international telecommunications system, and that in respect of the period from 2004 until January 2005, the Company effected short termination redirection of calls, without such calls ever leaving the boundaries of the country."

On October 17, 2005, Bezeq International filed its response to the Director General's above notice to the Ministry of Communications, in which it claimed, *inter alia*, that: Bezeq International has never provided any form of erotic

services, does not and did not have any commercial relations with suppliers of erotic content in Israel or overseas; Bezeq International has always been in strict compliance with the provisions of its license and the instructions of the Ministry of Communications and has acted effectively to block overseas destinations used for erotic services, to the extent that the Ministry of Communications has instructed it to do so; in any event, the Ministry of Communications has no real evidence that Bezeq International has breached the conditions of its license, and the charges against Bezeq International are based merely on groundless theories and baseless presumptions.

As at the date of this Report, the response of the Ministry of Communications to Bezeq International's response has not yet been received.

For further updates on the subject of legal proceedings, see Notes 6A(6), 6A(16) and 6A(26)(b) to the financial statements of the Company for the period ended September 30, 2005.

Section 4.21 – Risk factors

- a. Section 4.21(e) – Anchor countries – concerning a commitment made by Bezeq International in its official price list to the lowest prices in four countries (USA, Russia, France and Argentina) until the end of 2005, and consequently the possible adverse effect on the revenues of Bezeq International if the price lists of its competitors are revised to below Bezeq International's prices – during the first quarter of 2005 the tariff to these four countries was revised from 44 agorot per minute to 29 agorot per minute.
- b. Additional risk factor – International communication cables – The laying of a gas pipe along the shores of Israel by the Israel Electric Corporation is liable to damage the underwater communications cable system which is the main artery of Israel's international communications. The matter is being handled by the Ministries of Communications and Infrastructures. Med Nautilus, the company responsible for most of Bezeq International's underwater communications cable system, announced that its network is properly backed up and secured, including the marine connection relating to the gas pipe. In the estimation of Bezeq International, In view of this notice, the risk level of such damage appears to be low.

5. MULTI-CHANNEL TELEVISION – D.B.S. SATELLITE SERVICES (1998) LTD. (“DBS”)

Section 5.1 – General information on areas of operation

The number of DBS subscribers as at September 30, 2005 amounted to approximately 512,000.

For the “industrial espionage” incident see Section 2.20(b) above and Note 6A(25)(a) to the Company's financial statements for the period ended September 30, 2005.

Regarding section 5.1.2 to the Periodic Report (limitations, legislation and special restrictions) – on October 30, 2005, the Government decided to unify the operations of the Cable and Satellite Broadcast Council, the Second Television and Radio Authority Council, the Second Television and Radio Authority and the Public Broadcasts Regulation Administration into a single unified Commercial Broadcasts Authority, which shall be responsible for regulating all of the commercial television and radio broadcasts in Israel. The government has instructed the Ministry of Communications to prepare and distribute a Government Bill to regulate this change.

Regarding Section 5.1.5 to the Periodic Report (Substitutes for Products in the Area of Operations and Changes Applying to them) –

- a. an inter-ministerial committee was recently set up comprising of representatives of the Ministries of Finance and Communications, with the purpose of examining turning the terrestrial offices of the Broadcasting Authority and the Second Authority into digital offices in such a way as to enable national digital broadcast of Broadcast Authority and Second Authority transmissions. To the best of DBS's knowledge, no resolutions have yet been adopted on the matter.
- b. On August 9, 2005, the government decided to require the Minister of Communications and the Minister of Finance to do all of the acts required such that no later than January 1, 2007, 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. As part of this discussion, various governmental authorities have been instructed to promote and implement the decision, and in this context, to publish a tender to select an entity to plan, set up and operate the terrestrial digital broadcast system, and the digital satellite distribution system. If the government decision set out in this sub-section is put into action, the broadcasts of these channels shall constitute a partial substitute for DBS's broadcasts. DBS has submitted its objection to the proposal to the Minister of Finance and the Minister of Communications, under which it has even requested to hold a hearing preceding which it is to be provided with information under the Freedom of Information Law, 5758-1998.
- c. On August 9, 2005, the Government resolved to require the Minister of Communications and the Minister of Finance to take all action 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 the Company'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, legislative amendments relating to implementation of this decision have been included in the memorandum for the proposed Budget Law for 2006, which is to be submitted to the Knesset in the forthcoming weeks.

For Section 5.1.6 (structure of competition in the field of operations and the changes applying to it), the cable companies have recently started the sale and marketing of a basket of services, including multi-channel television, internet and fixed-line telephony.

Section 5.6 – Competition

For section 5.6.1 of the Period Report concerning competitors in the broadcasts market – DBS's portion of the multi-channel television market as at September 30, 2005, is estimated, to the best of its knowledge, at approximately 36% of total subscribers.

Further to Section 5.6.4 concerning positive and negative factors in competition – With respect to the advanced services including immediate video upon the individual demand of subscribers via broadband fixed line infrastructure – following applications by DBS to the Ministry of Communications to approve the grant of a license without the need for amendment of legislation, on October 11, 2005, DBS received a reply from the General Counsel of the Ministry of Communications to the effect that DBS's application to provide such services was still being examined by the professional staff

at the Ministry of Communications, together with the Public Broadcast Regulation Administration and the Ministry of Finance, and it was noted that an application would be made to the relevant persons to receive their positions. It was also noted in this reply that the receipt of a commercial license for the provision of the above services would require an amendment to legislation and that DBS's application for a commercial license for the provision of such services and a license for the performance of a marketing test are not possible for that reason. On October 27, 2005, the Senior VP Economics and Budget at the Ministry of Communications wrote to DBS (and to the best of its knowledge, to several other persons in the communications industry, including Bezeq, the cable companies and internet access licensees), requesting their positions on the matter by December 25, 2005. In its letter to the Company, the Ministry of Communications asked to examine specific issues relating to network capacity, the possibilities of use of it and pricing of the service.

Section 5.8 – Intangible assets

On the matter of section 5.8.1 to the Periodic Report – licenses – DBS's license to effect uplinks has been extended until January 19, 2014, or until the end of the term of DBS's broadcast license, whichever is the earlier.

Further to Section 5.8.1.2 to the Periodic Report – in February 2005, DBS contacted the Civil Administration with an application to extend the term of its license for satellite broadcasts in Judea, Samaria and the Gaza Strip until 2014. In June 2005, a representative of the Civil Administration replied that in light of the special conditions in Judea, Samaria and the Gaza Strip, there is no room, at this stage, to extend the term of the license, and therefore, the term of the above license remains unchanged (until January 2009).

Further to Section 5.8.1.3 to the Periodic Report – DBS is acting in order to extend the term of the license to effect uplinks, which expires on October 31, 2005 (and not until April 2006 as set out in the Periodic Report), until the latest date possible.

Section 5.9 – Human resources

Further to Section 5.9.1 to the Periodic Report – organizational structure – as at the date of this report, the organizational structure of DBS has been changed so that DBS now consists of only eight divisions (rather than 10), in light of the unification of the sales and marketing divisions and unification of the customer service and technical service divisions to form the customer service department.

Section 5.12 – Finance

On the matter of the financing of DBS's activities and the need to recruit additional sources of finance for it – In view of the position of the Ministry of Communications (which is described above in the update of Section 1.1), and without derogating from DBS's contentions in relation to that position, DBS is actively seeking alternative sources of financing for implementing its business plan (beyond bank credit). In March 2005 and April 2005, DBS entered into agreements with institutional bodies for receipt of NIS 50 million in long-term CPI-linked loans bearing 11% interest p.a., on inferior repayment terms compared with the bank credit except for exceptions similar to those applicable to the shareholders' loans which the shareholders of DBS have made available and will make available after April 1, 2005. To secure repayment of the loans to the institutional bodies, the Company made a commitment (which is contingent, *inter alia*, on a positive value of DBS), and the banks agreed that in the event of realization of the Company's shares in DBS by them, the institutional bodies would be entitled to a proportional part of the proceeds, at the percentage determined in the agreements. The institutional bodies were also given an option to extend loans in the same amount as already extended, provided that the amounts of the loans are required according to the business plan of DBS. Concurrently with these agreements, appropriate amendments were also signed in the financing agreement with the banks which are financing the operations of DBS.

In June 2005, an institutional entity which provided DBS with a long-term loan in April 2005 as set out above, exercised the option given to it under the loan agreement, and provided DBS with an additional loan in the sum of NIS 20 million, on the conditions of the original loan agreement. In September and October 2005, two institutional entities which had entered into loan agreements with DBS in March and April 2005 for long term loans exercised the option afforded to them under the loan agreements and provided DBS with an additional loan in the sum of NIS 30 million, on the conditions of the original loan agreements.

On this matter, see also Note 4(a) above and Note 6B to the financial statements of the Company for the period ended September 30, 2005.

Further to section 5.12.3 to the Periodic Report (credit sums received in 2004), since the beginning of 2005, DBS has received loans from shareholders and others in the sum of NIS 167 million and the banks have increased their credit by approximately NIS 18 million.

Further to Section 5.12.4 (credit of corporation) – DBS's credit allowance is approximately NIS 1,379 million. As at September 30, 2005, DBS has utilized NIS 1,368 million of its credit allowance.

Section 5.14 – Restrictions and supervision of the corporation

Further to Section 5.14.1 to the Periodic Report, specific legal restrictions on operations – according to a decision of the Cable and Satellite Broadcast Council (the “**Council**”), in 2002 DBS was in compliance with its obligation to invest in local productions, except for approximately NIS 3,900,000 and under-investment of approximately NIS 7,800,000 in original quality productions, and in 2003, DBS had met the obligation to invest in local productions except for the sum of approximately NIS 370,000 and under-investment of approximately NIS 5,200,000 in original quality productions, however the Council allowed DBS to make up these shortfalls during 2004 and 2005 (with original quality productions). DBS notified the Council that it had met its local production obligations for 2004 (including the proportional part of completing past obligations), and the matter is currently being examined by the Council. For 2006 onwards, no decision has been made as yet with regard to the percentage of DBS's revenues that will be invested in local productions (according to the Communications Law, that percentage is between 8% and 12% of the revenues), but the Communications Law states that increasing the percentage of the investment in local productions required of DBS necessitates a hearing for DBS by the Council, and DBS is unaware of any plans for such a hearing. According to a decision of the Council dated September 2005, the rate of investment of DBS's revenues in local productions during the years 2006 and 2007 will stand at 8% of such revenues.

Further to Section 5.14.2 – subordination of operations to the broadcasting license – according to a decision of the Supreme Court on March 22, 2005, in HCJ 7200/02 filed by DBS against the Council & Ors., apart from the Minister of Communications' authority to amend the broadcasting license of DBS (in consultation with the Council), the Council alone may also modify the terms of the broadcasting license, provided that before doing so, it gives the licensee the opportunity of a fair hearing.

Further to Section 5.14.3 to the Periodical Report – on June 30, 2005, the Satellite and Cable Broadcasting Council (hereinafter: the “**Council**”) passed a resolution regarding an “invitation to present positions regarding rules of ownership of channels produced in Israel”, as part of which, the Council invited the public to present it with its positions in this regard, including on the question of whether DBS should be under the channel production restrictions which apply at present only to cable companies, and in the event that it should be, which amendments and adjustments ought to be made to them in comparison with the rules currently applying to cable companies. In July 2005, DBS submitted its remarks in this regard to the Council, and in doing so, expressed the position that there was no room for applying limitations in the matter beyond those already set out in the Law at present.

Regarding the dispute use by DBS of cable infrastructure at subscribers' homes – in 2001, the Ministry of Communications issued an administrative order regulating the method of transfer of a subscriber from the services of the cable companies to DBS and vice-versa, and the use of infrastructure in the subscriber's home. The administrative instructions also provide an obligation to pay a monthly fee for infrastructure owned by the other multi-channel television provider. Since enactment of the Administrative Instructions, DBS and the cable companies have brought mutual complaints regarding breach of the Administrative Instructions by the other party, and considerable correspondence has taken place between DBS and the Ministry of Communications in this regard. On August 15, 2005, the Ministry of Communications gave notice to DBS and the cable companies that in light of their many breaches of the Administrative Instructions, 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 Instructions should remain in place, 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 companies title to the wiring installed by them in private homes. DBS also claimed that the sum set out in the Law as the consideration to be paid for purchase of the wiring (NIS 120) has no basis and that should the provision remain in force, it should be reduced considerably. DBS further claimed that the arrangement being considered by the Ministry of Communications is deficient and has many faults, and will prevent the proper transfer of subscribers under it, and will harm competition. On this matter, see also Note 6A(24) to the financial statements of the Company for the period ended September 30, 2005.

Section 5.15 – Material agreements

Further to Section 5.15.2 to the Periodic Report – pursuant to the Second Space Agreement (as defined in section 5.15.2 to the Periodic Report), in May 2005, DBS began to lease two additional space segments on the Amos 2 satellite, so that as at the date of this report, DBS leases a total of 6 space segments on the Amos 2 satellite. As at the date of this Report, DBS leases 7 space segments on the Amos 1 satellite, due to a technical limitation that is preventing the continued lease of the eighth space segment, and until solution of that limitation, rental is not being paid for the aforesaid eighth segment.

Further to Section 5.15.5 to the Periodic Report – finance agreement with the banks – See the update of Section 5.12 above.

Section 5.17 – Legal proceedings

- (a) Further to Section 5.17.3 of the Periodic Report in the matter of the petition filed by DBS to the High Court of Justice against the powers of the Minister of Communications to intervene regarding the injection of funds into DBS, and the matter of the appeal filed by DBS regarding the conditions of the merger with the Company, see the update to section 1.1 above.
- (b) In May 2005, arbitration proceedings commenced between DBS and Play TV Ltd., the producer of the "Playboy" and "Adult" channels (hereinafter: "Play TV" and the "Channels") regarding an argument by DBS regarding its right to rescind the agreement, and regarding other claims by Play TV as to performance of the Agreement. Following an application for interim relief submitted by Play TV, the arbitrator decided, on June 9, 2005, that DBS would not be able to offer an erotic channel produced by another supplier at a cheaper rate than the "Adult" Channel, and that DBS would not display that channel as a preferable channel the Play TV Channels. On June 22, 2005, the

parties submitted their pleadings to the arbitrator. In the claim filed by DBS, DBS petitioned for declaratory relief under which the agreement between the parties had been legally voided due to the broadcast of a film on the Channel, on three separate occasions, the content of which contravened the provisions of the Communications Law, and the Council's resolutions (hereinafter: the "Film"). In a suit filed by Play TV, it claims the sum of NIS 6,159,800, based on Play TV's claims regarding campaigns run by DBS, under which the Channels and films produced by Play TV were offered at a reduced price, without this being coordinated with it, and regarding various errors in DBS reports, on the basis of which, the consideration paid to Play TV is prescribed. Play TV also applied for declaratory relief under which the notice of rescission of the agreement was given unlawfully, that the monetary sanction imposed by the Council for broadcast of the Film be paid by the parties in equal shares, award of a mandamus order regarding broadcast of an "Adult" channel in a pay-per-night (PPN) viewing format, and comparison of its price as against the price of another erotic channel broadcast as part of DBS's broadcasts, and other auxiliary relief. The parties' responses to the mutual claims have yet to be filed. DBS gave notice to Play TV that notwithstanding its claims, *ex gratia* until the arbitrator's ruling on the matter, DBS would suspend the operative results of rescission of the agreement between the parties and would continue to act in accordance with the provisions of it. The file is in the evidence stage at present. At this stage, DBS's legal counsel are unable to assess the outcome of this dispute..

- (c) For further updates on legal proceedings, see Notes 6A(22), 6A(23), 6A(24) and 6A(26)(a) to the financial statements of the Company for the period ended September 30, 2005, and section 1.1 above.

November 16, 2005

Date

Bezeq – The Israel Telecommunication Corp. Ltd.

Names and titles of signatories:

Moshe Arkin, Chairman of the Board of Directors

Yacov Gelbard, CEO

The information contained in this periodic report constitutes a translation of the periodic 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.