"Bezeq" The Israel Telecommunication Corp. Limited

Annual Report for 2004*

Chapter A – Description of Company Operations

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

Chapter C – Financial Statements

Chapter D – Additional Details About the Corporation

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

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* The Annual Report was prepared in accordance with the Securities Regulations (Periodic and immediate reports), 5730-`1970. The values stated in respect of the report period are in reported amounts. All comparison numbers are adjusted to the index of December 2003.

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

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Chapter A – Description of Company Operations

1. Description of General Development of Group Operations

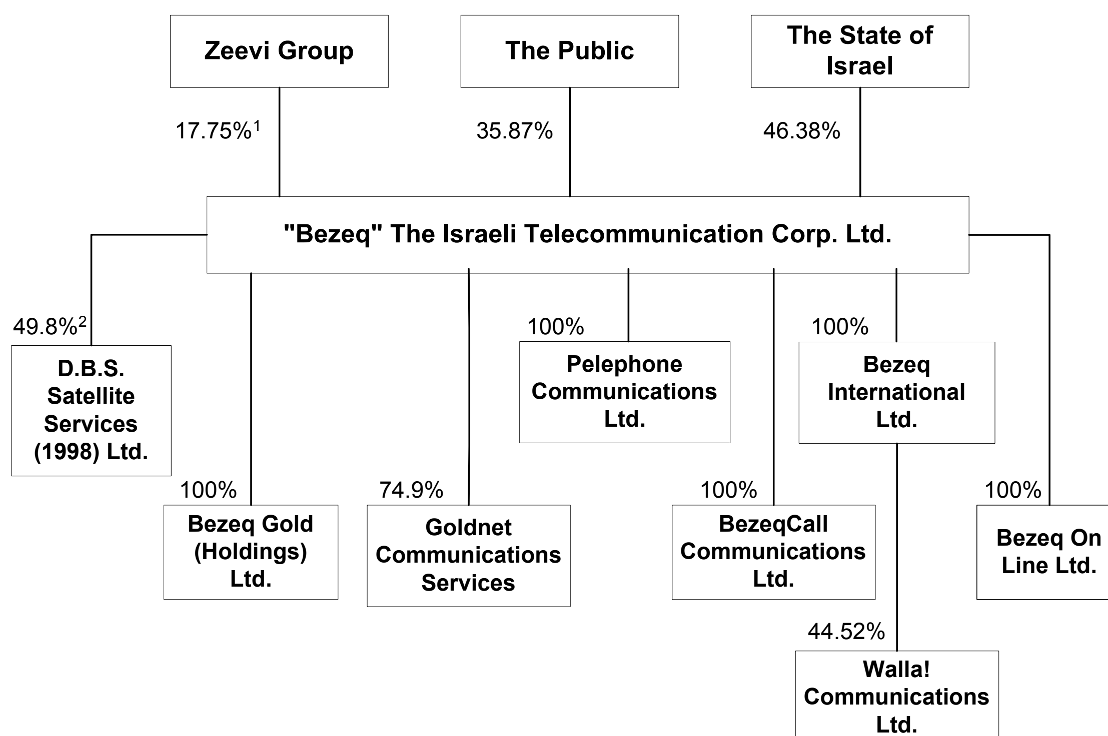
Bezeq The Israel Telecommunication Corp., Ltd. (hereinafter, "the Company" or "Bezeq") along with the subsidiaries (including partnerships) that it owns in whole or in part, whose financial statements are consolidated with the Company's, shall be jointly referred to in this periodic report as "the Group" or "the Bezeq Group".

1.1 Group Activity and Description of its Business Development

1.1.1 As of the date of this periodic report, The Bezeq Group is the principal provider of communications services in the State of Israel. The Bezeq Group implements and provides a broad range of telecommunications operations and services, including fixed-line domestic services, cellular services, international communications services, transmission to the public of satellite multi-channel television broadcasts, internet access services, customer call centers, deployment, maintenance and development of communications infrastructures, provision of communications services to other communications providers, satellite services, transmission to the public of television and radio broadcasts, provision of services and maintenance of equipment on customer premises (network end point services).

1.1.2 Both in the global markets and in Israel, the pace of development in the telecommunications sector is rapid. The telecommunications arena is affected by changes in technology, in relation to both the business structure of the industry and the applicable regulations.

1.1.3 The diagram below outlines the holdings in the Company and the holdings of the Company in its subsidiaries and principal affiliated companies, as of the date of the periodic report:



1 Of which 17.63% are held by Zeevi Communications Holdings Ltd., to which a receiver was appointed who is authorized to exercise the rights deriving from the shares as decided and approved by the court.

2 As of the date of the periodic report, the Company has an option to increase its holdings to approximately 57.5% reflecting the proportional percentage of its investments. [See Section 1.1.5b below].

1.1.4 The Company was founded as a government company in 1980.

On November 18, 2003, government holdings in the Company were reduced to below 50%. As a result, the Company has become a “mixed company” as defined in the Government Companies Law, 5735-1975 (hereinafter, "the Government Companies Law”). As of the date of this periodic report, the State of Israel holds approximately 46.38% of the Company’s issued share capital and is the controlling shareholder.

The State of Israel is in the process of selling its core control in the Company (see Section 1.3 below).

The Company is a publicly traded company.

1.1.5 <u>Mergers and Acquisitions</u>

A. <u>Pelephone Communications Ltd. (hereinafter, “Pelephone")</u>

On August 26, 2004, after having been issued all of the legally required approvals, the Company completed acquisition of the balance of the remaining 50% of Pelephone shares from a corporation in the Shamrock Group which had held these shares (hereinafter, “Pelephone Holdings”) for an exercise price of $60 million (approximately NIS 270 million). Furthermore, the Company converted convertible debentures (of $240 million par value, recorded in the Company’s financial statements at a zero value) and granted Pelephone Holdings a loan of NIS 1,766 million ($394 million) which Pelephone Holdings used to repay the balance of the loans taken to finance part of the cost of acquiring Pelephone shares.

On December 21, 2004, the aforementioned shares were transferred to the Company from Pelephone Holdings, such that as of the date of this periodic report, the Company directly holds all of the shares in Pelephone. This step was taken as part of the Company’s strategy to operate also in the cellular market (see also Note 8D to the financial statements for the period ended on December 31, 2004, which are included in this periodic report).

B. <u>DBS Satellite Services (1998) Ltd. (hereinafter, “DBS”)</u>

On July 19, 2004, the Company applied to receive the required regulatory approvals for exercise of its warrants into DBS shares (approval of the Ministerial Committee on Mergers, Minister of Communications and the Antitrust Commissioner for the merger). Should they be exercised, the Company’s holdings in DBS will increase to approximately 54.75%. Exercise of the warrants allotted to the Company against its investments in DBS does not entail payment of additional consideration. In accordance with the notice issued by the Minister of Communications on 31 August, 2004, the application made by the Company for exercise of the shares was not approved, and furthermore, in a letter dated December 31, 2004, the Minister imposed restrictions on the injection of the funds the Company had decided to invest in DBS. On February 14, 2005, after being requested by the Company to re-examine the issue, the Minister of Communications affirmed the decision of her predecessor with insignificant changes. The Company contends that the aforementioned decisions of both Ministers of Communications were issued without authority, and therefore, the Company appealed to the District Court requesting a declaratory judgment to determine that the decisions were issued without authority and should thus be cancelled.

On January 2, 2005, the Antitrust Commissioner approved the merger, contingent upon specified conditions. Given the restrictive conditions, the Company decided, at this point in time, to postpone exercise of the warrants and to appeal to the Antitrust Court regarding the restrictive conditions.

Continued operation of DBS is dependent on the injection of funds to DBS according to the business plan that was approved.

(For a detailed description of the developments in this matter, see also Note 8E to the financial statements for the year ended December 31, 2004, which are included in this periodic report.)

1.1.6 Sales - Intelsat Satellite Corporation (hereinafter, “Intelsat”)

The Company held 0.7405% of Intelsat shares. Additionally, the Company held approximately 0.8% of New Skies Satellites N.V. (hereinafter, “NSS”), a subsidiary that was “spun off” from the aforementioned corporation. According to the notification sent by Intelsat on November 17, 2004, Intelsat was sold, and the Company’s share of the consideration from this transaction amounts to approximately $23 million (the transaction was completed on January 28, 2005). In November 2004, the Company received an amount of approximately $8 million for its share of the consideration from the sale of NSS activity, assets and liabilities. The total consideration to the Company from both of these transactions is approximately $31 million.

As a result of performance of both of the aforementioned transactions, the Company will record a capital gain, based on the full amount of the expected consideration, of approximately NIS 135 million (approximately NIS 35 million in 2004 and approximately NIS 100 million in 2005). The taxes applied to these capital gains will be at the tax rates commonly applied to capital gains in Israel.

1.2 Areas of Activity

The Group is engaged in four main areas of activity as well as a "miscellaneous" area of activity that includes all other Group activities. These five areas of activity are reported as business segments in the Company’s consolidated financial statements (see also Note 26 to the financial statements for the year ended December 31, 2004, included in this periodic report).

1.2.1 Fixed-line domestic services

This segment primarily includes telephony services, internet access services, transmission services and data communications. This activity is performed by the Company.

1.2.2 Cellular services

Cellular communications services, marketing of end-user equipment, installation, operation and maintenance of cellular communications equipment and systems. This activity is performed by Pelephone Communications Ltd. (hereinafter, “Pelephone”).

1.2.3 International communications and internet services

International communications services as well as internet access services (ISP). This activity is performed by Bezeq International Ltd. (hereinafter, “Bezeq International”).

1.2.4 Multi-channel television

Multi-channel digital television broadcasts to subscribers over satellite (DBS) and provision of value-added services to subscribers. This activity is performed by DBS Satellite Services (1998) Ltd. (hereinafter, “DBS”).

1.2.5 Miscellaneous

This segment comprises three sub-segments, each of which alone, and the three combined together do not constitute a major component of the Group. They are as follows:

A. BezeqCall Communications Ltd. (hereinafter, “BezeqCall”)

Network end point services (installation, maintenance and operation of a private network, private exchanges and other communications devices at subscriber premises, including multi-line private switchboards and with the exception of home network end point services) as well as marketing and distribution of end-point equipment and private exchanges. Total revenues from this sub-segment in 2004 amounted to approximately NIS 233 million.

B. Bezeq On Line Ltd. (hereinafter, “Bezeq On Line”)

Customer call center services in a variety of areas. Total revenues from this sub-segment in 2004 were approximately NIS 54 million.

C. Goldnet Communications Services Partnership (hereinafter, “Goldnet”)

Content services to the business sector, operation of electronic communities and other services. Total revenues from this sub-segment in 2004 amounted to approximately NIS 31 million.

The activity of each of the above sub-segments in the reported year was balanced (approximately) in operating terms.

1.3 Investments in Equity and Stock Transactions

1.3.1 The Company raised capital in 2003 through the sale of State-owned shares which constituted approximately 9.4% of the Company's issued share capital to institutional investors. In parallel, the Company allotted shares to the State, at an amount representing 7.5% of the issued share capital. See also Note 20 to the financial statements for the year ended December 31, 2004, which is included in this periodic report.

1.3.2 On October 23, 2003, the Company increased its registered share capital by 190 million ordinary shares of NIS 1 par value each.

1.3.3 On June 1, 2004, The State of Israel, which is the controlling shareholder of the Company, offered through the Company's prospectus of May 24, 2004, 156,000,000 ordinary shares of NIS 1 par value each of the Company, (approximately 5.99% of the Company's issued capital). The result of the offer of sale to the public was the sale of 70,671,100 shares of NIS 1 par value each (approximately 2.71% of the issued capital of the Company), at a price of NIS 4.921 per share.

1.3.4 The State of Israel is currently in the process of selling its core control in the Company. On July 19, 2004, the Ministerial Committee on Privatization decided to sell the State’s holdings in the Company via a private offering of 30% of the Company's share capital and the issue of warrants for the purchase of an additional 10.66% of the Company's share capital. As of the date of this periodic report, review, carried out in the Company's information rooms by parties interested in participating in the process, is complete, and they have participated in presentations about the Group.

1.4 Distribution of Dividends

1.4.1 On February 20, 2003, the Company distributed a dividend in the amount of approximately NIS 190,000 thousand (7.8784 agorot per share).

1.4.2 In 2004, the Company did not distribute a dividend to its shareholders.

1.4.3 In 1991 it was determined that the cash dividend policy to which the Company aspires, is the distribution of 60% of its annual post-tax earnings. Although no other resolution has been passed with respect to the Company's dividend policy, for several years now the decisions on dividend distribution have been made specifically according to the financial results of the Company, its financial situation and other relevant data and circumstances.

It should be made clear that the dividend policy and decisions referred to above are not a representation or a commitment, and the Company reserves the right to change its dividend policy and to determine, from time to time, the amount of the dividend that will be actually distributed at that time to the shareholders, if at all.

1.4.4 It should be noted that a procedure issued by the Government Companies Authority for the sale of the core control in the Company stipulated that the sales agreement signed by the party purchasing the core control shall undertake, *inter alia*, to act in accordance with his holdings such that no division of the balance of accrued profits of the Company as at December 31, 2000, will be made (the procedure clarifies that this shall not prevent the distribution of accrued profits subsequent to December 31, 2000, under the Companies Law, 5759-1999). The purchaser of the core control shall also undertake to act in accordance with his holdings such that there will be no division of capital gains resulting from the disposal of capital assets the consideration for which was paid in kind shall be effected for a period of two years from the date of acquisition of the shares sold.

1.5 Financial Information on the Group's Areas of Activity

1.5.1 2004

	Domestic fixed-line communication	Cellular	International communication and internet services	Multi-channel television	Others	Adjustments to consolidated*	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Total revenues:							
From externals	4,736,756	2,966,486	797,735	529,838	238,989	–	9,269,804
From other areas of operation in the segment	222,935	8,493	18,704	12,304	80,387	(342,823)	–
Total	4,959,691	2,974,979	816,439	542,142	319,376	(342,823)	9,269,804
Total attibuted costs:							
Costs not constituting revenues in another area of operation	3,933,351	2,450,650	612,217	597,602	284,436	–	7,878,256
Costs constituting revenues from other areas of operation	55,324	145,001	85,999	29,921	26,578	(342,823)	–
Total	3,988,675	2,595,651	698,216	627,523	311,014	(342,823)	7,878,256
Operating income	971,016	379,328	118,223	(85,381)	8,362	–	1,391,548
Total identified assets as at December 31, 2004	8,589,680	4,775,659	598,090	1,364,941	235,240	(206,476)	15,357,134
Minority percentage in the segment					25.1%		

*Details of the nature of the adjustments to the consolidated – inter-company transactions between areas of activity.

1.5.2 2003

	Domestic fixed-line communication	Cellular	International communication and Internet services	Multi-channel television*	Others	Adjustments to consolidated**	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Total revenues:							
From externals	5,023,754	2,021,807	689,378	–	246,329	–	7,981,268
From other areas of operation in the segment	206,807	5,568	13,958	–	40,236	(266,569)	–
Total	5,230,561	2,027,375	703,336	–	286,565	(266,569)	7,981,268
Total allocated costs:							
Costs not constituting revenues in another area of operation	4,274,937	1,807,638	531,702	–	273,642	–	6,887,919
Costs constituting revenues from other areas of operation	49,005	123,724	81,633	–	12,851	(267,213)	–
Total	4,323,942	1,931,362	613,335	–	286,493	(267,213)	6,887,919
Operating income	906,619	96,013	90,001	–	72	644	1,093,349
Total identified assets as at December 31, 2003	9,903,468	2,258,000	527,565	–	213,574	(106,196)	12,796,411
Minority percentage in the segment					25.1%		

*Not consolidated in the financial statements.

** Details of the nature of the adjustments to the consolidated – inter-company transactions between areas of activity.

(1) 2002

	Domestic fixed-line communication	Cellular	International communication and Internet	Multi-channel television*	Others	Adjustments to consolidated**	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Total revenues:							
From externals	5,241,263	1,958,582	670,449	–	193,186	–	8,063,480
From other areas of operation in the segment	205,825	7,642	8,272	–	29,444	(251,183)	–
Total	5,447,088	1,966,224	678,721	–	222,630	(251,183)	8,063,480
Total allocated costs:							
Costs not constituting revenues in another area of operation	4,434,397	1,887,932	501,361	–	222,603	–	7,046,293
Costs constituting revenues from other areas of operation	32,884	140,964	69,337	–	8,642	(251,827)	–
Total	4,467,281	2,028,896	570,698	–	231,245	(251,827)	7,046,293
Operating income	979,807	(62,672)	108,023	–	(8,615)	644	1,017,187
Total identified assets as at December 31, 2002	10,046,942	2,258,690	685,059	–	189,419	(120,838)	13,059,272
Minority percentage in the segment					–		

*Not consolidated in the financial statements.

** Details of the nature of the adjustments to the consolidated – inter-company transactions between areas of activity.

1.6 General Environment and Effect of External Factors on Group Activity

The Group's business is affected by the level of the financial activity in the domestic market and therefore, positive or negative developments at this level are expected to have a corresponding impact on the business of the Group. Thus, for example, growth in the GNP and in the number of people employed in the market is expected to impact positively on Group revenues.

2. Fixed-line Domestic Services - Bezeq The Israel Telecommunication Corp., Ltd. (hereinafter, “the Company”)

2.1 General Information on Area of Activity

2.1.1 Area of activity and changes affecting it

The Company has a general license for the provision of fixed-line domestic communications services. Under this license, the Company provides telephony services, dial-up internet access and associated services; broadband internet access (ADSL); remote access; information services and data communications; transmission services; IP-VPN services; deployment, maintenance and development of infrastructures; internet access services between users and ISPs; and other activities, including sale of end-point equipment, satellite and video services, setting up and operation of radio and television broadcasting installations and services for external organizations (billing and collection services, deployment and maintenance of television cables, performance of engineering work, etc). In addition, the Company provides infrastructure and other services to other communications providers. Both in global markets and in Israel, the pace of development in the communications sector is rapid. The communications arena is affected by changes in technology, in terms of the business structure of the industry and in terms of applicable regulations.

2.1.2 Legislative and regulatory restrictions and special constraints

The Company’s activity is subject to comprehensive regulation and control that relates, *inter alia*, to matters such as determining and approving the fields of the Company's permitted activity and services, holding and transferring of means of control, licensing, determining tariffs, quality and terms of service to subscribers and obligation to pay royalties. These regulations and controls are attributable to the following: the status of the Company as a licensee, according to the Telecommunications (Telecommunications and Broadcasting) Law, 5742-1982 (hereinafter, “Telecommunications Law”), and are subject to the provisions of the Telecommunications Law, as well as the regulations and rules that have been promulgated there under, and the terms of its general license. The Company's status as an essential telecommunications service provider is subject to the provisions of Telecommunications Order based on section 4D of the Telecommunications Law; and the application of the Control of Commodities and Services Law 5718-1957, the Commodities and Services (Price Control) Law 5756-1996, and other laws.

The tariffs for the Company’s main activities are subject to strict regulation under various provisions of the law. The tariffs are updated and change from time to time in regulations, *inter alia*, according to recommendations of the Committee for the Regulation of Bezeq’s Tariffs. The tariffs were recently changed on June 1, 2004. (For a description of the updating mechanism see Note 1E(1)(a) to the Company’s financial statements for the year ended December 31, 2004, which are included with this periodic report).

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

Furthermore, some of the Company's activity involves the use of wireless frequencies and operation devices emitting electromagnetic radiation, which are respectively subject to the Wireless Ordinance (New Version), 5732-1972 and the Pharmacists Regulations (Radioactive Elements and their Products), 5740-1980 (see Section 2.15 below).

On November 18, 2003, government holdings in the Company were reduced to below 50%, and the Company became a “mixed company”. As such, various restrictions apply to it both by law (Government Companies Law, Foundations of the Budget Law, 5745-1985) and by the provisions of its articles of association which entered into effect upon the reduction of the government’s holdings in the Company to below 50%.

2.1.3 Changes in the volume and profitability of the activity

	2004	2003	2002
Revenues (NIS millions)	4,960	5,230	5,447
Operating income	971	907	980
Average monthly revenue per line (ARPL)(1) (in NIS)	107	111	126
Number of active subscriber lines as at the end of the year (thousands)	2,896	2,913	3,006
Total minutes of use in Israel (incoming outgoing) (millions)	23,194[2]	28,837	36,499

(1) Not including revenues from transmission and data communications services, services to communications providers, contractor work and other.

(2) Most of the decline in minutes is attributable to lower use of dial-up internet access and the switch to high speed internet services through ADSL technology or cable modem. Additionally, there is a more moderate yet steady decline in minutes as the result of competition with other communications providers (particularly cellular operators).

2.1.4 Developments in the market and in customer attributes

In recent years we have seen growing competition between fixed-line and cellular telephony. If in the past almost all calls were made between two fixed lines, today, more than two thirds of voice calls in the market start or end on cellular networks. As the number of cellular subscribers has grown and reached approximately 7 million subscribers (according to data published by the cellular companies), there has been a decline in the number of households and businesses holding a fixed line, as well as a decline in the number of lines per customer. Furthermore, there has been an ongoing average decline in the Company's regulated and unregulated tariffs (see Section 2.16.1 below).

2.1.5 Technological changes that significantly impact on the area of activity

A. Penetration of high speed internet and the availability of new IP-based technologies offer consumers a wide variety of applications and services over IP-based infrastructures. These include voice services, video transmission services and network services with organizational applications over the internet infrastructure (ERP, CRM, etc.).

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

B. Furthermore, there are a wide range of technologies that enable cellular service providers to compete with the Company's services more efficiently than with existing technologies.

C. Technological developments may enable other operators to build infrastructures that provide services similar to those offered by the Company at lower cost. Furthermore, as a result of the advances in technology on the one hand, and the aging technology implemented in the Company's systems, which may be difficult for suppliers to support, on the other hand, it may be necessary to switch to other technologies or increase the maintenance costs of the existing systems.

2.1.6 Critical success factors in the area of activity and changes affecting them

A. Ability to offer reliable communications systems at competitive prices.

B. Ability to offer technologies for advanced services to customers.

C. Technological and marketing innovation.

D. Ability to offer high quality and reliable service to customers.

E. Management of an intelligent price policy, subject to regulatory limitations, in light of growing competition and technological changes that are expressed in generally lower prices in the industry.

F. Provision of innovative value-added broadband services with a quick time to market through development of advanced technological infrastructure.

G. Intelligent migration of customers from traditional networks to next-generation networks.

2.1.7 Main entry and exit barriers of the activity and changes affecting it

The main entry barrier in the domestic fixed-line communications market is attributable to the need for substantial investments in a technological infrastructure and complementary systems until economy of scale is achieved, and from the high costs involved in establishing marketing, sales and customer support systems. In recent years the traditional entry barriers to the Company's areas of activity have been to a great extent removed. As a result, we have seen a decline in the prices of infrastructures, technological improvements, easing of regulatory restrictions for new competitors, and in particular – the cancellation of the universal service obligation for select general license holders as well as leveraging of existing systems of communications operators that are competing or are planning on competing against the Company.

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

2.1.8 Alternatives to products in the area of activity and changes affecting them

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

Recently we have seen a growing trend of transmission of voice calls over the internet or over organizational data networks, using dedicated software that is provided free of charge or at a discounted price by companies in Israel and abroad. Furthermore, the internet enables e-mail applications and instant messaging, which to a certain extent are also alternatives to telephone calls.

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

2.1.9 Competitive structure in the area of activity and changes affecting it

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

The area of high rate transmission and data communications was opened to competition at the end of 2000.

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

In the field of telephony, according to an announcement made by the Minister of Communications, "HOT Telecom", a partnership of cable companies, began providing commercial services on November 25, 2004. As at September 2004, the Minister is entitled to grant special general licenses for the provision of domestic fixed-line communications services without an obligation to provide universal service or provide service with a limited deployment. To the best of the Company's knowledge, as of the date of this periodic report, said licenses have not yet been issued. Furthermore, according to the amendment of the Telecommunications Law in January 2005, the

Minister is entitled to grant general licenses for telecommunications services or telecommunications activity and exemption by order of the licensing obligation. The Ministry of Communications recently issued a policy paper on the provision of telephony services over broadband access services (by the Company and by HOT), subject to a hearing and granted licenses for a ”paid marketing trial” for provision of said services. See Section 2.6.1 below regarding this matter. Additionally, the Company views cellular telephony services as alternative services to the telephony services it provides. In this regard, see Section 2.6.4 below.

Competition in the sector is dependent on a variety of factors, including: development of competition with HOT, issue of licenses to other domestic operators, the final policy to be determined regarding provision of telephony service over broadband infrastructure, increased competition with cellular companies; possible changes in the terms of the licenses of the Company and its subsidiaries as well as the conditions of the licenses granted to the competitors; mergers and alliances between companies that compete against companies of the Group; financing of universal service; new services the Company will be allowed to provide; tariff policy and the amount of flexibility the Company is given to offer service packages, including along with subsidiaries etc. (see Section 2.6 below).

2.2 Products and Services

2.2.1 The Company provides a wide range of communications services to business and private customers. The main services offered by the Company include telephony services, associated services, and value-added services, internet access services - both dial-up and broadband access to high speed internet, transmission and data communications services over a wide variety of infrastructures for businesses and other communications providers.

2.2.2 Telephony

The Company’s telephony services primarily include the basic telephone services provided over home telephone lines, installations and transfer of telephone lines, sale of end-user equipment and additional associated services such as voice mail, caller ID, 144 information, call waiting, call forwarding, speed dialing and conference calls.

Furthermore, the Company provides number services for businesses that enable incoming calls from anywhere through a single short speed dial (star plus four digits), with the 1-700, 1-800 area codes. These area codes enable business customers to determine whether the company or the customer will pay for the call.

The Company currently operates approximately 14,800 public telephones around the country that are operated by biodegradable prepaid cards ("Telecard"), billing a Bezeqcard or calling collect. This service generates a loss (in amounts that are insignificant). Draft regulations designed to ease the obligation of deployment of public telephones were compiled, but this draft was not approved by the Knesset Economics Committee, which determined that the Ministry of Communications should submit a revised draft.

The Company has also submitted a request to the Ministry of Communications to terminate its Bezeqcard service (post-paid calling cards) and has received agreement in principle. As at the date of this periodic report, the Ministry of Communications and the Company are discussing how to implement termination of the service.

The Company’s telephony services are among the main services provided by the Company, and in recent years they have been on a downward trend, both in use and in revenues. This is due primarily to the alternative services offered by the cellular companies and use of the cellular phone which is, to a great extent, an alternative to making a call on a fixed-line phone.

2.2.3 Internet access services

These services enable internet access and primarily provide access to high speed internet over regular telephone lines using ADSL technology.

At the end of 2004, the Company had approximately 650,000 ADSL subscribers, a rate constituting approximately 66% of the broadband internet market in Israel (based on

Israeli media reports relative to the number of subscribers who are not subscribed through the Company).

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

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

2.2.4 Transmission and data communications services

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

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

The Company offers transmission services, including high speed services, to its business customers and communications providers over a variety of protocols.

In 2004, the Company began providing point-to-point transmission services over Gigabit Ethernet protocol, which enables very fast, high volume transmission.

2.2.5 Other services

A. Services to communications providers

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

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

B. Satellite services

The Company provides satellite services via fixed antennas (in the Ella Valley and the Ayalon Valley), primarily including services for international communication: video transmission services, telephony services and satellite relay broadcasts for foreign broadcasting organizations in Europe and Asia. The Company also operates mobile units for spontaneous television broadcasts via satellite.

Furthermore, the Company provides users in regions around the world with various types of mobile satellite communications services (such as telephony, data and fax) via operation of a ground station for the provision of Inmarsat services in Emek Ha’ela. These services are provided under an agreement with Inmarsat Ltd. (which operates a satellite network that covers most of the world by land, sea and air). With respect to the Company’s plans regarding the Inmarsat station, see Note 9F to the Company’s financial statements for the year ended December 31, 2004, which are included in this periodic report.

The Company also currently operates and maintains seven radio networks operated by the Israel Broadcasting Authority, Channel 1’s television transmitters and those of Educational Television, Channel 2’s television transmitters in some parts of the country and the transmitters of four regional radio stations.

The Company is only responsible for operation and maintenance of the transmitters in order to distribute broadcasts of radio and television programs, and not for the content of the broadcasts.

C. Work as a contractor

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

The Company and two cable television broadcast licensees (in this Section, the "Licensees") have agreements for the provision of installation and maintenance services of cable networks for cable television using the Company's infrastructure, from the starting point of the licensees' operating point up to the point of delivery at the entrance to subscriber homes (the Company is not responsible for the connection and maintenance from these points to the subscribers' homes).

D. Billing and collection services

The Company has billing and collection agreements with five international carriers. An agreement with a sixth company is now being finalized. The terms of the agreements are similar and among other things stipulate that based on the data in the reports submitted by the carriers, the Company will collect payments due from customers for international telecommunications services through the phone bills it sends out to its customers and will transfer the actual amount collected, without bearing any responsibility for collection enforcement. Additionally, the Company provides collection and sales services to end-user equipment vendors and collection services for information providers, Internet Service Providers (ISPs), and network endpoint operators.

2.3 Breakdown of Revenues and Profitability of Products and Services

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

	2004		2003		2002	
	NIS millions	% of revenues	NIS millions	% of revenues	NIS millions	% of revenues
Telephony	3,206	64	3,462	66	3,594	66
Internet	497	11	440	9	385	7
Transmission and data communication	675	13	692	13	786	14
Other services	582	12	636	12	682	13

2.4 Customers

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

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

2.4.3 Company sales are divided into two main sectors: the private sector (approximately 60%) and the business sector (approximately 40%).

2.5 Marketing, Distribution and Service

2.5.1 The Company has marketing, sales and service systems for the private and business sectors, which include customer managers for the business sector, joint sales and

service centers (including the 199 center) located throughout the country, separate technical support centers for internet and IT services, support and repair centers for telephone services (166 center), as well as 24 points of sale and service (Bezeq Store) throughout the country.

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

2.5.3 The Company's general license and the regulations stipulate standards for the availability and quality of service the Company provides its customers. These standards relate to the maximum amount of time to repair problems, maximum amount of time for installation or transfer of a phone line and for handling calls to information (144) and calls to report problems (166). The Company has applied to the Ministry of Communications, asking to adjust the standards defined in its license to reflect actual practice and to match those in the licenses of other providers in order to allow the Company to compete. As at the date of this periodic report, the Ministry of Communications has yet to respond to this request.

2.5.4 The Company also operates service and support centers for all customers and provides them with a variety of services, including billing questions, ordering of various services and technical support for internet and IT services.

2.6 Competition

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

2.6.1 Telephony

In November 2003, a general license was granted to the partnership formed by the cable companies, HOT Telecom (in the foregoing and hereinafter, “HOT”), for the provision of fixed-line domestic services, including telephony. According to the notice issued by the Ministry of Communications, HOT began providing telephony services on November 25, 2004.

On August 1, 2004, a temporary order entered into effect, stipulating that for a period of two years from the date on which HOT began its commercial activities or until a difference of up to 1.05 billion traffic minutes is generated between calls that end on the Company’s network and those that end on HOT’s network, whichever comes first, interconnect fees for termination of the calls on said networks would not be paid. For more information regarding this matter, see Note 1E(1)(F) of the financial statements for the year ended December 31, 2004, which are included in this periodic report.

Following the adoption of the recommendations of the Kroll Commission, which was appointed to set guidelines for competition in the area of fixed-line telecommunications, and the accompanying legislative amendments, from September 2004, the Minister will be entitled to issue special general licenses for the provision of fixed-line domestic telecommunications services, including telephony, with no obligation to provide universal service or minimal geographical deployment. To the best of the Company’s knowledge, as at the date of this report, no such licenses have been issued.

On November 30, 2004, the Ministry of Communications issued a policy paper on the provision of telephony services over broadband access systems of a fixed-line domestic operator (in reality – the Company’s and HOT’s) (hereinafter, “VOB Services”[3]). According to the policy paper, VOB Services will be provided under the special general licenses in 2005; a VOB operator will pay mutual interconnect fees, but will not pay for use of the fixed-line operator’s network. The Company itself will only be allowed to provide this service from May 1, 2007 or after its market share in telephony falls below 85%; provision of international VOB services will be allowed by any party that provides the full range of international services. The company communicated its opposition to said policy to the Ministry of Communications.

[3] Voice Over Broadband

Following the responses received from the Company and HOT, the Ministry announced an additional hearing for holders of general licenses regarding the implications of the aforementioned guidelines. On January 30, 2005, the Company submitted another response to the Minister of Communications, demanding another thorough investigation of the matter, along with careful study of all aspects and its significant implications. The Company repeated and clarified: that VOB services conflict with the concept of independent infrastructures which are the basis for the regulation of the fixed-line telecommunications market in Israel; the Company is entitled to provide fixed-line telephony services in any manner whatsoever and it cannot be prevented from providing VOB services; provision of VOB services should also be allowed over cellular networks, if and when the provision of VOB services over fixed-line networks is allowed as the lack of symmetry will very seriously and negatively impact operators; an appropriate solution for the question of cross-subsidy needs to be found; VOB operators need to pay an interconnect fee; and the level of regulation of the Company needs to be significantly more flexible, with specific reference to regulation of tariffs to enable the Company to compete in the new conditions.

At the same time, the Ministry began issuing licenses for paid marketing trials of VoIP services to a number of organizations, including Golden Lines, Barak 013, and Bezeq International, and determined that the Company must immediately enter negotiations with the operators regarding the trial. The Company expressed its opposition and asked that the issue be put on hold until the VOB question is fully clarified. As at the date of this periodic report, the issue of the marketing trial is still being discussed by the Ministry of Communications, the Company and the organizations that were granted said licenses.

Furthermore, to a large extent, the Company views cellular telephony services as alternatives to the telephony services it provides. With regard to this matter, see Section 2.6.4 below.

2.6.2 Broadband internet access

The field of broadband internet access has become fiercely competitive since the partnership of the three cable companies (now a merged partnership, “HOT”) began competing against the Company in March 2000.

HOT has access to a cable and fiber-optic infrastructure over significant parts of Israel and a relatively high penetration rate into homes in those areas. The cable network underwent a major upgrade recently and is currently an advanced broadband digital network. Over this network, it is possible to provide a wide range of advanced communications services and advanced interactive applications. This network is currently the main universal alternative for competition against the Company in both the private and business sectors.

2.6.3 Transmission and data communications

At the end of 2000, segments of this area began to open to competition, as special licenses were granted for the provision of transmission services to licensees - Cellcom, Med-1 and Golden Lines. In November 2002, the licenses of Cellcom and Med-1 were expanded to include the provision of high-speed data communication services to organizations. The licenses prohibited the provision of voice, video and access services to ISPs as well as assistance with the implementation of these communications services in any manner whatsoever. At a later stage, these licenses were amended to allow Cellcom and Med-1 to provide access services to ISPs at symmetrical speeds above 2 Mb/s. Furthermore, to the best of the Company’s knowledge, restrictions on Cellcom were eased somewhat with regard to the prohibition on provision of video services.

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

HOT and Med-1 can be counted among the significant competitors in this market, given that they own a widely deployed fiber-optic network, as can the Internet companies which use leased infrastructures.

The formidable competition in the area of transmission has significantly and negatively impacted the revenues of the Company.

2.6.4 Competition from the cellular companies

The penetration rates of cellular technology in Israel are among the highest in the western world. The Company's opinion, which is not accepted by the Ministry of Communications, is that the penetration rate, combined with airtime tariffs which are low in international terms, have made cellular phones a product which is largely interchangeable with telephone lines. Over the past three years, the Company has lost an average of about one billion voice minutes per year, most of them to the cellular operators. The Company believes that increasing interchangeability between fixed-line and cellular telephones is one of the reasons for the growing rate at which telephone lines are being removed, to the extent that approximately 12% of Israeli households today do not have a fixed line (compared to approximately 5% in 1996). According to the Company's approach, that mobile telephony services are largely interchangeable with fixed-line services, the Company has appealed to the Antitrust Tribunal against the refusal of the Antitrust Commissioner to rescind the declaration of the Company as a monopoly, and its appeal is pending.

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

According to media reports, Partner has also announced its entry into the fixed-line domestic telephony market, based on the principles set out in the policy paper issued by the Ministry of Communications on the provision of telephony services of broadband access services.

2.6.5 Additional factors that may affect competition

A. Numbering and number portability

Under the Telecommunications Law, in order to guarantee competition and the level of service in the telecommunications market, the Minister is authorized to issue directives to licensees regarding designation and allocation of telephone numbers and dialing rules, preparation and management of a numbering plan, and its operation and application. The Minister may order each licensee to bear the costs, in whole or in part, it incurs in complying with the directives, and if licensees should incur shared costs in respect of number portability, the Minister may order that they be divided among the licensees. According to a directive issued by the Ministry of Communications, certain area codes in the Company's network were unified.

On September 1, 2004, the Ministry notified the Company that it intended to designate the 09 area code as a reserve code, and it thus intended to direct the Company not to allocate new numbers that overlap in the 02 and 09 area codes and to take as much action as possible to reduce the quantity of overlapping numbers. On January 3, 2005, the Company informed the Ministry of its position that there was no reason for frequent and unnecessary numbering changes that hurt and annoy customers and generate high costs for the overall market.

In a government decision of August 15, 2004, regarding increasing competition in the fixed-line and cellular communications areas, it was determined that "the Director General of the Ministry of Communications must take action to ensure number portability in the area of fixed-line and cellular communications services later [sic.] than February 1, 2006". In the Economic Policy Bill for the 2005 fiscal year (legislative amendments), 5765-2004 (hereinafter, "Economic Policy Bill"), there is a proposed amendment to the Telecommunications Law, according to which the Minister will prepare a numbering plan for number portability for

Licensees (including Licensees with special general licenses), as well as for organizations with a general license for the provision of cellular services, and direct them on its implementation and operation by February 1, 2006. The structure of payments in this regard will be determined by the Minister of Communication and the Minister of Finance such that it will guarantee full transparency and prevent any bias. In the commentary to said bill, it states that this is being done to encourage the development of competition in the area of fixed-line domestic telecommunications services and to contribute to increased competition in the field of cellular services. In a discussion held on March 3, 2005, in a joint meeting of the finance and economics committees of the Knesset, the Ministry of Communications proposed prohibiting the collection of payments both from subscribers who move with their number to the network of another operator and from the operator to which the subscriber switched.

In the current configuration of the Company's network, it is not possible to implement number portability and as long as it is not changed, heavy investment in replacing software versions and hardware in the Company's switching network will be required. Furthermore, the operation of number portability involves costs for joint registration and management with the relevant operators. These are significant costs which cannot yet be estimated. As at the date of this periodic report, the Company does not believe it will be able to implement number portability on the date proposed in the aforementioned bill.

B. Additional potentially competing infrastructures

In addition to the cable companies' cable and fiber-optic network and Cellcom's fiber-optic infrastructure, there are in Israel today a number of fiber-optic networks, most of which are owned by State-owned companies or government agencies. These include Israel Electric Corporation, Israel Railways, Mekorot, the Oil Infrastructure Company and the Trans-Israel Highway Company.

In the aforementioned government decision of August 15, 2004, it was decided to have the Director General of the Ministry of Communications take action to enable the provision of domestic transmission services, hosting services for communications services and broadband internet access services over existing infrastructures in which the State has holdings in various areas (including electricity, railway, Mekorot, Trans-Israel Highway, the Oil Infrastructure Company and others), as at March 1, 2005, and to make the required legislative amendments to the laws that regulate the activity of the owners of said infrastructures.

C. Advantages and technological developments

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

Another important reason for the Company's belief that real competition will develop in the sector and that its market segments will be hurt, are the developments and breakthroughs in telecommunications technology which will enable the competition rapid and relatively low-cost deployment of technologies such as voice services over data lines, voice over IP (VoIP), wireless data communications solutions and wireless technologies.

Another competitive factor is the "Bezeq-bypass networks". There are two main types of bypass networks: (1) those built on the Company's infrastructure – primarily various types of point-to-point lines, such as Sifranet and Frame Relay which compress speech channels and are used by organizations dispersed over a large number of sites around the country, and use of the internet infrastructure; (2) those that use other infrastructures or divert traffic to them, and primarily different types of wireless-cellular, microwave, laser, satellite networks and cellular adaptors. Systems using a combination of both of these types also exist.

The rapid growth in the number of internet subscribers along with technological developments enabling the transfer of telephony services over the internet (VoIP) and over a data communications network negatively affect the number of calls passing through the Company's network and a decline in its revenues. VoIP

technology is based on packet-switching and enables more efficient use of bandwidth and a reduction in call costs.

In the business sector there is also a common trend of bypassing the Company's switched telephony network, either through cellular adaptors installed by the customers themselves or by the cellular companies (installations on the customer's premises enabling conversion of calls originating from a fixed line to the cellular spectrum) or NEP licensees. Following a legal proceeding on the matter, cellular companies were ordered to disconnect the direct fixed-line transmission connectors, which illegally connected private networks on the premises of business customers to the cellular switch. The continuation of such connections in the security sector and the health system are, as at the date of this periodic report, being examined by the Ministry of Communications.

The Company believes that the said network bypasses along with the interchangeability of fixed-line and cellular services explain a substantial part of the decline in traffic minutes on its network. In addition to the technologies and methods described above, additional technologies and methods are being developed and are likely to be developed in the future, and these will even further reduce the use of the Company's telephony, data communications and transmission networks.

2.6.6 The Company's preparations for coping with increasing competition

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

A. The Company is launching new communications services and value-added applications, for among other reasons, to increase the volume of use of subscriber lines, respond to customer requirements and enhance the image of technological innovation. The Company invests in improving and modernizing its infrastructure to be able to provide its subscribers with advanced services and products.

B. The Company took action to introduce broadband (high-speed) internet services using ADSL technology and is working to maintain its market share in this area. In December 2003, the Company launched the "IPVPN secured business access service", which provides secure connectivity of branches and enables employees to connect from their homes to their organization's network. It also launched an ADSL-based service for business customers and high-speed data communications services for business customers and communications providers.

C. The Company is constantly working to improve the quality of service it delivers to its customers.

D. The Company has simplified its tariff structure and offers customers a number of alternative payment packages.

E. The Company is implementing a new billing system for business customers.

F. The Company is working to heighten awareness of use of the fixed-line telephone and to promote the use of other services which increase telephone use, such as numbering services (1-800), voice mail, marketing of digital cordless phones (under the B Digital brand), telephone information services and other value-added services.

G. The Company has entered into contractual arrangements with business customers for a defined period (generally three years, in rare cases – five years) to promote increased use of its services by assisting in the financing of communications equipment or annual financial bonuses in the form of discounts which the Company believes it is permitted to give. The Ministry of Communications believes that these agreements contravene the provisions of the Company's license, and it informed the Company that if said agreements are not cancelled, it intends to call in NIS 8 million of the bank guarantee the Company provided in accordance with its licenses. The Company does not agree with the position maintained by the Ministry of Communications and has appealed to the High Court of Justice in this matter. The High Court of Justice issued an order staying the cancellation of the existing agreements and calling in of the guarantee until the case is heard.

H. The Company is adjusting expenditures with the goal of reducing investments in fixed assets while at the same time diverting resources to growth activities and reducing operating costs. The Company has a policy of selective investments, effective utilization of existing resources and reducing the prices of the equipment and services it purchases. The Company has also changed the mix of its investments: less emphasis on investments for maintenance of existing items and heavier emphasis on development of growing services (such as ADSL and IPVPN), and the integration of advanced information systems for support of decision-making processes. Notwithstanding the foregoing, the Company's ability to make adjustments in its expenses in the short and medium term is limited due to its cost structure, which mainly comprises rigid short- and medium-term costs. These costs consist principally of depreciation expenses and expenses related to salary and benefits. Furthermore, the Company has other operating costs such as infrastructure maintenance and leasing as well as maintenance of buildings, which are also rigid short-term costs.

I. In recent years the Company has contracted with a number of leading strategic consultancy companies in order to prepare a strategic plan for work with business customers and corresponding adaptation of its organizational structure. There is no guarantee that these plans will be approved or implemented for reasons including the positions of the employees' committee, or that they will achieve their targets and objectives.

2.6.7 Positive and negative factors that affect the Company's competitive status

Positive factors

A. A modern infrastructure that is deployed throughout the country and technological innovation through which a variety of services are provided.

B. Presence in most businesses and households.

C. Strong capital structure and positive cash flow.

D. Expansive service infrastructure and various customer interfaces.

E. Professional experienced and trained staff.

F. Brand with presence and power.

G. Some of the lowest tariffs in the world.

Negative factors

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

A. Duty of structural separation

Under its license, the Company must maintain full structural separation between itself and the subsidiaries and affiliated companies that are specified in the license. At this stage, these restrictions do not apply to the other organizations operating in the communications market, and thus put the Company in an inferior position.

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

The Company believes it should be permitted to offer packages of services jointly with companies in the Bezeq Group, when these types of packages are offered by its competitors. The absence of such an option is a major disadvantage in the Company's ability to compete.

C. Lack of flexibility in tariffs

The Company is restricted in its ability to grant discounts on its principal services and to offer differential tariffs. Even the tariff baskets (which were supposed, among other things, to offer an immediate alternative to the normal tariffs) are so tied up in bureaucracy that they are frequently pointless.

Furthermore, the combination of the present supervisory mechanism and the restrictions that apply in relation to the structural separation, prevent any possibility of the Company being able to offer customers comprehensive service packages.

D. Universal service obligation

The Company is obligated to provide universal service to the general public throughout Israel. This obligation will not be imposed on the special local carrier licensees, which will be able to offer their services to the Company's profitable customers (particularly business customers), which represent a significant source of revenues for the Company. The Company believes that a fund should be established to finance universal service, so that an operator that does not provide service to any party requesting it will pay into the fund through which universal service will be funded.

E. Cross-subsidy

Due to regulation, Company tariffs include a cross-subsidy between traffic and access. This issue is in any case one of the most substantial difficulties the Company has in competing, and while competition rests on the Bezeq infrastructure and takes advantage of the access subsidy (such as VOB Services), the negative impact of this factor has grown.

Furthermore this influences the difficulties in labor relations and issues related to personnel. Implementation of plans for structural changes and significant reduction in the number of employees, as part of making the Company more competitive, in the past required and in the future is also expected to require coordination with the employees, come at a significant expense and cause unrest in labor relations.

The extent to which competition impacts on the Company (including positive implications) and on its revenues is dependent on a variety of factors, including the following: the rate at which competition with the cable partnership and other domestic operators develops; increased competition with cellular operators; the final policy determined regarding provision of telephony services over broadband infrastructure; ability to leverage the synergy between companies in the Group and the flexibility the Company will be given to offer joint packages of services and to determine its tariffs; tariff erosion; approvals for new services, combination of fixed-line and mobile services; financing of universal service; changes in licenses; symmetry in structural separation; implementation of economies of scale; changes in customer perceptions.

2.7 Fixed Assets and Facilities

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

2.7.2 Fixed-line domestic telecommunications infrastructure

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

A. Exchanges

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

B. Transmission network

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

C. Data communications networks

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

D. Access network

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

E. End-point equipment

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

2.7.3 Computing

The Company's IT system supports four main activities:

A. Marketing issues

Among other things, the IT system supports management of the Company's customer database, management of orders for service, management of tracking of customer complaints, management of the sales and customer service processes, and billing and collection. The billing and collection system includes production of bills to customers for services provided by the Company and for services of other communications operators. Furthermore, the system includes management of interconnect charges with other communications providers.

B. Information systems for engineering infrastructures of the telecommunications networks

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

C. Information systems for management of Company resources

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

D. Cross-organization systems

Support decision-making processes via a data warehouse system operated by the Company. The Company also operates a website that provides information about the Company's services and enables presentation of information regarding the telephone bills, payment of telephone bills and additional services. Computerized office systems (electronic mail, resolution follow-up, etc.), knowledge management systems, etc. are also operated by the Company.

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

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

2.7.4 Real estate

A. General

The Company's real estate assets come from two sources: Assets transferred to it by the State under an asset transfer agreement in 1984 and assets to which the

Company received or purchased rights after this date, including assets it leases from third parties.

The Company owns or leases about 415 real estate assets throughout the country. The total area over which the Company has full title or capitalized long-term lease rights (including joint long-term lease rights), amounts to approximately 725,000 m^2 of land, of which approximately 373,000 m^2 is built up. Eight of these properties are in Israeli settlements in Judea and Samaria, approximately 8,000 m^2 in area, with a total of 500 m^2 being built up.

In addition to those properties, there are another 14 properties, with a total area of 1,585,000 m^2, which are set out, in the agreement for the transfer of properties, as being under leases renewable every two years, and under the settlement agreement described below (hereinafter, the “Settlement”), this land is to be leased to the Company.

Of all of the properties owned or leased by the Company, 66 are properties which were under joint title with the Ministry of Communications, the rights of the Ministry in most of which having been transferred to the Postal Authority, to the best of the Company’s knowledge. The total area of these properties is approximately 126,000 m^2 of built-up land on plots totaling close to 130,000 m^2 (according to the data set out in the agreement for the transfer of properties). On June 30, 2004, The Company entered into an agreement with the Postal Authority to define and clarify the rights of both in these properties (see Section 2.17.9 below).

The parties are following the provisions of the agreement, *inter alia*, to separate joint charges and systems.

Furthermore, the Company holds some 80 properties in Israeli settlements in Judea, Samaria and the Gaza Strip, in a total area of approximately 10,500 m^2 of land, on which about 1,900 m^2 is built up. No written arrangement of the contractual rights in these properties exists, but in the Company’s opinion, this does not constitute a significant problem.

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

The Company leases about 131 land assets, with a total area of approximately 75,000 m^2, of which 72,000 m^2 are built up, from various lessors.

The Company has easements (rights of way, etc.) over other real estate (i.e. in order to erect transmitters and deploy cables). The Company also has about 300 concentration rooms at its disposal (rooms for cables and facilities used for neighborhood communications), with a total area of approximately 4,000 m^2, most of which are not regulated by written arrangements of rights with the owners (such as: The Israel Lands Administration, settling organizations, entrepreneurs of projects on which the properties are situated, and cooperative house committees).

B. Registration

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

C. The Settlement regarding the land

On March 10, 2004, the Settlement signed by the Company, the Israel Lands Administration (hereinafter, “ILA”) and the State was given the force of a judgment after a drawn out dispute over the most of the real estate assets transferred to the Company under the real estate transfer agreement which was executed when the Company began its commercial operations.

Under the Settlement, 14 properties specified in the agreement will be returned to the State through the ILA on different dates (through 2010) and in accordance with the terms stipulated in the agreement (hereinafter, “Returned Assets”), out of the 31 assets in the asset transfer agreement which will be under renewable 2-year

leases. Three additional properties in this category were returned to the ILA prior to the Settlement. Fourteen additional properties in this category which were specified in the agreement (hereinafter: the "Properties to be Retained"), are to remain in the Company's possession, under capital lease conditions as set forth below.

As of the date of this periodic report, of said properties, the Company has returned 6 to the ILA as well as parts of an additional property.

In addition to the Properties to be Retained by the Company, about 220 properties under long- term leases stipulated in the real estate transfer agreement (hereinafter, the "Properties under Long-Term Lease"), with the exception of a number of properties of an insubstantial cumulative value, are to be returned to the State. Of all of the leased properties, 66 are properties under joint title with the Postal Authority and/or the Ministry of Communications. It was determined that the rights of the Company in these properties under the Settlement will also be determined by the area in the use of the Company in said properties as will be determined or agreed upon in the future between the Company, the Postal Authority and/or the Ministry of Communications, as applicable (in this regard, see Section 2.17.9).

From the date the agreement entered into force, the Company's rights in the Properties to be Retained shall be as follows:

The Company and the ILA shall act within 180 days of the date the Agreement enters into effect to sign long-term lease agreements at 91% capitalized for each of the properties (close to the date of the publication of the periodic report, a final version for lease contracts was agreed to between the Company and the ILA); The Company's rights in properties are to be the lease rights for a period of 49 years commencing on March 22, 1993, with the Company having an option to extend the term of the lease for another 49 years in accordance with the ILA's procedures at the time regarding other long-term lessees in the municipal sector; the purpose of the lease shall be any permitted purpose under the plans applying and/or that may apply to the properties, and the Company shall be entitled to make any use of and do any act to such properties, at its discretion, as part of such long-term lease purpose; the basis for the Company's rights in the properties shall be the plans as defined in the Planning and Building Law, 5725-1965, lawfully approved on March 22, 1993; the Company shall not make any payment to the State and/or the ILA, including permit fees, lease fees, capitalization fees - until exploitation of all rights under plans lawfully approved as of March 22, 1993; subject to the execution of individual lease contracts as set forth in the foregoing, the Company shall be entitled to effect any transaction permitted under law on the properties, at its discretion, and without being required to pay the ILA for performance of such transaction. The Company shall be entitled (subject to execution of individual lease contracts as stipulated in the foregoing) to make improvements to the properties, subject to any law. In the event of any improvement, over and above the basis of the rights as set forth above, the financial arrangements stipulated in the agreement shall apply.

D. Properties with improvement potential

The Company is examining the possibility to develop and exploit those of its land assets which are currently undeveloped or partially developed, for instance by exploiting additional building rights, amending plans under the Planning and Building Law, or renovation and expansion of buildings where such is possible by law. Following the Settlement, which removed the uncertainty regarding the Company's rights and the Properties to be Retained, and defined them, it is possible to move forward with exercising the potential to improve such properties. The considerations are mainly based on criteria of the size, location and use of the real estate.

2.8 Intangible Assets

2.8.1 The Company's general license

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

2.8.2 Trademarks

The Company uses trademarks that reflect its products and services.

As of the date of this periodic report, the Company has 56 trademarks registered in its name with the Patent and Trademark Registrar. The main trade marks are:

"Bezeq" – Company name.

"B BEZEQ" – Company logo.

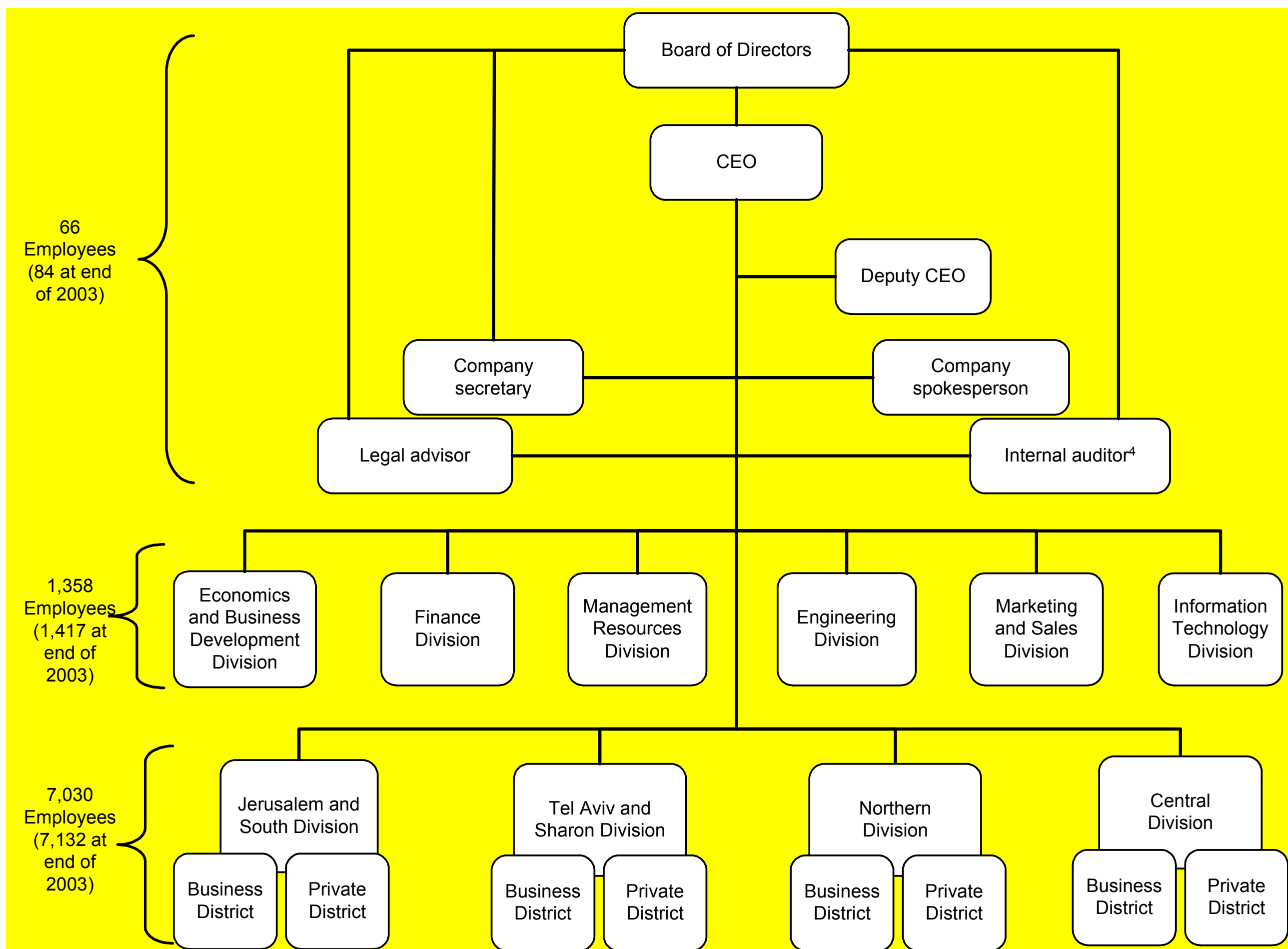
"WOW" – access to the Company's high speed internet services.

Advertisement of the main trademarks is done in the various media outlets such as the press, radio, television, billboards and mailings.

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

2.9 Human Resources

2.9.1 Organizational structure and personnel based on organizational structure (as of December 31, 2004)



[4] On January 4, 2005, the Audit Committee of the Board of Directors approved that the auditor report to the Chairman of the Board of Directors. The resolution will be brought to the Board for approval.

2.9.2 Personnel according to employment framework

Employment Framework	Number of Employees		Description of Employment Framework
	As at Dec. 31, 2004	As at Dec. 31, 2003	
Contracts for senior executives	87	89	Employees (including 16 senior executives) excluded from the provisions of the Company's collective bargaining agreements. Their terms of employment are set in personal agreements which are approved by the Government Companies Authority.
Permanent	4,079	4,425	Employees employed through collective bargaining agreements.
Inclusive salary agreements and personal contracts	942	937	Employees employed through personal contracts that are not part of the collective bargaining agreements.
Ranking contracts	185	140	Employees employed through personal contracts under the terms of the collective bargaining agreements for a period of six years on a track that will make them permanent employees.
Age contracts	39	41	Employees who have a right to permanent status after reaching the age of 48. Instead of granting these employees permanent status, they are employed through personal contracts, under the terms of the collective bargaining agreements.
Generation 2000	3,104	2,979	Employees engaged in defined activities, which in the past were staffed by workers from employment agencies. The employment of the employees and their conditions are stipulated in a special collective bargaining agreement for this group.
Temporary	18	22	Employees employed through personal contracts for a period of up to 5 years in a track that will result in permanent status.
Total	8,454	8,633	

2.9.3 Orientation and retirement of employees from January 1, 2004 through December 31, 2004

Employment framework	Intake	Retirement
Senior contracts	3	8
Permanent	0	398
Overall salary contracts	22	42
Generation 2000	938	694
Total	**963**	**1,142**

2.9.4 Company investment in training

The Company conducts internal training sessions given by professional experts who are Company employees and at times, with the assistance of external organizations, in all its areas of activity. The total number of workdays allocated for training activity for all employees in 2004 was approximately 40,000 days, reflecting an average of 4.5 days of training per employee. This training activity includes, professional training in the fields of technology, sales, management, service and others.

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

The Company implements a broad higher education program. In 2004, two classes completed their studies – one for a bachelors and the other for a masters in business administration. There are also two classes for undergraduate studies in electronics engineering and computer science.

The Company's total investment in training activity amounts to approximately NIS 5 million and approximately NIS 2.4 million for higher education.

2.9.5 Nature of employment contracts and streamlining plans

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

Under the 1985 collective bargaining agreement, the provisions of the State service articles, agreements, arrangements and work policies which existed or which are mandated by the Ministry of Communications (unless otherwise agreed) apply to Company employees. The national grades for employees in the public service sector and agreements regarding wages, benefits or labor conditions that apply to employees at those grades apply to Company employees, in addition to special collective bargaining agreements.

As the Company is not party to the negotiations between the State and the Histadrut regarding the salary terms for public sector employees, the application of these agreements to Company employees imposes conditions which do not necessarily reflect the Company's business considerations.

As a "mixed company", the Company is still subject to Section 29 of the Budget Elements Law, which restricts its ability to act independently in matters related to the salaries and benefits of its employees, and it imposes upon it an obligation to receive the approval of the Government Companies Authority in these matters.

It should be noted that the Company is in the middle of two key processes which may affect the streamlining plans and the number of personnel – opening the market to full competition and the sale of the State's controlling interest. However, beyond the existing retirement plan (as outlined in Note 16D to the financial statements for the year ended December 31, 2004, which are included in this periodic report) and ongoing streamlining, there are currently no other significant plans in this regard. This may change as the result of market developments and/or a change in the structure of the Company's ownership.

It should further be noted that in the policy regarding the sale of the core control, it was stipulated that the party purchasing the core of control shall undertake, to the best of its ability, to act in accordance with its holdings to ensure that the Company remains in full compliance with all of the collective bargaining agreements, collective bargaining arrangements, current valid and binding practices and personal contracts, subject to the provisions of the law, rights and contractual obligations.

For a list of the significant agreements with respect to labor relations, see Section 2.17.7 below.

2.9.6 Employee compensation plans

Currently the Company does not have special compensation plans, with the exception of a “pilot” approved for customer managers in the business sector, which was implemented several months ago and the Company is now checking how efficient it is. The Government Companies Authority has yet to approve the use of a full model for special compensation.

In accordance with the agreement between the workers’ committee and the Government Companies Authority, Company employees will be compensated for the public offering made pursuant to the prospectus of May 2004 and for the sale of the core control in the Company, such that employees will be offered shares held by the State in the amount of 4.71% of the share capital of the Company at a weighted price of 20% of the share price in a public offering under the prospectus, and 80% of the average share price on the stock market over the 30 trading days preceding the date of sale of the core control, with a discount of 30%. The employees may withdraw their request to have this arrangement apply to all of the employees in one go. Should the employee organization withdraw the request, the employees shall be given financial compensation under the Authority’s procedures for the compensation of employees for the private placement of the State’s shares (payment of up to 3% of the consideration from the sale). With respect to the benefit expected for this compensation, see Note 1G to the Company’s financial statements for the year ended December 31, 2004, which are included in this periodic report.

2.9.7 Company officers and senior executives

As of the date of this periodic report, the Company has 8 directors and 16 senior executives.

All directors in the company receive remuneration for attending Board and committee meetings in accordance with the Government Companies Regulations (regulations regarding remuneration and expenses for a public director in a government company), 5754-1994, as amended from time to time, at the ranking of a company at this level, and which by virtue of the resolution of the General Meeting of December 7, 2004. Both public directors serving on the Board receive remuneration in accordance with the Companies Regulations (Rules for remuneration and expenses of external directors), 5760-2000.

Senior executives are employed through personal contracts, the wording of which is approved by the Government Companies Authority and any change in the conditions of their employment requires the approval of the Authority as well as the approval of the Company’s Board of Directors in accordance with the provisions of its articles of association. As of the date of this periodic report, the conditions of employment of senior executives at the Company as a “mixed company” are linked to the conditions for employment of executives as determined by the Government Companies Authority for government companies (see Section 2.9.5 above).

2.10 Raw Materials and Suppliers, Purchase of Equipment and Suppliers

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

2.10.2 The following table lists the percentage of Company purchases in 2004 from the main suppliers and the type of contractual arrangement with them:

Main Products	Main Supplier	Type of Contractual Arrangement	% of Purchases out of Total Purchases in Area of Activity
Public switching equipment	Nortel	Framework agreement for purchase, upgrade and maintenance, which was renewed at the end of 2004 through the end of March 2007.	Less than 14%
Public switching equipment	Alcatel	1. Purchase agreement through the end of 2005. 2. Maintenance agreement that renews each year.	Less than 5%
Billing – computerized billing systems	Amdocs	Framework agreement for the provision of personnel for support, guidance and integration of the systems.	Approximately 6%
Transmission equipment	Supplier D	Framework agreement for purchase and maintenance through the end of March 2005.	Approximately 14%
IP/VPN – IT equipment and integration work	Supplier E	Framework agreement that can be extended each year through October 2010.	Approximately 5%

2.10.3 The Company believes that it is dependant on two suppliers of switching equipment: The Alcatel group, represented in Israel by Alcatel Telecom Israel Ltd. and The Nortel group, represented in Israel by Nortel Israel (sales and marketing) Ltd. In terms of the Company's billing systems for business customers, it is dependant on Amdocs Software Systems.

2.11 Working Capital

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

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

2.11.3 The follow table presents data on supplier and customer credit in 2004:

	Scope of average credit in NIS millions	Average days of credit
Customers	1,026	Current + 16
Suppliers	484	Current + 28

2.12 Investments

For information on investments in subsidiaries, see Note 8 to the financial statements for the year ended December 31, 2004, which are included in this periodic report. See also Sections 3 and 4 in Chapter 4 of this periodic report.

2.13 Finance

2.13.1 Average interest rate on loans

As at December 31, 2004, the Company is not financed by short-term loans (less than one year). The following is a breakdown of the loans from banking and non-banking sources:

Source of financing	Type of currency or linkage	Rate of average interest
Banking sources	CPI linked NIS	4.65%
	Dollar	Libor + 0.56%
Non-banking sources	CPI linked NIS	5.01%
	Euro	6.42%
	Non-linked NIS	Bank of Israel interest + 0.5%

2.13.2 Limitation in receipt of credit

A. With respect to limitations on Company loans – see Note 13 to the Company's financial statements for the year ended December 31, 2004, which are included in this periodic report.

B. Limitations imposed by the Bank of Israel regarding individual borrowers and groups of borrowers

Directives issued by the Supervisor of Banks in Israel include provisions according to which the liability of an individual borrower or group of borrowers for a banking institution shall not exceed 15% (individual borrowers) and 30% (group of borrowers) of the banking institution's capital. These provisions further stipulate that total liabilities of the banking institution's six largest borrowers and groups of borrowers shall not exceed 35% of the banking institution's capital. These provisions may, from time to time, affect the ability of some banking institutions to issue additional credit to the Company. However, as a rule, the Company does not have difficulty finding sources of finance. As the Company does not have data and exact information regarding the restrictions on individual borrowers that apply to the banks, and given the fact that the Company cannot quantify a portion of its liabilities to the banks, such as debentures issued by the Company and held by the banks, the Company is not able to estimate when and at what level of debt, if at all, these restrictions will impact on the Company's ability to secure credit.

2.13.3 Credit received during the reporting period

Source of financing	Credit amount (NIS millions)	Type of currency or linkage
Debentures	1,330	CPI-linked NIS

2.13.4 Credit received after December 31, 2004

Source of financing	Credit amount (NIS millions)	Type of currency or linkage
Debentures	324	CPI-linked NIS

Note: Raising credit through the sale of debentures (series 4) by Bezeq subsidiary, Bezeq Zahav (Holdings) Ltd. see Note 14A(1)(D) to the Company's financial statements for the year ended December 31, 2004, which are included in this periodic report.

2.13.5 Variable interest

The following table outlines the Company's loans and debentures with variable interest rates (in NIS millions, as at December 31, 2004):

Type of linkage	Change mechanism	Financial scope	Interest range in 2004	Current interest rate
Dollar and dollar-linked	Libor – USD	997	1.11%-2.21%	2.08%-2.94%
Euro and euro-linked	Libor – EUR 6M	32	2.07%-2.15%	2.2%
Shekel	Bank of Israel interest	109	4.1%-5.2%	3.9%

Notes:

(1) "Interest range" and "current interest rate" are the variable interest rates, not including the spread.

(2) As at December 31, 2004, total loans with variable interest constitute over 5% of the Company's assets in the consolidated balance sheet.

2.13.6 Credit rating

The Company is rated by four credit rating agencies. The following is a list of the ratings of each of the rating agencies:

Rating Agency	Rating	Changes in Rating	Type of Credit Rated
Maalot	AA	-	All series of debentures*
Midroog	Aa1 (Watch List)	Addition to Watch List	Debenture series (4) and (5)
Standard & Poor's	A- (Negative)	-	Eurobonds
Moodys	A3 (Stable)	-	Eurobonds

* Note: The rating is both for the issuer (the Company) and for the debenture series issued.

2.13.7 Estimate of raising funds in the coming year and sources of financing

The Company is expected to repay some of its loans in 2005. In order to finance the expected repayment, the Company can use its own sources, raise capital through new loans from banking institutions and/or raise capital on the capital market. On January 20, 2005, the Company's Board of Directors decided to approve a framework for raising debt during 2005 through the sale of debentures the Company issued to its subsidiary, Bezeq Zahav (Holdings) Ltd., in a total amount of up to NIS 500 million. The Company believes that it will not need to raise additional sources to cover the operation of its regular business.

2.13.8 Liens and guarantees

For information regarding the Company's liens and guarantees, see Note 19C to the financial statements for the year ended December 31, 2004, which are included in this periodic report.

2.14 Taxation

For information regarding taxation, see Note 11 to the Company's financial statements for the year ended December 31, 2004, which are included in this periodic report.

2.15 Environmental Protection

2.15.1 Regulations on facilities emitting electromagnetic radiation and proposed legislation

A. The Pharmacists (Radioactive Elements and their Products) Regulations, 5740-1980, regulate, among other issues, electromagnetic radiation from facilities that emit such radiation, and apply to some of the Company's facilities (including wireless communication facilities and the broadcasting stations it operates for the radio and television broadcasting authorities). Establishing such facilities, as stated in the foregoing, and dealing in this, require, *inter alia*, a permit from the Commissioner of Environmental Radiation at the Ministry of the Environment. The Commissioner may make the permit contingent upon certain conditions. Failure to conform with regulations or conditions stipulated in the permit is cause for cancellation or suspension of the permit.

B. The Ministry the Environment has distributed a bill regarding non-ionized radiation, which is designed, *inter alia*, to rearrange the use of devices, facilities and technological systems in the operation of which non-ionized radiation is or may be created (hereinafter, "Radiation Source”). According to the proposed legislation, the erection and operation of a radiation source will require a permit that may stipulate conditions. The proposed legislation includes penal provisions and severe provisions with respect to liability of officers.

C. The proposed legislation includes a transitional provision according to which whoever was involved in the construction or operation of a radiation source according to a permit under the Pharmacists Regulations prior to the enactment of the law, may continue to do so for the duration of the permit period.

The Company asked that the transitional provision be amended, arguing permits have been granted for most of its facilities within the framework of an approval in principal that was granted by the Commissioner at the beginning of 1996 for four prototypes of facilities.

The position of the Ministry of the Environment is that by virtue of the regulations, a permit can be granted, including a class permit, for a period not exceeding one year, and, therefore, the Company has no valid permits for facilities for which permits were granted in 1996. The Ministry of the Environment suggested a transitional provision according to which the law would come into force nine months after the date on which it is published. Furthermore, the Company believes that that the proposed legislation significantly alters the requirement regarding the operation of sources of radiation, something that requires substantial changes in ongoing operations related to sources of radiation, as well as allocation of significant resources.

As at the date of this periodic report, the Company is measuring radiation levels during erection of new broadcasting installations and when making changes to existing broadcasting installations. Furthermore, the Company is gradually measuring radiation levels at the broadcasting installations included in the list of prototypes of installations for which agreement in principle was given, in order to receive individual operation permits. Radio equipment installation technicians have been trained for this purpose.

2.15.2 Private legislative initiatives for supervision of sources of electromagnetic radiation

In addition to the proposed legislation on non-ionized radiation distributed by the Ministry of the Environment, there are about 10 private legislative initiatives in various stages of the legislative process, and whose aim is to regulate supervision of electromagnetic radiation sources). In some of the bills, various organizations are given the authority to remove a facility emitting radiation or to immediately terminate its operation. The Company approached the Ministry of Communications demanding that be assisted with this important matter in order to prevent possible damage to the Company and to the provision of the services it provides its subscribers.

2.15.3 With respect to permits for broadcasting installations that are required by the Planning and Building Law, 5725-1965, see Section 2.16.10 below.

2.15.4 With regard to claims filed regarding the Hillel broadcasting station – see Note 19A(10) to the financial statements for the year ended December 31, 2004, which are included in this periodic report.

2.16 Limitations and Regulation of Company Activity

2.16.1 Regulation of Company tariffs

The arrangements under Sections 15 through 17 of the Telecommunications Law apply to Company tariffs.

A. Pursuant to the provisions of Section 15(A), "The Minister, with the consent of the Minister of Finance is authorized to determine by regulation the payments for services to subscribers, in an addendum that can be made by the Licensee." The addendum includes services provided by the Company (including domestic telephony), for which tariffs are determined in the regulations. The Economic Policy Bill proposes canceling the addendum and the mention of it in the provisions of Section 15(A).

B. Furthermore, pursuant to the provisions of section 15(c), the Minister, in consultation with the Minister of Finance, may set tariffs for telecommunications services not listed in the addendum to the law. Regulations also determine tariffs for these services provided by the Company (including data communications, associated services and value-added services). The tariffs for these services are subject to supervision pursuant to the provisions of the Control of Prices of Goods and Services Law, 5756-1996, which prohibits the sale of a service during the course of business at a price which is different from the price stipulated. The Economic Policy bill proposes the elimination of Section 15(C).

C. The significance of the cancellations outlined in clause A and clause B, if and when they enter into effect, is unifying the approval mechanism for all tariffs on the Company's regulated services.

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

E. Pursuant to section 15(A) of the Telecommunications Law, if payments are stipulated for the service according to Section 15 of the Telecommunications Law, the Minister may, with the consent of the Minister of Finance, approve the request made by the Licensee for an "alternative payment basket" for a package of services.

The Company has recently petitioned the High Court of Justice for what it claims to be an unreasonable delay in issuing a decision regarding a number of "alternative payment baskets" for which the Company has requested approval.

F. Under Section 17 of the Telecommunications Law, "a Licensee may request a reasonable payment for a telecommunications service for which no payment is stipulated in Section 15." For these types of services provided by the Company (including broadband internet access service, business access, etc.) the Company sets tariffs and informs the Ministry of Communications of them in accordance with its general license.

2.16.2 The Company's general license

The Minister's policy paper

On March 31, 2004 a comprehensive and far-reaching amendment was made to the Company's general license, by virtue of which the Company, *inter alia*, operates. The Minister of Communications attached a policy paper to said amendment regarding the ability of the Company to offer discounts for size and service packages. On January 9, 2005, insignificant changes were made to the policy paper. The following are the principles of the paper, after its amendment:

Volume discounts - Once a competing domestic operator begins providing commercial telephony services, the Ministry will permit the Company to grant volume discounts of no more than 10% of the payment stipulated for the service, under Section 15 of the

Telecommunications Law. Such size discounts will be determined by way of an alternative basket of payments according to Section 15A of the Law. The discount shall not apply to the services for which discounts higher than 10% are set today in the regulations.

Basket of services - Once the market share of the Company in fixed-line domestic telephony in a particular customer segment (business or private) falls below 85% (of revenues), the Company's license will be amended so as to enable it to submit an application for the Minister's approval to market a basket of services in that customer segment, which includes telecommunications services provided by the Company and by a subsidiary, including broadcasts. The Minister's approval to market a basket of services will be granted, *inter alia*, on the status of competition in the area of telecommunications or broadcasts. If even before the Company's fixed-line telephony market share falls below 85%, a material deterioration occurs in the competitive status of a subsidiary of the Company, stemming from marketing a package of services that includes, among other things, telephony by a competitor, the Minister will consider amending the Company's license as stated above.

Highlights of amended license

A. Extent of the license and obligation to provide universal service

The Company is mandated to supply basic services, ancillary and other services as set forth in the appendix to the license; the term of the license is not limited in time; the license anchors the Minister's existing powers under the Law, to modify, revoke and suspend the license; the Company is required to supply its services to all persons, on equal and nondiscriminatory basis with respect to each class of service, regardless of the location or the unique cost. Generally, service that has started to be supplied will be supplied to every party requesting it no later than 12 months after the provision has begun.

B. Rules of structural separation

The Company must establish a structural separation between it and a "subsidiary", the definition of which, for this purpose, includes Pelephone, Bezeq International, BezeqCall Communications, DBS, Bezeq On-line, and Goldnet. (The Minister has the authority to expand the application of the rules of structural separation to an affiliated company[55], if it has been established that there is a real fear of injury to competition or to the public). Full separation between the respective managements of the companies, including all matters relating to the respective business, financial and marketing systems; full separation of the assets; and a prohibition against employing workers of the Company in the subsidiary and workers of the subsidiary in the Company; and also includes a prohibition on the transfer of commercial information to a subsidiary (where the definition of “commercial information” was expanded to include commercial information about the Company). No employee of the Company may be appointed a director of a subsidiary, if, within the scope of his duties in the Company, he has access to "commercial information" concerning a competitor, the use of which by the subsidiary could damage competition between it and the competitor. This limitation on appointment does not apply to the chairman of the board of directors of the Company).

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

C. Tariffs

Should the Director General (according to the license: The Director General of the Ministry of Communications or a person authorized by the Minister with respect to licenses in general or with respect to this license in particular, as a rule or for a specific issue) announce that the Minister intends to set a tariff for a new service in accordance with Section 15 of the Telecommunications Law, the Company shall

[5] Parent company, subsidiary, interested party, affiliated company, related company or partner.

not begin provision of the service before a tariff has been specified, unless the Minister so permits. The Company shall not charge a discriminatory price.

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

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

With respect to charging payment by standing order, credit card, prepayment or the deposit of a security - it was provided that as a rule, the Company shall not be entitled to demand that payment necessarily be made by these methods, with the exception of corporations or subscribers that have not effected payment within 21 days twice during one year. A new subscriber who does not have a bank account may also be required to prepay or deposit a guarantee of up to NIS 200.

D. Investments in other fields and restrictions on cooperation

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

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

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

E. Numbering and number portability

The license contains provisions regarding the preparation of a numbering program and implementation of the numbering program published by the Ministry, as amended from time to time. In addition, prohibitions have been made against the transfer of numbers that have been allocated to the Company’s use.

In regard to number portability, it is stipulated that if an instruction regarding its introduction is made, the Company will operate towards integrating the standards within its network so as to enable implementation of this feature, as provided in the directive. (With respect to this issue, see Section 2.6.5 (A) above.)

F. Operation of Company networks and service levels

The Company must maintain and operate the network and provide its services 365 days a year, around the clock, including at times of emergency, in a regular and proper manner, commensurate with technical requirements and service quality. The Company is also bound to work towards improving its services.

G. Interconnectivity and use

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

Note that the cover letter attached to the amendment of the Company's general license explained that the provision in the license dealing with provision by the Company of infrastructure services does not constitute a concrete provision regarding use by communications carriers of the Company's infrastructure segments (unbundling).

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

H. Arrangements in the field of security

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

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

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

I. Liability and insurance

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

J. Control and reporting

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

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

K. Various matters

The general license includes "cross-ownership" restrictions.

Neither the license nor any part thereof is transferable, or may be charged or attached.

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

The Company must provide a bank guaranty to secure performance of the license conditions and indemnify the State for any damage that may be incurred by it following the breach thereof, such guarantee to be in an amount equal to US$10 million. The Company has furnished the guarantee as required.

Under the provisions of the Law, the Minister of Communications has the authority, at any time, to revoke, limit or suspend a license, if, for among other reasons, performance of telecommunications activity or provision of telecommunications services by a Licensee do not conform with the standard and at a proper level of

similar activity or service, in accordance with the rules stipulated in the Law, or if the Licensee is in material breach of the terms of the license.

The Director General of the Ministry of Communications is authorized to impose a monetary sanction on breach of any of the terms of the license.

On December 23, 2004, the Ministry of Communications amended the Erotic Services Appendix to the Company's license, and the definition of "erotic service" was expanded in the licenses of the cellular operators. The meaning of a service being defined as an erotic service is that it is being subject to rules determined by the Ministry in this matter, including requirements for blocking.

On December 30, 2004, the Ministry of Communications began a process of amendments across all general licenses. The goal is to make the provisions and wording of similar sections in all general licenses uniform, as there is no real justification for the differences between them. As a rule, in terms of the Company, this consists of a small number of revisions which are not significant compared to the existing license.

2.16.3 Royalties

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

The regulations that entered into effect on January 1, 2001, Telecommunications Regulations (Royalties) 5761-2001 (hereinafter, "Royalties Regulations"), expanded the revenue base on which royalties must be paid, while at the same time gradually reducing the rates. Under the regulations, any party that received a general telecommunications license for the provision of fixed-line domestic services (including the Company), international telecommunications services and cellular services must pay royalties on revenues (without VAT) from the subscribed services in the addendum to the regulations, including revenues from these services in Judea, Samaria and the Gaza Strip (except for areas in the Palestinian Territory) and including revenues from the provision of these services to the security forces under Section 13 of the Law. The revenues on which royalties must be paid as stipulated in the addendum are as follows: For a Licensee providing fixed-line domestic telecommunications services (including the Company) – from January 1, 2004 – 3.5% on all revenues from the provision of telecommunications services that are attributable to charges of recipients of the Licensee's services, less revenues collected for another Licensee or which were transferred to another Licensee, or payments made to another general Licensee for completion of calls or their transfer on its telecommunications network, and less revenues from the provision of transmission service to other Licensees, revenues from a segment of transmission service via satellite, revenues from the sale of end-point equipment and bad debts related to revenues on which royalties must be paid.

From time to time, a dispute over royalties arises between the Ministry of Communications and the Company. From April 1999 through the end of 2000, the Company did not pay royalties on its revenues from interconnectivity from cellular subscribers to Company subscribers, as it claimed that the regulations regarding royalties that were in effect at that time did not apply to these revenues. The Ministry of Communications announced that it viewed the Company's refusal to pay said royalties as a breach of the provisions of the Royalties Regulations and of the provisions of the general license and asked the Company to reconsider its position and transfer a total of NIS 16,655,813 to the Ministry by January 1, 2005. On December 28, 2004, the Company notified the Ministry that it is steadfast in its position and therefore this does not constitute breach of law or license. The issue is being discussed by the parties.

With respect to the amendment of the Royalties Regulations regarding compensation for the "Bill and Hold" arrangement with HOT, see Note 1E(1)F to the financial statements for the year ended December 31, 2004, which are included in this periodic report.

The Economic Policy bill proposes applying license fees and royalties on the collection of fees under the Telecommunications Law and The Wireless Telegraph Ordinance

(New Version) 5732-1972 (hereinafter, the “Telegraphy Ordinance”) and the Tax Ordinance (Collection) 1929. The significance of the amendment, if and when it enters into effect – is the addition of a means of enforcing said payments.

2.16.4 Authority with respect to real estate

According to the provisions of Section 4(F) of the Telecommunications Law, the Minister of Communications granted the Company certain powers in connection with real estate, as set out in Chapter Six of the Law. Until the Law was amended in 2001, this Chapter did not distinguish between public and private land, and enabled the Company and the persons it authorized for purposes of providing telecommunications services, to enter any real estate in order to carry out surveys and examinations required for planning a telecommunication installation, and for examining, repairing or making changes thereto or therein. In most cases, prior notice was required to be given to the occupier of the real estate and the latter could appeal to the Court.

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

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

2.16.5 Immunities

The Minister of Communications granted the Company certain immunities as listed in Chapter Nine of the Law, pursuant to his authority to grant immunity to a general license holder.

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

(1) For direct damage caused by the restriction or discontinuance of a telecommunications service;

(2) For damage arising out of an intentional act or gross negligence of the Immune Licensee, its employees or persons acting on its behalf.

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

(1) By non-provision, delay, restriction or discontinuance of telecommunications services and accessory services as arises out of an intentional act of the Immune Licensee insofar as such act is necessary to the performance of a telecommunication operation or the provision of a telecommunications service;

(2) By an error in providing a telecommunications service, an error or omission in a telecommunications message, non-delivery of or a delay in delivering a communication message, delivery of a telecommunication message to a wrong address or an incorrect entry in a subscribers' directory or other publication of the licensee, unless the same is due to gross negligence.

Under Section 13 of the Law which relates to the provision of telecommunications services to the security forces, a licensee or any of its employees shall bear no criminal or civil liability for any act committed in the performance of a direction to be given according to said Section, except in circumstances in which the State employee bore

liability for the act. (According to the Civil Damages Ordinance, in any action other than negligence, a public servant will have a defense if the act was within the lawful field of their authority or was committed by him in good faith and he understands that he was acting within the scope of his lawful authority).

2.16.6 Regulations and rules under the Telecommunications Law

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

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

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

The Company may, with the consent of the Minister, terminate, disconnect or limit the provision of a telecommunications service if the service becomes outdated on technological grounds, or if the service is abused in such a way as to cause tangible financial harm to the public or a part of it, or to the Licensee. Pursuant to the regulations regarding methods of supervision of the acts of a Licensee, the Minister of Communications appointed a manager (an employee of the Ministry) authorized, *inter alia*, to ensure adherence to the provisions of the Communications Law, the regulations and license, for the classes of telecommunications services and conditions thereof, quality of such services and level of maintenance. In addition, provisions exist regarding reporting, according to which every Licensee must file periodic reports and reports of special events. Rules regarding the Company's services contain provisions relating, *inter alia*, to the issue of bills to subscribers, charging in installments, an appeal committee for complaints regarding charges, and the publication of an entry in the subscriber directory.

The Company acts to locate debtors and to collect debts from its customers. In cases where debts are not paid, legal action is usually taken through external lawyers. In cases such as when it is not financially feasible the debt is written off. According to the regulations, the Company may disconnect a line if the bill in respect thereof is not paid within 21 days of the payment date prescribed in the bill, and discontinue the service if prior written notice thereof has been given.

On November 22, 2004, draft regulations were submitted for the review of the Company, HOT, and cellular license holders. These were for the establishment of a committee made up of representatives of the public to examine requests for exemption or exception from the provisions stipulated in the regulations or in the general licenses for the provision of services by the Licensee to the general public. The Company submitted its response to the Ministry and, among other things, requested that an exemption or exception based on the existence of available alternatives in a region for provision of service be subject to the obligation of the Licensee whose request was successful to participate in the costs of financing of a Licensee that provides services in that region.

2.16.7 Laws on anti-trust practices

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

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

B. At the end of 1995, the Company transferred its activity in the field of provision of international telephone services to Bezeq International and as a result, Bezeq International "inherited" the Company's monopolistic position in this market. On April 29, 2001, the Commissioner decided to cancel the declaration of Bezeq International as a monopolist in the field of provision of international telephone services, due to the competition that had emerged in this market.

C. In light of the changes and developments which have occurred in the communications market overall, and particularly in the field of "basic telephone services", especially in light of the increasing competition in the field of this service compared with the cellular telephone companies, the Company applied to the Commissioner on March 6, 2000, requesting the cancellation of his declaration of the Company as a monopoly in the field of "basic telephone services".

The Company filed an appeal on September 9, 2001 against the Commissioner's decision not to cancel said declaration. As at the date of this periodic report, the issue is pending with the Antitrust Tribunal.

D. On December 11, 2000, the Commissioner declared the Company a monopoly in the field of “telecommunications infrastructure for the provision of high-speed access services via internet service providers”. On January 10, 2001, the Company filed an appeal against this declaration.

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

(1) Provision of fast access services to subscribers through the access network.

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

As a result and following the changes in the relevant marketplaces since the declaration, Bezeq notified the Court on November 17, 2004 that it wants to cancel the aforementioned appeal, and on November 18, 2004, the appeal was cancelled.

E. On August 26, 2004, the Commissioner approved the merger between Pelephone and the company (following the acquisition of Shamrock's share of Pelephone by the Company) under conditions that limit joint activity and transfer of commercial information as defined in said conditions.

F. Since September 1998, an officer overseeing the internal compliance of the Antitrust Law, 5748-1988 (hereinafter, “Antitrust Law”) has served in the Company.

The Company has adopted an internal compliance policy (hereinafter, the “Policy”) by which internal reporting and internal procedures were made which essentially ensured that the activity of the Company and its employees would be carried out in accordance with the provisions of the Antitrust Law. The Policy includes a general explanation regarding the Antitrust Law, guidelines for the Company's and its employees' conduct so as not to breach the provisions of the Antitrust Law. According to the Policy, the internal compliance officer issues, from time to time, general and specific directives on various issues (such as pricing, relations with subsidiaries, contacts with customers and the like). The internal compliance officer's directives obligate all the Company's employees and managers.

2.16.8 The Wireless Telegraphy Ordinance

The Wireless Telegraphy Ordinance regulates the use of the electromagnetic spectrum, and applies, *inter alia*, to the Company’s use of radio frequencies, as part of its infrastructure. Set up and operation of a system that uses radio frequencies is subject,

under the Telegraph Ordinance, to the grant of a license, and use of radio frequencies is subject to notice and allocation of an appropriate frequency. Under the Wireless Telegraph Ordinance, license fees and fees for notice and allocation of frequencies are imposed.

For a number of years, the Government has been coping with the shortage of radio frequencies for public use in Israel (among other reasons, due to the allocation of many frequencies for security use), by limiting the number of licenses granted for the use of frequencies on the one hand, and increasing the fees payable for allocation of a frequency in the lower range, on the other.

The frequency fees were raised in 1999, some at very high rates.

The Company and the Ministry of Communications have a number of differences of opinion regarding fees which the Company claims it does not owe and therefore has not paid. As at the date of this periodic report, the disputed amounts are approximately NIS 34 million (appropriate provisions have been included in the financial statements).

2.16.9 Proposed legislation regarding termination of contractual relations

The Knesset Economics Committee has recently been discussing a private member's bill to amend the Consumer Protection Law, which intervenes in the contractual relations between a person dealing in defined deals and the consumer. Under the bill, the contract will be deemed to provide that it will be cancelled unless the dealer offers the customer to extend the term of the contract and the customer so agrees.

As drafted in the bill, this provision will not apply to special offers for up to six months and transactions that will be stipulated in an addendum to the law. These transactions have yet to be defined, but the intention, as stated in the discussion of the Economics Committee, is to stipulate in the addendum the types of transactions which, if cancelled unilaterally, could cause injury to the consumer, such as basic telephony service.

2.16.10 Establishment of communications installations - National Outline Plan 36

A. The National Outline Plan for Communications, NOP 36, was designed to regulate the deployment and method of establishing communications installations to secure their functioning throughout the entire country, for radio broadcasting and reception, television and wireless communication, while minimizing harm to the environment and the landscape.

B. NOP 36A

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

A transitional provision contained in NOP 36A stipulates that: (1) a building permit or exemption from a permit that has been issued for a broadcasting installation and not in accordance with the provisions of NOP 36A, will be regarded as irregular use that has been permitted for a period of 18 months commencing from the date of the approval of NOP 36A; If the operator of the installation submits to the institution that approved the erection of the installation, within said period, a permit from the Commissioner on Radiation of compliance with the safety restrictions stipulated in the Plan, the permit or the exemption from the permit will be regarded as permitted irregular use. Otherwise, the permit or exemption will expire. (2) A permit issued within two years of the date NOP 36A was approved for broadcasting installations erected prior to January 1, 1989, shall not be deemed as conflicting with NOP 36A, provided it meets the safety restrictions stipulated in the Plan.

As of the date of this periodic report, the Company has submitted to the relevant licensing authorities a permit from the Commissioner on Radiation from all of the 74 small broadcasting installations erected under a permit issued prior to the approval of NOP 36A. The Company is working to receive permits from the relevant licensing authorities for 51 other small broadcasting installations.

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

On January 31, 2005, the National Council for Planning and Construction decided as follows:

(1) Building permits shall not be issued unless the applicant for the permit submits to the local committee a letter of indemnity for compensation under Section 197 of the Planning and Building Law, should a judgment go against the local committee;

(2) Pursuant to the provisions of the National Council of August 3, 2004, the editors' committee shall formulate a change to the NOP regarding increasing the amount of discretion held by the local committees and informing the public.

(3) The aforementioned decision is subject to approval of the government, which as of the date of this periodic report has not yet been granted.

C. NOP 36B

Part B of the Plan (NOP 36B) applies to all types of broadcasting installations, except for those included under NOP 36A. The licensing process proposed under NOP 36B requires the preparation of a detailed plan (except in unusual cases) and the receipt of the necessary approvals which are also required under NOP 36A.

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

The Company's broadcasting installations included in NOP 36B were for the most part built many years ago, some by State authorities.

NOP 36B further proposes to include a provision according to which a building permit will not be granted according to Chapters C and D of the Plan, unless the applicant for the permit has submitted a letter of indemnity for compensation under Section 197 of the Planning and Building Law, should a judgment go against the local committee. The Company submitted its objection to the inclusion of said provision in NOP 36B.

The provisions of NOP 36B were approved by the National Council for Planning and Construction and submitted for approval of the government. As of the date of this periodic report, such approval has not yet been granted.

D. With respect to radiation permits for broadcasting installations, see section 2.15 above.

2.17 Material Agreements

The following is a summarized description of the material agreements, which are not part of the Company's ordinary course of business, which were signed and/or are valid during the reporting period presented in this periodic report:

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

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

(hereinafter, "Bezeq Zahav Holdings") immediately prior to the Prospectus and were listed for trade according to the Prospectus.

2.17.2 Deed of trust for debentures (series 5) dated May 24, 2004 and an addendum to this deed dated December 6, 2004

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

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

2.17.3 Series of agreements regarding raising capital through the issue of debentures (Eurobonds) on the Luxembourg Stock Exchange

A series of agreements (including debentures) related to the issue of Company debentures on August 8, 2000 on the Luxembourg Stock Exchange – a series of 300 million euros par value 7-year debentures (as part of a total of up to 750 million euros as part of the EMTN Program). The debentures bear interest of 6.5% per aannum The interest is paid in annual installments, on August 8 each year, from August 8, 2001 through August 8, 2007.

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

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

2.17.5 Settlement agreement between the Company, State and Israel Lands Administration regarding rights related to land, dated May 15, 2003

See Section 2.7.4C above.

2.17.6 Various agreements with DBS and its other shareholders

A. On December 4, 1998, the founders of DBS – the Company, Eurocom Communications Ltd., Lidan Business Enterprise Ltd. and Gilat Communications Ltd., entered into a Founders Agreement, which regulates the establishment, management and relationship between the shareholders of DBS.

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

C. In November 2001, an agreement was signed between the shareholders (except for Gilat) and DBS, amending the dilution formula stipulated in the Founders Agreement and determined that the holdings of the shareholders be adjusted to their proportionate holdings in DBS, such that for the purpose of dilution, the investments (effected by way of shareholders loans) would bear CPI linkage differentials and annual compound interest at a rate of 5.5% per annum from the date of incorporation of DBS.

D. An agreement dated December 30, 2002 between DBS shareholders and DBS determines preference for shareholder loans given as of July 10, 2002 over the loans made prior to that date, and that these loans would bear CPI linkage differentials and annual linked compound interest at a rate of 5.5%, and an amendment to the agreement dated August 6, 2003 which stipulated an interest rate of 11% for new loans granted as of April 27, 2003.

2.17.7 Labor agreements

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

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

B. Special collective bargaining agreement for early retirement, dated November 23, 1997 as amended and extended on September 4, 2000 and March 18, 2004 between the Company, the Histadrut and Workers Committee

For information regarding this agreement, see Note 16D to the Company's financial statements for the year ended December 31, 2004, which are included in this periodic report.

C. Agreement to anchor rights, dated September 4, 2000 between the Company, the Histadrut and Workers Committee

A special collective bargaining agreement executed between the Company, the Histadrut and the Workers Committee, regarding anchoring the rights of the transferred employees. This agreement was intended to anchor the rights of the transferred employees to the pension rights to which they were entitled by virtue of their being former public servants, under the Company's pension agreement, adopted by the Company under its pension agreement. According to this agreement, these rights became "personal rights" which cannot be cancelled, other than by waiver of personal rights under law (i.e., by personal waiver by the individual employee).

D. "Generation 2000" agreement, executed on January 11, 2001 between the Company, the Histadrut and the Workers Committee

Following an amendment in July 2000 to the Employment of Employees by Human Resources Contractors, (Amendment) Law, 5760-2000, a special collective bargaining agreement was signed between the Company, the Histadrut and the Workers Committee on January 11, 2001 to recruit new employees and stipulate their salary conditions. The agreement applies to new employees and to employees who were previously employed at the Company via human resources companies, in positions listed in the appendix to the agreement (customer service representatives at call centers, administrative workers, typists, warehouse employees, secretaries, mail sorters and distributors etc., administrative employees such as porters, drivers and forklift operators, and others).

Employees are to be employed under this agreement for a period of no more than 6 years, with an option to extend the agreement for a period of two further years.

E. Adoption of agreement to encourage growth, executed on May 22, 2003

On July 29, 2003, the Company notified the Commissioner for Salaries and Human Resources at the Government Companies Authority that the Company was joining the collective bargaining agreement dated May 22, 2003, executed by the State, the Union of Local Authorities and others and the Histadrut with respect to encouraging growth. Under the agreement, Government and public sector expenditures would be cut in accordance with legislation on this matter. In accordance with the agreement, the salaries of Company employees were reduced beginning in July 2003. The agreement will expire in June 2005.

2.17.8 Agreement between the Company and the Shamrock Group with respect to Pelephone

For information regarding this agreement, see Note 8D to the Company's financial statements for the year ended December 31, 2004, which are included in this periodic report.

2.17.9 Agreement between the Company and the Israel Postal Authority

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

2.18 Legal Proceedings

For information regarding legal proceedings, see Notes 19A(1) through 19A(24) and 19A(37) through 19A(39) to the Company's financial statements for the year ended December 31, 2004, which are included in this annual report.

2.19 Objectives and Business Strategy

2.19.1 Forward-looking information

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

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

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

2.19.2 Summary of strategy and Company's future plans

Vision and objectives

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

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

A. Maintaining its leading position in an ever-more competitive environment (leadership in service and strengthening values – product innovation, reliability, closeness to customer);

B. Reducing the decline in revenues from core services;

C. Generating new sources of revenue;

D. Adapting the organization to the competitive environment and operational excellence.

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

Business customers

A. Offering a variety in its basket of products and services;

B. Providing a comprehensive solution based on the needs of the customer, while using a policy that dictates a commitment to quality and availability of service;

C. Encouraging customer migration from basic services for managed solutions to organizational and inter-organizational connectivity;

D. Offering a variety of value-added services.

Private customers

A. Continuing to penetrate broadband and improving infrastructures to increase bandwidth;

B. Providing differential pricing tracks;

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

Network

In order to achieve its strategic goals, the Company will strive to improve its network and adapt it to its business objectives, including:

A. The Company is examining the timing and manner of deploying a new-generation switching network (NGN), which will allow it to launch new services with a shorter time to market, simplify the structure of the network, reduce maintenance and operation costs, and leverage the potential of real estate.

B. The Company is formulating a policy that will allow significant increase in bandwidth to customers by bringing the fiber closer to the customer home and integrating new technologies.

Changing organizational structure

The Company has plans to change its organizational structure from a geographic structure to a functional one, but this has not yet been implemented at this stage. The new organizational structure, when implemented, is supposed to reduce the number of personnel.

2.19.3 Development trends in Company activities

A. The Company is working to increase bandwidth and data transmission rates for the services it provides to its customers. The Company takes marketing initiatives which are designed to switch its customers to its high speed internet service. Furthermore, the Company offers its business customers fast transmission and data communications services over a variety of protocols.

B. The Company is working to be part of IP (Internet Protocol) applications. It has therefore set up an IP network to serve as a platform for the services it currently provides and the additional services it plans to offer in the future.

C. The Company is studying the technological feasibility and the business model for distributing digital content (either owned by it or through license by third parties) over the Company's network and infrastructures.

D. The Company launched fixed-line and wireless home network services that enable multiple computers to connect simultaneously to the internet from a number of computers.

E. The Company launched a brand of telephones that operate on new technologies and which are equipped with advanced software. The Company is integrating the advanced phones as part of its marketing initiatives and the special offers it makes from time to time.

F. The Company is examining how to be involved in the provision of FMC (Fixed Mobile Convergence) services.

G. The Company has launched a variety of billing tracks for telephony services along with its basic tariff structure to increase the use of its services.

2.19.4 Main projects being planned or currently being implemented

The main projects currently being implemented by the Company include improving IPVPN services and those derived from it within the business sector, as well as upgrading the speed of ADSL-based high speed internet service to private customers. Additional projects include IP Centrex service as a platform for the provision of private virtual exchanges on the Company's private network. Furthermore, the Company is studying the significance of entering the FMC arena, by marketing dual phones that work both on the Company's network within the home or office and on cellular networks outside the home. From a technological perspective, the Company is preparing to conduct a field trial for customer migration in a number of services areas to a uniform IP-based network.

2.20 Events or Issues not within the Ordinary Course of Business

2.20.1 As noted in Section 1.3.4 above, the State of Israel is in the middle of a process to sell its core control in the Company. On July 19, 2004, the Ministerial Committee on Privatization decided to sell its holdings in the Company via a private offering of 30% of the Company's share capital and the issue of warrants for the purchase of an additional 10.66% of the Company's share capital. Parties interested in participating in this proceeding have submitted applications, which as of the date of this periodic report have completed study in the Company's information rooms and have participated in the presentations arranged by the Company.

2.20.2 Upon completion of the privatization process and the Company's changing from a "mixed company" controlled by the State of Israel to a company controlled by an entity that is not the State of Israel, the various restrictions imposed on the management and activity of the company, the restrictions regarding the terms of employment and other restrictions will be removed.

2.21 Risk Factors

A. Growing competition

Competition in fixed-line domestic communications in specific sectors (such as data transmission and data communications) is already underway, and in the area of telephony – this process has only recently begun. Furthermore, the Company views the cellular telephony market as a market which, to a large extent, is an alternative to the fixed-line domestic telephony market.

The organizations currently competing against the Company or which may compete against it in the future are generally subject to government regulation that is not as strict as that with which the Company must contend. They benefit from far more business flexibility, including the ability to partner with subsidiaries and affiliates and market joint service packages with them.

According to the policy paper issued by the Ministry of Communications, the provision of telephony services over the Company's and HOT's broadband infrastructure (VOB services) will be allowed.

B. Government regulation

The Company is subject to government supervision and regulation that, among other things, relate to licensing for activity, determining permitted areas of activity, operation, competition, payment of royalties, obligation to provide universal service, determining tariffs, ability to hold its shares, relationships between the Company and its subsidiaries and prohibition to terminate or restrict its services (which may force the Company to provide services even when not economically feasible or when it goes against its interests). Said supervision and regulation at times lead to State intervention, which the Company believes negatively affects is business operations.

C. Regulation of tariffs and the phenomenon of cross-subsidy

The Company's tariffs for services are subject to State regulation. These tariffs are stipulated in regulations, and regulations also stipulate a formula for linking them to the changes in the Consumer Price Index, less an amount for depreciation. The practical implication of this mechanism is erosion (in real terms) of the Company's tariffs. Some of the Company's tariffs

are subject to the Control of Prices of Goods and Services Law, 5756-1996. Furthermore, the bureaucracy involved in setting "tariff baskets" for the sale of service packages by the Company delays the time to market of the tariff baskets, affecting the Company's ability to compete.

In recent years the tariff committees and regulatory agencies have worked to reduce the phenomenon of cross-subsidies in the Company's tariffs, but cross-subsidies still exist between the tariffs of various services offered by the Company, some of which are provided at a lower tariff than the cost of providing the service, and others are provided at a higher tariff. The Company cannot cancel or reduce cross-subsidy without the approval of the regulatory agencies.

D. Difficulties in labor relations and human resources

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

Labor relations within the Company have been erratic over the years. The workers committee is actively involved in the Company's activities, and many managerial matters are subject to negotiation between the Company's representation and the management.

E. Restrictions on providing new services and on partnerships

The timetables stipulated in the Company's general license for approval of the services, the nature of the changes required by the Ministry of Communications for the service portfolio submitted and delay in the approval of the services by the Ministry do not allow the Company to increase the variety of its services at the pace it believes is required to respond to market-driven demand, and at the time required by the Company's customers.

F. Ownership and control by the State

The State of Israel holds, close to the date of this periodic report, approximately 46.38% of the Company's issued share capital, and it holds the controlling interest in the Company. As long as the core control in the Company has not been sold, the provisions of the Government Companies Law which apply to a mixed company as well as the provisions contained in its articles of association will continue to apply to it, under which certain resolutions of the Company require the approval of a Ministerial committee or the general meeting (for as long as the State holds 10% or more of the share capital of the Company, or as long as it controls the Company and no other entity is given control approval under the Telecommunications Order).

G. Limitations regarding the relations between the Company and the companies in the Bezeq Group

The Company's general license obligates it to ensure that its relationship with its principal subsidiaries in the Bezeq Group does not cause them to be preferred over their competitors. Under the general license, separation is required between the respective managements of the Company and said companies, and separation is also required in the financial and marketing systems, as well as assets and employees. Thus, the Company's ability to control and influence the activities of said companies is materially impaired, as is its ability to offer joint service packages with said companies.

H. Legal proceedings

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

Class-action claims can reach large amounts, as virtually all residents of the country are consumers of the Company's services, and a claim that relates to minor injury to a single consumer may become a significant case for the Company if it is recognized as a class action that applies to all consumers or a significant portion of consumers. Additionally, as the

Company provides communications infrastructures as well as billing and collection services to other Licensees, parties initiating legal action against said Licensees in other class action cases may even try to involve Company as a party to these proceedings.

For a description of the legal proceedings, see Section 2.18 above.

I. Exposure to exchange rates and inflation

The Company assesses exposure to changes in exchange rates and inflation by the surplus or deficit of assets against liabilities based on the type of linkage. Therefore the Company is exposed to changes in exchange rates against the shekel. However, due to the currency hedging policy implemented by the Company, exposure has until now been low. The Company has taken and continues to take protective actions against most exposure from fluctuation in the exchange rate. That said, the Company has not fully neutralized its exposure to exchange rate fluctuations, by converting its liabilities denominated in foreign currency to shekel-denominated liabilities.

J. Electromagnetic radiation and licensing of broadcast installations

The issue of electromagnetic radiation emitted from broadcasting installations is regulated both in the Pharmacists Regulations and in NOP 36. Furthermore, a number of bills have been proposed on this issue. (See sections 2.15 and 2.16.)

The Company is working to receive permits to build and operate its various broadcasting installation, however, the difficulties it faces in this activity, including difficulties related to the change in policy maintained by the various relevant organizations, may negatively impact on the infrastructure of said installations and on the regularity of provision of services using them.

The Company's third-party liability policy does not currently cover electromagnetic radiation.

Risk Factors Summary Table

	Effect of Risk Factor on Company Activity		
	Large	Medium	Small
Macro Risks			
Exposure to exchange rate fluctuations and inflation			X
Sector Risks			
Increasing competition	X		
Government supervision and regulation	X		
Regulation of tariffs		X	
Electromagnetic radiation / license of broadcasting installations		X	
Special Risks Faced by the Company			
Exposure in legal proceedings		X	
Difficulties in labor relations	X		
State ownership and control			X
Restrictions on relations between the Company and companies in the Bezeq Group		X	
Restrictions on offering new services and entry into joint ventures		X	

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

3.1 General Information on Field of Activity

3.1.1 Pelephone's area of activity

Four companies operate in Israel's cellular communications market. Activity in the mobile radiotelephone sector ("MRT") commenced with the founding of Pelephone in 1985. Pelephone engages in the provision of mobile cellular radiotelephone services (cellular communications), the marketing of end-point equipment, and the operation and maintenance of equipment and systems in the cellular communications field. Pelephone's revenues include, *inter alia*, the charging of MRT communications customers (payments for call minutes, regular subscriptions, added value services and migration services, payment in respect of the sale of end-point equipment and in respect of end-point equipment services) and revenues from other communications providers for interconnect (see sub-paragraph 3.18.2).

As of August 2004, Pelephone is wholly owned by "Bezeq" (hereinafter "the Company").

3.1.2 Legislative and secondary legislation restrictions applicable to Pelephone

3.1.2.1 General licence

Pelephone operates in accordance with an operating license from the Ministry of Communications - General License for the Provision of Mobile Radio Telephone Radio Services, which is valid until 2022 (hereafter: "**the license**").

3.1.2.2 Tariff control

Some of the tariffs that Pelephone is authorized to collect from its subscribers are restricted by secondary legislation and also in pursuant to its license. In December 2004, the Telecommunications Regulations (Telecommunications and Broadcasts) (Payments for Interconnect), 5760-2000, were amended in such a way as to reduce tariffs for interconnect to the MRT network regarding call completion, transmission of SMS messages and to modify the method of calculating the duration of chargeable time. (see sub-paragraph 3.18.2).

3.1.2.3 Royalties

In accordance with its license and with the Bezeq (Royalties) Regulations 5761-2001, Pelephone pays the State of Israel royalties at a rate of 3.5% of its revenues from the provision of telecommunications services, net of income and expenses stipulated in Regulations, the essential elements of which are: revenues from interconnect, payments transferred to the owner of an MRT operator for migration services, revenues from the sale of end-point equipment and bad debts related to revenues on which royalties were paid. In 2001, the rate of royalties was 5%, in 2002 - 4.5%, in 2003 – 4%, and in 2004, the rate was reduced to 3.5%. The Minister of Communications announced his intention of acting to institute an amendment in the Bezeq (Royalties) Regulations 5761-2001, such that, commencing 1.1.2006, the rate of royalties payable by the cellular companies would be reduced by an 0.5% each year, until scaled down to a rate of 1%.

3.1.2.4 Environment quality

The laying of the cellular infrastructure is subject to prior approvals from the Ministry of the Environment. The Ministry also establishes a standard for periodical radiation tests (see Clause 3.17).

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

The following data relate to the volume of MRT traffic and the number of subscribers (total outgoing and incoming minutes in the Pelephone network):

	2004	2003	2002
Revenues (NIS millions)	4,412	4,055	3,932
Operating profit (loss) (NIS million)	559	210	(126)
Number of subscribers at end of period[6] (in thousands)	2,132	1,955	1,761
Average use minutes per subscriber (MOU) per month	330	325	331
Average monthly revenue per subscriber (NIS) (ARPU)	153	160	176

3.1.4 Market development in customer attributes

In recent years, the cellular market has been characterized by lower growth rates than in the past. Growth rate competition encourages the companies to approach also customers making relatively little use of cellular services. Commencing 2003, Pelephone has been applying a "dual branding" strategy by means of the Pelephone brand, which addresses the adult community and business customers, and the Esc brand which addresses the youth community and "Mobile Entertainment" and multimedia service consumers. In the estimation of Pelephone, following the launch of the Esc brand, it has improved its market share in the years 2003 – 2004 among the "youth" community, which today stands at more than 350,000 customers.

3.1.5 Technological changes being such as to affect the company's field of activity

3.1.5.1 In 2004 Pelephone launched 3rd generation services in Central Israel by means of CDMA 2000 EVDO technology and is in process of spreading an EVDO network in the urban areas (for details see sub-paragraph 3.9). 3rd generation services to enable the Company to offer its customers a range of added value services (for details see sub-paragraph 3.2.1).

3.1.5.2 Pelephone chose the Motorola system by means of which it would be able to provide its customer with PTT (Push to Talk) services. This system is also operated by the two leading companies in the United States, which have a network employing the technology used by Pelephone. Setting-up of the system has been completed, and the service was launched at the beginning of 2005. The service is currently undergoing extensive user testing, and the launch is scheduled to take place at the beginning of 2005. This service will enable subscribers to initiate a call by pressing a button (without needing to dial) to an individual or a group on the Data network using VoIP (Voice Over IP technology).

3.1.5.3 Pelephone has the right to receive allocation of frequencies in ranges of 2000MHZ that can serve Pelephone for UMTS technology. (See Note 8D(3) to the financial statements for the year ended December 31, 2004, included in this periodic report). The UMTS technology, if applied, will enable Pelephone to provide services requiring the rapid transmission of information, may solve the problem of wireless disturbances (see sub-paragraph 3.22F) and will enable use of standard end-point equipment supporting GSM/UMTS which will permit the reduction of prices of end-point equipment and migration services.

3.1.6 Critical success factors and the changes commencing therein

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

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6 Subscriber data relate to active subscribers having received or made at least one call in the past six months.

3.1.6.1 Significant investments on a regular basis in the cellular infrastructure, both for the purpose of improving and securing maximum high quality media coverage throughout Israel, which is a basic condition for the provision of Pelephone services, and to provide customers with the most advanced services using the most progressive technological infrastructure.

3.1.6.2 Customer support and customer service in such a way as to enable Pelephone to retain its customers in a competitive market.

3.1.6.3 Ongoing expansion in the field of added value products and services supplied to Pelephone's customers.

3.1.6.4 Continuing success of the Company's marketing strategy for consolidating "Pelephone" brands addressing the adult market and business customers and the "Esc" brand addressing the youth and multimedia service consumers market.

3.1.7 Principal entry and exit barriers

The principal entry barrier to the cellular market derives from the need for a MRT license and the allocation of the frequencies, as well as the regulatory supervision to which the market is subject (see Clause 3.18). An additional entry barrier derives from the need for weighty investments in infrastructure, which are affected by frequent technological changes.

The field's principal exit barriers derive from long-term agreements with infrastructure suppliers and property owners with whom Pelephone enters into leasing contracts, and major investments that are recoverable by the company over a long period of time. In addition, Pelephone is committed to the provision of service to its customers in accordance with the conditions stipulated in its license.

3.1.8 Substitutes for Pelephone products

Domestic fixed-line telephone services provided by the domestic operator companies may constitute a substitute for some of the services provided by Pelephone.

3.1.9 Structure of competition in the field and changes occurring therein

Until the end of 1994, Pelephone was Israel's sole cellular company (until the end of 1993 – by virtue of the company's license and on its behalf[7]). In May 1994, Cellcom Israel Ltd posted the successful bid in an invitation to tender for a second operator for MRT service (hereafter: "**the second operator"** or **"Cellcom").** In February 1998**,** a third operator was selected by invitation to tender – namely Partner Communications Ltd. (**hereafter: "the third operator"** or **"Partner").** Commencing February 2001, MIRS Communications Ltd., (hereafter: "**MIRS")** has been operating as an additional cellular operator. After the entry of the second operator, and later, the third operator, into the cellular market, fierce competition developed among the operators (primarily Pelephone and the second and third operators). This competition resulted in market saturation expressed in the diminution of the number of subscribers joining the company, an increase in the transfer of customers between the cellular companies and an erosion of the real prices collected by Pelephone from its customers for services rendered by it (see Clause 3.7).

3.2 Products and Services

3.2.1 Pelephone provides its subscribers with comprehensive services of voice transmission, data communications and advanced multimedia services through its network.

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

Advanced services and products (hereafter – "added value services") - the subscriber may purchase added value services such as information services using SMS, voice information services using special-purpose asterisks, information and entertainment

[7] The change was actually made in April 1994 and was applied with retroactive effect to the beginning of 1994.

services via the Internet portal and advanced content services such as JAVA games, network games and video games. Among others, the subscriber may choose by means of the Pelephone Internet portal animation items or different ring-tones. Also, the subscriber may obtain services connected to his electronic diary (Outlook services) enabling the subscriber to obtain SMS messages regarding the arrival of e-mail messages, and to read and reply to them, all through his handset. Moreover, using his handset, the subscriber can look at and update his electronic diary, and view his address list. The subscriber can also receive SMS notice of scheduled events found in his electronic diary.

The added value services offered by Pelephone are location-based services. *Inter alia,* these services enable, while driving, early warning of an approaching police speed trap, guidance as to the fastest route from point to point, and information regarding the nearest points at which certain services needed by the subscriber may be obtained. The service also enables the employer to obtain information as to the location of his employees carrying a cell-phone.

Pelephone started supplying added value services as from the end of 2002. In 2003 and 2004, revenues from value added services constituted some 5% - 6% correspondingly, of total revenues. Pelephone anticipates an ongoing increase in added value service revenues in future years.

3rd generation services – with the upgrade of the network to a network using EVDO technology, Pelephone now offers its customers 3rd generation services including watching television channels such as: the news, music, sports and various entertainment channels.

3.2.2 Pelephone provides migration services (communications via MRT from various locations worldwide). In order to facilitate similar services also in Europe and in other countries where the network is not based on CDMA technology, Pelephone leases to its customers handsets adapted to the technology existing in those countries, in accordance with agreements between Pelephone and cellular operators in those countries.

3.2.3 Pelephone offers its customers ongoing repair service, against a monthly payment, providing warranty for the cellular telephone. The customer is invited to choose the most worthwhile service out of a range of services.

3.2.4 Pelephone offers its customers various types of mobile telephone and auxiliary accessories (hereafter – end-point equipment). With the launch of the 3rd general EVDO technology services, Pelephone commenced providing its customers, in 2004, with end-point equipment supporting of those services.

3.3 Segmentation of Revenues and Profitability from Products and Services

The following are data on the breakdown of Pelephone revenues (in NIS millions):

	2004		2003		2002	
	NIS millions	% of revenues	NIS millions	% of revenues	NIS millions	% of revenues
Revenues from Pelephone services and end-point equipment services	3,773	86%	3,506	86%	3,513	89%
Revenues from the sale of end-point equipment	639	14%	549	14%	419	11%
Total	4,412	100%	4,055	100%	3,932	100%
Rate of operating profit		27%		21%		13%

3.4 New Products

In 2004, Pelephone launched the EVDO 3rd generation technology (see sub-paragraph 3.9.1.6).

At the beginning of 2005, Pelephone launched its PTT (Push to Talk) services (see sub-paragraph 3.1.5.2).

3.5 Customers

Pelephone has two brands: the "Pelephone" brand which addresses private and business customers and the "Esc" brand which addresses youthful customers and military personnel (see Clause 3.1.4).

As at the end of 2004, approximately 70% of Pelephone's subscribers are private customers and 30% of Pelephone's subscribers are business customers.

3.6 Marketing, Distribution and Service

Pelephone's distribution system is based on 500 sales personnel, 80 points of sale operated by self-employed marketers and 63 Pelephone points of sale some of which are to be found in two major marketing chain-stores with which Pelephone has entered into contractual engagements

Pelephone's subscriber service system includes 24 active call-in centers operating round the clock, seven days a week, and providing technical support, data on customer charges and general information. Pelephone has 31 regional service and sales centers throughout Israel, engaging in customer service, the correction of malfunctions, the customizing of handsets and the sale of services and handsets, and there are also service representatives for the business sector.

Until the end of 2003, there was a separation between the service system and the sales system. During 2004, Pelephone began taking steps to modify the sales and service points system in order to increase the number of points at which both selling and service could take place.

In May 2003, Pelephone together with related companies formed the B-One General Partnership. The object of setting up the partnership is to market inclusive communication services to the Partnership's customers. Pelephone's share in the results of the Partnership correct to December 31, 2004, was 85%.

3.7 Competition

3.7.1 Pelephone faces fierce competition from other cellular operators: Partner, Cellcom and MIRS. This competition has resulted in a large increase in market volume and the addition of new subscribers, and the erosion of Pelephone's real prices. As a result of the penetration of MRT operators into sectors making relatively low use of cellular services, there commenced, as from mid-1996, a decrease in average minutes of use per subscriber and hence in the average revenue per subscriber.

As at December 31, 2004, Pelephone has 2.1 million subscribers. To the best of Pelephone's knowledge, as at December 31, 2004, Cellcom has 2.4 million subscribers, Partner has 2.3 million and MIRS has some 300,000 subscribers[8].

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

[8] Data on the subscribers of Pelephone, Partner, and MIRS relate to active subscribers having received or made at least one call in the past six months, Cellcom data relate to active subscribers in the past three months.

The Company's license imposes restrictions on it in all matters pertaining to its cooperation with its subsidiary companies. In the opinion of the Company and Pelephone, to the extent that these restrictions remain in force, without, at the same time, similar restrictions being imposed on the competing MRT operators, they will, as stated, adversely affect Pelephone's ability to compete with the competing operators.

3.7.3 As part of its preparations for meeting the competition, Pelephone took a number of steps designed to preserve its market share and profitability. Pelephone's principal marketing strategy was to create differentiation for its services, based on accentuating the quality of its services and its product diversity. Commencing January 2003, Pelephone has been applying a dual branding strategy: the "Pelephone" brand addresses the adult community and business customers, while the "Esc" brand addresses the youth community and advanced multimedia service consumers.

Pelephone chose this strategy on the understanding that the market consists of a number of target publics, each having different needs. In the opinion of Pelephone, activity under two brands enables it to provide a better response to each target public, while making it better able to compete in each arena against the competing brands.

3.7.4 In order to enable migration services in Europe or other countries where the network is not based on CDMA technology, Pelephone rents to its customers handsets conforming to the existing technology in those countries, unlike competing MRT operators which operate GSM technology networks, and whose subscribers, holding end-point equipment based on that technology, can make use of their end-point equipment also in other countries whose networks employ that technology and do not need to hire special end-point equipment.

3.7.5 Positive and negative factors affecting Pelephone's competitive position

Positive factors

A. The advanced 3rd generation cellular network supporting the download of data at a rate of up to 2.4 Mbps, and providing good network quality.

B. An advanced product range including data solutions for businesses, and a broad spectrum of multimedia and entertainment services.

C. Two strong brands, each in its relevant arena: Esc in the youth arena and Pelephone in the adult and business sector arena.

D. Service system and range of customer service interfaces enabling the provision of high-level service to customers.

E. An extensive distribution system specializing in the provision of solutions appropriate to each type of customer.

F. Strong capital structure and positive cash flow.

Negative factors

A. Reduction of interconnect tariffs by the Ministry of Communications.

B. Pelephone is subject to restrictions on entering into additional fields of activity and on expanding its customer service baskets, which do not apply to the competitors.

C. There exists a restriction on joint activity with the Company in the marketing of joint service packages.

3.8 Seasonal Fluctuations

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

3.9 Fixed Assets and Facilities

Pelephone's fixed assets include infrastructure equipment in sites (some 85% of the investments in fixed assets as at December 31, 2004), electronic equipment, computers and software

systems, motor vehicles, end-point equipment, office furniture and equipment and leasehold improvements.

3.9.1 Infrastructure

3.9.1.1 Pelephone's infrastructure investments

Investments in the years 2003 – 2004 served primarily to replace and upgrade the network to 20001XRTT CDMA and EVDO technology.

3.9.1.2 Pelephone operates two communications networks using three technologies

A. Digital technology using the CDMA2000 1XRTT method. This is a state-of-the-art technology and its advantages are the possibility of providing advanced services, greater capacity of talk calls and data for a given quantity of frequencies and fast data communications (up to 144KB). Today more than 95% of the traffic on the Pelephone network passes through a network employing this technology.

B. Digital technology using the EVDO method – see sub-paragraph 3.9.1.6 hereinafter.

C. Analog technology using the NAMPS (Narrow Band Advanced Mobile Phone System). This is an outdated technology and today less than 5% of Pelephone customers use cellular instruments making use of this technology.

The three technologies operate on the same frequency range allocated to Pelephone. As of the date of publication of the report, the CDMA technology utilizes some 50% of Pelephone's frequencies range and NAMPS uses 20%. At the beginning of the year 2002, the Pelephone Board of Directors decided to upgrade the densely populated urban area to CDMA2000 1XRTT technology, by means of equipment manufactured by Nortel. 1XRTT technology enables more efficient utilization of the frequencies at Pelephone's disposal, and also information transmission at the greater rapidity required for wireless Internet and for additional portal applications. In mid-2003, the decision was reached to continue to upgrade the Pelephone network in the other parts of Israel, using equipment manufactured by Motorola. By the end of 2003, the upgrade of the Pelephone network to 1XRTT technology was completed throughout Israel.

3.9.1.3 As at the date of publication of the report, Pelephone's MRT infrastructure (CDMA) is based primarily on 8 digital switches manufactured by Nortel, connected to some 1,350 radio sites (cells), in a countrywide spread. Each radio site incorporates an antenna for reception and transmission and a computerized control system, and covers a certain geographic area. The cells are connected to base station controls (BSC) that are hooked up to the switches. The switches are connected to one another and to all the other telecommunications operators (Bezeq, Partner, Cellcom, MIRS and international operators).

3.9.1.4 The depreciation rate of the site equipment is up to 10 years, depreciation for switching equipment is 5 – 7 years, and for data communications equipment and computers between 3 and 5 years. The write-down period of the equipment is determined on the basis of engineering opinions based, *inter alia*, on generally accepted practice in various other countries.

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

In 2004, Pelephone acquired equipment from Nortel in amounts of approximately NIS 336 million and from Motorola equipment in amounts of approximately NIS 160 million.

3.9.1.6 At the end of 2003, the Pelephone Board of Directors resolved to upgrade the CDMA 2000 1XRTT network to EVDO technology by means of the addition of

a special–purpose carrier for data communications in the urban areas of Israel. This technology enables communication between the network and the end-point equipment at rates of up to 2,400 KSS and between the end-point equipment and the network at rate of up to 144 KSS. In the invitation to tender for the upgrade of the network, the winning bid was posted by Nortel. Total cost of the project is some $ 44 million. The spreading of the network included in the contract commenced in June 2004 and will be concluded by the end of 2005. In parallel with the set-up of the network, a portal was established for video services, which is the key service using EVDO technology.

3.10 Intangible Assets

3.10.1 MRT license

Pelephone operates pursuant to a license issued to it (a general license for the provision of mobile radio telephone (MRT) services), which is valid until 2022 (see sub-paragraph 3.18.1.1). The license constitutes the basis for Pelephone's activity.

3.10.2 Frequency usage right

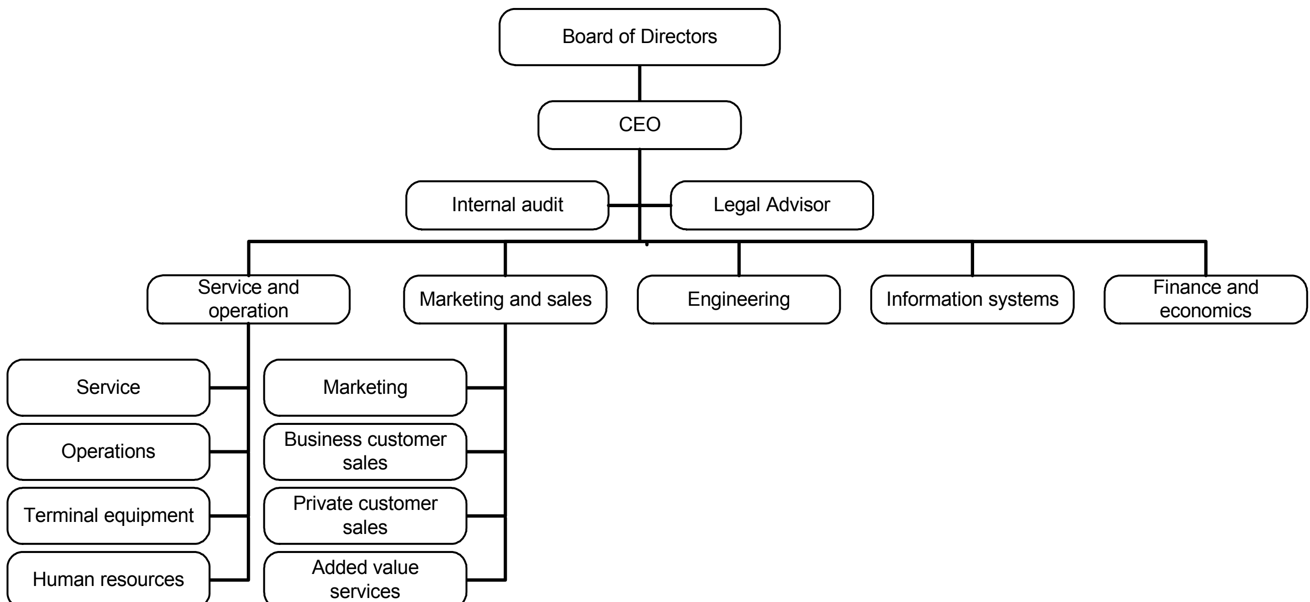
Pelephone uses frequencies in the 800 MHZ range, granted to it by virtue of its license. These frequencies serve the company with CDMA2000 1XRTT technology and EVDO technology. In addition, Pelephone was granted the right of future allocation and use of frequencies (in the 2000 MHZ ranges) using UMTS technology. Regarding this matter, see Note 8D(3) and Note 10 of the financial statements for the year ended December 31, 2004, included in this periodic report.

3.10.3 Trademarks

3.10.4 Pelephone has a number of registered trademarks. The principal ones are: the "'Pelephone" brand addressing the adult public and business customers and the "Esc" brand addressing the youth.

3.11 Human Resources

3.11.1 Organizational structure



3.11.2 Table of organization

The following details the number of employees[9] in Pelephone in accordance with its organizational structure.

Division	Number of employees	
	31.12.04	**31.12.03**
Headquarters and management	122	122
Marketing and sales array	979	968
Service and operations array	2,877	2,580
Information and engineering systems	587	595
Total	4,565	4,265

3.11.3 Changes in the number of employees during 2004

As at the end of 2004, Pelephone's manpower stands at 4,565, compared to 4,265 at the end of 2003. The changes derive from the increase in the number of employees in the service system.

3.11.4 Instruction and training

Pelephone invests resources in professional training in accordance with the type of employee and the field in which he is active. Most training courses take place in the service field, primarily in the service division. Pelephone's total expenses in 2004 and 2003 in respect of instruction and training amount to NIS 14 million and NIS 13 million, respectively.

3.11.5 Employee reward plans

It is the practice of Pelephone to award its employees, managers and office holders grants and incentives on a monthly, quarterly and annual basis commensurate with their achievement of the targets set for them.

3.11.6 Employment contracts

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

3.12 Products and Suppliers

The Pelephone products inventory includes a range of cellular telephone units and a range of auxiliary accessories (such as: battery, hands-free kit, earphone, data cable, charger and so forth). Likewise, Pelephone maintains an inventory of spare parts for the purpose of supplying repair services to its customers and an inventory of used units.

Total acquisitions of end-point equipment in 2004 amounted to NIS 1 billion. Pelephone acquires the end-point equipment and auxiliary accessories from various importer-suppliers in Israel.

Contractual engagements with the suppliers are entered into on the basis of framework agreements setting forth, *inter alia,* the technical support provided by the supplier for the end-point equipment it supplies, the availability of the spare parts and the turnaround time for repairs. These agreements include a commitment to make acquisitions, which are implemented regularly by means of procurement orders.

If a contract with a particular end-point equipment supplier is discontinued, Pelephone may increase the quantity purchased from other end-point equipment suppliers or procure end-point equipment from a new end-point equipment supplier. If the replacement of a supplier is required, as aforementioned, the replacement shall not be immediate, and shall be subject to a preparatory period of insignificant duration for adapting the end-point equipment of such supplier; beyond which, however, the replacement of the supplier shall not involve any material increase in costs to

[9] The number of employees represents the number of jobs as calculated by Pelephone (total work hours divided by monthly work-hours standard..

Pelephone. The breakdown of end-point equipment procurement among suppliers is such as not to create dependency on any one supplier or equipment model.

The decrease in costs of purchasing end-point equipment over the years derives from a decline in prices resulting from the mounting competition due to the entry of additional suppliers into the market and also from the decline in end-point equipment prices worldwide.

3.13 Working Capital

3.13.1 Policy governing inventory maintenance, return of merchandise and warranty

The amount of inventory maintained is derived from Pelephone's service policy and from selling requirements. The requirements necessitate maintaining an inventory for a period of 3 – 5 inventory months, depending on the type of inventory. As at the end of 2004, the inventory level stands at an amount of approximately NIS 292 million. Return of inventory handsets may be implemented by cancellation of a transaction or by the replacement of a unit for another (of the same standard or a higher standard against incremental payment to cover the price difference.)

Pelephone gives a warranty for units in accordance with the level of repair service and insurance to which the customer has subscribed.

3.13.2 Policy governing credit to customers

3.13.2.1 Credit in handset sale transactions – Pelephone enables most of its customers purchasing a mobile telephone to spread payments over 36 equal instalments.

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

As at the end of 2004, total customer credit amounts to NIS 1,159 million.

3.13.3 Credit from suppliers

Pelephone receives credit from its supplier for periods ranging from 30 days to 120 days. As at the end of 2004, total credit from suppliers amounted to NIS 527 million.

3.14 Investment in Investee Companies and in a Partnership

Pelephone is the holder, wholly owned, of Goncast Ltd., ("Goncast") The activity of Goncast has focused primarily on the operation and maintenance of a portal with cellular accessibility. (See Appendix A (note 7) of the financial statements for the period ended December 31, 2004, included in this periodic report).

In addition, Pelephone holds 85% of the B-One Partnership (See Clause 3.6 aforesaid).

3.15 Finance

3.15.1 The activity of Pelephone is financed out of shareholders' equity, long- and short-term bank loans, debentures and suppliers' credit.

The average interest rate in 2004 for undesignated loans:

	Short-term loans	Long-term loans (including current maturities)
Banking sources:		
CPI-linked – NIS	–	5.2
Fixed shekel	5.05	7.18
Dollar	–	1.13
Non-banking sources:		
CPI-linked – NIS		5.38

3.15.2 Restrictions

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

A. Pelephone's total debts not to exceed three times its shareholders' equity.

B. As long as the total of debts exceeds shareholders' equity by more than 1.5 times, Pelephone shall not distribute dividends and shall not pay management fees to shareholders. If Pelephone is in breach of this undertaking, it shall be obliged to repay to the bank, within 120 days of demand, all the loans outstanding to the credit of the bank at that time, or, alternatively, to amend the breach by increasing its shareholders' equity or repaying Pelephone's loan in such a way that the aforesaid ratio shall be preserved;

C. Total debts shall not exceed NIS 3.8 billion (linked to the known CPI as at January 2002). The amount of debts shall be examined on a quarterly basis in accordance with the financial statements which are reviewed by the auditors;

D. Not to mortgage Pelephone's assets under a fixed or floating charge, in any shape or form, or of any type and rank, without obtaining the bank's prior written consent that it may proceed;

E. Not to provide Pelephone shareholders or any third party whatsoever any security or lien on the assets of Pelephone or any guarantee, to secure credit received by the shareholders, without obtaining the bank's prior written consent that it may proceed;

F. Not to grant Pelephone shareholders any loan or credit without obtaining the bank's prior written consent that it may proceed;

G. To forward to the bank various information, details and reports;

H. If Pelephone shall be in breach of its aforementioned undertakings, then the bank shall be entitled to call for immediate repayment the amounts of the loans extended to it.

3.15.2.2 Pelephone gave a foreign bank an undertaking not to engage in a transaction or a series of transactions pursuant to which assets would be sold, mortgaged or otherwise transferred other than in the ordinary course of business, without obtaining the bank's consent, and not to perform any act of merger (except a merger with Bezeq) without obtaining the bank's consent. Likewise, certain instances were stipulated in which the bank may call for immediate repayment Pelephone's loans, the most significant being: (A) if Pelephone fails to pay to the lending bank any payment having fallen due; (B) if Pelephone shall be in breach of its undertakings to comply with the financial criteria aforesaid; (C) if Bezeq ceases to be a controlling shareholder in Pelephone and the lending bank will not be convinced that this change does not materially effect Pelephone; (D) if any material change takes place in Pelephone; (E) if Pelephone pursues any unlawful activity; (F) whenever any competent authority intervenes in the affairs of Pelephone; (G) if the management of Pelephone is ousted from office or if Pelephone's authority to manage its business is curtailed and such curtailment materially affects its business; (H) if Pelephone's license is revoked; (I) if any material change takes place (without the consent of the bank) in the nature of Pelephone's business or in case of nationalization or sale of all or most of Pelephone's assets by any Government or by virtue of any authority vesting in it; (J) if Pelephone fails to pay any one of the group of banks to which it has furnished an undertaking as regards financial criteria, any payment on due date thereof or if it is determined that its debt to any of the aforesaid group is due for payment or if any of the group of lenders shall have the right to call Pelephone's debts towards it for payment prior to the agreed due date thereof (provided that the amount to which all of the aforesaid applies shall be not less than 10 million

dollars); (K) if Pelephone shall be insolvent or if it is found by a court to be insolvent; (L) if proceedings are taken against Pelephone such as receivership, liquidation, compromise or arrangement with creditors and also (M) if the monetary loan becomes unlawful as regards the lending bank. In addition, if an agreement with Pelephone contains a tax grossing up Clause whereby, if any tax or levy shall apply to the lender, it shall be borne by Pelephone. To date, Pelephone has not been required to gross up tax payments, other than the grossing up of a tax withholding on the interest payable to lenders. In respect of loans from local banks, no tax obligation exists, and in respect of the loans obtained from the aforementioned foreign banks, Pelephone is exempt from payment of tax out of the interest in accordance with an exemption approval confirmation provided by the Income Tax Commission.

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

3.15.3 In June 2004, Pelephone made an issuance by way of private placement to institutional investors, of NIS 200 million par value debentures (in this Clause, hereafter: “**the debentures”)**, for a consideration of the nominal value thereof. The debentures are linked to the CPI, bear annual interest at a rate of 5.2% and are redeemable in 20 equal semi annual payments commencing from 2005.

Together with the debentures, Pelephone issued, free of payment, warrants for debentures totalling NIS 100 million, exercisable by December 27, 2004. The warrants were exercised and the consideration from the issuance was received in December 2004. The debentures issued in respect of the warrants bear the same terms as the original debentures, plus interest for the six months ended December 31, 2004. These debentures are redeemable in 20 equal wemi annual payments commencing from 2005.

On the day of issuance of the debentures, a trust deed was executed by the Company, for the trusteeship of Union Bank of Israel Ltd., which is to serve as trustee for the debenture-holders. Pursuant to this agreement, Pelephone undertakes to pay principal, interest and indexation differences in accordance with the terms of the debentures. The debentures are not secured by any charge, and the conditions of the negative lien and the credibility of the financial data that Pelephone maintains in relation to the Israeli banking system will also apply to the debenture holders (see Clause 3.15.2 aforementioned). The agreement details the conditions for immediate repayment of the debentures, being essentially as follows: (A) If Pelephone does not repay any amount whatsoever being due from it pursuant to these debentures by 30 days from the due date; (B) if a liquidator is appointed for Pelephone; (C) if liens are realised; (D) if an attachment is imposed on material assets of Pelephone; (E) if Pelephone ceases to exist or (F) if Pelephone discontinues its payments or serves notice of its intention to discontinue them. The trustee is entitled to take steps for immediate repayment in order to protect the debenture holders. The agreement moreover sets forth principles for indemnifying the trustee, trusteeship of the receipts, investment of moneys and conditions for convening a general meeting and adopting resolutions.

The debenture issuance was awarded AA minus rating by the Maalot rating company.

As at December 31, 2004, Pelephone is meeting its commitments to the banks and to the debenture holders.

Loans received subsequent to December 31, 2004

	Long-term loans (including current maturities)	Average interest rate
Bank sources: Linked to the CPI	100	4.6
Non-bank sources: (see Section 3.15.8 below)	500	4.4

3.15.4 Credit limits

The credit limits assigned to Pelephone by Israeli and foreign banks, including the debentures, amount to NIS 3.2 billion as at the date of the periodic report. There is no signed agreement with the banks regarding this amount, but rather a verbal agreement. As at December 31, 2004, Pelephone had utilized NIS 2.1 billion of its credit limit.

3.15.5 Guarantees and liens

See Note 19C to the financial statements for the year ended December 31, 2004, included in this periodic report.

3.15.6 Variable interest

As at December 31, 2004, Pelephone has no variable interest loans. Pelephone was, however, granted a loan by a foreign bank, renewable every three months within a framework set at three years. The interest, varying every three months, is calculated by either of two possible alternatives, a shekel track and a dollar track, at the discretion of the bank.

3.15.7 Credit rating

Rating company Maalot assigned Pelephone an AA minus rating on issuance of the debentures (see sub-paragraph 3.15.3 aforesaid).

3.15.8 Pelephone's capital recruitment estimate for the coming year, and recruitment sources

Pelephone is due to repay and re-finance some of its loans in 2005. In respect thereof, Pelephone plans to raise new loans from banking corporations and/or by means of capital financing through the capital market and/or through Pelephone's cash flows. On February 27, 2005, the Company issued, by way of private placement to institutional investors, NIS 500 million p.v. debentures, in consideration for the nominal value thereof. The issuance consideration will be received in March 2005. The debentures are linked to the CPI, bear annual interest at a rate of 4.4% and are redeemable in 20 equal semi annual payments commencing September 2005. Maalot awarded this issuance an AA minus rating.

3.16 Taxation

See Note 11 to the financial statements for the year ended December 31, 2004, included in this period report.

3.17 Environment

3.17.1 Provisions relating to the Environment – see sub-paragraphs 3.18.1.3 and 3.22.G hereinafter.

3.17.2 Anticipated costs and investments

Pelephone conducts periodical radiation tests in order to ascertain that it is in compliance with the permitted operating standards and the standards of the International Radiation Protection Agency. These tests are outsourced to companies specialising in the field. Pelephone invests on average NIS 4 million per annum in respect of this activity.

3.18 Restrictions on and Control of Pelephone's actions

3.18.1 Legislative restrictions

3.18.1.1 Communications Law and licensing obligation in respect thereof

The Telecommunications Law (Telecommunications and Broadcasts) 5742-1982 stipulates, *inter alia*, that that performance of telecommunication activity and the provision of telecommunication services, including the MRT services, are subject to a license from the Minister of Communications (in this chapter – the Minister).

Pelephone holds a general license for the provision of MRT services. The Minister is empowered to modify the terms of the license, to add thereto or to detract therefrom, while taking into consideration, *inter alia*, government telecommunications policy, considerations of public interest, suitability of the license holder to provide the services, the contribution of the license to competition in the telecommunications field and to the level of service therein.

Moreover, the Minister is empowered to annul, restrict or suspend a license in a number of situations (see sub-paragraph 3.18.3.1 hereafter).

The Law empowers the Director-General of the Ministry of Communications to impose financial sanctions in respect of various breaches of the provisions of the law and of orders and provisions issued by virtue thereof, and also by reason of a breach of license conditions.

The Law empowers the Minister to stipulate, through Regulations, a fee for the issue of a license and also an annual fee payable by the licensee for every type of telecommunications service it provides, except for a service in respect of which it pays statutory royalties by law.

3.18.1.2 Wireless Telegraph Ordinance

The Wireless Telegraph Ordinance (New Wording) 5732-1972 (hereafter: "**The Telegraph Ordinance")**, regulates the use of the electromagnetic spectrum, and applies, *inter alia*, to the use made by Pelephone of radio frequencies, as part of its infrastructure. The set-up and operation of a system making use of radio frequencies is subject, under the Telegraph Ordinance, to the issue of a license, and the use of radio frequencies is subject to designation and allocation of a suitable frequency. The Telegraph Ordinance imposes license fees and fees for designation and allocation of frequencies.

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

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

3.18.1.3 Facilities emitting electromagnetic radiation

3.18.1.3.1 The existing regulations

The Pharmacists Regulations (Radioactive elements and the products thereof) 5740-1980, regulate, *inter alia*, relate to electromagnetic radiation in facilities emitting such radiation, and are applicable to some of Pelephone's facilities. The set-up of such a facility and such activity are subject, *inter alia*, to a permit from the Commissioner for Environmental Radiation at the Ministry of the Environment, and the Commissioner is entitled to render the issue of a permit contingent on certain conditions, both for the issue thereof and for the validation thereof post-issuance. The Commissioner is also entitled to issue directives as to the adoption

of appropriate measures such as he may enumerate, if he is of the opinion that the facility is liable to jeopardize the health or wellbeing of an individual or the public or the environment. Non-fulfillment of the regulations or the terms of the permit or the Commissioner's directives is cause for revoking or suspending the permit.

3.18.1.3.2 Draft legislation

During 2004, the Ministry of the Environment circulated a Non-Ionizing Radiation bill (Government bill) designed*, inter alia*, to re-regulate dealing in instruments, facilities and technology systems, the operation of which, creates or are liable to create, non-ionizing radiation ("the radiation source"). Non-ionizing radiation has been defined as the emission of electromagnetic waves, the energy of which is less than 5 electron volts, and which cannot cause ionization. According to the bill, the set-up and operation of a radiation source shall be subject to a permit. Regarding this matter see also Clause 2.15 aforementioned.

3.18.1.4 The numeration plan

In accordance with the decision of the Ministry of Communications, commencing April 20, 2004, all area code numbers allocated to each MRT operator were unified into a single identifying area code for each operator, and an additional digit was added to the subscriber number (which, as a rule, will be identical to the third digit of the area code existing before the change). See also sub-paragraph 2.6.5(A) aforementioned.

3.18.2 Controlled tariffs

Payments for interconnect:

The Telecommunications Regulations (Payments for Interconnect) 5760-2000 ("the Regulations") stipulate restrictions as regards payments to be made to or received from a domestic operator (DO) or other MRT operator in accordance with these Regulations. The tariffs for calls incoming to cellular telephones were scaled down from October 2000 to January 2003. In December 2004, regulations were amended as follows:

A. For the purpose of interconnect payments received from a DO or other MRT operator for completion of a minute of MRT network traffic, the current tariff for call completion is to be scaled down to NIS 0.22 in accordance with the following outline (tariffs do not include VAT):

   (1) Commencing 1.3.2005, the current tariff of NIS 0.45 per traffic minute will be reduced to a maximum tariff of NIS 0.32.

   (2) Commencing 1.3.2006, the tariff will be reduced to a maximum tariff of NIS 0.29.

   (3) Commencing 1.3.2007, the tariff will be reduced to a maximum tariff of NIS 0.26.

   (4) Commencing 1.3.2008, the tariff will be reduced to a maximum tariff of NIS 0.22.

B. Regarding payments received from an international licensee for completion of MRT network traffic, the current tariff of NIS 0.25 for call completion will be reduced, commencing 1.3.2008, to a maximum tariff of NIS 0.22.

C. Regarding payments received from another MRT operator for the transmission of a short message (SMS) on an MRT network, the current tariff will be reduced, in two stages, so that commencing 1.3.2005 the current tariff of NIS 0.285 per SMS will be reduced to a maximum tariff of NIS 0.05. Commencing 1.3.2006, the aforementioned tariff will be reduced to a maximum tariff of NIS 0.025.

D. The tariffs per sub-paragraphs (A) to (C) aforementioned will be revised once a year, commencing 1.3.2006, in accordance with the rate of change of the Consumer Price Index.

E. For the purpose of computing payment for call completion to an MRT network, commencing 1.1.2009, the charge will be made in accordance with segments of one second (unlike from the current charging system which enables charging per segments of up to 12 seconds). Consequently, commencing 1.1.2009, the payments payable by the MRT operator for interconnect services to a DO line will likewise be revised.

F. Later, the Ministry of Communications intends to conduct an examination as to whether there are justifiable grounds for enabling MRT operators to collect initial payment in respect of the creation of a call.

G. In 2005, a hearing is due to take place concerning the intention to restructure the tariff to the consumer for an MRT call in such a way that, commencing from a reasonable date to be determined, the call price will not distinguish between an intra-network call and a call from an MRT network to another network, and the price will also include the interconnect component. A joint team of the Ministry of Communications and the Ministry of Finance will examine the matter.

The following table itemizes tariff development:

	To Sept. 2000	**From Oct. 2000**	**From Jan. 2002**	**From May 2002**	**From Jan. 2003**	**From May 2004**	**From Mar 2005**	**From Mar 2006**	**From Mar 2007**	**From Mar 2008**
Linkage – Domestic (tariff per minute)	62.0	54.0	50.0	50.0	45.0	45.0	32.0	29.0	26.0	22.0
SMS message	–	–	–	38.0	38.0	28.5	5.0	2.5	2.5	2.5
Linkage – International (tariff per minute)	62.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	22.0

Note: the tariffs are presented in agorot. Prices are rounded up and do not include VAT.

3.18.3 License and site licensing

3.18.3.1 Pelephone license

The General License for the provision of MRT services granted to Pelephone on 7.2.96 was for a period of 10 years commencing 1.1.94, with the option of extending for additional periods of 6 years each, under the conditions set forth in the license, consisting primarily of compliance with legal conditions. Following the tender in which 3rd generation frequencies were allocated to Pelephone the license was expanded in such a way as to be valid for a period of 20 years commencing 9.9.02.

(As to the arrangement with the State of Israel concerning right of use of frequencies, see Note 8D to the financial statements for the year ended December 31, 2004, included in this periodic report).

Likewise, in April 2001, the Civil Administration for the Judea and Samaria Region awarded Pelephone a general license for the provision of mobile radiotelephone services by the cellular method (MRT) in the region of Judea and Samaria, applicable to which (with some changes) are the provisions of the General License awarded to Pelephone by the Ministry of Communications.

The following are the principal provisions of the Pelephone license (hereinafter, in this Clause – the licensee):

A. Under certain circumstances, the Minister is entitled to modify the conditions of the license, to restrict it or to suspend it, and in certain instances to revoke it.

B. The license is non-transferable, and neither may 10% or more of any means of control in the licensee be transferred either directly or indirectly, nor may any means of control in the licensee or any portion of any means of control be transferred in any manner in such a way as to confer control in the licensee, nor may control in the licensee be acquired, either directly or indirectly, unless the Minister shall have given his consent beforehand.

C. A Pelephone shareholder, or a shareholder in an interested party therein, may not mortgage his shares in such a way that realisation of the lien will result in a change of ownership of 10% or more of the means of control in the licensee, unless the agreement contains a provision whereby the lien may not be realised except with the prior consent of the Minister.

D. The licensee shall take steps to establish interconnection of the network to another public telecommunications network in the State of Israel (including communities, military sites, and military bases in the areas of Judea and Samaria and the Gaza Strip). The licensee is obliged to provide interconnect service on equal terms to any other operator and must refrain from any discrimination in implementing interconnections.

E. The licensee shall refrain from awarding preference in the provision of infrastructure services to a licensee being a company with an interest[10] over another licensee, whether for the payment for the service, in the conditions of the service, or in its availability or otherwise.

F. The licensee is not entitled to sell, to lease or to mortgage any of the assets used for the implementation of the license without the consent of the Minister of Communications, except for:

(1) Mortgaging of any of the licensee's assets in favour of a banking corporation duly operating in Israel, for the purpose of obtaining bank credit, provided that notice shall have been served on the Ministry of Communications regarding the lien proposed to be made, whereby there is included in the mortgage agreement a Clause ensuring that realisation of rights by the banking corporation will not, in any event, result in any damage whatsoever to the provision of the services pursuant to the license.

(2) Sale of items of equipment during an upgrade procedure, including sale of equipment by the trade-in method.

G. The director (pursuant to the license: the Director-General of the Ministry of Communications) or whoever he shall have empowered for the purpose of the license, is entitled to issue directives concerning numbers mobility such that any subscriber of another MRT licensee may transfer to and become a subscriber of the licensee or receiving services from the licensee without changing his telephone number, and vice versa, and in such case, the licensee must incorporate into his telecommunications network devices enabling the application of this feature, as directed by the director.

H. During states of emergency, whoever shall have been statutorily empowered thereto shall have the authority to issue the licensee with certain instructions as to its mode of operation and/or mode of provision of services.

I. The license sets forth the types of payments that the licensee is entitled to collect from its subscribers, the mechanisms of setting tariffs, the reports the licensee is obliged to submit to the Ministry of Communications and also the duty of serving notice on the Ministry of Communications prior to modifying tariffs. The license also determines the Minister's power to intervene in the tariffs, in certain cases.

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

J. The license commits the licensee to a minimal standard of service, including setting up of service call-in centres, the determination of a maximum period for repair of malfunctions, an accounts collection procedure, protection of the privacy of the recipient of the service and so forth.

K. To secure the licensee's undertakings and also in order to compensate and indemnify the State of Israel in the event that it sustains damage due to acts of the licensee, the licensee must furnish a bank guarantee in the amount of $ 20 million. The license determines the instances in which such guarantee maybe forfeited.

Royalties

Pursuant to its license and to the Bezeq Regulations (Royalties), 5721-2001, Pelephone pays the State of Israel royalties at a rate of 3.5% of its revenues from the provision of telecommunications services net of income and expenses specified in the Regulations, foremost among which are: income from interconnections, payments transferred to the owner of a foreign MRT operator for migration services, revenues from sale of end-point equipment and bad debts relating to income respecting which royalties were paid. In the year 2001, the rate of royalties was 5%, in 2002 – 4.5%, in 2003 – 4%, and in 2004 the rate of royalties was reduced to 3.5%. According to a letter received on December 5, 2004 from the Ministry of Communications, the Ministers of Communications and Finance intend to amend the Telecommunication Regulations (Royalties) in such a manner that commencing 1.1.2006, there will be an annual decrease of 0.5% in the rate of royalties, until it is reduced to 1%.

Regarding a lawsuit filed by the State of Israel against Pelephone with respect to non-payment of royalties, see Note 19A (27) to the financial statements for the year ended December 31, 2004, included in this periodic report.

3.18.3.2 Licensing of sites

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

The setting-up and operation of cellular antenna necessitates building permits from the various planning and building committees, a procedure requiring, *inter alia*, a number of approvals from Government concerns and regulatory bodies, including:

A. Approval for setting-up and operation from the Ministry of the Environment (see sub-paragraph 3.17.1 aforementioned)

B. Approval from the Civil Aviation Administration in some cases.

C. Approval from the IDF.

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

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

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

In respect of a number of sites established several years ago, approvals from the Civil Aviation Administration and the IDF are still lacking, even though the applications for the approvals have long since been in the hands of those

authorities. Similarly, administrative or other delays occur in some planning and building authorities in the issue of building permits for sites. Accordingly, Pelephone (and also its competitors) operate a number of broadcasting sites for which building permits have not been issued. Applications for the building permits have been filed by Pelephone with the planning and building authorities, and are at various stages of discussion and approval.

The setting-up of a broadcasting site without obtaining a building permit constitutes a breach of the Planning and Building Law, 5725-1965, and in some instances, this has resulted in the issuance of demolition orders against sites or the filing of indictments or the adoption of civil proceedings against Pelephone and some of its office bearers.

As at the date of this report, Pelephone has in most cases succeeded in making arrangements in respect of the deficient licensing, in avoiding demolition or in delaying execution of demolition orders pursuant to arrangements reached with the planning and building authorities. These arrangements have not necessitated any admission of guilt, or conviction of office holders or directors on behalf of Pelephone. However, it is not certain that this state of affairs will continue in the future, or that there will be no further instances in which demolition orders are issued or indictments filed in respect of building permits, including against office holders.

Pelephone, like Israel's other MRT operators, is liable to be required to dismantle broadcasting sites for which the necessary approvals and permits have not been obtained. If a demand is made for the simultaneous dismantling of sites in a given geographic area, service in that area is liable to deteriorate, until substitute broadcasting sites can be built.

Likewise, Pelephone, like Israel's other MRT operators, provides internal relays inside buildings in order to provide service in the buildings. These relays are miniature installations connected to an outside antenna about 60 cm in size. This antenna facilitates the reception of a broadcasting signal from a nearby broadcasting site, which is then "relayed" to within the building. The radiation emission from these miniature antennae is similar to the radiation emitted by cellular end-point equipment. These relays have been accorded a classification approval by the Ministry of Communications.

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

The Ministry of the Environment is preparing a procedure for the issue of permits for the setting-up and operation of broadcasting facilities of the same class ("class permit") the purpose of which is, *inter alia*, to simplify the licensing process of miniature installations and internal relays.

If the planning authorities decide that permits are also required for the installation of facilities of this type, such decision could negatively impact the installation of such facilities.

3.18.3.3 Set-up of Communication Facilities - National Outline Scheme 36

National Communications Outline Scheme (hereafter: "**NOS 36**") was designed to regulate the spread and manner of setting-up of communications facilities in order to secure the functioning thereof, with full coverage of the State territory, for radio, television, and wireless communications transmission and reception, while minimizing damage to the quality of the environment and the landscape.

NOS 36A simplifies and streamlines the setting-up processes of miniature and small broadcasting facilities. It stipulates clear obligations and guidelines and creates a uniform framework for processing permit applications. Before it was approved, the various local authorities would apply different criteria, causing delays in the licensing process for the set-up of such facilities.

On 1.2.05, the National Planning and Building Council adopted the following resolution:

(1) No building permit shall be issued unless the applicant for a permit deposits with the local authority a letter of indemnity in respect of compensation pursuant to Section 197 of the Planning and Building Law, to cover such compensation as the committee may be ordered to pay. Section 197 of the Planning and Building Law confers on landowners injured by a plan applied within their territory or within neighbouring territory the right to compensation from the local committee. The outlined amendment of NOS 36A is liable to subject Pelephone to an inconsiderable financial charge in respect of the decrease in value of properties as a result of the positioning of cellular antennae adjacent thereto. However, at this stage, there is no certainty as to either the charge or the extent thereof, and they will not, of course, result automatically from the decision of the national council to amend NOS 36A.

(2) Further to the directives of the National Council as at 3.8.04, the Drafting Commission will formulate a change to the NOS as it concerns the greater discretion to be accorded to the local authorities, and the notification to the public.

(3) When the draft resolution concerning the greater discretion to be accorded to the local authorities is submitted to the Council, the possibility of changes in the indemnification obligation and the extent thereof will be examined.

All the aforementioned resolutions are subject to Government approval.

3.18.4 Standardization

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

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

The certificate was awarded on January 11, 2004, and is valid until January 31, 2007.

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

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

3.19 Legal Proceedings

See Notes 19A(9), 19A(27) to 19A(34) and 19A(39) of the financial statements for the year ended December 31, 2004, included in this annual report.

3.20 Goals and Business strategy

3.20.1 Pelephone's principal strategic goals are:

Increase market share;

Lead with third generation technology;

Improve profitability;

Streamline the company's distribution and sales system;

Improve the technological infrastructure and provide best-quality coverage;

Create valuable brands in the field of mobile entertainment and in the private and business sector.

3.20.2 Marketing strategy

As part of its marketing strategy regarding the activity of two distinct brands, Pelephone completed in 2004 a comprehensive strategic measure that included the launch of a special-purpose brand leading the youth and mobile entertainment arena, and the repositioning of the Pelephone brand for the private and business sector.

The youth brand was created on the basis of the concept that the use of the cellular telephone was about to evolve away from being merely a mobile phone and towards being a mobile entertainment platform.

Esc was launched in January 2003, in a comprehensive marketing drive, all of whose components hinge on the same values of differentiation, boldness, innovativeness, entertainment and a youthful spirit. A cellular portal was accordingly constructed, Israel's first cellular concept retail outlet was established, a progressive internet site and later Radio Esc99 were set up. By the end of the first year, over one hundred thousand customers had joined. Today, Esc has more than 350,000 customers.

The repositioning of the Pelephone brand – while forming its marketing strategy, Pelephone identified an unsatisfied need among its target public for a simple and practical personal approach, devoid of extravagant promises.

Accordingly, the Pelephone brand was repositioned in accordance with the values of simplicity, fairness, flexibility and innovative empowerment.

3.21 Outlook for the Coming Year

During 2005, a number of factors are expected to affect Pelephone's activities, the principal ones are as follows:

3.21.1 Reduction of connectivity fees

As noted in sub-paragraph 3.18.2, connectivity fees were reduced on 1.3.2005 from 45 agorot (excluding VAT) to 32 agorot (excluding VAT). Connectivity fees will subsequently continue to be scaled down annually until reaching 22 agorot (before VAT) on 1.3.2008. The reduction of connectivity fees is expected to adversely affect Pelephone's revenues, but Pelephone estimates that tariff revisions will help reduce the adverse effect. Further changes may take place to the extent of consumption and the flexibility of demand that are liable to result in Pelephone obtaining not more than partial compensation in respect of the loss of connectivity revenue. At this stage, Pelephone is unable to estimate the total effect of the change on Pelephone and on the cellular market in general.

3.21.2 Launch of 3rd generation services

In September 2004, Pelephone launched the 3rd generation EVDO network, enabling data communication at a rate of up to 2MBps. Pelephone estimates that it will succeed, thanks to this move, in securing a competitive edge. 3rd generation services are expected to yield Pelephone additional revenues and to increase income from customers.

3.21.3 IDF Centre and the Association for the Wellbeing of Israel's Soldiers

In 2005, two significant tenders for contracts held by Pelephone are scheduled to be reopened. These invitations to tender could affect Pelephone's subscribers list and its revenues. In January 2005, Pelephone once more successfully bid for a tender for the supply of MRT services to the Accountant General at the Ministry of Finance. See Note 19B to the financial statements for the year ended December 31, 2004, included in this periodic report.

3.21.4 Innovative added value services

In 2005, Pelephone is due to continue to launch a diverse range of advanced added value services that will help improve the perception of the brand and increase revenues from existing customers. Prime examples are the PTT (walkie-talkie) services that will enable new subscribers to be recruited in a market segment that was hitherto

inaccessible to Pelephone (primarily MIRS subscribers) and AGPS (location based) services, which will secure Pelephone a competitive edge and will enable a diverse range of services to be launched for the private and business sector.

This clause includes forward-looking information. Forward-looking information is uncertain information concerning the future, based on information available to Pelephone on the reporting date, and including Pelephone's assessments or intentions as at the reporting date. Circumstances liable to adversely affect the realisation of the expectations described above may derive from market behaviour, activity by the competition, mode of penetration of new services and technological difficulties.

3.22 Risk Factors

A. Mounting competition

Four companies operate in Israel's cellular market. The market is characterized by high saturation, fierce competition among the companies finding expression in, *inter alia*, an ongoing reduction of tariffs and the large-scale transfer of customers between the companies.

B. Investments in infrastructure and technological changes

The cellular market in Israel and elsewhere is characterized by material capital investments in the deployment of infrastructure and in subscriber equipment.

The frequent technological changes in the field of infrastructure and end-point equipment, and also the fierce competition over various market segments, impose a heavy financing burden on the companies operating in the market, which necessitates updating their infrastructure technology from time to time or to penetrate new products into the market at heavy cost.

C. Market risks

Pelephone is exposed to market risks a result of changes in interest rates, exchange rates, inflation, prices of infrastructure and subscribers' equipment.

The following is a detailed description of the market risks:

Dollar exchange rate - any change in the exchange rate of the shekel against the dollar itself constitutes economic exposure, since it may affect future cash flows and in particular repayment of foreign currency linked liabilities and payments for the acquisition of infrastructure and end-point equipment for subscribers.

Pelephone is also subject to accounting exposure deriving from the difference between rate of the change in the exchange rate of the shekel and the rate of change in the Consumer Price Index during the Report Period. Due to this exposure, Pelephone is exposed to a decrease or increase in the value of foreign currency linked liabilities that could affect its real financing expenses.

Interest rate – From time to time, Pelephone takes shekel loans bearing variable interest linked to the prime rate (on call). This exposure may affect Pelephone's financing expenses and its cash flows. On the other hand, the fact that the interest rate is variable causes the fair value of these loans to approximate their book value.

Pelephone does not protect itself against the exposures described above by entering into future interest rate transactions, but does take such effects into account in determining the type of loan. As at December 31, 2004, Pelephone has no loans of this type.

Inflation - the inflation rate affects Pelephone's operating income and expenses over the year. Pelephone does not have a tariff revision mechanism that is directly affected by the rise of the inflation rate. Pelephone does, however, adjust its tariffs from time to time at its discretion. The annual inflation rate and the breakdown thereof over the year may result in the material erosion of Pelephone's revenues. Pelephone's expenses are likewise affected by the inflation rate, with unlinked expenses such as payroll being eroded over the year, while acquisition costs, that are partly linked, do not change in real terms.

Pelephone's loans are linked to the "known index". The inflation rate creates exposure to higher principal and interest repayments.

Price of infrastructure equipment and subscriber end-point equipment – cash flows from Pelephone's activities are applied partially to investments in equipment. Equipment prices are influenced by changes in exchange rates and by international prices.

Pelephone institutes currency protection in accordance with a policy established by the finance committee of Pelephone's Board of Directors.

The following are the guiding principles of exposure management:

1. Infrastructure investments - investments in long term projects backed by contracts with milestones, are protected by means of forward transactions/ options/ dollar deposits.
2. Subscriber equipment – protection is instituted regarding invoices payable or open orders, taking into account existing inventory levels, in accordance with dollar exchange rate change forecasts.

D. Tariff control

Pelephone's connectivity fees are fixed by the Ministry of Communications and are subject to control and to changes that are liable to be made from time to time. The Ministry's decisions as to tariff changes may materially affect Pelephone's financial results. For a more detailed discussion of tariff development and control, see sub-paragraph 3.18.2 aforesaid.

E. Legal proceedings

Pelephone is party to legal proceedings, including class actions, which are liable to result in its being ordered to pay material amounts that cannot presently be estimated, and in respect of most of which no provision has been made in Pelephone's financial statements.

Pelephone is exposed to class actions. Class actions may reach high amounts, since approximately one third of the residents of the State of Israel are Pelephone consumers, and a claim relating to a small amount of damage to a single consumer may grow into a material claim against Pelephone if recognised as a class action applicable to all or a large proportion of those consumers.

Likewise, other proceedings (not being class actions) could result on aggregate in charges of considerable amounts.

Regarding legal proceedings to which Pelephone is a party, see section 3.19 above.

F. Restrictions applicable to frequencies and disturbance in use of the frequencies range

At present, the volume of vacant frequencies that can be allocated to Pelephone over and above the frequencies it has in the CDMA range is limited.

The frequencies range used by Pelephone for operating the CDMA technology network also serves land based television broadcasts, and part of the range – also for GSM technology cellular communications. Due to the use of those frequency ranges, broadcasts by a number of television stations transmitting in the Middle East cause disturbances in the operation of Pelephone's aforementioned network. In certain instances, these disturbances have reached a level preventing high quality CDMA-technology communication in parts of the Pelephone network.

Likewise, in light of the peace agreement with Jordan, Pelephone is precluded from making use of part of the frequency range that is suitable for the CDMA network, since the Jordanians use it for the networks they operate using GSM technology.

In addition, in the next few years, digital multi-channel television broadcasts are expected to evolve, transmitting a large number of compressed video channels, and this could aggravate the existing disturbances in the operation of Pelephone's CDMA network.

G. Electromagnetic radiation

Pelephone operates hundreds of transmission facilities that emit electromagnetic radiation (see sub-paragraph 3.18.1.3 aforementioned). Pelephone is taking steps to ensure that the levels of radiation emitted by the aforementioned transmission facilities do not exceed the radiation levels permitted by the directives of the Ministry of Environment (levels adopted in accordance with international standards). Pelephone's third party liability insurance policies do not presently cover liability for electromagnetic radiation.

H. Licensing of sites

The set up and operation of cellular antenna are subject to building permits from the various planning and building committees, a process that involves, *inter alia*, obtaining a number of approvals from Government entities and regulatory bodies.

For details of the difficulties encountered by Pelephone in the setting-up and licensing of sites, see sub-paragraph 3.18.3.2 above.

Risk Factors Summary Table

	Extent of effect of risk factor on Pelephone's operations		
	Large	**Medium**	**Small**
Macro Risks			
Exposure to changes in exchange rates		X	
Exposure to changes in interest rates		X	
Exposure to changes in inflation		X	
Sector Risks			
Increasing competition	X		
Investments in infrastructures and technological changes	X		
Tariff supervision	X		
Frequency restrictions and usage disturbances	X		
Electromagnetic radiation*			
Site licensing		X	
Special Risks to Pelephone			
Exposure to legal proceedings		X	

*** Pelephone is unable to assess the extent to which this risk factor will have on its activity.**

4. International Communications and Internet Services – Bezeq International (hereinafter: "Bezeq International")

4.1 General

4.1.1 Structure and changes in area of operations

Bezeq International, a fully-owned subsidiary of the Company, provides direct dialing services to some 240 destinations throughout the world. The international telephone services provided by Bezeq International, similar to the services provided by the other competing international operators, are based mainly on the Company's domestic network and on the cellular networks in order to connect subscribers to the international switchboard.

In addition to the international call services (hereinafter: "Voice Services"), Bezeq International provides data communications services (hereinafter: "Data Services") internet access services (ISP) (hereinafter: "Internet Services"), value-added services, telephony traffic routing services between foreign international communications suppliers and server and site hosting services (hereinafter: "Hosting Services").

Data communications services provided by Bezeq International include point-to-point lines, frame relay, ISDN, ATM, video conferencing, virtual private network facilities and IP services.

4.1.2 Legislative and statutory restrictions applicable to Bezeq International

The Israeli communications market is regulated mainly by the Telecommunications Law (Telecommunications and Broadcasts), 5742 – 1982 (hereinafter: the "Telecommunications Law") (see Section 4.17 below).

4.1.2.1 General license

Bezeq International operates pursuant to a general license for the provision of international telecommunications services (hereinafter in this chapter: the "License"), which is valid until 2022. The provisions of the License regulate, *inter alia*, the method of setting the tariffs which Bezeq International charges for its services, updates thereto and the collection of payments therefor.

4.1.2.2 Royalties

Pursuant to its License and the Telecommunications Regulations (Royalties) 5761-2001, Bezeq International pays the State of Israel royalties at an annual rate of 3.5%, on most of its revenues stemming from the provision of international call services and point-to-point lines, minus permitted expenses and except for revenues from the customers determined in said regulations.

In 2004 Bezeq International conducted an investigation, as a result of which it emerged that the basis for the revenues according to which the royalties paid by Bezeq International had been calculated on the basis of an incorrect rate, and that in previous years its royalty payments had been too high. Bezeq International consequently updated its royalty payments. As at the date of publication of the periodic report, there is a dispute between Bezeq International and the Ministry of Communications regarding said update.

4.1.3 The principal entry and exit barriers

4.1.3.1 The principal entry barrier to the international calls market derives from the need to receive a license pursuant to the Telecommunications Law and implementation of infrastructure investments which are affected by frequent technological changes. However, a change in the licensing policy, as will be described below, and expansion of the use of VoIP technology in this sector are leading to significant reductions in the effect of these barriers.

4.1.3.2 The principal entry barrier to the Data and Internet Services market stems from the need for investments in infrastructure (international capacity and access to the internet network and a broad service setup).

4.1.3.3 The principal exit barriers from these markets stem from long-term binding agreements with suppliers and investments requiring long repayment periods.

In addition, Bezeq International is obligated to provide service to its customers throughout the period of its agreement with them.

4.1.4 Alternatives to Bezeq International products

The international calls market contains service suppliers which are not licensees (illegal operations), and consequently are not subject to the restrictions imposed on Bezeq International by virtue of the License and the provisions of the law. In addition, the use of VoIP technology enables the transfer of international calls on the internet network to other users of this technology and also to users of the TDM networks, by means of software products and overseas communications suppliers. The attractive usage tariffs for these services are bringing about a steady increase in the number of users and this results in harm to the revenues of Bezeq International.

4.1.5 Structure of competition in the sector and changes therein

In the first year of its operation, from June 1996 to July 1997, Bezeq International was the exclusive provider of international telephony services in Israel. In July 1997 two other international operators entered this arena: Barak I.T.C. (1995) - International Telecommunications Services Co. and 012 Golden Lines, and this led to a sharp fall in the prices of international calls and extensive growth in market volume. In April 2004 the Communications Regulations (Telecommunications and Broadcasts) (Procedures and Conditions for the Receipt of a General License for International Telecommunications Services), 5764-2004 entered into effect. As at the date of publication of this report, the Ministry of Communications has granted general licenses for the provision of international telecommunications services to three more operators: Internet Gold-Kavei Zahav Ltd. (Internet Zahav), Netvision Ltd. and Xfone Communication Ltd., all of which started operations by the end of 2004. The expansion of competition has led to an additional fall in the prices of international calls, although, unlike 1997 when competition began, the volume of international traffic did not undergo a significant increase, since prior to the expansion of competition, call prices did not constitute a factor preventing the public from using the service. The above-mentioned expansion of competition had a negative effect on the results of Bezeq International's operation and on its financial condition, but since market prices have not yet stabilized, Bezeq International is unable to estimate, at this stage, the extent of the overall effect on the expansion of competition in the sector.

As at the date of the periodic report, licenses for the provision of Internet Services have been granted to some 70 companies, among them five of the aforementioned international operator licensees.

4.2 Products and services

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

4.2.1 Voice Services

In the Voice Services sector Bezeq International provides: International Direct Dialing (IDD) services to business and private customers; toll-free number services for business customers; telephone card services enabling prepaid and postpaid dialing, mainly from overseas to Israel, for business and private customers; and the 1809 service enabling dialing from Israel to overseas by dialing 1809.

4.2.2 Internet Services

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

4.2.3 Data Services

Provision of international data communication solutions for business customers, including global deployment in accordance with the customer's requirements.

4.3 Revenues

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

	2004	2003	2002
Total revenues	816	703	679
Gross profit rate	38%	39%	44%

4.4 New Products

Following are descriptions of the principal new products launched in 2004:

4.4.1 Overseas roaming services enabling fast internet surfing (wireless or line), based on a cooperation agreement with IPASS and Infonet. This service is aimed primarily at business customers.

4.4.2 A value-added service in the information security sector such as anti-spam, junk-mail filtering, content filtering and personal firewall software, all for corporate and private customers.

4.4.3 Online file backup service for private and business customers.

4.4.4 Support for new access lines, including IP-VPN, business access, ETH transmission and asymmetric VC of the Company and also transmission lines for Cellcom, Hot and Med-1.

4.4.5 Renewed launch of WiFi-Hotspot service enabling high-speed wireless surfing at various private and public localities and areas such as cafes, restaurants and hospitals.

4.4.6 Infonet services allowing Bezeq International to expand global communication network deployment for its customers and provide access to a wider range of advanced, high-quality communication services.

4.4.7 Fixed-line VoIP domestic telephony services which were launched in a restricted format as part of an experimental marketing license granted to Bezeq International (see Section 2.6.1 above).

4.5 Marketing, Distribution and Service

4.5.1 Bezeq International operates the following sales channels: recruitment center for internet and incoming voice call services providing solutions for demand, and recruitment center for internet and outgoing voice calls based on various files.

4.5.2 Retention center for internet and incoming voice call services providing solutions for customers wishing to leave Bezeq International and retention center for internet and outgoing voice call services which handles existing customers proactively.

4.5.3 National direct sales setup conducting "door to door" operations, operating points of sale and managing customers.

4.5.4 Distribution channel setup including external centers and field arrays for resellers and dealers.

4.5.5 Yes@wow – cooperation with DBS as part of which subscribers are recruited for integrated packages comprising internet access, multi-channel television, Company internet access infrastructure (for further details see also Section 5.16 below).

4.5.6 B-one – joint venture with the Group companies Pelephone and BezeqCall aimed at increasing sales of the products and services of the parties to the venture since it is a principal point of interface with customers which use it to purchase products and services. The venture will make the agreement with customers and collect service

usage fees, while each of the venture's companies will provide the services and maintain direct contact with customers for this purpose.

4.5.7 The marketing department coordinates all the operations for a number of permanent suppliers, among them advertising companies representing Bezeq International – which are used by Bezeq International to remain in contact with the various advertising media (television, internet, radio and the daily national press) – production and post-production companies (this changes depending on the requirements of each campaign), design and printing companies, and sales promotion and PR companies. Bezeq International believes that the loss of contact with any of its permanent advertising or marketing suppliers will have no significant effect on its marketing and distribution channels.

4.6 Competition

For the past few years Bezeq International has been engaged in fierce competition with the other international operators and internet suppliers, mainly those operating by virtue of a license granted to them by the Ministry of Communications, as well as with illegal operators. This competition has led to a steady erosion in the real prices charged by Bezeq International, and consequently in the volume of its revenues and average per-subscriber profitability. In the internet market the competition has generated significant growth in market volume and the addition of new subscribers. Expansion of the competition with international operators as described in Section 4.1.5 above has had a negative effect on the results of its operations and financial position, but since market prices have not yet stabilized, Bezeq International is unable to estimate, at this stage, the extent of the overall effect on the expansion of competition in the sector and its timing.

4.6.1 Voice Services

4.6.1.1 In 2004 six competitors were operating in the market: 014 Bezeq International (estimated market share 35%), 013 Barak (estimated market share 31%), 012 Golden Lines (estimated market share 31%), 015 Internet Zahav (entered the calls market in August 2004 – estimated market share 3%), 017 Netvision and 018 Xfone (entered the calls market in December 2004 and estimated market share is therefore minimal).

4.6.1.2 General characteristics of the competition in 2004:

4.6.1.2.1 Some 50% of households make international calls at least once a month.

4.6.1.2.2 The various sectors are extremely important (emphasis on immigrants originating from the former USSR) and marketing operations are designed accordingly.

4.6.1.2.3 The product is a commodity.

4.6.1.2.4 Price market (perception).

4.6.1.2.5 Lack of involvement from consumers, leads to difficulty in recruitment and customer loyalty retention owing to inertia.

With the entry of the new competitors and penetration of VoIP technology, competition is increasing. This increase is expressed in continued price reductions, erosion of profitability and decline in market share.

4.6.2 Internet services – Bezeq International@net

4.6.2.1 This market has five significant competitors: 014 Bezeq International (estimated market share 35%), Netvision (estimated market share 23%), Internet Zahav (estimated market share 17%), 012 Golden Lines (estimated market share 14%), and 013 Barak (estimated market share 11%).

4.6.2.2 General characteristics of the competition in 2004:

4.6.2.1.1 60% of Israeli households are connected to the internet (85% of them have high-speed connections).

4.6.2.1.2 ADSL is the leading infrastructure (65% of high-speed internet connections)

4.6.2.1.3 In addition to image-promoting operations, the market is characterized by an aggressive campaign battle.

4.6.2.3 Developments in 2004:

4.6.2.1.4 Continuing rapid growth of high-speed internet.

4.6.2.1.5 Increase in high-speed introduction package (256 Kb and 500 Kb) and transition to broader packages (750 Kb, 1.5 Mb, 2 Mb).

4.6.2.1.6 Expansion of ISP service basket – especially for information security solutions and site filtering.

4.6.2.1.7 Entry of home networking.

4.6.2.1.8 Beginning of hotspot services.

4.6.3 Solutions for the business sector – Bezeq International business

4.6.3.1 Products and services for the business sector

Voice Services, Internet Services, Data Services, Hosting Services and information security services.

4.6.3.2 Bezeq International market segments in this sector (as estimated by internal surveys)

4.6.3.2.1 Calls – approximately 35%.

4.6.3.2.2 Internet (high-speed) – approximately 31%.

4.6.3.3 Characteristics of the business arena in 2004

4.6.3.3.1 Competitive parameters – service standards, range of solutions, technical capabilities, attractiveness of prices.

4.6.3.3.2 Aggressive battle for each customer and price erosion.

4.6.3.3.3 Emphasis on transition from product sales to sale of overall communication solution.

4.6.3.3.4 Cable company strengthening operations in business sector and launching solutions competing with those offered by the Company.

4.6.3.3.5 Increase of competition in the small and medium business (SMB) sector.

4.6.3.3.6 Small and medium businesses – transition from single-user solutions to network and security services solutions.

4.6.3.3.7 Large businesses – transition to IP solutions.

4.6.4 Coping with the competition

In order to cope with the competition in its area of business, Bezeq International has changed its cost structure, reduced the number of its employees, and at the same time made its customers a range of offers and reduced its service tariffs (*inter alia*, as part of its anchor country policy, as set forth in Section 4.21.1(E) below).

4.7 Seasonality

In general, the revenues and profitability of Bezeq International are affected in a minor way by the seasons of the year and holidays. There is seasonality in the following services:

4.7.1 Voice Services for the business sector – decrease in August and the Passover/Pentecost holidays.

4.7.2 Voice Services for the private sector – increase in the summer months.

4.7.3 Internet services for the business sector – decrease in the summer months owing to the closure of educational institutions (customers in this sector are not billed for the Internet Services to which they subscribe in the summer vacation months).

4.8 Fixed Assets and Installations

4.8.1 The international communication infrastructure constitutes an extremely material component in the total fixed assets of Bezeq International. International communication traffic is being transferred from and to Israel via satellite, underwater cable and international exchanges. Most of the communication volume is routed via the Med Nautilus and Lev cables whose capacity is significantly in excess of that of the previous cables (Cios and Emos-I). Bezeq International has agreements with these cable operators. The most significant agreement is that with Mediterranean Nautilus Limited from March 26, 2001, regarding the purchase of capacity on the Med Nautilus cable. This cable connects Israel to Europe and then to the world (via continuation cables). The aim of the transaction was to supply the demand created for Bezeq International, mainly as a result of the growth in broadband internet, the need for significant international capacity, and consequently the dependence on this cable of Bezeq International which needs to provide its customers with Internet Services. The agreement with Med Nautilus enables Bezeq International to increase the capacity which will be at its disposal in accordance with its requirements from time to time, and Bezeq International therefore believes that in the near future there will be no lack of capacity to provide its customers with the full range of its services. In addition Bezeq International has agreements regarding the capacity of continuation cables which are used to transfer traffic to its final destination.

4.8.2 As at the date of publication of this report, Bezeq International has two international S-12 switches manufactured by Alcatel. At the end of 2004 Bezeq International signed an agreement with Veraz Networks to purchase SoftSwitches, which if they comply with technological requirements, are slated to replace the S-12 switches manufactured by Alcatel in 2005. These switches are used to route Bezeq International's voice traffic. The value-added services, including dialing cards, are based on an Intelligent Network (IN), which Bezeq International also intends to replace in 2005 as part of its upgrade of the voice setup.

Bezeq International's technological infrastructures which support the voice, data and internet setups are deployed in four sites in order to provide services with high survival.

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

4.9 Intangible Assets

4.9.1 License for the provision of Bezeq International services

Bezeq International operates within the framework of a general license for the provision of international telecommunications services, pursuant to the Communication Law, which anchors the right of Bezeq International to provide Internet Services. The license constitutes the basis for Bezeq International's operations.

4.9.2 Infonet

In December 2003 an agreement was signed by Bezeq International and Kardan Ltd. and Infonet Israel Ltd. (hereinafter: "Infonet"), whereby Bezeq International purchased the full rights to operate Infonet, including the assignment to Bezeq International of Infonet's agreements with its customers. On March 25, 2004, after the establishment of the suspending conditions, the transaction was completed. Since April 2004, the results of Infonet's operations have been included in the results of Bezeq International and the process of converting customer agreements to agreements with Bezeq International has begun. As at the date of this report, the conversion of most of the agreements to agreements with Bezeq International has been concluded. In fact, all customers receive service from Bezeq International (see Section 4.18.2 below).

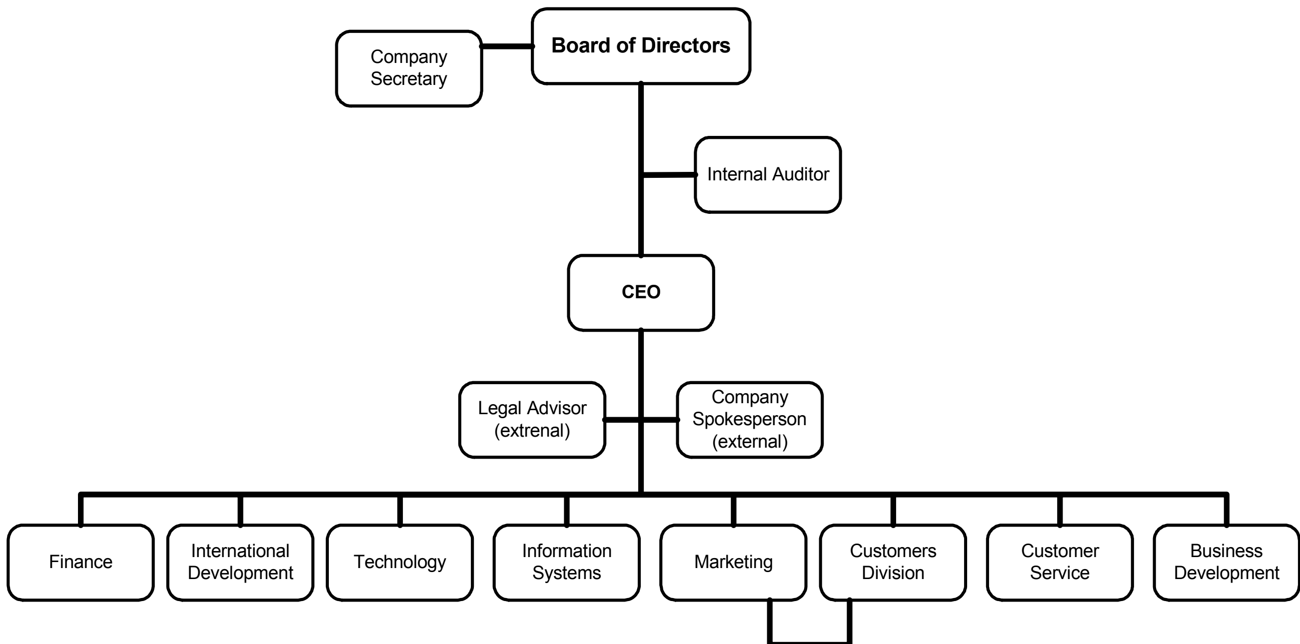
4.10 Human Resources

4.10.1 The number of people employed by Bezeq International (including external workers – personnel agency and outsourcing workers) stands at 1,162, broken down as follows: 19 workers in the Management Division (including business development and international development), 20 in the Management Resources Division, 30 in the

Finance Division, 378 in the Customer Division, 547 in the Customer Service Division, 103 in the Information Systems Division and 65 in the Technology Division.

4.10.2 Organizational structure

Below is a chart depicting the organization structure of Bezeq International:



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

4.10.4 A new benefit awarded this year to employees is a leasing arrangement enabling employees to receive vehicles at a cost determined in accordance with the terms of an agreement between Bezeq International and a leasing company.

4.10.5 Bezeq International invests professional training resources in accordance with employee type and job type, such as managerial reserve granted to department managers and professional employees, negotiation management and mediation, systems analysis, management skills, etc.

4.10.6 All of Bezeq International's employees have standard personal contracts based on their professions and positions.

4.11 Suppliers

4.11.1 Bezeq International has agreements with Alcatel Telecom Israel Ltd. (hereinafter: “Alcatel”), for the maintenance and technical support of two S-12 international gateway exchanges (which route incoming and outgoing international calls) and an intelligent network system (which operates dialing cards, 1-809 service numbers and a fraud control system). The maintenance agreements expired in 2004. Bezeq International and Alcatel signed an agreement to continue the provision of services for the coming months: this will remain in effect until 2005 when Bezeq International starts using the new SoftSwitches manufactured by Veraz. However, in view of the high cost, Bezeq International has decided not to renew the maintenance agreement for the IN system. Bezeq International is dependent on this service from Alcatel, and if service is interrupted for any reason, it could have a material negative effect on its operations and revenues. In addition, in February 2005 Bezeq International signed an agreement with SigValue for the purchase of an intelligent network system, the cost of which is not material. Bezeq International will be dependent on this provider.

4.11.2 Bezeq International has an agreement with Tadiran Information Systems Ltd. (which was acquired by IBM) which is implemented by IBM Global Services (Israel) Ltd. (hereinafter: “IBM”) for the maintenance and development of service absorption and pricing and billing systems. Bezeq International is dependent on this service from IBM.

4.11.3 In 2004 Bezeq International set up a contact center (a system which integrates switchboard, a collaborative system comprising computer, switchboard and interactive voice response). This setup is used by Bezeq International's service, support and sales centers, and is based on the Avaya company technology. For this purpose Bezeq International signed a three-year agreement with IBM to provide ongoing support and maintenance.

4.11.4 Bezeq International has financial relations with some 100 foreign operators, in approximately 240 destinations worldwide. The largest foreign operators, in terms of their traffic volume and cost, are AT&T, Sprint, MCI, British Telecom, France Telecom, etc.

4.11.5 Bezeq International is dependent on the international communication infrastructure provider Mediterranean Nautilus Limited, as described in Section 4.8.1 above.

4.12 Working Capital

4.12.1 Bezeq International's cash item includes bank deposits for immediate withdrawal as well as fixed-term deposits on which there are no usage restrictions and whose repayment date, on their investment date, does not exceed three months.

4.12.2 Bezeq International has negative working capital deriving from a surplus of foreign-currency current liabilities over current assets. This surplus derives from Bezeq International's agreement with foreign international communication operators to transfer voice minutes and purchase Data Services (see Section 4.21(A)). Since Bezeq International uses more services from these operators than it provides for them, the accounting with these operators usually leads to surplus liabilities. More often than not, the final accounting with each international operator can last a long time (sometimes even a few years), and so Bezeq International's actions to settle old accounts with them usually improve the deficit in working capital. So, for example, between December 2003 and December 2004, the deficit in Bezeq International's working capital, which originates in a balance with these operators, decreased by some NIS 25.7 million.

Bezeq International's expenses for foreign international communication operators are based on estimates of business volumes. The balance of the overseas operators includes adjusted estimates and assessments of costs in connection with those overseas operators. The source of these adjustments and estimates is the final accounting for the period in question.

4.13 Credit Policy

4.13.1 Credit for customers

4.13.1.1 Most of Bezeq International's customers have credit terms of net + 45.

4.13.1.2 Equipment sold to customers is usually billed in 24 installments.

4.13.2 Credit from suppliers

Bezeq International receives credit from its suppliers for a period ranging from 30 to 120 days (usually 90 days).

4.14 Investments

As at December 31, 2004, Bezeq International holds 44.97% of the share capital of Walla! Communications Ltd. (hereinafter: “Walla”), an Israeli company whose shares are listed on the Tel Aviv Stock Exchange, which provides Internet Services and is an internet portal provider. By the date of publication of this report Walla had allotted shares and options as part of a private allotment, and as a result and owing to further exercise of warrant options, the holding in Walla decreased to 44.52%. The balance of Bezeq International's investment as at December 31, 2004 amounted to NIS 14.4 million, while its market value remained at some NIS 44.4 million.

Walla became profitable in the third quarter of 2003 and ended 2004 with a net profit of some NIS 3.6 million.

For additional details regarding Bezeq International's investment in Walla, see Note 8F to the Financial Statements for the year ended December 31, 2004, which are included in this periodic report.

Moreover, since November 2003, Walla's reports to the Israeli public can be found on the Magna site of the Securities Authority.

4.15 Finance

4.15.1 As at the date of publication of this report, the Company has no liabilities to banking institutions and it does not use its approved line of credit.

4.15.2 Bezeq International recorded a negative pledge in favor of banking corporations, according to which it is unable to encumber its assets without their approval.

4.15.3 The source of Bezeq International's finance in the past two years is a positive cash flow from current operations.

4.15.4 Loans from the Company – during 2001 Bezeq International received from the Company loans totaling $ 38 million whose balance as at December 31 2004 and 2003 amounted to some NIS 169 million and NIS 167 million, respectively. The loans are not repayable for ten years from the date of their receipt and subsequently they are repayable upon notice from the Company, provided that on said repayment date all Bezeq International's bank loans have been repaid. The loans are CPI linked and od not bear interest.

4.15.5 Bank guarantees – in February 2002, pursuant to a demand from the Ministry of Communications, Bezeq International set up a bank guarantee in the amount of 2 million dollars, in fulfillment of all the license conditions for the provision of international telecommunications services.

4.16 Taxation

See Note 11 to the Financial Statements for the year ended December 31, 2004, which are included in this periodic report.

4.17 Restrictions on and Supervision of Bezeq International's Operations

4.17.1 Legislative restrictions

4.17.1.1 The Telecommunications Law (Telecommunications and Broadcasts), 5742-1982 and the general license for the provision of international telecommunications services.

Pursuant to the Telecommunications Law, the implementation of telecommunications operations and provision of telecommunications services, including international telecommunications services and internet access services, require a license from the Minister of Communications. The minister is authorized to change the terms of the license, add to them or remove from them, while taking into consideration, *inter alia*, the government's telecommunications policy, the interests of the public, the matching of the licensee to the provision of services, the contribution of the license to competition in the telecommunications industry and the level of service therein.

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

A recently introduced amendment to the provisions of the Telecommunications Law permits the Minister of Communications to determine telecommunications services, the provision of which does not

require a license. Pursuant to his declarations, the Ministry of Communications intends to exempt the provision of internet access services.

In view of said provisions of the Telecommunications Law, all Bezeq International's telecommunications services are provided by virtue of the provisions of the license granted to it and pursuant to its terms, as set forth in Section 4.1.2 above.

4.17.1.2 Interconnect payments

The Telecommunications Regulations (Payments for Interconnect), 5760-2000 (hereinafter: the "Regulations") regulate the payments made to the domestic operator or the cellular operator.

In September 2000 the Ministry of Communications enacted a regulation regarding the tariffs for calls to cellular telephones. Pursuant to the new regulation incoming call tariffs decreased gradually from October 2000 to January 2003.

With regard to payments to be made by Bezeq International, as an international licensee, for the completion of traffic on a cellular network, the present tariff of NIS 0.25 for completion of a call will be reduced from March 1, 2008 to a maximum tariff of NIS 0.22.

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

4.17.1.3 Royalties

For payment of royalties, see Section 4.1.2.2 above.

4.17.1.4 Standardization

Bezeq International is ISO 9001:2000 certified for quality management systems and ISO 7799 certified for information security management systems by the Israel Standards Institute.

4.18 Cooperation Agreements

4.18.1 In April 1997 Bezeq International signed an agreement with the communications corporation Concert for the sale of data transfer services via Concert. The corporation was set up by British Telecom (BT) and the American company AT&T and also provides uniform communications services to multinational companies. In 2002 the corporation split up and the network is presently managed by BT. Bezeq International has a BT service distribution agreement in Israel whereby Bezeq International provides network services managed by FR technology.

4.18.2 In June 2003 Bezeq International signed an agreement with Infonet Corporation (hereinafter: "Infonet") for the distribution of Infonet's data communications services. Infonet is a network connecting many sites worldwide and enables the efficient transfer of data between these sites. In December 2003 an agreement was signed by Bezeq International and Kardan Communications Ltd. for the acquisition of the operation of Infonet Israel Ltd., the Israeli representative of Infonet which provides international data communication and IP services on the Infonet network in Israel. The customer files were transferred to Bezeq International which received the equipment and rights to provide Infonet services in Israel, and it will provide technical support to all Infonet's global customers requiring services in Israel. This acquisition process enables Bezeq International to serve as a franchisee and strategic partner of Infonet in Israel and provide its customers with an expanded deployment of global communication networks and access to a wider range of advanced, high-quality communication services. On January 28, 2004, the Anti-Trust Commissioner gave his approval to the acquisition of the operation as a merger transaction. On March 24, 2004, an agreement was also signed with Infonet. The agreement from December 2003 was conditional upon the signature of this agreement. This agreement replaced the agreement with Infonet as of June 2003.

4.19 Legal Proceedings

4.19.1 On November 24, 1998, an equipment provider filed a claim in the Tel Aviv District Court against the Company and Bezeq International. The plaintiff argued that the Company and Bezeq International, jointly and severally, owe it some NIS 12 million owing to a violation of the agreement signed by the plaintiff and the Company in December 1995, the subject of which was the upgrading of an exchange.

Bezeq International, in its statement of defense, rejected the arguments of the plaintiff and even filed an application to dismiss the claim *in limine*. With consent from the parties the case was sent to a mediation proceeding. The mediation did not succeed and the hearing was returned to the District Court. A preliminary discovery of documents took place. The plaintiff filed its primary evidence affidavit on October 19, 2003, and Bezeq International's primary evidence affidavit was filed on March 30, 2004. On April 13, 2004 a reminder meeting was held regarding the case in which an evidentiary hearing was set for October 21, 2004. The evidentiary hearing was postponed until March 7, 2005 and was later cancelled and in its place a pretrial hearing was set for March 2, 2005.

The legal counsel of Bezeq International believe that in respect of some of the plaintiff's arguments Bezeq International has good counter-arguments, but they are unable to estimate, at this stage, the chances of the claim and Bezeq International has consequently decided not to include a provision for this claim in the financial statements.

4.19.2 On April 4, 2004 a competing international communications operator filed a claim in the Jerusalem District Court against the State of Israel in the amount of NIS 11.2 million, for damages allegedly caused to it by a violation by the State of Israel of an obligation to place at its disposal part of the total capacity of an underwater cable (which was granted as part of the tender which opened the international communications market to competition in 1995).

On September 22, 2004 the State of Israel filed a statement of defense and third-party notice against Bezeq International and the Company. In the third-party notice the State argues that if the claim is accepted, in whole or in part, Bezeq International and the Company will have to bear all the consequences of any relief handed down against the State in the claim. The State further argues that Bezeq International acted in bad faith as a licensee toward the regulator in that it used capacity which had been earmarked for the other licensees. The State also makes similar arguments to the Company and also argues that Bezeq International, as a subsidiary of the Company, bears full liability alongside the Company for the Company's operations.

On December 20, 2004 Bezeq International and the Company filed a statement of defense to the third-party notice filed by the State in which they argued that the third-party notice should be dismissed, *inter alia*, because the claim and the third-party notice exceeded the period of limitation, that Bezeq International and the Company had acted in good faith, pursuant to the provisions of the agreements, which did not cause a violation of the agreements by the State, that they had protested that they would be unable to comply with the obligations contained therein and that they had not violated the provisions of the license. On December 30, 2004 the State filed a statement of response to said statement of defense.

On January 27, 2005 the court handed down a mutual order for discovery of documents and the submission of questionnaires within 30 days, and also ordered the parties to file all their applications to be heard before the start of the evidentiary proceeding, up to 30 days before the pretrial date, which was set for April 10, 2005.

The legal counsel of Bezeq International believe that Bezeq International has good defense arguments against the claim and the third-party notice, among them arguments of exceeding the period of limitation and that there is a good chance that the third-party notice will be dismissed. However, especially in light of the preliminary stage which contains the third-party notice, the legal counsel of Bezeq International are unable to estimate, at this stage, the chances of the claim and Bezeq International has consequently decided not to include a provision for this claim in the Financial Statements.

4.19.3 On January 2, 2005 a claim was filed against Bezeq International, against two other international operators and against another company, in the amount of NIS 10 million, based on the argument that a patent for a prepaid telephone system had been infringed by persons alleging that they are the inventors and owners of said patent. According to the plaintiffs each of the defendants is infringing the patent which they own and unlawfully enriching themselves at their expense. In the statement of claim the plaintiffs demand that detailed reports of said revenues stemming from the infringement of the patent be submitted to them and that said full revenues, plus reasonable royalties and punitive compensation, be paid to them pursuant to the provisions of the Patents Law.

As at the date of preparation of this report, a statement of defense had not yet been filed on behalf of Bezeq International. The legal counsel of Bezeq International are unable to estimate, at this stage, the chances of the claim and no provision for this claim has been included in the Financial Statements.

4.19.4 For further claims, see Notes 19A(8), 19A(11), 19A(24) to 19A(26) and Note 19A(39) of the financial statements for the year ended December 31, 2004, included in this annual report.

4.20 Goals, Business Strategy and Expected Development

4.20.1 As part of the preparations for 2004, Bezeq International set itself a number of key goals outlining the nature of its operations and reflecting the strategy which it adopted during the year:

4.20.1.1 Increase of profitability compared with the previous year.

4.20.1.2 Transition to profitability and retention of leadership in high-speed internet market in general and ADSL in particular.

4.20.1.3 Readiness to expand international calls market for competition.

4.20.1.4 Addition of income sources.

4.20.1.5 Reduction of expenses for 2005 when competition will expand and have a greater effect.

4.20.1.6 Stabilization of organizational structure and improvement of work processes.

4.20.2 Bezeq International's goals for 2005

4.20.2.1 Improvement and streamlining of its customer service setup.

4.20.2.2 Retention of average fixed income per-customer.

4.20.2.3 Development of alternative income sources for voice, internet and data.

4.20.2.4 Adaptation of expense structure to the new income structure.

4.20.2.5 Steady streamlining, *inter alia*, by defining indices and compliance with goals.

4.20.2.6 Focus on and retention of customer base.

4.20.2.7 Retention of leadership status via market share or leading margin.

4.20.2.8 Achievement of profitability in data sector, thereby justifying volume of operations.

4.20.2.9 Focused and differentiated operations based on value-added services.

4.20.2.10 Assimilation of SoftSwitch and IN without harming service standards.

4.20.2.11 Utilization of benefits deriving from IT investments.

4.20.3 In 2004 Bezeq International positioned itself as Israel's leading service provider in its three core areas – Voice Services, internet access services in general, and high-speed internet in particular, including a range of value-added services as well as datacom operations for international customers.

4.20.4 An additional area is Voice over IP in accordance with the marketing trial license Bezeq International received in December 2004. The trial is expected to continue in 2005 and include some 8,500 private and business customers. As part of the marketing trial,

Bezeq International will examine various scenarios for operation in the domestic calls arena. For the Company's position regarding this matter, see Section 2.6.1 above.

4.20.5 An additional operation is in the Application Service Provider (ASP) area, in which Bezeq International will examine various possibilities for providing private and business applications over the internet.

4.20.6 In 2004 Bezeq International retained its market position in all the areas of its operations. This year Bezeq International has expanded its data operations by acquiring the Infonet Israel operation (see Section 4.9.2), an acquisition which has turned Bezeq International into Israel's leading entity in this area.

4.20.7 In 2004 Bezeq International penetrated the hotspot field in which it succeeded in achieving market leadership in a number of sites (approximately 70) including strategic targets (leading café chains, gas stations, the Congress Center in Gan Oranim, etc.). In 2005 Bezeq International is planning to expand the deployment of its public infrastructures (WiFi hotspots) into additional sectors and offer value-added services on this infrastructure to end-customers.

4.20.8 In view of the intensifying market competition, observers believe that the market is likely to undergo consolidation processes, which will create merger and acquisition opportunities for the leading market players. Bezeq International will examine such opportunities as they are created based on their financial feasibility and on regulatory decisions, insofar as it will be permitted to do so.

4.20.9 In 2004 Bezeq International signed two strategic cooperation agreements with the global company iPass in order to increase its revenues from the surfing services created by incoming and outgoing business tourism, by providing surfing services to Bezeq International subscribers staying overseas as well as surfing services in Israel for overseas internet subscribers staying in Israel.

A public company traded on the Nasdaq, iPass is a remote access aggregator (with various access methods: analog, fixed and wireless broadband). iPass has more than 10,000 WiFi hotspots worldwide in more than 150 countries.

The first agreement (signed in the first quarter of 2004) was designed to provide Bezeq International subscribers traveling overseas with surfing services using all types of access (dial-up, broadband and WiFi). The second agreement (signed in the fourth quarter of 2004) was designed to allow iPass subscribers arriving in Israel to surf in all the public areas in which Bezeq International provides surfing services, particularly in the hotspots which Bezeq International has deployed throughout the country. In 2005 it will examine the possibility of signing agreements with other roaming services suppliers worldwide.

4.20.10 In 2005 Bezeq International is expected to replace its existing switches with the SoftSwitches manufactured by Veraz, and its current intelligent network system with a system manufactured by SigValue, as described in Section 4.11.1 above.

4.20.11 The above information looks to the future and as such is not certain and might not become reality, in whole or in part. The forward-looking information is based on information existing in Bezeq International as at the date of publication of this report, and contains estimates made by Bezeq International, its work assumptions or intentions, as at the date of publication of this report. The actual results are likely to be materially different from the results estimated or inferred from this information.

Management’s forecast is based on forecasts related to continuation of the recovery in the Israeli market, continuation of broadband technology penetration and continuation of growth in the number of internet users.

The above forecast might not become reality at all or might become reality in part only, owing to a downturn in the Israeli economy which will reduce purchasing power in Israel, owing to regulatory changes liable to harm the ability of Bezeq International to provide solutions to existing or changing market requirements, and owing to all the other risk factors listed below.

4.21 Risk factors

Changes in exchange rates, CPI and interest rates

A. Changes in exchange rates – the main currency used by Bezeq International is the shekel which is also its reporting currency. There is a special risk in the nature of Bezeq International's international transactions: most of its operations (sales) derive from Israeli customers. In addition, Bezeq International provides services to customers worldwide and collects the payments to which it is entitled in foreign currency, mainly in US dollars. In contrast, Bezeq International uses services from suppliers throughout the world and pays them for these services in foreign currency, mainly in US dollars. The changes in the exchange rates of the currencies in which Bezeq International operates against the shekel expose it to exchange rate differentials which are liable to harm its profitability by increasing finance expenses as well as its cash flow. To protect itself against currency exposure Bezeq International enters into hedging transactions and purchases other financial instruments. The Board of Directors of Bezeq International have nominated its internal financial committee to oversee its policy in respect of management of the market risks to which it is exposed. The internal financial committee of Bezeq International meets from time to time, at least once a quarter, in order to discuss market risks and ways of minimizing their effect on its financial position, its operating results and its cash flow. The finance committee reports to the Board of Directors every quarter and as necessary upon request.

   Changes in the CPI – Bezeq International is exposed to changes in the CPI, mainly in connection with CPI-linked loans it has received from the Company (see Section 4.15.4 above). In addition, the linkage of these loans to the CPI has no effect on the profitability of Bezeq International but on its shareholders' equity only, since the entire effect of the change is charged to a capital reserve account in accordance with accounting treatment of transactions between a corporation and a controlling party thereof in the financial statements.

   Changes in interest rates – Bezeq International has immaterial exposure to changes in interest rates in connection with disputes with the Ministry of Communications as stated in Section 4.1.2.2 above.

B. Competition – for the effect of the competition on the businesses of Bezeq International, see Section 4.6 above.

C. Investments in infrastructures, technological changes and dependence on suppliers – see Section 4.11 above.

D. Government oversight and regulation – for the application of the provisions of the Law and licensing policy and their effect on Bezeq International, see Sections 4.1.2 and 4.1.3.1 above.

E. Anchor countries

   Bezeq International has committed in an official price list, to the lowest prices for 4 countries (USA, Russia, France, Argentina) until the end of 2005. As a result, the revenues of Bezeq International will undergo an immediate negative effect if the price lists of its competitors are adjusted to below the existing price list of Bezeq International.

F. Verio

   On September 30, 2004, Bezeq International was notified by the American company Verio of termination of the agreement between the companies and a cessation in the supply of hosting server management services which it had provided, owing to the failure of Bezeq International to pay for the services and the consequent violation of their agreement. On October 7, 2004, Verio halted the service which it had supplied to Bezeq International and erased the content of the hosting servers which it had operated (belonging to Bezeq International and installed on its server farm).

   As a result of the above action taken by Verio, the site hosting service supplied by Bezeq International to its customers was halted. Bezeq International made immediate preparations to look after its customers and restore normal service.

   Bezeq International granted comprehensive compensation by giving three months' service free of charge to the site hosting service customers which had been subscribers to Verio services when the service was halted. The total extent of the compensation is not material.

To date, a few customers have requested additional compensation and two claims have been filed against Bezeq International. The cumulative rate of these demands is also not material.

At this stage it is not possible to estimate the extent of the additional exposure which Bezeq International might and will have in this regard.

G. Transition to SoftSwitch and upgrade of the IN system

In 2005 Bezeq International will replace the switch and upgrade its intelligent network system. Such an undertaking entails the risk of delaying timetables and faults which could harm service.

H. IN maintenance agreement

Failure to renew the IN system maintenance agreement with Alcatel from the conclusion of the previous agreement at the end of 2004 until the system replacement date, as set forth above in Section 4.21.1G, is liable to lead to a situation where a fault in the present system will not be repaired by Alcatel and Bezeq International will be required to present an alternative solution. Ongoing maintenance and backups are performed by Bezeq International employees so that the only risk is in the event of a system fault.

I. Legal proceedings

Bezeq International is a party to legal proceedings, among them class actions which are liable to cost material amounts and cannot at this stage be estimated, and for most of which no provision has been made in the financial statements of Bezeq International and the Company. For legal proceedings to which Bezeq International is a party, see Section 4.19 above.

Risk Factor Summary Table

	Extent of effect of risk factor on Bezeq International's operations		
	Large effect	**Medium effect**	**Small effect**
Macro risks			
Exposure to changes in exchange rates	X		
Exposure to changes in interest rates			X
Exposure to changes in inflation		X	
Sectoral risks			
Increasing competition	X		
Investments in infrastructures and technological changes	X		
Government oversight and regulation	X		
Special risks for Bezeq International			
Exposure to legal processes	X		
Anchor countries		X	
Verio			X
Transition to SoftSwitch switches and IN	X		
Failure to renew the IN maintenance agreement		X	
Dependence on suppliers	X		

5. Multi-channel Television – DBS Satellite Services (1999) Ltd. (hereinafter: "DBS")

5.1 General Information Regarding the Area of Operations

DBS, which trades under the name of "Yes", provides its subscribers with multi-channel satellite television services. Founded on December 2, 1998, DBS has been providing the service since July 2000.

This service allows for the provision of multi-channel encoded digital television broadcasts and value-added services to subscribers who receive the broadcast at home via small antenna dishes without the need for a ground communication infrastructure, except for the connection of the dish to a domestic decoder in the subscriber's home and connection of the decoder to the television.

Most of the revenues of DBS stem from subscriber fees and other subscriber payments. As at December 31, 2004 DBS had 470,494 subscribers.

DBS is the only company currently operating in the satellite multi-channel television broadcasting sector, even though neither the law nor the license awarded to it grant it exclusivity.

5.1.1 Structure and changes in area of operations

The multi-channel television broadcasting sector in Israel, consists of DBS and three principal cable television broadcasting corporations (hereinafter: the "Cable Companies"), is characterized by the broadcasts of Israeli and foreign television content to subscribers in the form of various broadcasting packages in return for subscriber fees and additional accompanying payments.

The field of multi-channel broadcasts is characterized by extensive competition between DBS and the Cable Companies. They operate by means of broadcasting licenses awarded to DBS and the Cable Companies by the Minister of Communications.

Since July 2002 the Cable Companies have been engaged in a process of merging into one company (which has not yet been concluded). In December 2003 the Cable Companies embarked on the launch of a joint brand ("HOT") and the change to a uniform screen appearance for marketing purposes allowed subscribers and potential subscribers to identify them. Furthermore, as far as DBS knows, content purchases, marketing and branding are implemented jointly by the Cable Companies.

5.1.2 Legislative restrictions and special constraints

The Telecommunications Law requires that a broadcasting license be obtained in order to transmit satellite television broadcasts to the public. In January 1999 DBS received the above-mentioned broadcasting license by virtue of the provisions of the law and pursuant to the Telecommunications Regulations (Processes and conditions for the granting of a satellite broadcasting license) 5758-1998 (hereinafter: the "Broadcasting License").

The broadcasting license granted to DBS is valid until 2014. Thereafter it may be renewed for additional six-year periods.

DBS' broadcasting operations are also overseen by the Cable and Satellite Broadcast Council (hereinafter: the "Council"). The Council sets policy and general standards in respect of broadcast content, duty to provide original broadcasts, division into genres, broadcasting ethics and other broadcasting policy topics, and also approves the channels which DBS wishes to broadcast or stop broadcasting.

The Council also has consumer protection powers, so that the determination and updating of price lists and customer promotions require its approval or advance notification. The Council does not interfere in DBS' tariffs but ensures that there is no bias or discrimination between subscribers or breach of the provisions of the law. Reductions, discounts, and promotions do not require Council approval, but a report should be submitted to the Council chairperson, who may intervene if it emerges that they deceive the public or discriminate between subscribers.

In addition, DBS is subject to oversight from the Ministry of Communications, in respect of the matters defined in its license (mainly technical and consumer matters). The provision of services and implementation of ancillary and supplementary broadcasting operations sometimes require licensing from the Ministry of Communications.

5.1.3 Critical success factors in the area of operations and changes therein

DBS regards the following factors as critical to the success of its operations:

5.1.3.1 Differentiation, innovation and originality in its broadcasting content compared with the broadcasting content of its competitors, the Cable Companies. These factors are reflected in the purchase of content, which includes current movies, documentary programs and many series containing unique and innovative characteristics, as well as in the initiation, production and purchase of original Israeli programming. For this purpose, there is a need for continued investment in the purchase and renewal of the broadcasting content and value-added services (such as pay-per-view services and interactive services) provided to DBS customers.

5.1.3.2 Differentiation at the customer service level provided to DBS subscribers by the customer support and customer service setup, which constitutes a critical success factor in DBS' ability to retain customers in a competitive market.

5.1.4 The principal entry and exit barriers

5.1.4.1 The principal entry barrier derives from the burdensome regulation prevailing in the broadcasting sector, including the duty to operate in accordance with the relevant provisions of the law, pursuant to the provisions of the license and according to its conditions, as well as the ongoing oversight of the Council and of the Ministry of Communications.

5.1.4.2 An additional key entry barrier which derives in part from the above-mentioned barrier, is the enormous investment required from a competitor in the market in order to establish a public multi-channel broadcasting setup (including a broadcasting center and national infrastructure to receive satellite broadcasts and purchase satellite space segments or a nationally deployed cable infrastructure) and in order to broadcast and distribute content to the public in accordance with market requirements (see Section 5.1.3.1 above), and pursuant to regulatory requirements and restrictions.

5.1.4.3 The principal exit barriers from the sector derive from long-term agreements with satellite segment leasing companies (see Section 5.15.2 below), the large investments requiring long repayment periods and an obligation to repay the bank loans taken out by DBS (see Section 5.12.2 below). In addition, DBS is bound to provide service to its customers throughout the period of its agreement with them.

5.1.5 Alternatives to and changes in sectoral products

With regard to the broadcasting and service basket offered by DBS to its customers, the range of terrestrial channels and other channels broadcasted at no cost to the Israeli public can be categorized as alternative products. Among these channels are Channel 1 (belonging to the Israel Broadcasting Authority), Channel 2, the commercial Channel 3 ("Channel 10"), the Knesset channel, Channel 23 belonging to Educational Television, the Music Channel ("Channel 24"), the Russian-language channel ("Israel Plus"), and the Shopping Channel. In addition, video and DVD libraries constitute providers of alternative products to some of DBS's services.

5.1.6 Structure of competition in the areas of operation and changes therein

The broadcasting sector is characterized by competition between the Cable Companies and DBS. The concentrated and complex ownership structure in the areas of content, communication and infrastructure in Israel is likely to lead to control by groups throughout the content production, packaging and supply chain. With their broad deployment of advanced infrastructures and being owned by other communication entity partners, the Cable Companies will soon offer a service basket containing line telephony, high-speed internet and multi-channel television, which constitutes a key component in creating differentiated offers to potential subscribers.

5.2 Products and Services

DBS provides its subscribers with a wide range of channels: approximately 100 different video channels, 17 radio channels, 30 music channels, and service and interactive game channels which can be ordered on a daily and monthly pay-per-view basis.

The broadcasts include a basic package which each subscriber is required to purchase as well as additional channels chosen by the subscriber, whether as a package or whether as a single channel, based on plans defined from time to time by DBS, with the approval of the Council and pursuant to the terms of the broadcasting license.

The main channel packages marketed by DBS in addition to the basic package are the movie package, the entertainment package, the children's package, the music package and the sport package. These channel packages appeal to different target populations depending on their viewing habits and preferences.

As part of its operations, DBS also allows its subscribers to purchase movies and programs on a pay-per-view basis, from a list of movies and programs which is updated from time to time.

DBS is endeavoring to increase the broadcasting frequency of its pay-per-view movies as well as demand for them. This is leading to a significant increase in revenues from this service.

5.3 Revenues and Profitability of Products and Services

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

	2004	2003	2002
Revenues	1,028	842	660
Gross profit	15	(170)	(409)

5.4 New Products

During January 2005 DBS began selling, through external resellers, a new decoder known as a Personal Video Recorder (PVR) under the brand name yesMax. This device, which offers enhanced audio and sound quality, replaces the ordinary decoder and adds advanced features while retaining simplicity of operation, among them the ability to record content selected by the subscriber, enable viewing of a program while at the same time recording another program, order recordings directly from the electronic broadcasting schedule, and pause a program during its broadcast and continue viewing from the point where it was paused.

Development updates of the software operating the device are expected from time to time, but material investments in development of the device are not expected in the near future.

5.5 Marketing and Distribution

DBS services are marketed by means of advertisements in various media outlets as well as by means of four principal distribution channels:

5.5.1 Sales people in the field working to recruit subscribers.

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

5.5.3 Sales stations in shopping malls and commercial centers throughout the country.

5.5.4 External resellers of the company's services working on the basis of agreements with the company.

The distribution channels, except for the external resellers, are operated by DBS employees.

5.6 Competition

5.6.1 Competitors in the broadcasting market

DBS's main direct competition comes, as stated above, from the three principal cable companies: Arutzei Zahav and Co., Matav Cable Communication Systems Ltd., and Tevel Israel International Communications Ltd.

DBS estimates its share of the multi-channel television market as at December 31, 2004, to the best of its knowledge, at around 33% of total subscribers.

5.6.2 Broadcasting characteristics of the competitors

The Cable Companies have been operating in the broadcasting market since the beginning of the 90's, formerly by virtue of regional franchises under the exclusivity conditions granted to them, which were replaced in 2002 by long-term broadcasting licenses. Currently, the cable companies are collaborating, as mentioned in section 5.1.1 above.

DBS transmits its broadcasts using only a digital method, by means of tiering at various price levels, while the Cable Companies transmit their broadcasts to most of their subscribers using a digital broadcasting method and the above-mentioned tiering, while for the remainder (who number around 35% of the Cable Companies' subscribers as at December 31, 2004) they use an analog broadcasting method, which does not allow for broadcasting packages but one identical channel package (for additional implications of this difference, see Section 5.6.4(B) below).

5.6.3 Characteristics of the current competition

In 2001 and 2002 the number of DBS's subscribers increased rapidly and within a relatively short space of time attained extremely high penetration rates compared with accepted global rates. The successful penetration derived from, *inter alia*, the temporary regulatory concessions granted to DBS at the time (and from which it no longer benefits) and from the technological preference for digital broadcasting which characterized DBS's broadcasting, as opposed to cable broadcasting which was analog only until the middle of 2001. In 2003 and the first half of 2004 there was a significant downturn in DBS's rate of acquiring new subscribers, but in the second half of 2004 this rate began a new upward path.

At present, the competition in the broadcasting sector is focused on content, on the channel packages offered by the broadcasting companies, on prices of channels, on packages and on service.

There is fierce competition between DBS and the Cable Companies in the content sector and each entity seeks to purchase content differentiating it from its rivals, which constitutes an incentive for subscribers to switch providers.

DBS invests efforts and resources both in marketing its services to the subscribers of its rivals as well as in purchasing special, quality content which it includes in its basket of services and broadcasts.

5.6.4 Positive and negative factors regarding the competition

DBS's management believes that DBS has a significant advantage thanks to the technical quality of the satellite broadcasts which also enable the reception of broadcasts in areas without a cable infrastructure. However, DBS' broadcasting infrastructure suffers from inferiority in a number of areas, the main ones being:

A. The fast satellite infrastructure is unidirectional (from broadcasting satellite to subscriber home), whereas the return direction (from subscriber home to broadcasting center) is based on the Company's telephone line and this makes it difficult for DBS to use its infrastructure to launch services such as internet services which require a high-speed bidirectional infrastructure. This is at a time when the Cable Companies together with an affiliated corporation are offering internet services alongside their broadcasts. Consequently, internet services are offered to DBS subscribers as a result of DBS' cooperation with internet access companies using the Company's infrastructure.

   DBS has recently received approval for an experimental transmission of movies and video content using the Company's ADSL infrastructure. However, DBS has

not yet received approval to offer these services on a commercial basis owing to legal examinations of this issue being conducted by the Ministry of Communications and the Council with the aim of granting the approval and stipulating its conditions.

B. Some of the customers of the Cable Companies' are customers of the cable analog systems (see Section 5.6.2 above). Insofar as such customers wish to switch to the digital system, the Cable Companies have much greater access to them since the analog broadcasting system allows its subscribers to receive lower-cost broadcasts without using a digital decoder.

C. Since the Cable Companies were for a long time the first and only players in the market, a large number of homes of potential DBS subscribers have internal wiring installed by the Cable Companies which DBS usually has no alternative but to use. The directives issued by the administration of the Ministry of Communications require 36 hours' notice before disconnection of an existing subscriber of the Cable Companies (and vice versa in the case of disconnection of an existing DBS subscriber). The Cable Companies can exploit this time frame to make special offers to existing subscribers about to leave them for DBS, in order to retain their custom. In addition, where the internal wiring infrastructure is owned by the Cable Companies, the management directives stipulate that payment must be made thereof (and vice versa).

The Company's license imposes restrictions on the structural separation between the Company and its subsidiaries and certain affiliated companies, among them DBS. The longer these restrictions remain in force, and at the same time no similar restrictions are imposed on the Cable Companies (and telephony and internet corporations affiliated to them), the more they will harm the competitive ability of DBS (for further details regarding these restrictions, see Section 2.16.2B above).

5.7 Fixed Assets and Installations

DBS broadcasts to its subscribers via an engineering setup which contains a ground broadcasting center located in Kfar Saba broadcasting to the satellite the content received at the center via optical fibers, cassettes and direct reception from the satellites, a secondary broadcasting site situated close to the Re'em Junction, leased space segments on the Amos 1 and Amos 2 satellites and receiver dishes and decoders located in subscriber homes, enabling receipt of the satellite broadcasts and decoding in accordance with the broadcasting package purchased by the subscriber.

5.7.1 Rental of structures

The DBS management and its broadcasting center, including all the technical and technological equipment contained in the broadcasting center, are located in two structures in the eastern industrial area of Kfar Saba in a total area of some 6,800 sq. m., alongside which are parking spaces and ancillary installations which have been leased by DBS in accordance with a memorandum signed with Azorim Shoar Ltd. (hereinafter: "Azorim") in May 1999. DBS leases these structures (which are fully occupied) for a lease period which ends in 2009, and it has the option of extending the lease period for another 10 years under the same conditions. DBS has the right of first refusal to purchase the premises from Azorim whenever they are put on sale. In addition, DBS leases offices in various areas throughout the country, as follows:

Location of asset	Area in sq.m. (approximate)	Date of termination of lease
Haifa	1,288	05/2008
Beit Barkan	960	06/2006
Givat Savyon	1,350	01/2006
Kanot	1,100	08/2007

5.7.2 DBS also uses a third-party site at the Re'em Junction which provides it with services allowing for the operation of the secondary broadcasting site, in which DBS' broadcasting and backup equipment are located.

5.7.3 End-point equipment

DBS installs a receiver dish and other end-point equipment in subscriber homes, among them, decoders used as a receiving and decoding unit for the reception signals, which constitute an infrastructure to the subscriber's television screen as well as smart cards used to decode the encrypted broadcasts, which are transmitted via the encryption system of NDS company (see Section 5.15.3 below).

Some decoders are leased to subscribers in return for a fixed leasing fee paid during the broadcast reception period and some are lent to subscribers (some of these loans are made in return for a deposit which is reduced over the subscription period). A small number of the decoders are sold to subscribers and owned by them. The YesMax devices are currently being sold only by an external distributor.

5.8 Intangible Assets

5.8.1 Licenses

DBS owns the following licenses:

5.8.1.1 Broadcasting license valid until January 2014 - this license is material to DBS's operations and constitutes the regulatory permit for its broadcasting operations (for the conditions of this license, see Section 5.14 below).

5.8.1.2 License for satellite television broadcasts in the Judah and Samaria region valid until January 2009, and by virtue of this license whose provisions are similar to those of DBS's main broadcasting license, DBS broadcasts to the Judah and Samaria region.

5.8.1.3 License to perform uplink operations (transfer of broadcasts from DBS's broadcasting center to the broadcasting satellite and implementation of set and ancillary operation activities), which is valid until April 2006. This license is material to DBS's operations and constitutes the regulatory permit for the transmission of broadcasting messages from the broadcasting center to the broadcasting satellites and from them to subscriber homes.

5.8.1.4 License for the provision of uplink/downlink services to other communication licensees which is valid until July 2008. As at the date of publication of this report, DBS does not use this license.

5.8.1.5 License for the transmission of SMS messages between DBS subscribers and between them and subscribers of the cellular companies or email subscribers. This license is valid until April 2008. As at the date of publication of this report, DBS does not use this license.

5.8.2 Trademarks

DBS owns a range of trademarks designed to protect its various brands and services and also a number of trademarks which are in the process of being registered with the Trademark Registrar. The main trademarks relate to the protection of its trading name (Yes), its key content channel names, the channel packages it markets and its unique terminal equipment which it installs in subscriber homes.

5.8.3 Copyright

DBS owns the copyright to the various television content it produces as well as the copyright usage licenses owned by third parties for the purpose of broadcasting within the framework of its subscriber broadcasts. For these usage rights DBS pays the content copyright holders via the five official organizations in Israel, which collect the royalties owed to the owners of the intellectual rights pursuant to the general licenses granted to DBS. These payments are sometimes based on the number of subscribers viewing the content (or listening to recordings, as applicable), the rights to which have been purchased and sometimes on various pricing methods, including some which are not dependent on the above-mentioned number of subscribers.

In 2004 DBS paid said collection organizations some NIS 10 million.

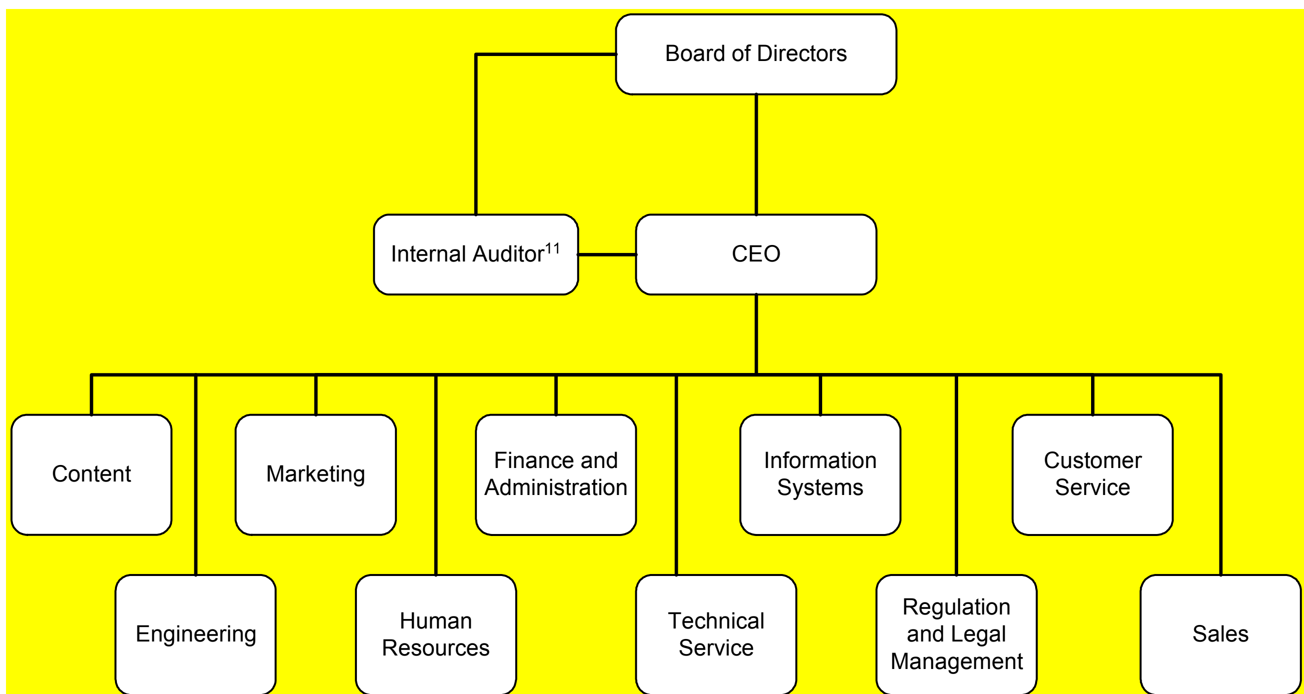
5.8.4 Investments in content

DBS purchased broadcasting rights for 2004 from various owners of copyrights to intellectual property for purchased content. DBS's usage rights to said content are very important to its operations since most of its broadcasts use third-party content and also combine purchased content with content used by DBS for the purpose of producing programs and trailers. DBS from time to time grants usage rights to television content it produces for franchisees from the Second Television and Radio Authority for re-broadcasting of said content. The total costs of the broadcasting rights to said content for 2004 amounted to some NIS 375 million.

5.9 Human Resources

5.9.1 Organizational structure

DBS consists of 10 divisions, each of which is headed by a vice president who serves as a member of DBS's management. The divisions include sales, customer service, technical service, content, marketing, engineering, finance and administration, human resources, regulation and legal management and information systems, as depicted in the following chart:



[11] External accountant

5.9.2 Headcount of DBS personnel by division

Division	Number of employees	
	As at December 31, 2003	As at December 31, 2004
Sales	266	388
Customer service	615	738[12]
Technical service	355	405
Content	39	38
Marketing	20	26
Engineering	61	63
Finance and Administration	88	91
Human Resources	7	10
Regulation and Legal Management	2	2
Information Systems	59	66[12]
Management	5	4
Total	1,517	1,771

5.9.3 Training and development of human capital

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

In 2004 DBS set up a training and instruction center consolidating the three main training tracks, which is used as a training center for all DBS managers and employees.

DBS trains some 1,000 employees every year.

5.9.4 Organizational change

DBS recently completed the transition from an operating setup based on geographic – district division, to a national operating setup covering all DBS' sales and service operations. As at the date of this report DBS has begun the process of consolidating customer service and technical service divisions into one division which will be called the Customer Division.

5.9.5 Employee compensation programs

In 2004 DBS integrated a target based compensation plan for its senior management.

5.10 Raw Materials and Suppliers

5.10.1 Main raw materials

The main raw materials used by DBS for its broadcasting operations are:

A. Television content

Television content, broadcasting and broadcasting channel rights purchased by DBS for its broadcasts. The broadcasting rights include movies, series and other original programs from local and foreign producers, mainly from the USA (see Sections 5.8.3 and 5.8.4 above).

In view of the proliferation of content providers from which DBS purchases broadcasting rights, DBS does not have a main provider and is not materially dependent on one single content provider. However, in the Israeli sport broadcasting sector there is dependence, as at the date of this report, on the purchase of broadcasting rights for the channels known as "Channel 5" and "Channel 5+" from the provider of these contents.

[12] In addition, DBS receives services in these divisions from third-party employees.

B. Space segments

DBS leases rights to satellite space segments via which DBS broadcasts from the satellites to the reception dishes installed in subscriber homes. The space segments are leased by means of long-term agreements with two owners of the rights to the space segments (see Section 5.15.2 below).

DBS is dependent on the continuing regular availability of the space segments (see Section 5.19(E) below).

C. Digital decoders

DBS purchases digital decoders in order to receive and decode encrypted broadcasts in the homes of its customers. DBS is dependent on the provider from which it purchases the decoders. Replacement of this provider with another provider does not entail material extra cost, but the replacement would require a significant preparation period to adapt the decoders of the replacement provider to DBS' broadcasting and encryption system. For a description of the agreement with this provider see Section 5.15.1 below.

D. Operating and encryption systems

DBS purchases from NDS services linked to the operating systems of its broadcasting setup and encryption means (see Section 5.15.3 below) as well as hardware for these services. DBS is dependent on the continuing supply of these services.

5.11 Working Capital

5.11.1 Content inventory

The broadcasting rights purchased by DBS are presented in DBS's books on the basis of their cost, where the broadcasting usage rights relating to the screening of movies and television programs includes payments made to rights providers pursuant to the agreements with them.

The broadcasting rights are amortized in accordance with their purchase agreements, on the basis of the actual content screening (where the part which is not amortized by the end of the agreement period is amortized in full on the basis of the agreement period) or in equal parts on the basis of the rights agreement period.

The costs of the independent productions of programs which DBS believes may be broadcasted a number of times or may be sold to a third party are considered part of the broadcasting rights inventory of DBS, and their cost is amortized over their estimated usage period.

5.11.2 Customers

DBS collects subscriber fees from its customers at the end of each calendar month for the previous completed calendar month. As at December 31, 2004, customer credit amounted to NIS 113,377 thousand.

5.11.3 Supplier credit

The average supplier credit period in 2004 was 204 days.

5.11.4 Deficit in working capital

As at December 31, 2004, DBS's deficit in working capital amounted to NIS 470,836 thousand. DBS intends to use appropriate cash flow sources, should there be any, to minimize its working capital deficit by means of reducing supplier credit.

5.12 Finance

5.12.1 Average interest rate for loans

5.12.1.1 Shareholders

The loans granted to DBS by its shareholders (among them the Company) are divided into three types:

5.12.1.1.1 CPI-linked non interest-bearing loans.

5.12.1.1.2 CPI-linked loans bearing annual interest of 5.5%.

5.12.1.1.3 CPI-linked loans bearing annual interest of 11%.

5.12.1.2 Banks

Short-term interest – the average interest rate for this credit as at December 31, 2004 is 7%.

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

A. Loans based on prime interest rates where the average interest rate as at December 31, 2004 is 6.5%.

B. CPI-linked loans where the average interest rate as at December 31, 2004 is 6.8%.

5.12.2 Credit restrictions applicable to corporations

Pursuant to the finance agreement of May 2001, as amended from time to time, between DBS and a bank consortium which arranged bank finance for DBS (hereinafter: the "Finance Agreement"), DBS must comply with all the following financial criteria:

A. Minimum overall income.

B. Minimum operating surplus.

C. Minimum operating surplus less DBS investment in decoders and modems.

D. Maximum supplier credit.

E. Minimum targets for coverage of the bank debt and debt balances.

F. Maximum overall finance requirements.

G. Maximum churn rate.

The values for compliance with the financial criteria change and are measured each quarter. Noncompliance grants the banks the right to demand early repayment of the loans and the right not to award DBS any further unused credit line. In addition to compliance with the financial criteria, the main condition for the bank credit not yet granted to DBS is the raising of shareholders' loans at rates determined in the Finance Agreement before the various types of bank credit were awarded. As at December 31, 2004 DBS is complying with all the financial conditions determined in the Finance Agreement.

In addition to the above-mentioned financial commitments, pursuant to the Finance Agreement additional restrictions anchored therein apply to DBS, the main ones being:

A. Restrictions on its compliance with its business plan and the update of this plan.

B. Restrictions on the assumption of third-party liabilities, including the receiving and granting of credit.

C. Restrictions on the distribution of profits and payment of management fees to the shareholders.

D. Restrictions on the creation of pledges and sale of certain assets without consent from the banks.

E. Restrictions on DBS's transactions with interested parties, changes of ownership in DBS, the purchase of securities in any corporation and the offering of its securities to the public (including the issue of debentures).

F. Restrictions on the shareholders' loans granted to DBS by the Company, among them their subordination in relation to the bank credit and restrictions on their repayment before repayment of the bank credit.

DBS encumbered its assets and goodwill with a floating lien in favor of the banks and placed fixed liens on its rights in accordance with material agreements to which it is a party.

DBS shareholders, with the exception of the Company, pledged the DBS securities in their possession in favor of the banks, to secure the amounts which the banks made available and will make available to DBS. Most of the shareholders also pledged their rights to repayment of the shareholders' loans granted to DBS in favor of the banks and confirmed to the banks that these loans would be subordinate to the bank credit. In view of the restrictions on the Company's ability to pledge its assets as a result of the negative pledge created by the Company in favor of its creditors (see Note 13D(1) to the financial statements for the year ended December 31, 2004, which are included in this Periodic Report), on November 23, 2000 the Company gave a guarantee of DBS's debts to the banks, provided that the amount which the banks receive in repayment by the Company of its guarantee does not exceed the value of its shares in DBS on the date on which the banks realize the shares which the other shareholders pledged in their favor. The Company also gave a commitment to sell its shares if the shares pledged by the banks are sold. Pursuant to a note of amendment to the guarantee of May 2, 2002, the Company consented that in the event of realization of the collateral given by the other shareholders the Company would waive repayment of the shareholders' loans it granted to DBS. The Company also consented that its guarantee would also apply, *mutatis mutandis*, to the options allotted to DBS and to the right to receive them.

The shareholders in DBS with the exception of Gilat DBS Ltd., gave an undertaking to the banks not to oppose the sale or other realization of their shares in DBS, which had been pledged or in respect of which a guarantee had been given (by the Company), so that the bank could make the sale without disturbance in the form of a friendly liquidation.

5.12.3 Credit amounts received in 2004

In 2004 DBS received shareholders' loans amounting to some NIS 326 million and the banks increased their credit framework by some NIS 58 million.

5.12.4 The Corporation's credit framework

DBS's credit framework is some NIS 1,360 million and it is used for the current operation and the granting of bank guarantees for DBS's operations. As at December 31, 2004 DBS had used NIS 1,352 million of this credit and there was no material change in the use of this framework.

5.12.5 Need for raising of additional sources of capital

DBS believes that for the purpose of the business plan, it will require additional credit from the banks (pursuant to the credit framework to which it is entitled in accordance with the Finance Agreement) as well as shareholders' loans from its shareholders (regarding this matter, see Section 5.19B below and Note 8E to the financial statements for the year ended December 31, 2004, which are included in this periodic report).

5.13 Taxation

See Note 11 to the financial statements for the year ended December 31, 2004, which are included in this periodic report.

5.14 Restrictions on and Supervision of the Corporation

5.14.1 Specific legal restrictions on operations

DBS's operations are regulated by and subject to a special extensive system of laws (from primary legislation to administrative directives and Council decisions). The abovementioned legislation, secondary legislation, Council decisions and administrative directives have a material effect on DBS and its operations. Legislation and secondary legislation also have a material effect on DBS in the communications arena in general.

Restrictions are applicable to DBS by virtue of the Telecommunications Law and the regulations promulgated pursuant thereto. The Telecommunications Regulations (Procedures and conditions for the granting of a satellite broadcasting license), 5758-1998 (hereinafter: the "License Regulations"), determine the processes and conditions for receipt of a broadcasting license, and also various restrictions applicable to a licensee in the license period. The License Regulations determine, *inter alia*, suitability

conditions for a satellite broadcasting licensee, relating to the direct or indirect holdings of the broadcasting licensee and the interested parties therein, in cable broadcasting franchisees, in franchisees pursuant to the Second Authority for Television and Radio Law, 5750-1990, and in proprietors of daily newspapers.

The Telecommunications Regulations (Television Broadcasts through Satellite) (License Fees and Royalties), 5759-1999 determine the percentage of royalties and broadcasting license fees to be paid by the satellite broadcasting licensee to the state. Pursuant to these regulations, DBS is committed to pay royalties at 3.5% of its revenues from the provision of broadcasting services in 2004 and thereafter.

By virtue of Section 6(49) of the Telecommunications Law, maximum prices to be billed to the subscriber may be determined in the license.

In accordance with the requirements of the broadcasting license and regulations determined by the Council, in 2004 and 2005 DBS shall invest in local productions an amount which is not less than 8% of its revenues from subscriber fees.

In accordance with the requirements of the law and the license, DBS is obligated to allow independent channel producers pursuant to Section 6(55) of the Telecommunications Law to use its infrastructures in order to transmit broadcasts to its subscribers, in return for a payment which will be determined in the agreement, and in the absence of an agreement, in return for a payment which the Minister will determine after consultation with the Council.

5.14.2 Subordination of operations to the broadcasting license

DBS's operations are subject to the provisions of its broadcasting license. The Telecommunications Law, the License Regulations and the license stipulate a number of grounds on the basis of which the Minister of Communications can terminate, restrict or make the Broadcasting License conditional, after consultation with the Council and the granting of a hearing to the Broadcasting Licensee, among them, violation of the provisions of the law or rules and regulations pursuant thereto, a material violation of the terms of the Broadcasting License or a non-material violation which was not amended after a warning from the Minister or the Council, the cessation of broadcasts for an unreasonable period of time or the total cessation of broadcasts for 14 consecutive days, noncompliance of the licensee with the restrictions determined in relation thereto in the License Regulations, and the appointment of a receiver or temporary liquidator for the licensee or the issuing of a liquidation order, all pertaining to the licensee.

The Minister of Communications, in consultation with the Council, and after granting the Broadcasting Licensee an opportunity to make its arguments and considering the harm to its rights, may change the terms of the broadcasting license, *inter alia*, for the purpose of the goals stipulated in the license.

5.14.3 Principal restrictions by virtue of the law and broadcasting license

The Telecommunications Law and Broadcasting Regulations stipulated the following principal general conditions: the broadcasting license may not be transferred or attached; encumbrance of the broadcasting license, insofar as it may be encumbered under the law, requires prior written approval from the Minister of Communications; transfer, encumbrance or attachment of any of the assets of the broadcasting license from August 2001 onwards, which were not granted advance permission in the license, require approval from the Minister of Communications, except for encumbrance of an asset in favor of a banking corporation; an encumbrance placed on any of the broadcasting license's assets shall not be realized unless as determined by the Minister of Communications; a change, directly or indirectly, in control or holding of the means of control in a percentage of 10% or more or in any percentage resulting in a person becoming an interested party or controlling party in the licensee requires approval from the Minister of Communications, after consultation with the Council (this provision does not apply to a change which does not exceed 15% of the holding of the means of control in a company whose shares are listed on the Stock Exchange, provided that it is not a change in the control thereof, all in relation to said shares listed on the Stock Exchange); reporting requirements were stipulated concerning holders of the means of control and restriction on encumbrance of the means of control; cross-ownership in the licensee is prohibited as set forth in the License Regulations; competition pertaining to

the provision of broadcasts and services shall not be prejudiced, including terminal equipment or other telecommunications services, by any agreement, arrangement or understanding to which the broadcasting licensee, any body in which the broadcasting licensee, an officer of the broadcasting licensee, or any owner of a right in a company owning a broadcasting license (and also an officer of the owner of a right therein) are parties thereto, unless approved in advance and in writing by the Council; advertising broadcasts are prohibited (this prohibition also applies to the Cable Companies) except for the transmission of foreign channels containing advertisements which are not aimed primarily at Israel and except for sponsorships and service broadcasts.

The broadcasting license also contains terms governing the establishment and operation of a satellite broadcasting system; terms governing subscriber services, among them the duty of the Council and the Uniform Contracts Tribunal to approve subscriber agreements, the duty to connect applicants and ban on stipulating conditions, the duty to maintain the service throughout the year, prohibition on discrimination between subscribers, except for the offering of various tariffs to subscriber types which are reasonably differentiated, the establishment of a subscriber service center; establishment of an ongoing setup for the supply and maintenance of terminal equipment and protection of subscriber privacy; terms concerning the provision or disconnection of service and terms linked with the oversight of the operations of the broadcasting licensee and the duty to submit reports to the Ministry of Communications.

The broadcasting license stipulates provisions regarding the types of payments that the broadcasting licensee may collect from its subscribers. The broadcasting license also stipulates that the list of prices that the broadcasting licensee collects from its subscribers for broadcasts and services shall first be submitted to the Council for approval, and that each change therein shall first be submitted to the Council chair for approval, except for reductions, discounts and promotions (for a restricted period) which should be notified to the Council chair no later than the date of publication or commencement, the earlier of the two, and the chair may cancel them retroactively.

DBS also transmits to its subscribers the television and radio (FM) channels lawfully broadcast in Israel which can be received from the air, ground or satellite, the educational television channel and "must carry" broadcasts. By virtue of the provisions of the law, DBS currently transmits broadcasts of two "must carry" channels, the music channel ("Channel 24") and the Russian-language channel ("Israel Plus"), in return for a sum to be set by the Minister of Communications (as at the date of publication of this report a fixed payment had not yet been set for the transmission of the "must carry" channel), and also two independent licensees "Nature of Things Channel" and "Clicka" channel which collect subscriber fees directly from their customers.

5.15 Material agreements

Following is a summary description of the principal agreements likely to be considered as material agreements not in the normal course of business of DBS which have been signed and/or are valid in the period of the Periodic Report:

5.15.1 Agreement for the purchases of decoders

In August 2000 DBS signed an agreement for the purchase of decoders with Advanced Digital Broadcast Ltd. (hereinafter: "ADB") and Eurocom Marketing (1986) Ltd. (hereinafter: "Eurocom"), in which Eurocom Communications Ltd., an interested party in DBS, is also an interested party (hereinafter: the "ADB Agreement"). Pursuant to the ADB Agreement, DBS purchased from ADB a minimum number of decoders and is also entitled to purchase additional decoders from time to time in accordance with a purchase order which DBS will send to Eurocom. DBS is also responsible for the converters and support service thereof by means of Eurocom. Repair to the decoders is carried out in accordance with an agreement with it from April 2001, which is automatically renewed unless terminated by one of the parties thereto, and which determines conditions and dates for the provision of maintenance services (and replacement of the decoders, if necessary) by Eurocom.

5.15.2 Space segment lease agreements

First space agreement

In order to transmit the satellite broadcasts DBS signed an agreement in April 1999 with the HLL Satellite Communications Company (Spacecom) Ltd. (hereinafter: "HLL"), in which there is an interested party which is also an interested party in DBS, and with Israel Aircraft Industries for the leasing of space segments in the Amos 1 satellite as amended in May 2003 (hereinafter: the "First Space Agreement"). The lease period determined in the First Space Agreement will conclude on June 30, 2009 (in relation to the period from January 1, 2009 – subject to the purchase by DBS of insurance cover as defined in the agreement) or upon the end of the life of the Amos I satellite, the earlier of the two, and if DBS continues to use the space segments after the end of the lease period, it shall continue to pay the leasing fees. DBS undertook to lease at least 8 space segments on the Amos 1 satellite and it was granted an option to lease up to twelve additional space segments and the right of first refusal to lease any space segment on the satellite's Middle East beam, which will be offered for leasing by HLL or Israel Aircraft Industries. As at the date of publication of this Periodic Report, the company is leasing 8 space segments on the Amos 1 satellite.

The leasing fees set in the First Space Agreement consist of fixed monthly leasing fees and monthly leasing fees of varying amounts, in levels set in the agreement in accordance with the number of DBS subscribers, up to a ceiling fixed in the agreement.

The First Space Agreement regulated mechanisms guaranteeing a reserve and backup in the event of satellite faults. *Inter alia*, it was determined that the satellite's reserve transponder used as backup for the satellite's entire capacity would serve as reserve capacity for DBS if the reserve transponder were used to restore any satellite capacity. HLL undertook to make available one space segment within six months and within a further three months another reserve space segment which would be used as reserve capacity for the satellite's entire capacity. In the event of a fault at the same time as another capacity DBS is granted priority for restoration of its leased capacity.

Second Space Agreement

In May 2000 DBS signed another agreement with HLL to lease space segments on the Amos 2 satellite, as amended in May 2003 (hereinafter: the "Second Space Agreement"), whereby DBS leases from HLL no fewer than 12 space segments on the two satellites (of which 8 on Amos 1), and during 2005 DBS will start to lease two additional segments on the same polarity, so there will be no need to adjust DBS's receiver dishes. The Second Space Agreement stipulates that at the end of the First Space Agreement the leased capacity on Amos 1 will be transferred to Amos 2 or to another suitable subsequent satellite.

Pursuant to the Second Space Agreement, the lease period for the space segments on Amos 2 is for 12 years from the date on which the satellite is stationed in space (which took place during April 2004) or until the end of the satellite's life, the earlier of the two. The consideration for the lease determined in the Second Space Agreement consists of annual lease fees to be paid in monthly installments, the amount of which depends on the total number of segments leased on the Amos 2 satellite, DBS, its shareholders and lessors affiliated with it and/or with its shareholders, as defined in the Second Space Agreement. The Second Space Agreement brings together space segments which will be used as reserve capacity for the leased capacity on Amos 2, and alternative capacity if the leased capacity becomes unusable, and awards DBS the right of first refusal to lease other space segments on Amos 2 under the terms specified in the agreement.

HLL has undertaken to act to extend the lease period for the space segments beyond the current lease period, and for this purpose to endeavor to station a subsequent satellite in a suitable position, with similar technical characteristics, so that it will not be necessary to make changes to the receiver systems of DBS subscribers, under the conditions determined in the agreement, until December 31, 2013, provided that an appropriate agreement for the continuation of the satellite's life is signed by the parties, as shall be determined in said agreement, pursuant to which DBS will lease at least 14 space segments in consideration of annual leasing fees under similar commercial conditions.

As at the date of this report, DBS is leasing 4 space segments on Amos 2. In 2004 the lease fees for the First Space Agreement and the Second Space Agreement amounted to some NIS 96 million.

5.15.3 Information and encryption system development agreement

In October 2000, DBS signed an agreement with NDS Limited (hereinafter: "NDS") for the development, licensing, supply, training, assimilation and maintenance of software and equipment for encryption, broadcasting, compression operations and ancillary operations required for DBS's multi-channel, broadcasting system, including development of a smart card inserted into a special decoder drive, by means of which the subscriber's viewing options can be controlled. The smart card may be updated using a satellite broadcasting signal. NDS undertook to adapt its equipment and services to the decoders purchased by DBS in accordance with the provisions of the agreement. NDS also undertook to provide DBS with support services and provide a warranty for its products. Pursuant to the agreement DBS may order and pay for additional broadcasting equipment and software and also make modification to the existing ones under the conditions set forth in the agreement. DBS pays for NDS's services and products based in principle on the number of converters it uses and the number of its active subscribers. In March 2004, DBS signed an additional agreement with NDS whereby NDS provides DBS with services linked to the integration and assimilation of interactive applications into DBS subscriber services, the granting of usage licenses for these applications and the development of future interactive technological services.

5.15.4 Information systems outsourcing agreement

In March 2004 DBS signed an outsourcing agreement with Ness A. T. Ltd. (hereinafter: "Ness") whereby DBS transferred its information system management and project implementation services (hereinafter: the "Service") to Ness and Ness assumed overall responsibility for the supply to DBS of the Service in an outsourcing format. DBS also transferred to the ownership of Ness certain equipment for which the services are provided and which will be transferred to DBS upon expiry of the agreement. The agreement period (subject to early termination rights conditional upon payment) has been defined as eight years from April 1, 2004 (hereinafter: the "Original Agreement Period"), and at the end of the Original Agreement Period the agreement term will be extended automatically for an additional period of five years (hereinafter: the "Extension Period"), unless one party notifies the other party in writing, at least 12 months before the end of the Original Agreement Period of its desire not to extend the Original Agreement Period. In the Extension Period each party may notify the other party in writing, at least 12 months in advance, of its desire to terminate the agreement.

5.15.5 Finance agreement with the banks

For a summary of the main points of the agreement, see Section 5.12 above and also the description in Note 8E to the financial statements for the year ended December 31, 2004, which are included in this Periodic Report.

5.15.6 Agreements with DBS shareholders – see Section 2.17.6

5.16 Cooperation Agreements

DBS has a joint venture with Bezeq International Ltd., a subsidiary of the Company, for the supply of a basket of services including multi-channel television services (supplied by DBS), infrastructure connection to the internet and internet access services (supplied by Bezeq International Ltd.).

The venture has been operating in the present format since the beginning of 2003 under the brand name "Yes-Wow" and the period of the venture has not been defined. As part of the joint venture, the parties operate customer service centers and they also implement marketing, sales, customer retention and joint operations.

The expenses common to the two parties, such as customer service center maintenance, are divided by the parties into two equal parts. In addition, each party bears its own individual expenses.

DBS collects the bill for the joint venture's services from the subscribers and transfers to Bezeq International Ltd. payment for its services.

5.17 Legal Proceedings

5.17.1 On January 30, 2003, a letter was received from the Ministry of Communications, stating that the arrangement whereby DBS takes from its subscribers a deposit lower than the purchase cost of the decoder lent by it, and deducts from it 10% of the value of the decoder every year is not legal and contravenes the provisions of the broadcasting license and subscriber agreement. In addition, DBS was required to stop implementation of said agreement and reimburse all its customers, from whose deposits money had been deducted in accordance with the arrangement. On June 16, 2003, the Telecommunications Regulations (Franchises), 5747-1987 were amended so that DBS could deduct up to 10% of the purchase cost of the equipment. From the date of said amendment of the regulations and until the date of this report DBS had not received any additional demand from the Ministry of Communications.

On April 14, 2004, DBS received a letter from the vice president of the Israeli Consumer Council (hereinafter: the "Consumer Council") in which the Consumer Council argued that the deductions made by DBS from the amounts of the deposit which had been reimbursed to subscribers (who had left) before the amendment of said regulations had been unlawfully implemented. The Consumer Council therefore demanded that DBS reimburse to said subscribers the deducted amounts which according to its argument had been deducted unlawfully and submit a detailed report regarding the matter to the Council

DBS rejected the arguments of the Consumer Council with the argument that it had acted in respect of said deduction pursuant to the license and the subscriber agreement. By the date of this report no further enquiry had been received from the Consumer Council. DBS's management believes that, based on the opinion of its legal counsel, it is impossible to estimate the possible exposure and consequently no provision has been included in the Financial Statements of DBS.

5.17.2 On September 27, 2004 two foreign companies filed a claim in the Tel Aviv District Court against DBS and Synergia Productions Ltd. (hereinafter: "Synergia"), arguing that the television program "Project Y" broadcast by DBS (in this section: the "Program") and produced by Synergia is a copy of a format which they had created. Consequently the amount of NIS 8.2 million (or alternatively, NIS 1.8 million without proof of damage) is being claimed from Synergia and DBS. On December 15, 2004, DBS submitted a statement of defense in which it argued that the format is not a creation protected by Israeli law and therefore the Program does not constitute a copy of said claimed format. A date for hearing of the claim has not yet been set. The legal counsel of DBS are unable to estimate the chances of the claim.

5.17.3 On February 23, 2005, DBS filed a claim in the Jerusalem District Court to obtain declaratory orders directing that a decision of the Minister of Communications from December 31, 2004, directed the Company in connection with the injection of the Company's funds to DBS and a decision of the Minister of Communications from February 14, 2005, mostly confirming the said decision, are null and void since they were made in an extremely unreasonable manner, disproportionately and breached DBS's right to a hearing (for details and the proceedings implemented by the Company in relation to the above ministerial decisions, see also Section 1.1.5B above and Note 8E to the financial statements of the Company for the year ended December 31, 2004, which are included in this Periodic Report). As at the date of publication of this Periodic Report no response had been received from the State to this claim and at this stage it is impossible for DBS to estimate its results.

5.17.4 On November 21, 2004, the Tel Aviv District Court approved an arbitration order granted on August 18, 2004, in a financial claim filed by Israel ICP Cable Programming Ltd. against DBS whereby DBS was ordered to pay NIS 9 million to the plaintiff.

5.17.5 For additional legal proceedings in which DBS is involved, see Sections 19A(35), 19A(36) and 19A(39) to the financial statements for the year ended December 31, 2004, which are included in this Annual Report.

5.18 Business Strategic Goals

DBS's goals for the coming year are to continue the trend of increased revenues by continuing the growth in the number of its subscribers and in average per-subscriber revenues.

In order to achieve said goals, DBS intends to invest significant efforts in marketing and sales and an appropriate marketing strategy adapted to continuing subscriber recruitment, by using its sales setup (see Section 5.5 above), and also continuing its effort to create differentiation and innovation in broadcasting content compared with the content of the Cable Companies (see Sections 5.1.3.1 – 5.4 above). In order to increase revenues from subscribers, the Company is also working to increase the volume of the content sold to subscribers and raise its prices (including reduction of discounts), and in this context on February 1, 2005 it raised its monthly price for the basic package by NIS 10.

DBS's goals relating to growth in the number of its subscribers and average per-subscriber revenues are based on forecasts of DBS's management, on the current trend in the broadcasting market and on DBS's assumptions regarding competition in the broadcasting arena and the present prevailing regulation. However, it is possible that the forecasts of DBS' management will not be fulfilled in view of changes in demand in the broadcasting market, the intensification of competition in this sector and the regulatory restrictions which have been imposed or will be imposed on DBS or on its cooperation with the Company (see Sections 5.1.6 and 5.17 above and Section 5.19 below).

5.19 Risk Factors

A. Licensing and regulation system

DBS's operations and broadcasts are subject to a licensing system, oversight and approvals from various regulatory bodies (see Section 5.14 above), and consequently DBS is likely to be influenced and restricted by considerations of the policy dictated by these entities and by changes in communications legislation; the content of DBS's broadcasts is subject to special legislative arrangements, to supervision by the Council and to the obtaining of approvals from the Council. Failure by the Company to comply with the provisions and rules of the regulatory bodies is liable to cause the imposition of financial sanctions and even termination of the licenses held by DBS.

B. Further injection of funds from shareholders and the banks in accordance with DBS's business plan

Continuation of the injections of funds from shareholders pursuant to DBS's business plans in the coming year is critical to DBS's capability to comply with its business plan and achieve a cash flow balance in accordance therewith (for the regulatory restriction on these cash flows, see Note 8E to the financial statements of the Company for the year ended December 31, 2004, which are included in this Periodic Report).

Non-implementation of all the cash flows from shareholders in accordance with the business plan also constitutes grounds for terminating the bank credit which DBS is authorized to receive in 2005 from the banks pursuant to the Finance Agreements, and is also liable to constitute grounds for making the bank credit payable immediately pursuant to and subject to the provisions and reservations of the Finance Agreement (see Section 5.12.2 above).

C. Ability to offer integrated services

The Cable Companies that compete with DBS are permitted to offer a basket of services including multi-channel television, internet connectivity and line telephony, while DBS is prevented, at this stage, from offering its subscribers a corresponding basket of services, in light of the restriction imposed on the Company (see Section 2.16.2 above).

D. Foreign currency risks

A material part of DBS's expenses and investments is linked to changes in the exchange rate of the US dollar. Consequently sharp changes in the exchange rate have a material effect on the Company's business results.

E. Broadcasting and satellite centers

DBS broadcasts from two broadcasting centers in Kfar Saba and at the Re'em Junction (see Section 5.7 above). Damage to the broadcasting center is liable to make it extremely difficult to continue broadcasting, however, the duplication of the broadcasting centers significantly

reduces the risk entailed by damage to one of them and improves the survival ability of the broadcasts. As at the date of this report DBS broadcasts from the two broadcasting centers simultaneously. If one broadcasting center is damaged DBS will transfer most of its broadcasts through the other broadcasting center.

DBS broadcasts through space segments on the Amos 1 and Amos 2 satellites stationed in identical points in space (see Section 5.10.1 above). The duplication of the satellites by means of which broadcasts are transmitted to subscribers enables a significant reduction of the risk entailed by damage to one of them, and improves the survival ability of the broadcast. If there is a failure in one of the satellites, it will be possible to transfer most of the channels broadcast by DBS via the space segments on the second satellite and even possibly via additional segments which will become available.

F. Technical inferiority

DBS's infrastructure suffers from technical inferiority compared with the infrastructure of its competitors, as explained in Section 5.6.4 above.

Risk Factor Summary Table

	Extent of effect of risk factor on DBS operations		
	Large effect	**Medium effect**	**Small effect**
Licensing and Regulation regime		X	
Continued financial infusions	X		
Capability to offer combined services	X		
Exposure to changes in rates of exchange			X
Broadcast and satellites center			X
Technical inferiority compared with competition			X

Date

"Bezeq" The Israel Telecommunication Corp. Limited

Name and title of the signatories:
Adv. Miriam (Miki) Mazar, Chairperson of the Board
Amnon Dick, CEO

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

March 3, 2005

Chapter B of the Periodic Report

Directors' Report on the State of the Company's Affairs for the year ended December 31, 2004

We respectfully present the Directors' Report on the state of affairs of "Bezeq" - The Israel Telecommunications Corporation Limited (hereinafter: "the Company") and the consolidated Group companies (the Company and the consolidated companies together are hereinafter referred to as "the Group") for the year ended December 31, 2004 (hereinafter: "the Directors' Report").

The Group is the principal provider of communications services in Israel and it operates and provides a broad range of telecommunications services. The Group operates in four areas which are reported as business segments in the Company's consolidated reports, as set forth below:

1) **Fixed-line domestic communications** – service provided by the Company.

2) **Cellular** – service provided by Pelephone Communications Ltd. (hereinafter: "Pelephone").

3) **International communications and internet services** – service provided by Bezeq International Ltd. (hereinafter: “Bezeq International”).

4) **Multi-channel television** - D.B.S. Satellite Services (1998) Ltd. (hereinafter: "DBS")

The Company has other areas of business which are not material to the Group’s operations which are included in the Company's Financial Statements for December 31, 2004 as an “Other” business segment, and they include mainly network end point services, customer call center services and content services for the business sector.

Below is a table detailing the reports which were fully consolidated for the first time in the years ended December 31, 2004 and 2003.

	2004	2003
Pelephone Communications Ltd.	Full consolidation from August 26, 2004	50% proportional consolidation
D.B.S. Satellite Services (1998) Ltd.	Full consolidation from June 21, 2004	-

1. Financial Position

A. The Group's assets as at December 31, 2004 amounted to approximately NIS 20.17 billion, compared with NIS 16.09 billion on December 31, 2003. Of these, approximately NIS 10.74 billion (approximately 53%) are fixed assets, compared with approximately NIS 8.70 billion (54%) on December 31, 2003. NIS 3.38 billion of the increase in total assets originates from the first-time consolidation.

In the fixed-line domestic communications segment there was a decrease in the net book value of the fixed assets resulting from the difference between the depreciation expense and the investment made during the Report Period There was also a decrease in cash balances and short-term investments compared with the prior year.

In the cellular segment there were additional investments in sites and an investment in 3G infrastructure, as well as an increase in inventory which contributed to the increase in total assets.

B. The Group's shareholders' equity as at December 31, 2004, amounted to approximately NIS 7.47 billion, comprising approximately 37% of the total balance sheet, compared with approximately NIS 6.84 billion on December 31, 2003, comprising approximately 43% of the total balance sheet. The increase in shareholder' equity derived from the Group’s net earnings arising during the Report Period.

C. Total Group debt to financial institutions and debenture holders as at December 31, 2004, amounted to approximately NIS 8.32 billion, compared with approximately NIS 5.51 billion on December 31, 2003. Approximately NIS 2.42 billion of the increase derives from the first-time consolidation and the remainder derives from the receipt of loans and an issuance of bonds to the public and institutional investors by the Company and Pelephone.

D. Group balances in cash and short-term investments as at December 31, 2004, amounted to approximately NIS 2.74 billion compared with approximately NIS 3.29 billion on December 31, 2003. The decrease derives mainly from exercise of the option to purchase the second half of the shares in Pelephone. The decrease was offset by the cash flow from current operations in the main segments of the Group's business and also from an issuance of bonds and receipt of loans.

2. Results of Operations

A. Principal results

Net earnings for 2004 amounted to approximately NIS 621 million, compared with a net loss of approximately NIS 438 million in the corresponding period in the prior year. The difference in the results derives mainly from the Other income (expenses) item, where an expense of approximately NIS 983 million (before tax) was recorded in the corresponding period mainly in connection with early retirement costs and a provision for claims for salary components in pensions. In addition, in the prior period, deductions were recorded in respect of impairment in assets and expenses connected with changes in the estimated useful life of assets. The source of the increase in earnings is also an increase in the Group's operating income.

Below are details of the changes in the results of the segments as compared with the previous year.

Segment	**2004 NIS millions**	**2003 NIS millions**
Fixed-line domestic communications	971	907
Cellular[1]	379	96
International communications and internet services	118	90
Multi-channel television [2]	(85)	-
Others	8	-

Earnings per share for the year 2004 amounted to NIS 0.238 per NIS 1 par value, compared with a loss of NIS 0.179 per share in the corresponding period in the prior year.

B. Revenues

Group revenues in 2004 amounted to approximately NIS 9.27 billion, compared with approximately NIS 7.98 billion in the corresponding period in the prior year. An increase of approximately NIS 1.26 billion derives from the first-time consolidations.

Revenues from the fixed-line domestic communications segment decreased from approximately NIS 5.23 billion in 2003 to approximately NIS 4.96 billion in 2004 (a decrease of approximately 5%). Most of the reduction in the segment's revenues derives from tariff reductions in September 2003 and June 2004 and a decrease in call and internet dial-up traffic. In contrast, the segment's revenues from fixed fees increased as a result of the continued rising trend in subscribers from the high speed internet service (ADSL) and the

[1] First-time full consolidation
.[2] First-time consolidation

increase of fixed fee tariffs per line commencing in September 2003. In addition, revenues in the segment rose due to an increase in installations and sales of equipment. The auditors drew attention to the ongoing opening of the telecommunications industry to competition and changes in tariffs in their opinion letter to the shareholders.

Revenues from the cellular telephone segment increased from approximately NIS 2.03 billion to approximately NIS 2.97 billion, mainly as a result of the effect of the first-time full consolidation implemented in the Report Period. In addition, the segment's revenues increased as a result of the increase in the number of subscribers and the increase in revenues from the sales of handsets to customers. For the future effect on revenues of the segment resulting from the amendment to the cellular network interconnect regulations, see Note 1 F (2) to the Financial Statements.

Revenues from the international communications and internet services segment increased from approximately NIS 703 million in 2003 to approximately NIS 816 million in 2004 (an increase of approximately 16%). The segment's revenues increased mainly as a result of the increase in internet revenues which derived from the growth in the number of high speed internet customers, the sale of internet access service capacity, growth in international call routing traffic and in data services. The growth was slowed by a decrease in call and internet tariffs.

Revenues of approximately NIS 542 million from the multi-channel television segment have been included for the first time in the financial statements. There has been an increase in revenues in this segment compared with the corresponding period on account of the increase in the number of subscribers and the average revenue per subscriber.

C. General and Operating Expenses

The Group's general and operating expenses in 2004 amounted to approximately NIS 5.57 billion, compared with approximately NIS 4.49 billion in the corresponding period in the prior year. Approximately NIS 991 million derives from first-time consolidation.

In the fixed-line domestic communications segment expenses decreased by approximately 1%. Most of the decrease is attributable to the decrease in salary expenses in the segment due to the retirement of employees under the early retirement plan. The decrease was partially offset by a rise in expenses of materials and satellite communications.

In the cellular segment the increase in expenses arises from the first-time consolidation. Expenses in the segment did not increase compared to the prior year, despite the growth in operations.

In the international communications and internet services segment there was an increase in operating expenses due to the growth in operations and as a result of a change in estimates relating to depreciation and doubtful debts in 2003.

Operating and general expenses from the multi-channel television segment amounting to approximately NIS 473 million have been included for the first time in the financial statements.

D. Depreciation

The Group's depreciation expense decreased from approximately NIS 2.16 billion in 2003 to approximately NIS 2.09 billion in 2004. The decrease is due to the cessation of the depreciation charge on fixed assets and a decrease in investments in new assets in the fixed-line domestic communications segment. Furthermore, an additional decrease was recorded due to the change in the estimated useful lives of assets in this segment. A decrease in depreciation in the cellular segment also contributed to the overall decrease. The Group's depreciation expense increased by approximately NIS 227 million as a result of the first-time consolidation,

E. <u>Royalties to the Government of Israel</u>

The Group's royalties expense in 2004 amounted to approximately NIS 221 million as compared to approximately NIS 243 million in the corresponding period in the prior year. The source of the decrease is the reduction in the percentage of royalties payable on the Group's revenues, from 4% to 3.5%, effective January 1, 2004. The decrease was partially offset by additional royalties of approximately NIS 28 million, the source of which is the first-time consolidations referred to in Section A above.

F. <u>Operating income</u>

The Group's operating income in 2004 amounted to approximately NIS 1,392 million, compared with approximately NIS 1,093 million in the corresponding period in the prior year, an increase of approximately NIS 299 million. The increase in operating income derives from the changes in the results of the segments described above in the revenues and expenses items. These changes led to a rise in the profitability of all the Group's segments of operation. The operating income of the Group was partially offset by the first-time consolidation of DBS, as described in Section A above.

G. <u>Financing expenses</u>

The Group's net financing expenses in 2004 amounted to approximately NIS 218 million, compared with approximately NIS 158 million in the corresponding period in prior year. Commencing in 2004, financing expenses included in the financial statements reflect the nominal financing expenses rather than the inflation-adjusted financing expenses recorded in the past, due to the transition to financial reporting based on nominal financial data. Therefore, there is no basis for comparison of the results. Approximately NIS 66 million of the financing expenses are attributable to the first-time consolidations, as described in Section A above.

The financing expenses in the period were affected mainly by changes in the CPI and the exchange rates of the dollar and the euro. The effect of the changes in the foreign currency and shekel rates was largely eliminated by hedging transactions and by financing income from financial instruments. The financing expenses in the fixed-line domestic communications segment rose mainly due to a decrease in revenues from investments and deposits. In the international communications and internet services segment, and the cellular segment financing expenses decreased. In the cellular segment this decrease was due, *inter alia*, to the decrease in the total debts.

H. <u>Tax expenses</u>

The Group's tax expense in 2004 amounted to approximately NIS 497 million, compared with approximately NIS 48 million in the corresponding period in the prior year. Following the amendments to the Income Tax Law coming into effect including, *inter alia*, the gradual reduction in corporate tax rates from 36% to 30%, the Group reduced its tax asset and set it at the rate expected to apply when that asset is utilized. As a result, an additional tax expense of approximately NIS 84 million was recorded.

I. <u>Other Income (Expenses)</u>

Income amounting to approximately NIS 80 million was recorded in 2004 in the Group's Other Income (Expenses) item, compared with an expense of approximately NIS 983 million in the corresponding period in the prior year.

Most of the expense in the corresponding period was an increase in the provision for early retirement. Furthermore, a reduction in Company assets and investments and in Bezeq International and a provision in connection with certain employee claims were also recorded. The income recorded in the Report Period derived from a reduction of the provision for employee claims recorded by the Company in the corresponding period. This income was partially offset by an additional increase in the provision for early retirement. (For details, see Note 24 to the financial statements). The Company's auditors have drawn attention to the Company's retirement plans and to the claims filed against it.

J. Group's equity in losses of affiliates

The Group's equity in losses of affiliates decreased compared with the corresponding period of the prior year, from approximately NIS 343 million in 2003 to approximately NIS 135 million in the Report Period. Most of the decrease derived from the decrease in the Company's equity in the losses of DBS in the first half of the year. With the full consolidation of DBS close to the end of the first half, the results of its operations are presented in the financial statements on a consolidated basis, rather than on the equity basis (see Note 8 to the financial statements).

The Company's auditors have drawn attention to the financial condition of DBS and to the fact that its continued operation is contingent upon further receipt of loans from the shareholders including loans from the Company in accordance with the DBS's work plan.

K. Quarterly data – Consolidated statements (in NIS millions)

	Year 2004	Q4 2004	Q3 2004	Q2 2004	Q1 2004
Revenue from telecommunications services	9,269.8	2,775.5	2,473.5	2,011.6	2,009.2
General and operating expenses	5,565.1	1,830.1	1,511.0	1,133.2	1,090.8
Depreciation	2,092.5	597.4	556.3	467.0	471.8
Royalties to the Government of Israel	220.7	64.9	59.8	48.7	47.4
	7,878.3	2,492.4	2,127.0	1,648.9	1,610.0
Operating income	1,391.5	283.1	346.5	362.7	399.2
Financing expenses, net	217.5	80.9	67.9	38.0	30.7
Earnings after financing expenses	1,174.0	202.2	278.6	324.7	368.5
Other income (expenses), net	79.7	(29.2)	131.9	7.5	(30.5)
Earnings before tax	1,253.7	173.0	410.5	332.2	338.0
Income tax	497.5	64.4	166.3	161.5	105.3
Earnings after income tax	756.2	108.6	244.2	170.7	232.7
Equity in losses of affiliates	(134.8)	(4.1)	(1.4)	(64.4)	(64.9)
Minority share in earnings (losses) of a consolidated company	0.6	0.6	0.1	-	(0.1)
Net earnings	620.8	103.9	242.7	106.3	167.9

The quarterly financial results were affected mainly by the first-time consolidations which commenced in the third quarter and by the recording of one-time other income (expenses) in the various quarters. The results of the second quarter were affected mainly by a change in the tax rates (see Section H above). In the fourth quarter there was a decrease in operating income in the Group's principal segments as compared with the third quarter. The reason for the decrease is partly a seasonal decline in income and partly a rise in operating expenses.

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in 2004 amounted to approximately NIS 2,850 million, compared with approximately NIS 2,692 million in the corresponding period in the prior year. The increase in consolidated cash flows from operating activities was due to first-time consolidation and to an increase in the operating cash flows of the international communications and internet services segment.

Cash flows generated by operating activities are the principal source of financing of the Group's investments, which during the Report Period included, *inter alia*, approximately NIS 1,651 million in the development of telecommunications infrastructure and approximately NIS 390 million investment in investee companies. During the year, the Group repaid approximately NIS 3,263 million in debts, of which approximately NIS 2,605 million was in respect of long-term loans, approximately NIS 601 million in respect of debentures and approximately NIS 57 million in respect of short-term credit.

The Group raised new debt in a total amount of approximately NIS 1,843 million by an issuance of debentures (of which NIS 850 million par value was by a stock exchange issuance) and receipt of new long-term loans.

The average monthly short-term credit during the period was approximately NIS 52 million. The average monthly long-term liabilities for the period was approximately NIS 6,565 million.

Working capital as at December 31, 2004, amounted to approximately NIS 287 million, compared with working capital of approximately NIS 1,111 million on December 31, 2003. The decrease derives mainly from the first-time consolidation described in Section A above, and from a decrease in the Company's working capital deriving mainly from a decrease in cash and short-term investments.

4. Group involvement in the community and donations

Since becoming a “mixed company”, the Company is no longer forbidden to make donations, as was the case when it was a government company.

During the Report Period the Group was active in the community through its involvement in social institutions and organizations such as the education system in distressed areas and the confrontation line. To mark the twentieth anniversary of its establishment, the Company initiated a campaign of donations to various organizations during 2004. The amount of the monthly donation is the higher of 5% of its call revenues on the twentieth day of each month of the campaign or NIS 200,000. The twelve month campaign commenced on February 20, 2004. During the Report Period the Company donated a total of approximately NIS 2.562 million through this campaign.

The Company initiated and invested approximately NIS 846,000 in the "Summer for the Community" project in which 16-18-year old children of employees worked in medical institutions and community centers.

Pelephone donated NIS 500,000 during the Report Period , as well as the use of part of its infrastructure, for the "Good Day" project of the "Israeli Spirit" society.

5. Details concerning market risks exposure management

The Company and the consolidated companies each manage their market risks individually and not from a consolidated perspective. The financial statements contain financing expenses of approximately NIS 16.1 million from hedging transactions made during the Report Period. Following is a description of the risks and their management by the Company:

Responsibility for the Company’s market risks

The person responsible for management of the Company's market risks is the Chief Financial Officer, Mr. Ron Eilon. For details of his education and experience, see Section 13(C) in Chapter D of the Periodic Report.

Description of market risks and the Company's risk management policy

The Company is exposed to market risks as a result of changes in interest rates, exchange rates, inflation, the prices of raw materials and equipment and the prices of securities.

Interest rate –Most of the Company's foreign-currency loans bear variable interest at the LIBOR rate plus a margin. The Company is exposed to changes in the LIBOR rate. This is an accounting exposure and can affect the financing expenses recorded of the Company as well as its cash flows. On the other hand, the fact that the interest rate is variable makes the fair value of these loans similar to their book value, thereby neutralizing possible economic exposure.

Company loans and debentures that are linked to the Consumer Price Index ("CPI") usually bear fixed interest and therefore a change in the interest rate will affect the fair value rather than the book value. This same is true of the euro-denominated debentures that the Company issued on an overseas stock exchange.

The Company has investments in marketable bonds that are recorded in its books at their market value. This market value is influenced by changes in the interest rates in the economy.
The Company has investments in marketable bonds defined as a "permanent investment", and therefore their presentation is not affected by market value or by changes in the interest rate in the economy.

As of the date of this report the Company does not hedge against the aforementioned exposures. It is not inconceivable, however, that it will do so under future market circumstances. Furthermore, the Company takes into account such influences when considering the types of loans it takes and in the management of its investment portfolio.

Exchange rates – Of itself, a change in the shekel exchange rate constitutes economic exposure in that it can affect the Company's future earnings and cash flows, mainly the repayment of currency-linked obligations and payments for the currency-linked purchase of equipment and raw materials.

In order to minimize this exposure, the Board of Directors decided that the Company should partially or fully hedge the accounting exposure deriving from all the balances recorded in the balance sheet. In the event of partial hedging, the unhedged exposure would not exceed an amount equivalent to $150 million, of which not more than the equivalent of $ 50 million would relate to currencies other than the U.S. dollar. In addition, the Company is be able to implement additional hedging transactions from time to time against exposure to expected transactions during one year of operation, this being limited to a total volume not exceeding the equivalent of $ 100 million – of which not more than the equivalent of $ 30 million would relate to currencies other than the U.S. dollar. The reduction of exposure during the Report Period was accomplished by means of forward transactions of currencies hedged against shekels or against CPI-linked shekels. The time frame of the forward contracts is equal to or shorter than the time frame of the hedged exposure. We note that inherent in some of the Company's hedging transactions is a CPI-linked shekel interest rate, which increases the Company's exposure to the CPI. With the transition in 2004 to financial reporting and measurement based on nominal shekels the Company has increased the volume of transactions against the nominal shekel.

The Company bears no significant costs in making hedging transactions against the exchange rate, since they were made as forward transactions. The financial statements include financing income of approximately NIS 3.8 million from these hedging transactions.

Inflation – The rate of inflation affects the operating income and expenses of the Company during the year.

The Company's tariff updating mechanism as set forth in the Regulations allows tariffs to be updated according to the rise in the CPI (less a fixed efficiency factor) once a year. As a result, the annual rate of inflation and its spread over the year can have a material influence on the erosion of the Company's tariffs and on its revenues. On the other hand, the influence of the rate of inflation on the Company's expenses is reduced, since some of these expenses have direct or indirect linkage mechanisms.

In addition, the Company invests a considerable part of its cash balances in unlinked shekel deposits and mutual funds, and these deposits are exposed to changes in their real yield due to a change in the rate of inflation.

The low rate of inflation prevailing in Israel in recent years has considerably reduced the financial significance of this risk.

The Company has a surplus of liabilities over CPI-linked assets. Commencing 2004 there is a transition of financial reporting and measurement to a nominal shekel basis. This transition increases the abovementioned exposure and in positive inflationary periods increases the Company’s financing expenses.
As part of its policy of minimizing exposure, the Company has made hedging transactions against the CPI so as to reduce this risk.

Prices of raw materials and equipment – Cash flows generated by the Company's operations are used partially for investment in equipment. The prices of equipment are affected by the indices to which they are linked, including sectorial price indices, exchange rates and global prices. The Company is not hedged against this exposure.

Prices of securities – The Company invests some of its cash balances in securities. The composition and amount of the securities portfolio are determined by the Board of Directors of the Company. With the aim of preventing fluctuations in the portfolio's yield, the Board of Directors set investment principles whereby most of the investment will be in bonds, shekel deposits and interest-bearing foreign currency instruments, while the share component will not exceed 15% of the investment portfolio and will include shares invested in the TASE 100. The types of bonds and their proportional part in the portfolio were determined according to criteria based on linkage, redemption date and separation between government and non-government bonds. Additionally, a monetary ceiling was determined for the various types of investments.

Supervision and execution of market risk management policy

Following the amendment to the Securities Regulations (Periodic and immediate reports) with respect to the subject of exposure to market risks and its management, a sub-committee of the Finance Committee of the Company's Board of Directors was established, with a mandate to discuss the market risk management policy of the Company and make recommendations to the Finance Committee and the Board of Directors. An exposure report formatis designed to oversee the relevant activities of the Company's Management on the matter was subsequently approved for the sub-committee and the Board of Directors. The committee receives monthly reporting on the status of the exposures and from time to time conducts discussions.

Description of the risks and their management in the consolidated companies

The persons responsible for management of the market risks in the principal consolidated companies are the Chief Financial Officers of those companies and at Pelephone, the Treasurer of the company. The consolidated companies make hedging transactions in accordance with the decisions and under the supervision of their boards of directors.

Report on linkage bases

Note 29 to the financial statements includes information about the linkage terms of the monetary balances of the Company and the Group as at December 31, 2004.

Positions in derivatives as at December 31, 2004 (consolidated)
(Amounts are in NIS thousands)

	Dollar / NIS							
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging - recognized for accounting	1,178,681	17,232			(56,514)	191		
Hedging - not recognized for accounting	21,540				(920)			
Call option								
Hedging –not recognized for accounting	120,624				378			
Put option								
Hedging - not recognized for accounting		43,080				(255)		

Dollar / CPI-linked NIS								
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
Currency exchange transactions at predetermined interest rates								
Hedging - recognized for accounting	43,080				(8,174)			

Euro / NIS								
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging - recognized for accounting	1,335,817				44,917			

Euro / CPI-linked NIS								
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
Currency exchange transactions at predetermined interest rates								
Hedging - recognized for accounting	146,920				28,500			

CPI / NIS								
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging - recognized for accounting	520,000		130,000		(1,241)		(901)	

6. Utilization of proceeds from securities

An offer for sale and issuance to the public through a prospectus were published on May 24, 2004. The application of proceeds from the offering will be decided by the Company from time to time, in accordance with its requirements, including, taking into account the necessity of replacing loans by early repayment. As at the date of approval of the financial statements there has been no need to replace such loans (except for a loan of NIS 5 million which was repaid by the Company before its due date).

7. Disclosure concerning the internal auditor in a reporting corporation

A. The Internal auditor of the Company

Name: Daniel Freedman
Date of commencement of office: August 1, 2003 (appointed as substitute until December 2, 2003)

Qualifications: BA in Accounting (Hebrew University); MA in Economics and Statistics (Hebrew University); CIA (Certified Internal Auditor – USA); CISA (Certified Information Systems Auditor) – USA);
Internal auditing experience: 20 years in various internal auditing positions.
Basis and scope of employment: Senior employee with personal contract, full-time position.

B. **Audit department employees**

The internal auditing department has 20 full time employees, including the internal auditor. Seventeen of the unit's auditing employees have academic degrees in the following fields: accounting, law, economics, business management, statistics, criminology, electrical engineering, political sciences.

C. **Considerations in determining the internal audit work program**

The guiding principle behind the annual work program for the internal audit is the risk inherent in the Company's processes and operations. In order to assess the risks, the audit prepares a 'control risk survey' of the Company every year. As part of this survey the audit examines, in cooperation with the Company's senior management, the material exposures and risks in the Company's operations and the control environment existing for the management of these risks. The survey's findings are used to compile the topics for the annual and multi-year work program.

Additional considerations taken into account in the compilation of the work program are:

(1) Reasonable coverage of all the Company's areas of operation (finance; sales and marketing; personnel and payroll, investments, mergers and acquisitions; safety and security; information technology – IT; economics and logistics; engineering and planning).

(2) Preparation of follow-up checks – at the request of the Board's Audit Committee or the recommendation of the Internal Auditor.

(3) Preparation of reports to follow up the implementation of decisions made by management and the Audit Committee during the two years preceding the year of account.

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In addition to the subjects determined in the annual work program, the audit performs 'special examinations '. These examinations are not included in the work program, and are prepared at the request of the Chairman of the Board of Directors, Chairman of the Audit Committee or the CEO.

D. **The audit's response to corporations comprising a material holding**

An internal auditor and audit committee have been appointed in all the corporations representing material holdings of Bezeq. The audit reports are discussed in the audit committees of these corporations. The Company auditor regularly receives the audit reports of the corporations which are fully held by Bezeq (Pelephone Communications, Bezeq Online, Bezeq International, and BezeqCall) and submits a summary of their material findings to the Chairman of the Board of Directors, the CEO and the Chairman of the Audit Committee.

At the request of the Chairman of the Board of Directors, the internal auditor prepares special audit examinations for DBS Satellite Services (1998) – "YES". These examinations are not part of the work program of the YES internal auditor, but additional to it.

E. Work standards

The Bezeq internal audit is prepared pursuant to the binding standards of the IIA (Institute of Internal Auditors). This year an external audit investigation of Bezeq's internal audit department was carried out, as required by Standard 1312 of the IIA. The conclusion of this investigation was that the work of Bezeq's internal audit department is carried out in accordance with accepted professional internal audit standards.

F. Organizational officer responsible for the internal auditor

During the Report Period, the officers responsible for the Company's internal auditor were the Chairperson of the Board of Directors, Adv. Miriam (Miki) Mazar and the CEO, Mr. Amnon Dick.

Following the change in Bezeq's status from a government company to a mixed company, the Government Companies Law, which determined the above-mentioned dual responsibility, ceased to apply to the Company. On January 4, 2005, the Board's Audit Committee gave its approval for the auditor to be hierarchically subordinate to the Chairman of the Board of Directors. The decision will be submitted for approval by the Board of Directors.

G. Dates for submission of the audit reports

The internal auditor regularly submits the audit reports during the Report Period to the Chairman of the Board of Directors, the CEO, the Chairman of the Audit Committee and the committee members. During the Report Period, 28 reports were submitted, of which two were follow-up reports resulting from implementation of decisions made by management and the Audit Committee in 2002 and 2003.

H. Dates on which the Audit Committee convenes

The Board's Audit Committee regularly discusses the audit reports submitted by the internal auditor during the Report Period. The committee convenes on average once a month. The following table presents the meeting dates during the year of account , divided into quarters:

First quarter	Second quarter	Third quarter	Fourth quarter
January 6, 2004	April 20, 2004	July 15, 2004	October 28, 2004
January 29, 2004	May 13, 2004	August 5, 2004	November 4, 2004
March 30, 2004	June 10, 2004	September 21, 2004	January 4, 2005 This meeting was held instead of the meeting that was scheduled for December 2004 and which was postponed.

29 audit reports were discussed at these meetings. Most of the reports discussed were published during the Report Period and a few at the end of the prior Report Period. In addition to discussions of the audit reports, the committee discussed subjects that it is obligated by law to discuss.

I. Authority and responsibility of the internal auditor

(1) The authority and responsibility of the Company's internal auditor are determined in the procedure "The Internal Auditor of the Company". In view of the change in the Company's status (from a government company to a "mixed" company) and in accordance with the customary auditing standards, the procedure was revised and approved by the Board's Audit Committee on January 4, 2005.

(2) Duties of the internal auditor according to the procedure

a. To examine whether the activities of the Company, its officers and senior employees are proper from the perspective of upholding the law and proper business management.

b. To verify that the Company's operations were carried out lawfully by a qualified person, while adhering to principles of efficiency, thrift and purity of ethics and to ensure that they contribute to achievement of the goals defined.

c. To indicate deficiencies in the management of the business of the Company.

d. To examine the authenticity and quality of the financial and management information.

e. To inspect the cash management, the Company's liabilities and arrangements to safeguard the Company's assets and their entirety, and their operative efficiency and use.

f. To check whether the Company's decisions, including at the Board and its committee levels, were made in accordance with proper procedures.

g. To inspect the Company's information systems and information security system – in the computer environment and in the computer systems.

h. To examine the correctness of the Company's transactions dealings with its senior employees, with their families or with corporations under their control.

i. To examine the correctness and effectiveness of the Company's procedures for entering into commitments.

j. To investigate complaints made by Company employees and complaints from the public regarding damage to purity of ethics and proper procedures.

k. To recommend that the Audit Committee determine or amend procedures on significant topics.

l. To expose deficiencies, identify the reasons for their existence and note the causes responsible for them.

m. To make proposals for correcting the deficiencies and preventing their recurrence.

n. To reaudit in order to follow up implementation of the recommendations in the various departments.

(3) Authorities of the Company's internal auditor in accordance with the procedure

a. The Company's internal auditor may demand and receive any information, explanation and document required at his discretion for the performance of his duty, and every Company employee is obliged to provide any document or information at the Company's internal auditor's first request. Every Company employee requested to transfer information to the auditor is required to comply with the request at the time and in the manner determined therefore.

b. The internal auditor is authorized to perform an audit at any time, with a scope that he deems appropriate, in any of the Company's departments.

c. The manager and employees of the audited department will allow the internal auditor and his staff to perform the audit and will assist them with any request.

d. For performance of his duty, the internal auditor shall be granted access to any ordinary or computer databank, to any database and to any automated or non-automated data processing work program in the Company.

e. The internal auditor may enter and inspect any of the Company's assets.

f. The above authorities are also granted to audit department staff and to any person acting on behalf of the internal auditor.

J. Opinion of the Board of Directors

Based on Sections A - I above, the members of the Company's Board of Directors believe that the scope of the Company audit performed in 2004, the nature and continuity of the

internal auditor's activities, as well as the work program, are reasonable under the circumstances and they achieve the objectives of the audit.

8. Critical accounting estimates

The preparation of the financial statements according to accepted accounting principles obligates the management of the Company to make estimations and assessments that influence the reported values of the assets and liabilities, income and expenses, and disclosure relating to contingent assets and liabilities.

Management bases its estimations and assessments on past experience and on additional factors which it believes are relevant, taking into account the circumstances. The actual results can differ from those assessments on various assumptions and conditions. Management has identified the most critical assessments and estimations that require significant discretion in preparing the consolidated financial statements. Management believes that these assessments and estimations are critical because every change in them and in these assumptions has the potential to materially affect the financial statements.

Estimated useful life of fixed assets

The estimated useful lives of fixed assets serve to determine the depreciation expense that will be recorded during the Report Period.

The main part of the telecommunications infrastructure is managed in accordance with asset groups. The depreciation rates are based on the average useful life of an asset group and not of each individual asset. The useful life of an asset group is examined periodically and is based on past experience, taking into consideration expected technological changes, Company plans or other changes. If such changes take place earlier than expected or differently from expectations, the remaining useful life of such assets may be shortened. This results in an increase in future depreciation expenses. If the changes take place later than expected the remaining useful life may be extended, and this results in a decrease in the depreciation expense. In light of the importance of the Group's depreciation expenses in respect of the above changes, the effect on the operating results and the financial condition of the Group can be extremely significant. In addition, in accordance with the instructions of Accounting Standard No. 15 of the Accounting Standards Institute, the possibility of decreasing the value of the asset is reviewed when there is an indication of a decrease in the recoverable value of the asset.

Regarding a change in the estimated useful life of a fixed asset and the outcome of the review of a possible decrease in the value of the Group – see Note 9 to the financial statements.

Period of amortization of goodwill

Pursuant to Accounting Standard No. 20 of the Accounting Standards Institute, goodwill will be systematically amortized over its useful life. The amortization period reflects the best estimate of the period in which future economic benefits are expected to derive to the entity from the goodwill. The amortization period shall not exceed 20 years.

The period during which future economic benefits are expected to derive to the Company is estimated by management. Use of other assumptions is likely to result in a different estimate of the period during which economic benefits from the goodwill are expected.

For the amortization period and changes thereto – see Note 2(D) to the financial statements.

Liability for employee severance benefits

Liability for employee severance benefits included in the financial statements are based on numerous assumptions and estimations. Significant assumptions and estimations are linked to early retirement plans. This provision is based on actuarial calculations which include many calculation assumptions which can be different in practice. The assumptions relate, *inter alia*, to interest rates for capitalization, mortality tables, wage creep – for details, see the actuary's letter attached to the financial statements. Some of the severance pay liabilities, such as a provision for redemption of sick leave, a provision for severance and a provision for employee claims, are also based on assumptions and estimations which are likely to be clarified in the future.

With regard to changes in estimations in respect of the cessation of the employer employee relationship, see Note 16 to the financial statements.

Deferred taxes

Deferred taxes are calculated at the tax rate expected to be in effect on their date of utilization. The tax benefit is included in the financial statements since the Company's business plans anticipate realization of the tax benefit. In the nature of things, actual business results can differ from business plans, and this can affect the future realization of the tax benefit.

See Note 11 (D) and Note 11 (F) to the financial statements.

Contingent liabilities

The Group's companies have pending liabilities in amounts for which the possible maximum exposure is considerable. Among these, class actions of extremely significant amounts are pending against Group companies.

The Company makes regular estimations of the potential liabilities associated with every claim. It is naturally very difficult to determine the outcomes of the claims. The Company uses its best judgment and the assessments of its legal advisers to determine whether it is reasonable for the Company to bear the costs of settling claims and whether they can be reasonably estimated.

Taking into consideration the uncertainty inherent in legal claims, it is possible that all or some of them will be concluded with charges for the Company, in amounts materially different from the provisions included in the financial statements, if any.
For details of contingent liabilities, see Note 19 to the financial statements.

9. Directors with accounting and financial expertise

A. The Company's Board of Directors determined that the appropriate minimum number of directors who have accounting and financial expertise is two. The Board of Directors believes that this number will enable it to fulfill the duties imposed upon it by law and by the documents of association, including review of the financial condition of the Company and preparing and approving the financial statements, taking into consideration the nature, activities and business of the Company.

B. Serving directors who have the above skills:

1. Yigal Cohen-Orgad (outside director)

B.A. in economics and education, studied for M.A. in economics and business administration (Finance track).
Former Minister of Finance of Israel.
Deputy Chairman of the Board of Bank Leumi le'Israel B.M., 1989-1993.

2. Hava Shechter

B.A. in economics, MBA – major in finance and accounting.
Currently serves as Chairperson of the Issuance /Privatization Committee of the Board of Directors of the Company, and member of the Finance Committee.
Owner of C. Shechter & Co. Investment House Ltd. – a company specializing in financial solutions, issuances, mergers and acquisitions.
Started her career in the Issuances department of Israel Discount Bank Ltd., and managed the analytical department of the Investments section at Bank Leumi le'Israel B.M.
Formerly a partner in Zmicha Investment House Ltd., and head of its Integrated Financial Services segment.
Lecturer at an investment banking course for M.A. students.

C. Directors with the above skills who served during the Report Period and who, as at the date of this report, no longer serve.

1. Yoram Aridor

B.A. in humanities, minors: economics and politics, LLM and licensed to practice law.
Former Minister of Finance and Minister of Communications in Israel, and member of the Knesset Finance Committee, 1983-1988.
Served as a director in Maalot Israeli Securities Rating Co. Ltd., 1994-2000.
Chairman of the Herut Movement Committee, 1979-1987.
Served as director until November 26, 2004.

2. Shilo Lifschitz

Qualified CPA, and M.B.A. from the Hebrew University of Jerusalem.
Economist at the Bank of Israel, 1988-1993.
Various positions at United Mizrahi Bank Ltd, 1994-2000, including manager of the bank's Asset and Liabilities Management department.
Deputy Director General at the Institute for Forward Contracts and Options Ltd., 2000-2001.
Lecturer in accounting and finance courses, 2000-2002, and since 2001 Director of Research Budget Control at the Hebrew University of Jerusalem.
Member of the Finance Committee of the Company Board of Directors and chairman of the sub-finance committee for market risk management.
Served as director until December 17, 2004.

3. Shoshana Weinshel

LLB and licensed to practice law.
Between 1956 and 1991, served in various positions at Bank Leumi le'Israel B.M., including Legal Counsel, and managed the Underwriting and Issuances Department at the bank. In her last position at Bank Leumi, she headed the Business Division and was a member of the bank's *"cabinet"*. From 1991 to the present, she has served as a director in public companies such as EL AL Israel Airlines Ltd., Israel Fuel Co. Ltd., Dan Hotels Ltd., Rafael Weapons Development Ltd., and Mercantile Discount Bank Ltd. – where she is currently Chairperson of the Loans Committee.
She is Chairperson of the Company Audit Committee and a member of the Finance Committee of the Board of Directors.
Served as director until February 17, 2005.

We thank the managers of the Group's companies, its employees and the shareholders.

Adv. Miriam (Miki) Mazar Chairperson of the Board of Directors	Amnon Dick President &CEO

Chapter C – Financial Statements

"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

FINANCIAL STATEMENTS

DECEMBER 31, 2004

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Auditor's Report to the Shareholders of “Bezeq” The Israel Telecommunication Corp. Limited

We have audited the accompanying balance sheets of “Bezeq” The Israel Telecommunication Corp. Limited (the Company) as at December 31, 2004 and 2003, the consolidated balance sheets as at such dates and the related statements of income, shareholders’ equity and cash flows for each of the three years the last of which ended on December 31, 2004. These financial statements are the responsibility of the Company’s Board of Directors and its Management. Our responsibility is to express an opinion on these financial statements based on our audits.

We did not audit the financial statements of consolidated subsidiaries, (and in respect of 2003 and 2002 those consolidated by the proportionate method) whose assets included in the consolidation constitute approximately 36% and approximately 20% of the total consolidated assets as at December 31, 2004 and 2003 and whose revenues included in the consolidation constitute approximately 49%, 37% and 34% of the total consolidated revenues for the years ended December 31, 2004, 2003, and 2002, respectively. Furthermore, we did not audit the financial statements of affiliates in which the investment was approximately NIS 70 million and approximately NIS 241 million as at December 31, 2004 and 2003, respectively, and the Group's equity in their operating losses is approximately NIS 135 million, approximately NIS 341 million and approximately NIS 349 million for the years ended December 31, 2004, 2003 and 2002 respectively. The financial statements of those companies were audited by other auditors whose reports thereon were furnished to us and our opinion, insofar as it relates to amounts emanating from the financial statements of such companies, is based solely on the said reports of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards, including standards prescribed by the Auditors’ Regulations (Manner of Auditor’s Performance), 1973. Such standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Board of Directors and by Management of the Company, as well as evaluating the overall financial statement presentation. We believe that our audits and the reports of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and on the reports of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of the Company and the consolidated financial position of the Company and its subsidiaries as at December 31, 2004 and 2003 and the results of their operations, the changes in shareholders’ equity and their cash flows for each of the three years the last of which ended December 31, 2004, in conformity with generally accepted accounting principles. Furthermore, in our opinion, the financial statements referred to above are prepared in accordance with the Securities Regulations (Preparation of annual financial statements), 1993.

Somekh Chaikin, a partnership registered under the Israeli Partnership Ordinance, is the Israeli member firm of KPMG International, a Swiss cooperative.

As explained in Note 2B, the financial statements for dates and reporting periods subsequent to December 31, 2003 are stated in reported amounts, in accordance with the accounting standards of the Israel Accounting Standards Board. The financial statements for dates and reporting periods that ended through the aforementioned date are stated in values that were adjusted to that date according to the changes in the general purchasing power of the Israeli currency, in accordance with opinions of the Institute of Certified Public Accountants in Israel.

Without qualifying our opinion, we draw attention to the uncertainties relating to the following matters, the maximum possible exposure of which is significant:

1. The continuing opening of the communications sector to competition, changes in the tariffs and their effect on the Company’s financial position and operating results, as described in Note 1.

2. A program for early retirement, as described in Note 16D.

3. Claims made against the Company and against investee companies, as described in Note 19A.

4. The financial position of a consolidated company including:

   (a) Restrictions imposed by the Ministry of Communications on the Company with respect to additional cash transfers to the consolidated company.
   (b) Resolution of the Board of Directors of the Company dated February 17, 2005 whereby it stands behind its resolution dated March 30, 2004 to continue to invest in the consolidated company according to the work plan which was approved, together with the other shareholders and financial institutions, despite the aforementioned restrictions.

   As mentioned in Note 8E, the continuation of the operations of the consolidated company is conditional upon the continued receipt of shareholders' loans, including loans from the Company, pursuant to the consolidated company's work plan.

Somekh Chaikin
Certified Public Accountants (Isr.)
A member firm of KPMG International

March 3, 2005

Balance Sheets

	Note	Consolidated		Company	
		December 31 2004	December 31 2003	December 31 2004	December 31 2003
		Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003
		NIS thousands	NIS thousands	NIS thousands	NIS thousands
Current assets					
Cash and cash equivalents	3	**1,457,107**	1,954,350	**1,327,731**	1,896,518
Short-term investments	4	**1,287,809**	1,340,341	**1,285,920**	1,340,248
Trade receivables	5	**2,115,070**	1,667,623	**970,766**	1,021,267
Other receivables and debit balances	6	**416,113**	415,372	**370,284**	363,959
Inventory		**314,549**	83,995	**–**	–
		5,590,648	5,461,681	**3,954,701**	4,621,992
Materials and spare parts		**130,922**	151,911	**130,922**	151,911
Broadcasting rights					
Cost		**234,757**	–	**–**	–
Less – rights utilized		**94,261**	–	**–**	–
		140,496	–	**–**	–
Investments and long-term receivables					
Investments, deposits and debit balances	7	**872,575**	765,971	**570,541**	654,400
Investments in investee companies	8	**70,308**	240,667	**6,484,476**	1,509,101
		942,883	1,006,638	**7,055,017**	2,163,501
Fixed assets	9				
Cost		**34,311,281**	28,385,188	**22,124,083**	23,184,549
Less – accumulated depreciation		**23,570,947**	19,686,070	**15,993,634**	16,401,414
		10,740,334	8,699,118	**6,130,449**	6,783,135
Other assets					
Goodwill		**1,792,658**	18,628	**–**	–
Deferred charges and other assets	10	**387,904**	190,049	**13,434**	11,016
Deferred taxes	11	**446,136**	560,739	**339,280**	441,420
		2,626,698	769,416	**352,714**	452,436
		20,171,981	16,088,764	**17,623,803**	14,172,975

	Note	Consolidated		Company	
		December 31 2004	December 31 2003	December 31 2004	December 31 2003
		Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003
		NIS thousands	NIS thousands	NIS thousands	NIS thousands
Current liabilities					
Bank credit	12	**88,102**	144,714	**–**	–
Current maturities of:					
Long-term bank loans	13	**1,304,916**	685,883	**473,578**	324,827
Debentures	14	**240,481**	598,153	**210,481**	598,153
Trade payables	15	**1,675,569**	1,130,716	**648,218**	686,517
Employee severance benefits, net	16	**592,474**	602,520	**592,474**	602,520
Other current liabilities	17	**1,402,140**	1,188,200	**909,194**	949,835
		5,303,682	4,350,186	**2,833,945**	3,161,852
Long-term liabilities:					
Long-term loans	13	**2,860,934**	1,754,293	**529,734**	1,046,212
Debentures	14	**3,824,539**	2,324,582	**6,114,628**	2,324,582
Employee severance benefits, net	16	**680,096**	770,909	**658,355**	761,283
Other long-term liabilities	18	**47,375**	43,764	**21,374**	34,104
Loans extended by the minority in a consolidated company:					
Loans		**1,057,988**	–	**–**	–
Less – minority share in deficit of a consolidated company		**(1,057,988)**	–	**–**	–
		7,412,944	4,893,548	**7,324,091**	4,166,181
Minority rights		**(10,412)**	88	**–**	–
Contingent liabilities	19				
Shareholders' equity	20	**7,465,767**	6,844,942	**7,465,767**	6,844,942
		20,171,981	16,088,764	**17,623,803**	14,172,975

Adv. Miriam (Miki) Mazar	**Amnon Dick**	**Ron Eilon**
Chairperson of the Board	President & CEO	Chief Financial Officer

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2

Date of approval of the financial statements: March 3, 2005
The notes to the financial statements are an integral part thereof.

Statements of Operations for the Year Ended December 31

		Consolidated			Company		
		2004	2003	2002	2004	2003	2002
		Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003		Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	
	Note	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues	21	**9,269,804**	7,981,268	8,063,480	**4,959,691**	5,230,561	5,447,068
Costs and expenses							
General and operating expenses	22	**5,565,090**	4,485,300	4,525,933	**2,347,448**	2,366,547	2,399,726
Depreciation	9	**2,092,475**	2,160,011	2,270,214	**1,495,909**	1,776,279	1,888,511
Royalties to the State of Israel		**220,691**	242,608	250,146	**145,318**	181,116	179,027
		7,878,256	6,887,919	7,046,293	**3,988,675**	4,323,942	4,467,264
Operating income		**1,391,548**	1,093,349	1,017,187	**971,016**	906,619	979,804
Financing expenses, net	23	**(217,529)**	(157,522)	(165,316)	**(93,216)**	(62,372)	(117,134)
Earnings after financing expenses		**1,174,019**	935,827	851,871	**877,800**	844,247	862,670
Other income (expenses), net	24	**79,680**	(983,178)	(1,206,704)	**109,904**	(846,948)	(1,207,182)
Earnings (loss) before income tax		**1,253,699**	(47,351)	(354,833)	**987,704**	(2,701)	(344,512)
Income tax	11	**(497,485)**	(48,013)	(207,333)	**(387,079)**	(33,513)	(229,641)
Earnings (loss) after income tax		**756,214**	(95,364)	(562,166)	**600,625**	(36,214)	(574,153)
Equity in earnings (losses) of investee companies	8	**(134,773)**	(343,334)	(353,616)	**20,200**	(401,622)	(338,622)
Minority share in loss (earnings) of a consolidated company		**(616)**	862	3,007	**–**	–	–
Net earnings (loss) for the year		**620,825**	(437,836)	(912,775)	**620,825**	(437,836)	(912,775)
Primary and diluted earnings (loss) per NIS 1 par value of common shares (in NIS)	25	**0.238**	(0.179)	(0.379)	**0.238**	(0.179)	(0.379)

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2

The notes to the financial statements are an integral part thereof.

Statements of Changes in Shareholders' Equity

	Share capital	Capital reserve – share premium	Capital reserve in respect of transactions between the Company and a controlling shareholder	Dividend proposed after the balance sheet date	Retained earnings (deficit)	Total
	Adjusted for the effects of inflation in shekels of December 2003					
	NIS thousands					
Balance as at January 1, 2002	6,116,378	938,134	37,775	–	410,568	7,502,855
Changes in 2002 –						
Net loss	–	–	–	–	(912,775)	(912,775)
Dividend proposed subsequent to balance sheet date	–	–	–	186,416	(186,416)	–
Balance as at December 31, 2002	6,116,378	938,134	37,775	186,416	(688,623)	6,590,080
Changes in 2003 –						
Net loss	–	–	–	–	(437,836)	(437,836)
Dividend paid	–	–	–	(186,416)	1,070	(185,346)
Allotment of shares	192,755	685,289	–	–	–	878,044
Balance as at December 31, 2003	6,309,133	1,623,423	37,775	–	(1,125,389)	6,844,942

	Share capital	Capital reserve – share premium	Capital reserve in respect of transactions between the Company and a controlling shareholder	Dividend proposed after the balance sheet date	Retained earnings (deficit)	Total
	Reported amounts*					
	NIS thousands					
Balance as at January 1, 2004	6,309,133	1,623,423	37,775	–	(1,125,389)	6,844,942
Changes in 2004 –						
Net earnings	**–**	**–**	**–**	**–**	**620,825**	**620,825**
Balance as at December 31, 2004	**6,309,133**	**1,623,423**	**37,775**	**–**	**(504,564)**	**7,465,767**

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2

The notes to the financial statements are an integral part thereof.

Statements of Cash Flows for the Year Ended December 31

	Consolidated			Company		
	2004	2003	2002	2004	2003	2002
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003		Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	
		NIS thousands			NIS thousands	
Cash flows from operating activities						
Net earnings (loss)	**620,825**	(437,836)	(912,775)	**620,825**	(437,836)	(912,775)
Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities (see A below)	**2,229,157**	3,129,841	3,742,957	**1,489,789**	2,553,040	3,324,909
Net cash flow generated by operating activities	**2,849,982**	2,692,005	2,830,182	**2,110,614**	2,115,204	2,412,134
Cash flows from investing activities						
Investment in fixed assets	**(1,650,557)**	(1,413,803)	(1,353,916)	**(842,224)**	(853,166)	(876,038)
Proceeds from disposal of fixed assets and sale of operations	**131,576**	86,492	24,690	**44,897**	7,742	12,895
Proceeds from disposal of investment in affiliated companies	**–**	–	116,816	**–**	–	116,203
Investment in long-term deposits and investments	**(42,064)**	(159,564)	(286,270)	**(42,064)**	(150,808)	(279,930)
Realization of long-term deposits and investments	**18,094**	77,216	159,745	**18,094**	67,176	149,614
Increase in short-term investments, net	**135,602**	(107,137)	(754,311)	**135,509**	(107,137)	(769,565)
Decrease (increase) in materials and spare parts	**625**	(260)	22,769	**625**	(260)	22,769
Acquisition of companies consolidated for the first time (see C below)	**(246,935)**	–	(3,861)	**–**	–	–
Investment in investee companies	**(142,753)**	(190,037)	(359,517)	**(2,376,699)**	(188,542)	(472,414)
Dividend from a subsidiary	**–**	–	–	**18,838**	–	–
Investments in other assets	**(130,700)**	(51,124)	(126,328)	**(2,598)**		(8,824)
Net cash outflow used for investment activities	**(1,927,112)**	(1,758,217)	(2,560,183)	**(3,045,622)**	(1,224,995)	(2,105,290)
Cash flows from financing activities						
Issue of other debentures (after deduction of issue expenses)	**1,528,092**	–	106,986	**1,322,171**	–	106,986
Repayment of other debentures	**(601,481)**	(207,623)	(221,386)	**(601,481)**	(207,623)	(221,386)
Receipt of long-term loans	**314,900**	493,191	207,332	**–**	–	–
Repayment of long-term loans	**(2,605,012)**	(557,302)	(826,605)	**(354,469)**	(378,828)	(619,755)
Receipt (repayment) of short-term bank credit, net	**(56,612)**	(374,137)	75,938	**–**	–	–
Proceeds from allotment of shares	**–**	878,044	–	**–**	878,044	–
Dividend paid	**–**	(185,346)	–	**–**	(185,346)	–
Net cash generated by (used for) financing activities	**(1,420,113)**	46,827	(657,735)	**366,221**	106,247	(734,155)
Increase (decrease) in cash and cash equivalents	**(497,243)**	980,615	(387,736)	**(568,787)**	996,456	(427,311)
Cash and cash equivalents at beginning of year	**1,954,350**	973,735	1,361,471	**1,896,518**	900,062	1,327,373
Cash and cash equivalents at end of year	**1,457,107**	1,954,350	973,735	**1,327,731**	1,896,518	900,062

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2

The notes to the financial statements are an integral part thereof.

Statements of Cash Flows for the Year Ended December 31 (contd.)

	Consolidated			Company		
	2004	2003	2002	2004	2003	2002
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003		Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands			NIS thousands		
A – Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities						
Revenues and expenses not involving cash flows:						
Depreciation	**2,092,475**	2,160,011	2,270,214	**1,495,909**	1,776,279	1,888,511
Disposal of assets and provision for impairment of fixed assets	**–**	327,295	–	**–**	198,686	–
Deferred taxes	**219,975**	(137,670)	30,149	**113,330**	(182,167)	63,829
Company's equity in (earnings) losses of affiliated companies	**134,773**	343,334	353,616	**(20,200)**	401,622	338,622
Minority share in (losses) earnings of a consolidated company	**616**	(862)	(3,007)	**–**	–	–
Increase (decrease) in employee severance benefits, net	**(110,334)**	46,488	(280,971)	**(112,974)**	47,662	(286,269)
Loss (gain) from disposal of fixed assets	**(7,338)**	(1,634)	(12,739)	**(5,674)**	(1,570)	(12,254)
Gain from sale of an operation	**(35,033)**	–	–	**(35,033)**	–	–
Provision for decrease in value of investments	**26,000**	14,603	1,219,566	**26,000**	14,603	1,219,566
Erosion (appreciation) of and interest on long-term deposits and investments	**31,199**	36,407	(204,341)	**(6,023)**	36,407	(204,341)
Erosion (appreciation) of short-term investments, net	**(10,584)**	(75,381)	56,916	**(10,555)**	(75,378)	55,509
Appreciation (erosion) of long-term liabilities:						
Other debentures	**115,674**	207,133	204,985	**115,674**	207,133	204,985
Long-term loans and other long-term liabilities	**(17,104)**	(77,647)	(13,380)	**(9,971)**	(82,015)	13,951
Amortization of other assets and deferred expenses	**110,083**	127,191	229,645	**6,098**	(8,466)	11,444
Changes in asset and liability items:						
Increase in broadcasting rights	**(17,516)**	–	–	**–**	–	–
Decrease (increase) in trade receivables	**52,827**	29,835	29,422	**50,501**	67,096	97,636
Decrease (increase) in other receivables and debit balances	**(8,223)**	129,706	4,885	**(54,988)**	163,158	(27,828)
Decrease (increase) in inventory	**(122,824)**	78,083	(44,803)	**–**	–	–
Increase (decrease) in trade payables	**(102,466)**	(123,852)	51,057	**(23,124)**	(30,925)	110,564
Increase (decrease) in other current liabilities	**(126,652)**	63,054	(131,416)	**(26,451)**	45,460	(123,727)
Decrease in deferred revenues	**3,609**	(16,253)	(16,841)	**(12,730)**	(24,545)	(25,289)
	2,229,157	3,129,841	3,742,957	**1,489,789**	2,553,040	3,324,909

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2

The notes to the financial statements are an integral part thereof.

Statements of Cash Flows for the Year Ended December 31 (contd.)

	Consolidated			Company		
	2004	**2003**	**2002**	**2004**	**2003**	**2002**
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003		Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands			NIS thousands		
B – Non–cash transactions						
Acquisition of fixed assets, other assets, materials and spare parts on credit	**102,687**	313,119	208,253	**25,553**	180,463	126,481
Sale of fixed assets on credit	**1,196**	–	5,800	**1,196**	–	5,800
Investment against a loan to a consolidated company	**–**	–	–	**2,560,089**	–	–
C – Company consolidated for the first time and assumption of full control of a proportionally consolidated company (Note 2DD)						
Operating capital (excluding cash and cash equivalents)	**2,057,632**	–	6,504	–	–	–
Fixed assets	**(2,967,819)**	–	(6,018)	–	–	–
Long-term liabilities	**2,322,740**	–	794	–	–	–
Minority loans to a consolidated company	**1,048,637**	–	–	–	–	–
Less minority share in the deficit	**(1,048,637)**	–	–	–	–	–
Minority rights as of acquisition date	**(16,549)**	–	723	–	–	–
Investment in an affiliate	**178,339**	–	1,066	–	–	–
Goodwill	**(1,821,278)**	–	(6,930)	–	–	–
	(246,935)	–	(3,861)	–	–	–

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2

The notes to the financial statements are an integral part thereof.

NOTE 1 – GENERAL

A. "Bezeq" The Israel Telecommunication Corp. Limited (“the Company”) is a "mixed company", and as such certain provisions of the Government Companies Law, 5735-1975 apply to it, as well as certain provisions, similar to those in that law, by virtue of its Articles of Association. The Company operates under a general license for implementing telecommunications activities and providing telecommunications services, which was granted pursuant to the Telecommunications Law (Telecommunications and broadcasts), 5742-1982 (“the Telecommunications Law”). The Company, together with the subsidiaries (“the Group”), is a main provider of communications services in Israel.

B. Most of the Group companies are required to pay royalties to the Government of Israel. Since January 2001 the revenue base on which the royalties are calculated has been broadened, together with a gradual reduction of the royalty rate, until a uniform rate is attained for all communications operators. The rate of royalties in 2003 was 4% and from 2004 onwards, it was lowered to 3.5%.

On December 5, 2004 the Minister of Communications notified Pelephone that he and the Minister of Finance intend to act for amendment of the regulations so that from January 1, 2006, the royalties rate paid by the cellular companies will be reduced each year by 0.5%, until reduced to a rate of 1%.

C. Pursuant to an agreement reached between the Company and Pelephone, from September 2004, Pelephone ceased certain payments to the Company. Until that date, Pelephone paid the Company 3% of a defined list of revenues from cellular services.

D. The Company was declared a monopoly in the principle fields in which it operates. An appeal filed by the Company against the non-revocation of the declaration of the Company as a monopoly in the basic telephony field, is pending in the Antitrust Tribunal.

E. All the segments of operation of the Group operate in a competitive environment. The Group's operations are generally subject to administrative regulation and supervision. The principal changes that occurred during the period of the financial statements are described below:

(1) Domestic fixed-line communication services

a. Most of the tariffs for the Company's services are set according to Section 15 of the Communications Law and are updated in accordance with the regulations. In the future, tariffs will be updated on the basis of the change in the Consumer Price Index ("CPI") less an efficiency factor ("the Efficiency Factor"), which was set at minus 2.5% as long as the average rate of the Company's growth and output is within the range of minus1% to minus 3% per year (the Efficiency Factor will decrease by one half of one percent with each decrease of one percentage point in the growth rate beyond minus 3%, and will increase by one half of one percent with each rise of one percentage point in the growth rate beyond minus 1%, successively). This tariff arrangement will be in effect until December 31, 2007, with an option to extend it for an additional year. These changes in the Company's tariffs have caused a decrease in revenues and the operating income of the Company. The Company believes, based on its projections, that the mechanism for updating the tariffs as described above will have a materially adverse effect on its revenues and operating income.

b. In November 2003 a partnership owned by the cable companies was granted a general license for providing domestic fixed-line telecommunications services, including telephony, data communications and access to internet providers. The partnership is obligated to gradually provide its services nationwide. In November 2004 the partnership commenced providing services under its license on a commercial basis.

c. In June 2003 the Communications Law was amended so that from September 2004, special general licenses will be able to be granted for providing domestic fixed-line services without an obligation for providing universal service and without an obligation to provide services in a minimum number of areas.

NOTE 1 – GENERAL (CONTD.)

E (Contd.)

(1) Domestic fixed-line communication services (contd.)

d. On July 5, 2004, regulations were published relating to procedures and conditions for the receipt of a special general license for the provision of domestic fixed-line communications services with no universal service obligation. Under the regulations, the licensee is to be the owner and operator of the telecommunications network by means of which the services are to be provided to its subscribers, but at the same time, the licensee will be entitled to use the infrastructure of others, provided that it is the owner and operator of the switch via which the services are provided to its subscribers.

e. On November 30, 2004, the Ministry of Communications published a policy paper regarding "Licensing the provision of telephony service by means of broadband access (VOB) of a domestic fixed-line operator". The Company submitted its position against this policy. In the meantime, the Ministry of Communications began to grant licenses to several entities, among them Bezeq International, for a " trial marketing for payment" to provide domestic fixed-line communication services in accordance with the policy paper it published, which allows such trials in certain circumstances.

f. On August 1, 2004, a temporary provision took effect which provided that interconnect fees would not be paid for calls between the Company's network and a domestic operator's network for the earlier of a period of two years or until a difference of up to 1.05 billion traffic minutes is generated between the Company's network and that of the domestic operator (other than a special domestic operator and the Company). Pursuant to a letter received from the Ministry of Communications, the Company will receive compensation for non-payment of these interconnect fees up to the sum of approximately NIS 40 million, by way of amendment of the Royalties Regulations.

The Company expressed its objection to this arrangement because in its opinion, the arrangement harms it and its property, there is no similar precedent anywhere in the world, and it could generate distortions, market failure and abuse. Therefore, on July 29, 2004, the Company filed a petition in the High Court of Justice against the aforesaid temporary provision, claiming *ultra vires*, discrimination and harm to the Company's property. The Company also claimed that whilst the arrangement regarding non-payment of the interconnect fee is supposed to take effect on August 1, 2004, there is no corresponding arrangement in force for the compensation promised to the Company. Following the filing of the petition, a letter was sent on August 4, 2004 from the Minister of Communications and the Minister of Finance, enclosing a draft amendment to the Royalties Regulations and clarifying that they intend to act to amend the Royalties Regulations in such a way as to guarantee the aforesaid compensation to the Company, and that in the event that the amendment of the Royalties Regulations does not come into force, they will act to suspend the temporary provision until such amendment is effected. On September 22, 2004, the Knesset Finance Committee approved insertion of the aforementioned amendment to the Royalties Regulations. To date, the State and the cable companies have filed their responses to the petition and a preliminary hearing has been held, following which the Company filed an amended petition. The case is scheduled for hearing on April 14, 2005.

g. The Economic Policy for 2005 Bill (Legislative amendments), 5765-2004 ("the Economic Policy Amendment Bill"), proposes an amendment to the Communications Law whereby the Minister will prepare a numbering plan for number portability with regard to a general licensee (including a special general licensee) and with regard to a general licensee for the provision of cellular services, and will direct regarding its implementation and operation by February 1, 2006. The Ministers of Communications and Finance will determine the payment structure for this matter in a way that will ensure full transparency and prevent any discrimination. At a meeting of the Knesset Joint Finance and Economics Committee on March 3, 2005, the Ministry of Communications proposed that it be prohibited to collect payment both from a subscriber who transfers with a number to the network of another operator and from the operator to which the subscriber transfers.

NOTE 1 – GENERAL (CONTD.)

E (Contd.)

(1) Domestic fixed-line communication services (contd.)

g. (Contd.)
In the present configuration of the Company's network number portability cannot be implemented, and its modification will require considerable investment in changing software versions and hardware in the Company's switching network. The operation of number portability also involves costs in respect of joint records and management with the relevant operators. These are very significant costs that cannot yet be estimated. Number portability is expected to facilitate customer transfer between competing communications operators. As at the date of publication of the financial statements, the Company is of the opinion that it will be unable to implement number portability within the timeframe proposed in the above bill.

(2) Cellular services

a. In July 2003 the Minister of Communications issued a decision stating that the compensation in respect of bad debts that the Company deducts from the amounts it transfers to the cellular companies will be set at 1.1%, in the period from October 2, 2000 to August 31, 2003. The decision also states that from September 1, 2003 onwards, the Company will not make any compensatory deduction from the amounts it transfers to them.

The Company appealed the decision of the Minister in the District Court, arguing that the rate of the deduction stated in the decision, and its cancellation from September 2003, do not reflect the bad debts and the collection expenses incurred by the Company.

On August 9, 2004 the Company received the decision of the Court, which stated that it is not competent to hear the appeal, and therefore the appeal had been stricken. On October 13, 2004 the Company approached the Minister of Communications with a request that he re-examine his decision in the light of the Ministry's position as presented in relation to interconnect fees to the cellular network (see section b. below) and the economic findings that were presented by the Ministry of Communications in support of that position. The Ministry rejected the Company's position.

In the financial statements of the Company as at December 31, 2003 and 2002, expenses of approximately NIS 29 million and NIS 59.6 million, respectively, were recorded in respect of the possible effects of the decision of the Minister of Communications on the rate of the deduction from the volume of traffic for the relevant periods.

b. On December 5, 2004 the Minister of Communications notified Pelephone and the Company that as part of a process for re-examination of interconnect fees to a cellular network, the Ministry of Communications had decided to amend the Communications Regulations (Telecommunications and broadcasts) (Payment for interconnect), 5760-2000 (“the Regulations”) in a way that will reduce the interconnect fees to a cellular network for call completion, SMS messages and the computation of the duration to be charged.

The main amendments are:

(1) Reduction of payments receivable from a domestic operator or a cellular operator for the completion of one traffic minute on a cellular network from 45 agorot per traffic minute to a maximum tariff of 32 agorot, as from March 1, 2005, to a maximum tariff of 29 agorot as from March 1, 2006, to a maximum tariff of 26 agorot as from March 1, 2007 and a maximum tariff of 22 agorot as from March 1, 2008.

(2) Reduction of payments receivable from an international licensee for completion of a traffic minute on a cellular network from 25 agorot per minute to a maximum tariff of 22 agorot per minute, as from March 1, 2008.

NOTE 1 – GENERAL (CONTD.)

E (Contd.)

(2) Cellular services (contd.)

(3) Reduction of payments receivable from a cellular operator for the transfer of an SMS message in a cellular network from 28.5 agorot per traffic minute to a maximum tariff of 5 agorot per minute as from March 1, 2005 and 2.5 agorot per minute as from March 1, 2006.

(4) From March 1, 2006, an annual updating mechanism will be introduced for call completion and SMS tariffs in a cellular network, whereby the tariffs will be updated once a year according to the rate of change in the CPI.

(5) For counting the traffic minutes for computation of the payment for call completion to a cellular network, from January 1, 2009, billing will be according to segments of one second rather than 12 seconds as is customary today.
In addition, the Ministry intends to examine whether there is justification for enabling the cellular operators to collect an initial payment for initiating a call.

In addition, in 2005 a hearing will be held on the intention to introduce changes in the structure of the tariff to the consumer for the cellular calls, so that starting on a reasonable date to be determined, there will be no distinction between the price of a call within a network and a call from one cellular network to another network, and the price will also include the interconnect component. The issue will be examined by a joint team of the Ministry of Communications and the Treasury.

(3) International communication services

On April 22, 2004 the Communications Regulations (Telecommunications and broadcasts) (Procedures and conditions for receipt of a general license to provide international telecommunication services), 5764-2004.

The Ministry of Communications granted general licenses to provide international telecommunication services to three additional companies, all of which had commenced operation by the end of 2004. The broadening of competition has led to a further lowering of international call prices, although unlike when competition started in 1997, the volume of international traffic has not increased significantly as a result, since in the period prior to the broadening of the competition, the cost of the calls was not a factor that deterred the public from using the service. In addition, the broadening of the competition had an adverse effect on the results of operations of Bezeq International and its financial position, however, since prices in the market have not yet stabilized, Bezeq International and the Company are unable to estimate, at this stage, the extent of the overall effect of the broadening of competition in the field.

The increasing competition and the entirety of the changes in the communications market as described above, are expected to have an adverse effect on the business results of the Group. That effect cannot be assessed.

F. As part of an offer for sale and public offering pursuant to the Company's prospectus published on May 24, 2004, the State (the Government Companies Authority) and the employee representatives of the Company reached an arrangement regarding compensation to Company employees for the public offering pursuant to the prospectus and for the private sale of the State's shares in the Company (future sale of controlling interest). The arrangement includes conditions for compensation by means of an allotment of 4.71% of the shares of the Company held by the State to Company employees, the employees entitled to the compensation, the term of the arrangement, the price at which the shares will be offered to the employees, the agreed rate of the discount, suspending

conditions etc. It Should be noted that the arrangement embodies a benefit to the employees in a material amount.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY

A. DEFINITIONS

In these financial statements –

(1) the Company – Bezeq, The Israel Telecommunication Corp. Limited.

(2) the Group - Bezeq, The Israel Telecommunication Corp. Limited and its investee companies, as listed in Appendix A – List of Group Companies.

(3) Subsidiaries – Companies, including a partnership or joint venture, whose financial statements are fully consolidated, directly or indirectly, with the financial statements of the Company.

(4) Proportionately consolidated companies – Companies, including a partnership or joint venture, whose financial statements are partially (proportionately) consolidated, directly or indirectly, with the financial statements of the Company.

(5) Affiliated companies – Companies other than subsidiaries or proportionately consolidated companies and including a partnership, in which the Company's investment is stated, directly or indirectly, on the equity basis.

(6) Investee companies – Subsidiaries, proportionately consolidated companies or affiliated companies.

(7) Investments in venture capital funds – Investment in a fund in which two conditions obtain:
  a. The principal business of the fund is research, development or marketing of innovative and high-tech products or processes;
  b. The source of at least 90% of the fund's financing is shareholder capital (including shareholder loans and credit guaranteed by the shareholders), with the support of State authorities or research grants.

(8) Related parties – As defined in Opinion No. 29 of the Institute of Certified Public Accountants in Israel ("ICPAI").

(9) Interested parties – As defined in Paragraph (1) of the definition of an "Interested Party" in a corporation, in Section 1 of the Securities Law.

(10) Controlling interest – As defined in the Securities Regulations (Presentation of transactions between a company and its controlling interest in financial statements), 5756-1996.

(11) CPI – The Consumer Price Index published by the Central Bureau for Statistics.

(12) Adjusted value – A nominal historical amount adjusted in accordance with the provisions of Opinions 23, 34 and Opinions 36, 37 and 50.

(13) Reported value – An amount adjusted for inflation to the transition date (December 31, 2003), with the addition of amounts in nominal values added after the transition, and less amounts deducted after the transition date.

(14) Adjusted financial reporting – Financial reporting based on the provisions of Opinions 23, 34, 36, 37 and 50.

(15) Nominal financial reporting – Financial reporting based on reported amounts.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

B. DISCONTINUANCE OF ADJUSTMENT OF FINANCIAL STATEMENTS

(1) In October 2001, the Israeli Accounting Standards Board ("IASB") published Accounting Standard No. 12 – "Discontinuance of Adjustment of Financial Statements". Pursuant to this Standard, and Accounting Standard No. 17 of December 2002, the adjustment of financial statements will be discontinued from January 1, 2004. Until December 31, 2003, the Company continued to prepare adjusted statements in accordance with Opinion 36 of the ICPAI. From January 1, 2004, the Company is applying the provisions of the Standard and accordingly, adjustment has been discontinued.

(2) In the past, the Company prepared its financial statements on the basis of historical cost adjusted for the CPI. The adjusted values included in the financial statements as at December 31, 2003 served as the starting point for nominal financial reporting which commenced on January 1, 2004. Additions made during the period were included in nominal values.

(3) Values in respect of non–monetary assets do not necessarily represent market value or an up-to-date economic value, but rather, the reported values of those assets.

(4) In the financial statements, "cost" means cost at the reported value.

(5) All comparative data for prior periods are stated adjusted to the CPI of December 2003.

C. REPORTING PRINCIPLES

(1) Balance sheets
   a. Non-monetary items are stated at reported values.
   b. Monetary items are stated at historical nominal values as at the balance sheet date.

(2) Statements of operations
   a. Revenues and expenses deriving from non-monetary items or from provisions included in the balance sheet are derived from the difference between the reported value opening balance and the reported value closing balance.
   b. The remaining items of the statement of operations are stated at nominal values.

D. CONSOLIDATION OF FINANCIAL STATEMENTS

(1) The consolidated financial statements include the financial statements of the Company and of those companies over which the Company has control. Jointly controlled companies are consolidated in the financial statements by the proportionate consolidation method.

(2) A list of the companies whose reports are included in the consolidated financial statements, the percentage of the holding in shares which grant voting rights and the percentage of the holding in shares granting a share in profits, is presented in Appendix A to the financial statements. In addition, a list of companies of the Corporation which were not consolidated is also presented in Appendix A to the financial statements. Regarding a company consolidated for the first time and the assumption by the Company of full control of a proportionally consolidated company – see Note 2DD.

(3) For the purpose of the consolidation, the amounts included in the financial statements of the companies that were consolidated were taken into account after the adjustments necessary in order to apply uniform accounting principles used by the Group.

(4) a. The excess cost of the investment over the fair value of its identified assets less the fair value of the identified liabilities (after allocation of taxes deriving from temporary differences) at the acquisition date, is recorded as goodwill.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

D. CONSOLIDATION OF FINANCIAL STATEMENTS (CONTD.)

(4) b. The excess cost allocated to assets and liabilities is recorded under the appropriate items in the balance sheet.

(5) The Company applies Accounting Standard No. 20 concerning the period of amortization of goodwill. Goodwill is stated in the consolidated balance sheet under "Other assets and deferred charges" and is systematically amortized over its useful life. The amortization period reflects the best estimate of the period in which the Company can expect to derive future economic benefits from the goodwill.

The Standard applies to financial statements for periods commencing on or after January 1, 2004. The change in the amortization period of goodwill balances as at January 1, 2004 is treated as a prospective change of estimate ("from now on"). Such balances will be amortized systematically over the balance of the period remaining for completion of the amortization period determined.

During 2004 the Company changed the goodwill amortization period from 10 years to 20 years, following the first-time application of Accounting Standard No. 20. The effect of the change on the consolidated financial statements is as follows:

	Data before change of estimate	Effect of change of the estimate	Data stated in the financial statements (after change of estimate)
	NIS thousands	NIS thousands	NIS thousands
Amortization expenses	31,617	(11,006)	20,611
Earnings before income tax	1,242,693	11,006	1,253,699
Net earnings	609,819	11,006	620,825
Earnings per share (NIS)	0.234	0.004	0.238

(6) Material inter-company balances and transactions between the consolidated companies were eliminated. Earnings from inter-company sales not yet realized outside the Group, were also eliminated.

(7) a. The consolidated financial statements include the proportional part of the items of the assets, liabilities, expenses and revenues of the proportionately consolidated companies according to the percentage of the holding in those companies.

b. Earnings from the sales of the holding company to proportionately consolidated companies not yet realized outside the Group – were eliminated at a rate proportional to the holding.

c. Earnings from the sales of the proportionately consolidated companies to the holding company, not yet realized outside the Group – were eliminated at the full share of the earnings relating to the holding company.

E. USE OF ESTIMATES

Preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions which affect the reported amounts of assets and liabilities and of contingent assets and liabilities disclosed in the financial statements, as well as amounts of revenues and expenses for the reporting period. Actual results may differ from these estimates.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

F. CASH AND CASH EQUIVALENTS

Cash and cash equivalents include short-term bank deposits and marketable government bonds with an original maturity at the time of making the investment that did not exceed three months.

G. SECURITIES

(1) Marketable securities
Marketable securities held as a current investment are stated at the realizable value on the stock exchange at the balance sheet date. The changes in the values of securities are charged to the statement of operations in full. Marketable securities held as a permanent investment are stated at cost (regarding debentures – including accrued interest and linkage differentials and amortized premium and discount), less a provision for reduction in value of a non-temporary nature (see also section G(3) below).

(2) Non-marketable securities
Non-marketable securities are stated at cost (regarding debentures – including accrued interest and linkage differentials and amortized premium and discount) which, in the opinion of management, does not exceed the realizable value (see also section G(3) below).

(3) Decrease in value of investments
The Company periodically checks to see whether a non-temporary decrease has occurred in the value of its permanent investments. The review is carried out upon the existence of signs indicating that the value of permanent investments has been impaired, including falling market prices, the business of the investee, the sector in which the investee operates and other parameters. The deductions for adjusting the value of these investments, which in management's opinion are based on examination of all the relevant aspects and giving them their proper weight, and which are not of a temporary nature, are recorded in the statement of operations.

H. PROVISION FOR DOUBTFUL DEBTS

The financial statements include specific provisions for doubtful debts which, in the opinion of management, properly reflect the loss inherent in debts, the collection of which is considered doubtful. In determining whether the provisions are appropriate, management considered, among other matters, the assessment of risk concerning the financial situation of the debtors as derived from the information in its possession, the scope of their operations, the collateral they provided and the accumulated experience of the Company and its external lawyers who handle the collection of past debts. Doubtful debts which management and its legal advisers believe cannot be collected are written off in the Company's books following a management decision. Advance payment transactions with credit companies for transactions made with customers by credit card for payment in installments, where the risk of collection was transferred in full to the credit companies, are removed in full from the books. The financial statements also include a general provision in respect of doubtful debts.

I. INVENTORY

Inventory of subscriber equipment and user equipment is stated at the lower of cost or value to the business, where the cost is determined by the moving average method.

As part of its current operations, Pelephone upgrades user equipment for its customers. As a result, inventory includes user equipment returned from customers. The value of the returned inventory is stated at the lower of cost or market value. Inventory also includes spare parts which are used by Pelephone, *inter alia*, for the repair of user equipment as part of the repair service it provides for its customers.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

J. MATERIALS AND SPARE PARTS

Materials and spare parts are valued at the lower of cost (which is determined by the moving average method) or market. Materials are intended primarily for installation in fixed assets. The Company customarily reduces the value of slow moving materials and spare parts purchased in previous years.

K. INVESTMENTS IN AFFILIATED COMPANIES

(1) Investments in affiliates are accounted for by the equity method. In determining the equity of the investments in these companies, the amounts as they are included in the financial statements of the companies, after adjustments necessitated by accepted accounting principles, are taken into account.

(2) Regarding goodwill amortization policy – see D(5) above.

L. IMPAIRMENT OF INVESTMENTS IN INVESTEE AND NON–INVESTEE COMPANIES

Regarding impairment of investments in investee and non-investee companies, see G(3) above and BB below.

M. COMPANY INVESTMENT IN VENTURE CAPITAL FUNDS

(1) The Company's holdings in venture capital funds are presented at adjusted cost less a provision for impairment, if a decrease in value occurs which is not of a temporary nature.

(2) See also G(3) above.

N. FIXED ASSETS

(1) Fixed assets are stated at cost.

(2) The cost of an asset which the Company is constructing for itself includes materials, subcontractors, wages and financing expenses in the construction period, but not exceeding their recoverable amount.

(3) Improvements and enhancements are charged to the cost of assets, while maintenance and repairs are charged to the statement of operations as incurred.

(4) In the event of a decrease in the value of the assets to the business, a provision is recorded accordingly. Regarding provision for the impairment of assets, see section BB below.

(5) Real financing expense for loans and credit used for financing the construction or purchase of fixed assets and other costs relating to the purchase or construction of the fixed assets, are charged to the cost of those assets in accordance with Accounting Standard No. 3 – Capitalization of Credit Costs. (See also U below).

(6) Depreciation is calculated by the straight-line method, based on the estimated useful lives of the assets.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

N. FIXED ASSETS (CONTD.)

(6) (Contd.)
Annual depreciation rates:

	% depreciation	% principal depreciation
Buildings	4	4
Digital switching equipment	5-20	10
Transmission and power equipment	10-20	20
Network equipment	5-20	5
Subscriber equipment and public telephones	20	20
Motor vehicles	15	15
Internet equipment	25	25
Office equipment	10-20	10
Computers	20-33	33
Cellular telephone infrastructure equipment	10-20	20

Improvements to leased premises are amortized over the term of the lease (including the Company's option to extend the lease period), which does not exceed the economic life of the asset.

(7) On change of estimate, see Note 9(g).

O. DEFERRED CHARGES AND OTHER ASSETS

(1) Cost of issue of debentures and raising loans
Costs of issue of debentures and raising loans (treated as a non–monetary item) are amortized over the term of the debentures, pro rata to the balance of the debentures in circulation.

(2) Cost of subscriber acquisition
Since 1999, Pelephone has been capitalizing its net direct costs paid to a third party ("subscriber acquisition") in respect of a sale to subscribers who signed an undertaking to remain customers of Pelephone. Violation of the undertaking leads to payment of a penalty by the customer and the immediate charging of the amortization of the asset to the statement of operations. These costs are amortized over the period of the subscribers' undertaking, which is up to 36 months.

(3) Frequencies
Regarding Pelephone's investment in cellular communication frequencies in third generation technology, see Note 8D(3).

(4) Acquisition of operations (resources)
An acquired operation is stated at cost and in accordance with the present value of the future long-term payments. The cost of the acquisition is amortized on the basis of actual realization of the allocated components and on the basis of the estimated useful life of those components.

P. DEFERRED TAXES

The Group companies allocate taxes in respect of temporary differences. Temporary differences are differences between the value of assets and liabilities for tax purposes and their book value. Deferred tax balances (asset or liability) are calculated according to the tax rates which will be in effect at the time of utilization of the deferred taxes, or upon realization of tax benefits, based on the tax rates and tax laws enacted or the legislation of which is all but completed by the balance sheet date.

The main factors for which deferred taxes were not calculated are as follows:

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

P. DEFERRED TAXES (CONTD.)

(1) A temporary difference generated at the time of first recognition of goodwill.

(2) A temporary difference generated at the time of initial recognition of an asset or liability in a transaction which is not a business combination and on the date of first recognition, there is no effect on either book earnings or taxable income (loss for tax purposes).

(3) The adjustment amounts for changes in the purchasing power of the shekel which relate mainly to buildings and land, in accordance with the principles laid down by the IASB.

(4) Investments in investee companies, where the Company does not intend to realize these investments.

(5) A tax benefit receivable in respect of temporary differences, where the likelihood of realizing the benefit is in doubt.

Q. CLASSIFICATION OF PROFIT AND LOSS ITEMS

Profit and loss items were classified and stated in the order dictated by the character of the Company's business as a telecommunications company.

R. REVENUE RECOGNITION

(1) Revenues are attributed to the statement of operations upon being generated on the accruals basis.

(2) The Company does not include in the cellular revenues/expenses items the revenues/expenses from interconnect fees from the cellular operators; rather, they are recorded net in accordance with the tests prescribed in EITF 99-19, since the Company's tariffs (including interconnect fees) are set by the State in regulations. In 2004 these interconnect fees amounted to approximately NIS 1.5 billion (2003 – approximately NIS 1.6 billion, 2002 – approximately NIS 1.9 billion). Interconnect fees at Pelephone, using the same tests, are recorded gross.

(3) Revenues from sales of exchanges and business systems are charged upon completion of their installation on the customer's premises.

(4) Revenues from leasing of exchanges and other equipment are recorded proportionally over the term of the agreement, starting on the date of operation.

(5) Revenues from the development of communications infrastructure over a period of up to 12 months are charged upon completion of the work.

(6) Revenues from sales of subscriber equipment are charged upon delivery to the end user.

(7) Revenues from sales of subscriber equipment by installments are charged at their present value upon delivery to the customer. Interest income in respect of these transactions is charged to the statement of operations over the period of the installments by the interest method.

(8) Revenues from Pelephone services are charged proportionally over the term of the agreement or on the date of providing the service.

(9) A consolidated company, D.B.S. Satellite Services (1998) Ltd. (“DBS”), leases digital satellite decoders to its customers under operating leases. The revenues from the lease fees are charged proportionally over the term of the lease agreement.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

R. REVENUE RECOGNITION (CONTD.)

(10) DBS collects deposits from its customers for the decoders on the customers' premises in an amount not exceeding the cost of the decoders. Upon termination of the agreement with DBS, the customers are entitled, under the agreement, to the proportional part of the deposit remaining. The revenues from amortization of the deposits is charged to the statement of operations in accordance with the terms of the agreement with the customers over 5 or 10 years.

S. ADVERTISING EXPENSES

Advertising expenses are charged to the statement of operations as incurred.

T. SUPPLIER DISCOUNTS

Current discounts from suppliers are included in the financial statements as received.

Discounts received from suppliers at the end of the year, for which the Company is not required to meet certain targets, are included in the financial statements upon making the proportional purchases that entitle the Company to those discounts.

U. CAPITALIZATION OF CREDIT COSTS

The Company capitalizes credit costs in accordance with Accounting Standard No. 3 – Capitalization of Credit Costs, which requires the capitalization of specific and non-specific credit costs to qualified assets. Non-specific credit costs are capitalized to the investment or part thereof which was not financed by specific credit, at a rate which is the weighted average of the cost in respect of those credit resources whose cost was not specifically capitalized and in accordance with the Standard, credit costs attributed to assets under construction are capitalized until the date on which all significant activities required to prepare the assets for their intended use have been completed. See Note 9A.

V. EARNINGS PER SHARE

Earnings (loss) per share are calculated in accordance with Opinion No. 55 of the ICPAI.

W. SOFTWARE DEVELOPMENT COSTS

The costs of software development for internal use are treated according to the position paper of the American Institute of Certified Public Accountants – SOP 98-1: Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. The costs of software development for internal use are capitalized after completion of the preliminary design stage, the project is expected to be completed and the software will be used for its designated purpose. The capitalization is halted when the software virtually complete and ready for its designated use. Capitalized software development costs are amortized by the straight-line method according to the estimated useful life of the software. Significant improvements to the software are also capitalized to the cost of the software and current maintenance costs are recorded in the statement of operations.

X. FOREIGN CURRENCY AND LINKAGE

Assets (excluding securities) and liabilities denominated in or linked to a foreign currency are stated at the representative exchange rates published by the Bank of Israel on the balance sheet date.
Assets (excluding securities) and liabilities linked to the CPI are stated on the basis of the linkage terms of each balance.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

X. FOREIGN CURRENCY AND LINKAGE (CONTD.)

Details of the CPI (2000 basis) and foreign currency exchange rates are as follows:

	Consumer Price Index	Exchange rate of the US dollar	Exchange rate of the euro	Consumer Price Index	Exchange rate of the US dollar	Exchange rate of the euro
				%	%	%
Year ended December 31, 2004	**100.6**	**4.308**	**5.877**	**1.207**	**(1.621)**	**6.217**
Year ended December 31, 2003	99.4	4.379	5.533	(1.848)	(7.557)	11.350
Year ended December 31, 2002	101.3	4.737	4.969	6.496	7.269	27.182

Y. DERIVATIVES

(1) The results of derivatives held for hedging of existing assets and liabilities are charged to the statement of operations in parallel with the accounting treatment of the result of the hedged items.

(2) Derivatives not designated for hedging are stated in the balance sheet at their fair value. Changes in the fair value are charged to the financing item in the statement of operations in the period in which they occurred.

The fair value of derivatives is determined according to their market prices or to quotations from financial institutions.

Z. BROADCASTING RIGHTS

Broadcasting rights in a consolidated company are stated at cost. Costs of broadcasting rights acquired for the screening of films and television programs include the amounts of contracts with suppliers of the rights, with the addition of direct costs incurred in order to adapt said films and programs for screening in Israel. Broadcasting rights are amortized in accordance with their acquisition agreement, based on actual screening (the portion not amortized by the end of the term of the agreement being fully amortized upon termination), or in accordance with the term of the rights agreement. The costs of independent productions which, in the opinion of the consolidated company, can be broadcast a number of times or sold, are charged to the broadcasting rights and amortized on the basis of the estimated duration of their utilization.

AA. SEGMENTAL REPORTING

Segmental reporting is stated in accordance with Accounting Standard No. 11. See also Note 26.

BB. IMPAIRMENT OF ASSETS

The Group companies apply Accounting Standard No. 15 – Impairment of assets (“the Standard”), which defines procedures which the Company must apply in order to ensure that its assets in the consolidated balance sheet are not stated in an amount exceeding their recoverable amount, which is the higher of net selling prices and usage value (the present value of the estimated future cash flows expected to derive from the use and disposal of the asset).

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

BB. IMPAIRMENT OF ASSETS (CONTD.)

The Standard applies to all the assets in the consolidated balance sheet except inventory, tax assets and monetary assets (excluding monetary assets which are investments in investee companies that are not subsidiaries). The Standard also lays down the rules of presentation and disclosure for assets whose value has been impaired. Where the value of an asset in the consolidated balance sheet exceeds its recoverable amount, the Company recognizes a loss from impairment in the amount of the difference between the book value of the asset and its recoverable amount. The loss so recognized will be cancelled only if changes occur in the estimates that were used to determine the recoverable amount of the asset, from the date on which the last loss from impairment was recognized.

In September 2003 the IASB published Clarification No. 1 concerning the accounting treatment of an impairment of an investment in an investee company which is not a subsidiary ("the Clarification"). The Clarification states that in the reporting periods subsequent to the period in which the provision for impairment was first created in respect of an investee company which is not a subsidiary, the investment in the investee company should be stated according to the lower of the recoverable amount and the investment account according to the equity method, where the recoverable amount is calculated in each reporting period in which there are indications that a change has occurred in the recoverable amount. Losses from the impairment of an investment in an investee company that is not a subsidiary, which were recognized or cancelled during the period, are included in the Company's equity in the earnings (losses) of investee companies item.

Until December 31, 2002, the Group's companies considered the need to record a provision for impairment of assets according to international accounting standards which are similar to the provisions of Standard 15.

CC. DISCLOSURE OF THE EFFECT OF NEW ACCOUNTING STANDARDS IN THE PERIOD PRIOR TO THEIR APPLICATION

In July 2004, the IASB published Accounting Standard No. 19 – "Income Taxes". The Standard prescribes that deferred tax liabilities should be recognized for all temporary differences liable to tax, with a small number of exceptions. Similarly, deferred tax assets for all deductible temporary differences, losses for tax purposes and unutilized tax benefits should be recognized where it is anticipated that there will be taxable income against which these may be utilized, with a small number of exceptions. The new standard will apply to financial statements for periods commencing January 1, 2005. The Standard requires that it is to be adopted by way of a cumulative effect of a change in accounting policy. The effect of the transition to Standard No. 19 is not expected to be material.

DD. COMPANY CONSOLIDATED FOR THE FIRST TIME AND ASSUMPTION OF FULL CONTROL IN A PROPORTIONALLY CONSOLIDATED COMPANY

1. **D.B.S. Satellite Services (1998) Ltd.**

(a) A number of gradual, substantial changes have taken place over recent years in the Company's investment in D.B.S. Satellite Services (1998) Ltd. ("DBS"), principal among them being the percentage of holding, changes in undertakings to invest in and finance DBS, and changes in actual investments. These developments gradually made the Company the dominant interested party in DBS until, upon implementing the resolution of the Board of Directors to inject NIS 440 million into DBS on the terms set out in the resolution, the Company became, for the first time, the sole shareholder financing DBS's operations. The Company therefore gave notice of its intention to consolidate DBS's financial statements from that date. On July 1, 2004, the Board of Directors of the Company resolved to approve that management act to exercise the warrants and on July 19, 2004, the Company applied for regulatory consents, including the approval of the Antitrust Commissioner, to increase its holdings in DBS to more than 50% ("Merger") (see Note 8E).

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

DD. COMPANY CONSOLIDATED FOR THE FIRST TIME AND ASSUMPTION OF FULL CONTROL IN A PROPORTIONALLY CONSOLIDATED COMPANY (CONTD.)

1. **D.B.S. Satellite Services (1998) Ltd. (Contd.)**

Due to initial comments of the Antitrust Authority prior to submission of notice of the Merger and which indicated a possible difficulty in approving the Merger due to the structure of the communications market, the Company applied to the Securities Authority, requesting its position on the possibility of postponing the date of full consolidation of DBS until it became completely certain that the regulatory approvals could be obtained for the increase in the Company's holdings in DBS to more than 50%. The plenum of the Securities Authority discussed the Company's request on August 17, 2004 and notified the Company that it must commence consolidation of the financial statements of DBS in the Company's financial statements as at June 30, 2004. On June 21, 2004 the Company began to inject funds on account of the aforementioned NIS 440 million, and from that date the financial statements of DBS have been consolidated with those of the Company. From that date the Company has been fully recording its share of the financial results of DBS in its financial statements. In view of the developments described in Note 8E, the Company approached the Securities Authority for its position on the continued need for the consolidation of DBS, and was informed that those developments do not justify halting the consolidation.

(b) Below are the DBS data as included in the consolidated financial statements as a result of the increase in the percentage of the Company's holding:

	On the date of acquisition of control	December 31, 2004
	NIS thousands	NIS thousands
Balance sheet		
Operating capital (excluding cash and cash equivalents)	**(1,795,696)**	**(488,290)**
Fixed assets and broadcasting rights, net	**1,204,051**	**1,242,562**
Long-term liabilities	**(20,862)**	**(1,288,726)**
Minority loans to a consolidated company	**(1,048,637)**	**(1,049,534)**
Less minority share in deficit	**1,048,637**	**1,049,534**
Minority rights	**16,549**	**10,412**
Goodwill	**776,511**	**759,809**
Statement of Operations		
Revenue		**542,122**
Net loss		**(160,396)**
Group’s equity in the loss		**(160,396)**

(c) The total of goodwill generated following consolidation of DBS’s financial statements for the first time amounts to approximately NIS 452,000. The goodwill derives from non-participation of the minority in the capital deficit in which the minority is not a guarantor and in respect of which it extended no loans.

2. **Pelephone Communications Ltd.**

(a) On August 26, 2004 the exercise of the option to purchase the remaining 50% of the shares of Pelephone from the Shamrock Group transaction was finally completed (increase of the Company's holding from 50% to 100%). With completion of the transaction, all the shares of Pelephone are now fully owned by the Company (see Note 8D(2)).

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

DD. COMPANY CONSOLIDATED FOR THE FIRST TIME AND ASSUMPTION OF FULL CONTROL IN A PROPORTIONALLY CONSOLIDATED COMPANY (CONTD.)

2. **Pelephone Communications Ltd. (Contd.)**

(b) Below are the Company data included in the consolidated financial statements as a result of the increase in the percentage of holding:

	On the date of acquisition of control	December 31, 2004
	NIS thousands	NIS thousands
Balance sheet		
Operating capital (excluding cash and cash equivalents)	**(171,938)**	**(422,447)**
Cash	**25,465**	**43,344**
Fixed assets, net	**1,527,962**	**3,093,675**
Long-term liabilities	**(2,391,877)**	**(3,071,711)**
Other assets	**235,806**	**440,531**
Goodwill	**1,044,767**	**1,026,698**
Investment in an affiliated company	**2,215**	**519**
Statement of Operations		
Revenue		**1,324,164**
Net earnings		**(124,334)**
Group's equity in the earnings		**(124,334)**

(c) The total of goodwill generated following the first-time consolidation of Pelephone's financial statements amounts to approximately NIS 1,045 million.

3. **Goldnet Communication Services – Registered Partnership**

In 2002 the financial statements of Goldnet Communication Services – Registered Partnership were consolidated for the first time, when the Company's holding increased from 49% to 54%. See also Appendix A(4).

NOTE 3 – CASH AND CASH EQUIVALENTS

	Consolidated		Company	
	December 31 2004	December 31 2003	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Israeli currency	**1,425,433**	1,913,373	**1,322,168**	1,891,995
Foreign currency	**31,674**	40,977	**5,563**	4,523
	1,457,107	1,954,350	**1,327,731**	1,896,518

NOTE 4 – SHORT-TERM INVESTMENTS

	Consolidated		Company	
	December 31 2004	December 31 2003	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Marketable securities:				
Government bonds				
Linked to the CPI	**309,701**	599,819	**309,701**	599,819
Unlinked	**465,187**	167,498	**465,187**	167,498
Linked to the U.S. dollar exchange rate	**1,346**	23,605	**1,346**	23,605
Securities tradable abroad	**139,035**	136,769	**139,035**	136,769
Corporate bonds	**127,111**	24,208	**127,111**	24,208
Short-term loan	**41,006**	14,653	**41,006**	14,653
Shares and options	**43,354**	50,736	**43,354**	50,736
Mutual fund participation certificates	**137,585**	147,195	**137,585**	147,195
Debentures convertible to shares	**1,595**	28,514	**1,595**	28,514
	1,265,920	1,192,997	**1,265,920**	1,192,997
Short-term bank deposits:				
Linked to the CPI	**–**	130,850	**–**	130,850
Unlinked	**21,889**	16,494	**20,000**	16,401
	1,287,809	1,340,341	**1,285,920**	1,340,248

For a discussion of the management of capital funds raised to finance employee retirement costs, see Note 16D.

NOTE 5 – TRADE RECEIVABLES

	Consolidated		Company	
	December 31 2004	December 31 2003	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
On open account	**1,550,725**	1,306,088	**732,669**	844,170
Income receivable	**240,912**	273,101	**225,579**	205,767
Credit cards and checks receivable	**458,456**	273,289	**175,696**	154,286
Investee companies	**–**	75,886	**33,125**	31,629
Current maturities of long-term trade receivables	**293,261**	97,330	**–**	–
	2,543,354	2,025,694	**1,167,069**	1,235,852
Less provision for doubtful accounts	**428,284**	358,071	**196,303**	214,585
	2,115,070	1,667,623	**970,766**	1,021,267

NOTE 6 – OTHER RECEIVABLES AND DEBIT BALANCES

	Consolidated		Company	
	December 31 2004	December 31 2003	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Deferred tax asset (see Note 11D)	**237,319**	208,797	**159,023**	170,213
Income tax refundable	**7,660**	13,254	**5,570**	14,561
Prepaid expenses	**86,082**	49,091	**22,081**	28,866
Receivables in respect of derivatives	**76,627**	114,372	**76,394**	113,867
Other receivables and debit balances	**8,425**	29,858	**107,216**	36,452
	416,113	415,372	**370,284**	363,959
Including consolidated companies	**–**	–	**99,486**	–

NOTE 7 – INVESTMENTS, DEPOSITS AND DEBIT BALANCES

	Consolidated		Company	
	December 31 2004	December 31 2003	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Investment in shares – companies that are not investee companies	**25,954**	48,389	**22,389**	48,389
Other investments (1)	**301,437**	352,011	**301,437**	352,011
Bank deposit for granting loans to employees (2)	**203,196**	211,078	**203,196**	211,078
Investment in venture capital funds	**19,769**	19,769	**19,769**	19,769
Long-term loan receivable (CPI + 6.25%)	**23,750**	–	**23,750**	–
Receivables in respect of derivatives	**–**	23,153	**–**	23,153
Long-term trade receivables(3)	**298,469**	111,571	**–**	–
	872,575	765,971	**570,541**	654,400

NOTE 7 – INVESTMENTS, DEPOSITS AND DEBIT BALANCES (CONTD.)

(1) Other investments

a. Linkage and interest terms

		Consolidated and Company	
		December 31 2004	December 31 2003
		Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	Interest rate	NIS thousands	NIS thousands
Convertible corporate bonds linked to the U.S. dollar	6 month LIBOR + 3.4	**30,156**	30,653
	3 month LIBOR + 1.65	**30,156**	30,653
Investments in fund – euro investments*	–	**35,261**	33,199
CPI-linked investments:			
Capital notes:	5.8 - 5.9	**125,988**	109,860
Galil convertible bonds **	4	**79,876**	78,368
Convertible corporate bonds	4.95	**-**	49,278
Unlinked deposit	Variable 14.5	**-**	20,000
		301,437	352,011

* In September 2003 the Company invested approximately 6 million euro in a security issued by Deutsche Bank.(•). The security was issued on August 21, 2003 and matures on August 31, 2010. The security is 90% hedged from the investment fund. The yield is contingent on the performance of a solid fund that invests in hedging funds of liquid investments. The security bears no interest.

(•) As part of its financial activities, the Company is in need of various banking services which are provided by Deutsche Bank ("the Bank"), among others. These banking services include, *inter alia*, trading in securities, in foreign currency, in debentures and in derivatives, and the management of financial assets. The services are provided to the Company by the Global Markets division of the Bank, which is completely separate – internally, structurally, personnel-wise and managerially, from the Global Corporate Finance division which prepared, among other items, valuations for the Company as part of a framework agreement for the provision of financial advice services between the Company and the Bank. In 2002, 2003 and 2004 the Company paid Deutsche Bank for financial advisory services, approximately $1.2 million, $1.1 million and $0.74 million, respectively. In addition, Pelephone Holdings paid the Bank approximately $3 million in 2001. During 2004 the Company terminated the receipt of the financial advisory services from Deutsche Bank.

** In May 2002 the Company purchased convertible corporate bonds in a total amount of approximately NIS 77.4 million. The bonds are repayable in a single lump sum on August 31, 2011.

NOTE 7 – INVESTMENTS, DEPOSITS AND DEBIT BALANCES (CONTD.)

(1) Other investments (Contd.)

b. Repayment dates

	NIS thousands
2006	**–**
2007	**60,312**
2008	**–**
2009	**–**
2010 and thereafter	**241,125**
	301,437

(2) The deposit is unlinked and the average weighted monthly interest rate is approximately 0.33%. The Company is responsible for the loans to the employees. The deposit serves as collateral for the bank to extend loans to Company employees.

(3) Long-term receivables

a. Linkage and interest terms

		Consolidated	
		December 31 2004	December 31 2003
		Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	Interest rate	NIS thousands	
Linked to the CPI	7.5	**20,252**	17,983
Unlinked	7.1	**562,743**	190,918
Linked to the U.S. dollar		**8,735**	-
		591,730	208,901
Less current maturity		**293,261**	97,330
		298,469	111,571

b. Repayment dates

	NIS thousands
2005	**293,261**
2006	**216,474**
2007	**79,284**
2008	**1,892**
2009 and thereafter	**819**
	591,730

NOTE 7 – INVESTMENTS, DEPOSITS AND DEBIT BALANCES (CONTD.)

c. The balance of long-term receivables is presented net of deferred interest income which constitutes the difference between the amount of the original debt and its present value on the day of recognition of the revenue and after deducting a provision for doubtful debts in the amount of NIS 50,167,000 (for December 31, 2003 – NIS 34,700,000, constituting NIS 17,350,000 in proportional consolidation).

d. In 2004, Pelephone made transactions with credit companies for the final clearance of current debts amounting to NIS 276 million (2003 – NIS 170 million, which is NIS 85 million in proportional consolidation.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES

A. Composition:

	Consolidated		Company	
	December 31 2004	December 31 2003	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Affiliated companies				
Shares – cost	**164,006**	137,170	**90,921**	64,085
Long-term loans (1)	**1,386,504**	1,270,587	**1,357,861**	1,248,544
Post–acquisition losses	**(1,168,064)**	(1,052,937)	**(1,100,760)**	(990,673)
Increase in holding percentage – company consolidated for the first time	**(178,339)**	–	**(180,555)**	–
Provision for impairment in respect of an affiliated company – see Section G below	**(59,196)**	(59,196)	**(38,078)**	(38,078)
Amortization of goodwill	**(74,603)**	(54,957)	**(74,259)**	(54,690)
	70,308	240,667	**55,130**	229,188
Consolidated subsidiaries				
Shares – cost			**703,046**	430,646
Loans			**4,733,726**	168,262
Increase in holding percentage – company consolidated for the first time and assumption of full control of a proportionally consolidated company			**1,194,844**	–
Post–acquisition losses			**(161,345)**	(251,480)
Provision for impairment			**(4,716)**	(4,716)
Amortization of goodwill			**(36,209)**	(1,074)
			6,429,346	341,638
Proportionally consolidated company				
Shares – cost			**485,065**	503,903
Post-acquisition earnings			**490,080**	395,228
Increase in holding percentage – acquisition of minority share			**(1,014,289)**	–
Amortization of surplus equity over cost charged to fixed assets			**39,144**	39,144
			–	938,275
			6,484,476	1,509,101

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

A. COMPOSITION (CONTD.):

(1) Loan balances of approximately NIS 177 million linked to the CPI ("known"), bearing 5.5% annual interest and for which no repayment date has yet been set (preferred loans – see E below).
Loan balances of approximately NIS 446 million linked to the CPI ("known"), bearing annual interest of approximately 11%, for which no repayment date has yet been set (preferred loans – see also E. below).
Loan balances of Pelephone amounting to approximately NIS 16.4 million, linked to the CPI and bearing annual interest of 7.5% and for which no repayment date has yet been set.
Loan balances of Bezeq International to Walla Communications Ltd. (a listed affiliate) (hereinafter – "Walla") amounting to approximately NIS 6 million, linked to the CPI and interest-free. The loans will be repaid on a date soon after the date on which Bezeq International invests in Walla.
The loan balances are linked to the CPI ("known"), bear no interest and no repayment date has yet been set.

The market value of Walla, a listed company, as at December 31, 2004, is approximately NIS 44.4 million (book value NIS 14.4 million).

	Consolidated		Company	
	December 31 2004	December 31 2003	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Goodwill not yet fully amortized – consolidated in respect of investee companies	**1,797,691**	347,046	**1,792,658**	352,831

A list of the companies in the Group appears in an appendix to the financial statements.

B. INVESTMENT ACTIVITY IN 2004 IS AS FOLLOWS:

	Consolidated	Company
	NIS thousands	NIS thousands
Balance as at the beginning of the year	**240,667**	**1,509,101**
Movement during the year:		
Investment in shares	**26,836**	**299,236**
Increase in holding percentage	**(178,339)**	**–**
Dividend from a subsidiary	**–**	**(18,838)**
Investment in loans	**115,917**	**4,637,552**
Erosion in respect of loans	**–**	**37,225**
Equity in losses of affiliates	**(134,773)**	**20,200**
Balance as at the end of the year	**70,308**	**6,484,476**

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

C. SUMMARY OF COMPANY EQUITY IN ASSETS, LIABILITIES, REVENUE AND EXPENSES OF A PROPORTIONATELY CONSOLIDATED COMPANY, AS INCLUDED IN THE CONSOLIDATED STATEMENTS (SEE ALSO NOTE 2DD)

	December 31 2003
	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands
Current assets	594,577
Other assets	1,875,712
Current liabilities	838,626
Long-term liabilities	693,388

	For the period ended August 26, 2004*	For the year ended December 31 2003	2002
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Revenues	**1,658,452**	1,899,709	1,823,267
Costs and expenses	**1,438,414**	1,803,052	1,885,295

* On August 26, 2004 the transaction for exercise of the option to purchase the remaining 50% of the shares of Pelephone was finally closed. Since that date, Pelephone has been wholly owned by the Company. See Note 2DD(2).

D. PELEPHONE COMMUNICATIONS LTD.

(1) Following various indications of a decrease in the value of Pelephone and as a result of valuations of Pelephone prepared by Deutsche Bank(•) and received during 2002, according to which the estimated value of Pelephone was between $650 million and $850 million, in 2002 the Company wrote off its investment in debentures convertible to shares in a corporation from the Shamrock Group (hereinafter – Pelephone Holdings). The write-off was effected since the bank financing obtained by Shamrock for purchasing the Pelephone shares (approximately $380 million, including interest) is secured by a first-ranking lien, and no available balance remained for repayment of the debentures issued to the Company by Shamrock. The write-down was included in the "Other expenses, net" item, and as a result, net earnings in 2002 were reduced by approximately NIS 1.2 billion.

(•) See footnote in Note 7(1)a.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

D. PELEPHONE COMMUNICATIONS LTD. (CONTD.)

(2) On August 26, 2004, after receipt of approvals from the Ministerial Committee on Privatization, the Minister of Communications and the Antitrust Commissioner for the merger of Bezeq, Pelephone Holdings and Pelephone, the transaction for exercise of the option was finally closed when the Company exercised an option to purchase the remaining 50% of Pelephone's shares in consideration of an exercise price of US $60 million (approximately NIS 270 million). In addition, immediately prior to closing the option exercise, Pelephone distributed to its shareholders a dividend of approximately US $8.3 million (about NIS 38 million). With the closing of the exercise transaction as aforesaid and conversion of the convertible debentures (of a par value of $240 million, stated in the financial statements at zero value), the Company extended a loan of NIS 1,766 million (US $394 million) to Pelephone Holdings, which was used for actual clearance of the balance of the loans it had taken from the bank to finance part of the cost of purchasing the Pelephone shares. After the closing of the transaction as aforesaid, the Company recorded NIS 1,045 million of goodwill through purchase. The goodwill will be amortized over a period of 20 years, which is the expected period of economic benefit.

It is noted that the approval of the Antitrust Commissioner was made contingent upon a number of conditions which in the opinion of the Company restrict business or commercial cooperation between the Company and Pelephone even more than the restriction relating to structural separation that is written into the Company's general license. It is further noted that on October 10, 2004, the Company was served with an appeal filed in the Antitrust Court by Cellcom, petitioning for revocation of the Merger approval. According to Cellcom, the Antitrust Commissioner erred in deciding to approve the Merger, and the Company should therefore be ordered to sell the recently-purchased Pelephone shares or alternatively, to make the Merger contingent upon additional conditions. In the opinion of the legal advisers of the Company, the chances that the petition will be allowed in a way that will lead to revocation of the transaction are smaller than the chances that the petition will be dismissed, and it is difficult to estimate the chances of the possibility that the court will make the Merger contingent upon additional conditions. However, they do believe that the conditions of the Merger laid down by the Antitrust Commissioner are harsh ones for the Company and for Pelephone.

Towards the end of the year, Pelephone Holdings transferred all its assets (including Pelephone shares) and liabilities to the Company, and as a result, all Pelephone shares are wholly owned by the Company. Pelephone Holdings is currently in voluntary liquidation.

(3) On December 18, 2001, the Minister of Communications notified Pelephone that it had won a tender for an additional band of frequencies which would be used for cellular communications with third generation technology. Following the award of the tender, Pelephone's existing license was amended so as to extend its term until 2022. The grant of the frequencies was made contingent upon preconditions that include, *inter alia*, payment of NIS 225 million (plus Accountant General's interest except for the first payment, which is linked to the CPI) for the new frequency ranges, and a guarantee of $20 million to guarantee the terms of the license, which was amended in 2004 to $10 million. The payment determined at the award is to be paid in six installments on various dates through 2006. On the contract for purchase of the frequencies, see also Note 19B(5).

E. D.B.S. SATELLITE SERVICES (1998) LTD.

In January 1999 DBS received a license from the Ministry of Communications for satellite television broadcasts and commenced provision of services in July 2000. DBS suffers from considerable losses and negative cash flows. Its losses for 2004 amount to approximately NIS 366 million and its negative operating cash flows from current activities amounts to approximately NIS 74 million. As a result of these losses, the capital deficit and working capital deficit of DBS as at December 31, 2004 amount to approximately NIS 3,189 million and NIS 471 million respectively.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

E. D.B.S. SATELLITE SERVICES (1998) LTD. (CONTD.)

The Company's investment in DBS (mainly shareholders' loans) as at the balance sheet date was approximately NIS 1,497 million (nominal). The Company's equity in the accumulated losses (from the relevant purchase dates) of DBS is approximately NIS 1,270 million, of which approximately NIS 267 million was recorded during the year of account. The balance of DBS's current debt to the Company and its consolidated companies amounts to approximately NIS 68 million.

At the beginning of May 2002 the Company was allotted additional shares in DBS, thereby increasing its holding to 44.9%. In August 2003 yet more shares were allotted to the Company, brining its holding in DBS to 49.8%. This increase in the Company holdings in DBS created goodwill of approximately NIS 391 million for the Company. On the amortization of the goodwill, see Note 2D(5).

On May 23, 2001, a financing agreement (hereinafter – the Financing Agreement) was signed between DBS and certain banking institutions (hereinafter – the Banks), prescribing, *inter alia*, undertakings by DBS to meet suspending conditions, cumulative milestones and various financial requirements.

On August 6, 2003, an agreement amending the Financing Agreement (hereinafter – the Amendment Agreement) was executed by the Banks and by DBS. Under the Amendment Agreement, the Banks will provide DBS with additional sums to those provided under the Financing Agreement and an additional credit facility approved in December 2002, subject to DBS's meeting the conditions and milestones set out in the Amendment Agreement, including implementation of additional investments by shareholders in amounts of no less than 150% of the amounts to be provided by the Banks. The Amendment Agreement came into force in December 2003. Pursuant to the Amendment Agreement, during 2004 DBS converted short-term credit of a total amount of NIS 1,276 million to long-term loans.

Following the approval for additional investments by the Company in DBS (see below), negotiations were completed in July 2004 between DBS and the Banks, following which a further amendment to the Amendment Agreement was signed, in which it was agreed to amend the conditions that DBS was required to fulfill. As at December 31, 2004, DBS is meeting those amended conditions.

The Company has signed a perpetual guarantee in favor of the Banks for the payment of DBS's debts. The guarantee is up to a maximum amount equal to the percentage of the Company's holdings in DBS multiplied by the value of DBS as derives from disposal of the pledged shares of the remaining shareholders. If the Company joins the sale in the framework of disposing of the pledged shares of remaining shareholders, the amount of the guarantee will not exceed the proceeds that the Company will receive from the disposal of its shares in DBS. The deed of guarantee includes numerous restrictions on the Company with respect to disposing the shares it holds, and details circumstances of violations which, if committed, will enable the Banks to call in the guarantee. The Company also undertook to put its shares up for sale in the event of sale of the pledged shares by the Banks, and agreed that in the event of exercise of the securities given by the other shareholders, the Company will waive repayment of the Shareholders' loans given to DBS, and that its guarantee will apply also, *mutatis mutandis*, to the options and the right to receive them.

The shareholders in DBS, with the exception of one shareholder, made a commitment to the Banks not to object to the sale or other exercise of their charged or guaranteed (by the Company) shares in DBS, in such a way as to enable the Banks to effect the sale and exercise without interference (friendly liquidation).

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

E. D.B.S. SATELLITE SERVICES (1998) LTD. (CONTD.)

Under an agreement between DBS and its shareholders dated December 30, 2002, it was decided that the loans extended by the shareholders to DBS starting on July 10, 2002 (hereinafter – the New Shareholders' Loans) would have priority over the shareholders' loans to DBS which were made earlier (hereinafter – the Old Shareholders' Loans). Under the agreement, the New Shareholders' Loans will be entitled to repayment in full by DBS before any distribution of dividends by DBS and/or repayment of the Old Shareholders' Loans extended to DBS by shareholders, this being subject to DBS's cash flow and liabilities under agreements with the Banks (including the priority of repayment of the bank financing). The New Shareholders' Loans are linked to the CPI and bear annual interest of 5.5%. In addition, under the same agreement, the shareholders who invest in the New Shareholders' Loans are permitted to choose between an allotment of shares and options for shares deriving from their investments. On April 25, 2004, the Company received warrants which will enable adjustment of their percentage holding in DBS to the percentage of their investments in it as at March 31, 2004. If the Company's holdings in DBS exceed 50%, exercise of the options by the Company (as opposed to their receipt) will require Government approval, the approval of the Minister of Communications in consultation with the Council for Cable and Satellite Broadcasts and the approval of the Antitrust Commissioner. The warrants are convertible at any time for no additional consideration, and can be transferred as if they were shares, subject to the approvals of the Banks pursuant to the Financing Agreements.

The Old Shareholders' Loans are linked to the ("known") CPI and are interest-free. According to a note of amendment to the aforementioned agreement, the New Shareholders' Loans made in the framework of the Amendment Agreement will be linked to the known CPI plus 11% annual interest. Under the Agreement, any change in the interest rate is subject to the consent of 75% of the shareholders. No date has been set for the repayment of these loans.

Based on a resolution of the Board of Directors of the Company, continued investment in DBS will be effected by way of preferred New Shareholders' Loans, and the Company is to receive warrants for shares in accordance with the existing agreements between DBS and its shareholders. Similarly, the Board of Directors approved the immediate bringing forward of the balance of the investment under the current financing agreement (in the amount of approximately NIS 55 million, provided in full during April-May 2004), against receipt of the aforementioned warrants. Under the present financing agreement of DBS and the level of the Company's investments in DBS, the Company will be entitled to shares, in respect of expected investments in the program, which will bring its holdings to approximately 60%, and/or warrants for shares which, if exercised, will bring its holdings to the same percentage (all presuming that an additional shareholder meets its full obligations under the present financing agreement, and if not, the Company will be entitled to shares bringing its holdings to approximately 61%; the Management of the Company considers that the additional shareholder will meet its obligations). The additional shareholder has, at this stage, provided approximately $ 4.3 million on account of the aforesaid undertaking.

On March 9, 2004, the Board of Directors of DBS approved a multi-year work plan for 2004 and 2005 (hereinafter – the Work Plan), *inter alia*, following a report commissioned by the Company from an external economic consulting firm on the business condition of DBS, which was presented to the Board of Directors of the Company on January 8, 2004. The economic report reveals a negative difference between DBS's financing plan and its actual financing requirements during those years. According to the Work Plan, DBS will need significant additional amounts of outside financing in the aforementioned years, over and above the Amendment Agreement.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

E. D.B.S. SATELLITE SERVICES (1998) LTD. (CONTD.)

In view of the requirements of DBS, the difficulty in obtaining additional bank financing and the non-participation of the other shareholders in financing DBS beyond the present Financing Agreement, the Board of Directors of the Company adopted a resolution on March 30, 2004, which was later amended, to approve an additional investment (beyond the present Financing Agreement) of approximately NIS 440 million through the end of 2005, which would be made gradually, according to the requirements of DBS and the Work Plan. According to the resolution, which was amended on May 10, 2004, the investment of NIS 440 million will take into account development of regulatory conditions in the communications market that are to the satisfaction of the Company and subsequent to implementation of the Banks' commitment under the present Financing Agreement. In this regard, from time to time, developments will be examined by the Board of Directors of the Company. Similarly, the resolution provided that its implementation is subject to receipt of the required consents and pursuant to the remarks of the Attorney General. Commencing June 21, 2004, the Company began providing sums on account of the NIS 440 million investment. On the commencement of the provision of these aforementioned funds, the financial statements of DBS were consolidated with those of the Company (see Note 2DD(1)).

In the Company's opinion, relying on its legal advisers, continued investment by the Company in DBS does not, in and of itself, require the approval of the authorities provided that the Company has not exercised the warrants allotted to it. The Government Companies Authority notified the Company that the Deputy Attorney General has confirmed that upon the Company's becoming a mixed company, it will no longer require the consent of the Ministerial Committee on Privatization in order to increase the Company's exposure in DBS. Exercise of the warrants does require the approval of the authorities. Likewise, under the articles of association of DBS, DBS will issue shares or convertible securities after the Banks making loans to DBS confirm that such securities are secured in their favor.

At its meeting on July 1, 2004, the Board of Directors of the Company resolved to approve that the Company's Management should act to exercise some of the warrants for shares in DBS. On July 19, 2004 the Company applied for the required regulatory approvals for exercise of the warrants (the Ministerial Committee on Privatization, the Minister of Communications and the Antitrust Commissioner) which, if exercised, would bring the Company's holdings in DBS to approximately 54.75%.

On January 2, 2005 the Antitrust Commissioner gave notice of his consent to approval of the Merger of the Company with DBS, but limited the injection of funds by the Company so that it would not exceed, in the nine-month period from the date of approval of the Merger, its proportional part in the shares of DBS. Most of the funds will be injected by the other DBS shareholders and institutional investors.

On January 6, 2005, the Board of Directors of the Company resolved that in view of the oppressive conditions upon which the Merger had been made contingent, the Company would delay, at this stage, the exercise of the warrants it holds, so that its holdings in DBS would remain, for the time being, at approximately 49.8%. The Board also resolved that the Management of the Company would file an appeal in the Antitrust Court against the Commissioner's decision.

On August 31, 2004. the Minister of Communications notified the Company that, after a preliminary examination of the Company's request that it exercise the options it holds for shares in DBS, he believes that the process raises significant concern of damage to competition in the field of communications. In light of this, the Minister also informed the Company, in his aforementioned letter, that he does not approve its request to exercise the options, and that the Company is required, meantime, until formulation of his decision, not to implement the additional injection of funds (in the amount of NIS 440 million) of which the Company gave notice in its request and of which part had already been transferred to DBS.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

E. D.B.S. SATELLITE SERVICES (1998) LTD. (CONTD.)

As part of a process of consolidation and out of a desire to find a pragmatic solution, the Company agreed to cooperate with the Ministry of Communications and to reach an arrangement on the matter of the funding, without prejudice to its legal position in the matter of the authority of the Minister of Communications concerning the injection already made at the time. Under this arrangement, the Company and DBS submitted to the Ministry of Communications the documents and information they requested.

On October 28, 2004, the Board of Directors of the Company was presented with an external legal opinion stating that the Minister of Communications does not have the authority to prevent the Company from injecting funds into DBS. Nevertheless, and without derogating from that legal opinion, the Board of Directors resolved to authorize the Management of the Company to continue talks with the Ministry of Communications on the continued injection of funds into DBS at the same time as the Ministry carries out its examination.

In a letter dated December 31, 2004, the Minister of Communications notified the Company that based on the findings of the examination it had carried out and after hearing the arguments of the Company and DBS, he is instructing the Company, in the matter of limiting the aforementioned further injection of funds, to the following format:

a. The total amount of the additional injection will be limited to a maximum of NIS 350 million (rather than NIS 440 million).
b. With reference to the NIS 195 million of the additional funding already injected by the Company into DBS, no additional action will be taken.
c. The balance of the sum, a maximum of NIS 155 million, will be transferred once every quarter in equal parts during 2005, on the following principles:
   (1) The Company's share in the aforementioned amount will not exceed 55% (a maximum of NIS 82.25 million).
   (2) The share of the other shareholders in DBS and of the banks or institutional bodies in transfer of the remainder of the balance, will be not less than 45% (a minimum of NIS 69.75 million).

The Minister of Communications also stated in his letter that in order to provide the time to reach financing agreements based on the principles he had laid down, and as an interim step, the Company may inject funds into DBS, out of its share, without a corresponding transfer from the other shareholders, banks or institutional bodies, provided that the required proportions of such a transfer are fully maintained, no later than April 30, 2005, and that the Company may not grant a guarantee to the shareholders in DBS, the banks or financing institutional bodies, or make any other similar commitment, for securing their part in the additional transfer or in credit provided by them to DBS.

In view of the appointment of a new Minister of Communications, the Company postponed taking legal action on the matter and requested that the new Minister re-examine the decision of the outgoing Minister from December 31, 2004.

The new Minister concluded that there was no justification for changing the aforementioned decision. However, taking into consideration the arguments of the Company and DBS in the matter of the need for time to implement the directive, she has seen fit to allow staggered implementation of the outgoing Minister's decision in the following manner:

a. The Company will be able to inject 75% of the maximum amount by the end of June 2005 (i.e. an additional NIS 10 million beyond the amount it has transferred to date out of the maximum amount), provided that up to that date the proportions of the transfer decided upon by the outgoing Minister are fully maintained.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

E. D.B.S. SATELLITE SERVICES (1998) LTD. (CONTD.)

b. The Company will be able to inject the remainder of the maximum amount (NIS 21.25 million) during the period July 1, 2005, through the end of 2005, provided that the proportions of the transfer are maintained as set out in the outgoing Minister's directive.

In view of this decision of the new Minister of Communications, the Company filed a legal claim in the Jerusalem District Court for a declaratory decision determining that the decision of the [former] Minister had been made *ultra vires* and was therefore void. On February 23, 2005 DBS filed a claim in the District Court for declaratory relief against the Minister of Communications. The claim filed by DBS requested that the Court give declaratory orders whereby the decision of the Minister of Communications from December 31, 2004, is void, oppressive and invalid, and that the decision of the [new] Minister of Communications from February 14, 2005, not to cancel the decision of the Minister is, for the most part, also null and void. In response to the aforementioned claim, the Ministry of Communications applied to the court, requesting that the proceeding be transferred to a Supreme Court proceeding.

In the opinion of the Company, the instructions contained in the notice of the Minister are significantly damaging to DBS and to the Company as the principal shareholder in DBS.

On February 17, 2005, the Board of Directors of the Company resolved that it stands behind its resolution from March 2004 as amended in May 2004, to invest in DBS according to the approved Work Plan, together with the other shareholders and financial bodies. The Ministry of Communications notified the Company that should it transpire that the Company is taking the law into its own hands and is violating the directive of the Minister, the Ministry of Communications will be compelled to adopt the means of enforcement available to it for ensuring compliance with the terms of the Company's license, including calling in the bank guarantee (see Note 19C(2)).

As at the date of approval of the financial statements, the Company had completed its part in the shareholders' loans in accordance with the Amendment Agreement. The Company injected into DBS, as at December 31, 2004, the sum of NIS 218.5 million on account of the Work Plan. Subsequent to the balance sheet date the Company injected into DBS another NIS 36 million. As at the date of publication of these financial statements, warrants for shares, if exercised, will increase the Company's holdings in DBS to approximately 57.5%.

Without derogating from its arguments and legal steps as described above, the Company approached the other shareholders in DBS, and all in view of the position of the Antitrust Commissioner and the Minister of Communications as explained above. At a meeting of DBS's shareholders on January 16, 2005, the two representatives of the additional shareholders gave notice that they intend to recommend to the appropriate bodies in their companies that they participate in the additional injections in the amounts of NIS 20 million and NIS 10 million into DBS. The recommendations for the additional injections will be in a situation whereby DBS will also have resources from the other shareholders (including the Company) in order that it may fulfill its business plan and without legal proceedings being instituted in which the interim relief which will be sought could halt the process. Since the date of the aforementioned decision through the date of approval of the financial statements, one other shareholder injected NIS 5 million into DBS and another shareholder injected another NIS 2 million.

DBS's continued operations are conditional upon the continued receipt of shareholders' loans, including loans from the Company pursuant to DBS's Work Plan.

Management of DBS and the Company believe, that, in view of the decision of the shareholders to continue investing in DBS according to the Work Plan, the chances of arranging the financial resources that it will require in the coming year are good.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

F. WALLA! COMMUNICATIONS LTD.

Bezeq International invested in Walla! Communications Ltd. (hereinafter – Walla), an Israeli company which is listed on the Tel Aviv Stock Exchange and which provides internet services and operates internet portals. As at December 31, 2004, Bezeq International holds 44.97% of the rights in Walla.

Under the investment agreement between Bezeq International and Walla, Bezeq International undertook to invest a total of $5.9 million in Walla, either directly or through a strategic investor. By December 31, 2004, Bezeq International had invested a total of approximately NIS 80 million through investment in shares in and provision of loans to Walla. These investments, on the dates they were made, constitute the total investment approved by the Government of Israel that Bezeq International may invest in Walla. As at December 31, 2004, Bezeq International had met its entire prospectus and contractual undertaking to invest in Walla.

As part of Bezeq International's aforementioned investments in Walla, Bezeq International extended loans to Walla during 2003 and 2002 which were linked to the CPI and interest-free, and which amounted, as at December 31 2004 and 2003, to NIS 5,755 thousand and NIS 13,945 thousand, respectively. Repayment of the balance of these loans as at December 31, 2004, will be on a date soon after the date of which Bezeq International invests in the share capital of Walla.

In February 2004 Walla published a prospectus for an offering of warrants to its existing shareholders by way of rights. Bezeq International made a prior commitment to exercise options (Series 3) in a total amount equal to the balance of the shareholders' loans that it had provided to Walla as at September 30, 2003 (approximately NIS 14 million). Bezeq International's commitment is subject to the provisions of Section 328 of the Companies Law, i.e., Bezeq International will not exercise warrants in such a way that after exercise it will hold more than 45% of the issued share capital of Walla, except in compliance with the provisions of the law.

In March 2004, Bezeq International purchased 7,073,980 warrants (Series 3) (36.74% of all of the options offered) for a consideration of NIS 1,414,000, which was set off against the aforementioned shareholders' loans. During 2004, Bezeq International exercised 3,786,940 warrants (Series 3) in consideration of NIS 6,816,000, which was offset against the balance of the aforementioned shareholders' loans. Following exercise of the aforementioned warrants, the percentage of Bezeq International's holding in Walla increased from 36.74% on December 31, 2003 to 44.97% as at the date of signing these financial statements (at full dilution, as at December 31, 2004 – 34.2%).

Subsequent to the balance sheet date, Walla issued 231,121 ordinary shares and 192,600 warrants (Series 3) to other shareholders through a private placement. As a result thereof, and following additional exercise of warrants subsequent to the balance sheet date, the percentage of Bezeq International's holding in Walla decreased to 44.52% (at full dilution – 33.88%).

During 2002, Bezeq International reduced the book value of its investment in Walla by NIS 13,089 thousand. The balance of Bezeq International's investment in Walla after that reduction, plus the additional investment it made by way of loans, reflected, in the opinion of Bezeq International's Management, the fair economic value of Walla to Bezeq International at that time.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

G. ADANET FOR BUSINESS GROUP LTD. (IN TEMPORARY LIQUIDATION) ("ADANET")

Adanet is a private company in temporary liquidation whose business was the installation and servicing of networks and computer equipment.

In view of the uncertainty regarding the realization of Adanet's business plan as written and regarding the outcome of the discussions with the banks for arranging the financing required by Adanet, there was considerable concern regarding the continued existence of Adanet as a going concern. On November 10, 2003, Adanet filed an application for a stay of proceedings order while formulating a rescheduling and recovery plan for the Adanet group. Later, and in the absence of consensus among the banks, the stay of proceedings order was canceled and temporary liquidation orders were issued against Adanet and its subsidiaries or temporary receivers were appointed for their assets. Due to the financial condition of Adanet and the proceedings described above, in 2003 the Company wrote off the balance of its investment in Adanet.

In February 2004 the Company received a letter from the temporary liquidator of Adanet and some of the Adanet Group companies, in which it is claimed that the Company had made a commitment to provide the financing required for the current operations of the companies through March 31, 2004, as well as additional financing. In the opinion of the Company, in view of Adanet's situation, the basis for the undertaking made by the Company, if and insofar as made, no longer exists, and therefore it rejected the claims of the liquidator and made no provision in its financial statements. In any case, the Company considers that there is no significant exposure arising from from the liquidator's claims.

On March 29, 2004, the Court allowed the application of the temporary liquidator, who had meanwhile been appointed special administrator, to investigate the circumstances that led to the collapse of Adanet. On May 17, 2004, the special administrator sent summonses for questioning to five senior employees of the Company who were involved in Adanet's activities (some of them served as directors in Adanet). In addition, on December 14, 2004, the liquidator filed an application in court for the provision of various documents, and a proceeding is in progress on the matter. It should be made clear that the filing of a claim by the liquidator against a third party (including shareholders), is subject to the approval of the court which is overseeing the liquidation proceeding. The liquidator has not yet filed an application in this matter. In the opinion of the Company, relaying on its legal advisers, it is not possible at this stage to assess the future steps of the liquidator regarding the possibility that he make a request that a claim be filed against the Company, concerning the causes of action that will be claimed and concerning the chances of his claims.

H. B-ONE GENERAL PARTNERSHIP

In May 2003, Pelephone, Bezeq International and BezeqCall established the general partnership B-ONE (the Partnership). The purpose of the Partnership is the marketing of complete communications services to the customers of the three companies. The Partnership will assist in increasing the sale of the products and services of the parties to the agreement, as a main interface point with customers who purchase products and services through it and which are supplied to them directly by each of the partners.

NOTE 9 – FIXED ASSETS

A. COMPOSITION AND ACTIVITY

Consolidated

	Land & buildings	Switching, transmission and power equipment	Network equipment	Subscriber equipment	Motor Vehicles	Office equipment and computers	Total
	Reported amounts NIS thousands						
Cost –							
Balance as at January 1, 2004	2,270,543	11,934,296	11,837,432	633,127	202,606	1,507,184	28,385,188
Additions	**39,880**	**772,909**	**177,021**	**361,948**	**1,450**	**266,556**	**1,619,764**
Addition to cost in respect of a company consolidated for the first time	**89,691**	**3,887,623**	**–**	**1,920,469**	**34,613**	**576,132**	**6,508,528**
Disposals (1)	**(29,645)**	**(1,833,934)**	**(40,018)**	**(73,844)**	**(47,935)**	**(176,823)**	**(2,202,199)**
Balance as at December 31, 2004	**2,370,469**	**14,760,894**	**11,974,435**	**2,841,700**	**190,734**	**2,173,049**	**34,311,281**
Accumulated depreciation –							
Balance as at January 1, 2004	1,418,951	7,982,099	8,902,804	298,298	136,740	821,854	19,560,746
Additions	**103,335**	**1,086,196**	**348,903**	**273,824**	**23,066**	**257,151**	**2,092,475**
Accumulated depreciation in respect of a company consolidated for the first time	**52,230**	**2,518,191**	**–**	**944,338**	**18,622**	**366,114**	**3,899,495**
Cancellation in respect of disposals (1)	**(26,760)**	**(1,756,123)**	**(40,018)**	**(68,307)**	**(42,826)**	**(173,059)**	**(2,107,093)**
	1,547,756	**9,830,363**	**9,211,689**	**1,448,153**	**135,602**	**1,272,060**	**23,445,623**
Provision for impairment –							
Balance as at January 1, 2004	2,371	115,467	–	–	66	7,420	125,324
Balance as at December 31, 2004	**2,371**	**115,467**	**–**	**–**	**66**	**7,420**	**125,324**
Net book value –							
As at December 31, 2004	**820,342**	**4,815,064**	**2,762,746**	**1,393,547**	**55,066**	**893,569**	**10,740,334**
As at December 31, 2003	849,221	3,836,730	2,934,628	334,829	65,800	677,910	8,699,118

NOTE 9 – FIXED ASSETS (CONTD.)

A. COMPOSITION AND ACTIVITY (CONTD.)

Company

	Land & buildings	Switching, transmission and power equipment	Network equipment	Subscriber equipment	Motor Vehicles	Office equipment and computers	Total
	Reported amounts						
	NIS thousands						
Cost –							
Balance as at January 1, 2004	2,185,096	7,606,426	11,837,432	613,351	147,423	794,821	23,184,549
Additions	**16,125**	**310,274**	**177,021**	**190,544**	**195**	**153,252**	**847,411**
Disposals (1)	**(23,935)**	**(1,573,950)**	**(40,018)**	**(65,684)**	**(36,787)**	**(167,503)**	**(1,907,877)**
	2,177,286	**6,342,750**	**11,974,435**	**738,211**	**110,831**	**780,570**	**22,124,083**
Accumulated depreciation -							
Balance as at January 1, 2004	1,374,222	5,292,899	8,902,804	284,194	107,414	404,399	16,365,932
Additions	**89,890**	**750,555**	**348,903**	**146,221**	**14,236**	**146,104**	**1,495,909**
Cancellation in respect of disposals (1)	**(23,633)**	**(1,573,950)**	**(40,018)**	**(65,684)**	**(32,901)**	**(167,503)**	**(1,903,689)**
	1,440,479	**4,469,504**	**9,211,689**	**364,731**	**88,749**	**383,000**	**15,958,152**
Provision for impairment -							
Balance as at January 1, 2004	–	35,482	–	–	–	–	35,482
Balance as at December 31, 2004	**–**	**35,482**	**–**	**–**	**–**	**–**	**35,482**
Net book value –							
As at December 31, 2004	**736,807**	**1,837,764**	**2,762,746**	**373,480**	**22,082**	**397,570**	**6,130,449**
As at December 31, 2003	810,874	2,278,045	2,934,628	329,157	40,009	390,422	6,783,135

(1) Fixed assets are written off the books at the end of the year in which they became fully depreciated, except for land, buildings and vehicles, which are written off the books when sold. In 2004, fully depreciated fixed assets with a cost of approximately NIS 1,847 million (2003 – NIS 1,769 million) were written off the consolidated and Company books.

(2) The cost includes the amount of NIS 6,658 thousand in the Company and NIS 9,274 thousand consolidated, which constitute real financing expenses in respect loans and credit which were capitalized during the construction period, calculated at an average real interest rate of approximately 6.5% per annum (prior year – 7.4%).

NOTE 9 – FIXED ASSETS (CONTD.)

B. Most of the real estate assets used by the Company were transferred to it by the State under an agreement dated January 31,1984 and for the consideration detailed therein. Some of these assets are leased for 49 years with an option for an extension for another 49 years, and some are rented for renewable periods of two years each.

On May 15, 2003, a settlement agreement was signed between the Company and the Government of Israel in the name of the State of Israel and the Israel Lands Administration ("the Administration"). The agreement regulates the dispute between them relating to the rights of the Company in various real estate assets which were transferred to the Company when it commenced operations in 1984, under an asset transfer agreement signed between the Company and the State ("the Asset Transfer Agreement"). Under the settlement agreement, 14 real estate assets out of the 28 in the Company's possession with renewable lease status (assets leased entirely to the Company for a period of two years, renewable each time for a further two years, unless the State exercised its right to terminate the lease on terms prescribed in the Asset Transfer Agreement), as well as three assets which were returned to the Administration before the settlement agreement, and the Administration will allocate to the Company three substitute assets to replace part of the assets which the Company will return to the State. The remainder of the renewable lease assets in the Company's possession and assets which were leased to the Company under the Asset Transfer Agreement, will remain in the Company's possession on capital lease terms set out in the agreement. The Administration will also allocate and lease to the Company, after the completion of planning proceedings, an area of 70 dunams at the "Sakia" site, on the lease terms set out in the agreement. The agreement also includes several arrangements concerning individual disputes which arose between the parties, some of which related to particular assets of those which were the subject of the dispute and some of which were not part of the dispute. These arrangements include, *inter alia*, agreement that the Company will return some additional assets (one of which is not among the assets in dispute), as set out in the agreement.

The agreement was approved by the Audit Committee of the Board of Directors of the Company, the Board of Directors and the General Meeting of the Shareholders (as it is an exceptional transaction between the Company and its controlling interest – the State of Israel). It was also approved by the Israel Lands Administration. On March 10, 2004 the agreement was validated as a decision by the Court, without an order to pay costs, subject to any application to the Court in connection with the settlement agreement being made in a separate proceeding and not as part of the same case. The agreement took effect on the same date. The aforesaid has no material effect on the financial statements of the Company.

C. The Company's holdings in the satellite corporation Intelsat, which was privatized in 2001 when every member of Intelstat became a shareholder proportionate to the percentage of its investment therein, is 0.7405%. In addition, the Company had a holding of 0.8% in a subsidiary spun-off from Intelsat called New Skies Satellites N.V. NSS ("NSS").

On November 17, 2004, the Company received approximately $8 million in respect of its share of the proceeds from the sale of the activity, assets and liabilities of NSS. A capital gain in the full amount of the consideration was recorded during 2004.

In addition, on November 17, 2004, notice was received from Intelsat confirming the intention to sell the corporation for consideration, of which the Company's share amounts to approximately $23 million. The sale transaction was completed on January 28, 2005 at its original price. A capital gain in the full amount of the consideration will be recorded in the first quarter of 2005.

D. As at December 31, 2004 Pelephone had a commitment to purchase terminal assets during 2005 in a total amount of NIS 501 million.

E. As at the balance sheet date there are agreements to purchase fixed assets amounting to approximately NIS 956 million consolidated and approximately NIS 224 million in the Company (the amounts include the assets referred to in D above).

NOTE 9 – FIXED ASSETS (CONTD.)

F. In September 2003, the Board of Directors of the Company adopted a resolution to close the Inmarsat station (a satellite communications station) and to try to sell the equipment and/or operation. In view of the uncertainty as to the consideration it would receive, if any, a loss of approximately NIS 35 million due to impairment of assets was recorded in the financial statements which was attributed to fixed assets, which was included under the "other expenses" item in the statement of operations. The Ministry of Communications notified the Company that it is not authorized to decide on the closure of the station. Consequently, the Company (with the knowledge of the Ministry of Communications) contacted representatives of the Ministry of Defense and the Israel Defense Forces ("IDF") in an attempt to reach an arrangement for termination of the service. IDF representatives stated unequivocally that the Inmarsat service is an essential service that the IDF cannot forgo. In light of this, the Company is now examining a number of possible actions, including sale of the service (with the consent of the Ministry of Defense, the IDF and the Ministry of Communications), introduction of a strategic partner or continued operation of the service while significantly reducing its costs.

G. Depreciation policy

1. Pursuant to the Company's policy of periodically re-examining the useful lives and the values of its assets, a committee was appointed in 2003 to assess the need to update the period of the useful life and value of the assets and to make recommendations to the Management regarding its conclusions. The examination covered only the Company's fixed assets and was based on the balance of its fixed assets as at December 31, 2003. In interim conclusions relating to the value of the assets, the committee found that due to the decline in traffic in the Company's communications network, mainly as a result of the decrease in the number of subscribers and of the decline in dial-up internet traffic, the Company had ceased using equipment having a net book value of approximately NIS 163 million. As a result, in 2003 an expense was recorded in that amount under the "Other expenses" item in the statement of operations. In May 2004, the panel submitted its recommendations to the Management of the Company regarding the estimated useful life of the assets. The panel's recommendations mainly took into consideration the Company's investment plans, technological innovations in fixed-line communications, rates of depreciation used by similar communications companies around the world as well as the regulation and opening of the fixed-line communications market to competition.

   The changes in the estimated useful lives recommended in the report included shortening the life of terminal equipment used for data communications networks from 5 years to 4 years, and shortening the life of new copper cabling from the exchanges to the distribution boxes from 20 years to 15 years. Conversely, it was recommended that the lives of SDH transmission should be extended from 7 years to 8 years, and of the data communications networks (ADSL, ATM) from 5 years to 7 years. The panel also recommended extending the depreciation period of the network in which there was investment until 1991 and which should have been fully depreciated by the end of 2007, through to the end of 2010. Another recommendation was for an estimated useful life for the new transmission systems and data networks which are scheduled for operation in the near future.

   The Company's Management and the Board of Directors adopted the recommendations of the panel and the new depreciation rates have been applied since January 1, 2004. As a result of adoption of the recommendations, the depreciation expense in respect of the Company's existing assets decreased by approximately NIS 77 million in 2004 and in the future will decrease by approximately NIS 74 million in 2005, NIS 62 million in 2006, NIS 75 million in 2007 and will increase by NIS 96 million in 2008.

NOTE 9 – FIXED ASSETS (CONTD.)

G. Depreciation policy (Contd.)

2. DBS depreciates its digital satellite decoders ("the Decoders") using the straight-line method, based on the estimated duration of their use. With the accumulation of experience and data during the course of DBS's operations, DBS decided to examine the useful life of the Decoders in June 2004. As part of this examination, DBS received an engineering opinion relating to the useful life of the Decoders. Pursuant to the above opinion, which takes into account, *inter alia*, exposure to technological changes, the useful life of a Decoder is no less than 6 years. Based on the engineering opinion, the depreciation rate for Decoders was changed from 25% to 17%with effect from April 2004. The effect of this change was to decrease the amount of depreciation in 2004 by approximately NIS 59 million. Based on the balance of the cost of the Decoders as at December 31, 2004, the change will reduce the amount of depreciation in 2005 by NIS 37 million.

3. The following shows the effects of the above on the Company's financial statements:

	Data before change of estimate	Effect of the change of estimate	Data presented in the financial statements (after the change of estimate)
	Reported amounts		
	NIS thousand	NIS thousand	NIS thousand
For the year ended December 31, 2004			
Depreciation expenses	2,218,642	(126,167)	2,092,475
Earnings before income tax	1,127,532	126,167	1,253,699
Net earnings	521,608	99,217	620,825
Earnings per share (NIS)	0.200	0.038	0.238

H. BEZEQ INTERNATIONAL – PROVISION FOR IMPAIRMENT, CHANGE OF ESTIMATE AND REMOVAL OF ASSETS IN 2003

As part of the preparation of its financial statements for 2003, Bezeq International conducted a comprehensive review of the book value of all its fixed assets, as required, *inter alia* for the following reasons: the coming into force of Standard No. 15 of the IASB - Impairment of Assets and the resolution of the Board of Directors of Bezeq International to investigate the implications of the Standard; Bezeq International's assessment regarding market trends in the fields in which it operates, arising from economic research and analyses carried out by Bezeq International, including transactions which Bezeq International contracted into at that time; the possible consequences of the decision of the Ministry of Communications to broaden competition in the international communications market (see Note 1E(3)); and the strategic decisions taken by Bezeq International regarding most of the technology equipment it was using at that time, and its plans to replace it in response to the economic and market changes likely to occur, in Bezeq International's estimation, as a result of the factors listed above.

Following the comprehensive review described above, expenses derived from fixed assets in an aggregate amount of NIS 146.8 million were recorded in 2003. Of this amount, NIS 89.8 million included in the "Other expenses, net" item in the statement of operations for 2003, derived from writing down assets, mainly underwater cables (the international communications market (underwater cables) is characterized by the use of both old transmission technology and more advanced transmission technology, both of which are used by Bezeq International. The costs of operating and maintaining the more advanced transmission technology are considerably lower than those for the old generation equipment), which Bezeq International Management believes, based, among other things, on the opinions of external experts, to have an economic value lower than their book value and/or to have ended their economic life; NIS 21.1 million included mainly in the "Operating expenses" item in the statement of operations for 2003, derives from a change in estimate of the remaining useful economic life of part of Bezeq International's assets as described below; and NIS 35.9 million included in the

NOTE 9 – FIXED ASSETS (CONTD.)

H. BEZEQ INTERNATIONAL – PROVISION FOR IMPAIRMENT, CHANGE OF ESTIMATE AND REMOVAL OF ASSETS IN 2003 (CONTD.)

"other expenses, net" item in the 2003 statement of operations, are the result of the removal of assets since they are no longer used.

The amount of the deduction according to Standard No. 15 was determined, *inter alia*, on the basis of the assessments of experts as stated below and the assessments of the Management of Bezeq International of the net sale price, as derived from agreements made by Bezeq International at that time, and the usage value of the assets under review. For the purpose of determining usage value, Bezeq International used, where relevant, a discount rate of 10%.

As part of the comprehensive review of the book value of all its fixed assets which Bezeq International carried out while preparing its financial statements for 2003 as aforesaid, the Management of Bezeq International decided to carry out a comprehensive review of the economic life of its assets. Examination of the said remaining economic life was carried out with the assistance of external and internal experts in the field, mainly for switching equipment and systems, transmission equipment (old-generation undersea cables) and internet equipment. Based on the opinions of these experts, the remaining economic life of the assets examined is shorter than the economic life attributed to them by Bezeq International in the past. Based on these opinions, the economic life of switching equipment and systems was shortened by two years (to 10 years, after the opinion of the external expert was submitted to Bezeq International); the economic life of the transmission equipment (underwater cables) that was examined was estimated mostly at 5-15 years (rather than the 10-20 years used prior to submission to Bezeq International of the opinion of the external expert); and the economic life of internet equipment that was examined was assessed at 4 years (rather than 12 years as was used prior to submission to Bezeq International of the opinion of the external expert). Consequently and relying on the aforementioned opinions, starting from the date of the review, Bezeq International is depreciating the balance of the net book value of the assets which were the subject of those opinions, over the stated periods.

The above change of estimate led to an increase of NIS 21.1 million in depreciation expenses for 2003.

The amount of NIS 35.9 million derived from assets removed due to termination of their use, represents their net book value as at the date of their removal in 2003, and includes mainly the net book value of NIS 24.7 million of old-generation undersea cables which Bezeq International decided would no longer be operated, and the net book value of improvements to leased premises which Bezeq International had vacated, amounting to NIS 4.6 million.

NOTE 10 – DEFERRED CHARGES AND OTHER ASSETS

Consolidated

	Cost	Accumulated amortization	Balance for amortization December 31 2004	Balance for amortization December 31 2003
			Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Capitalized subscriber acquisition costs	809,560	695,636	**113,924**	79,730
Frequencies (1)	220,104	–	**220,104**	77,948
Acquisition of operations (2)	43,847	13,720	**30,127**	18,660
Rights in channels	5,477	3,298	**2,179**	2,695
Prepaid long-term expenses in respect of a lease agreement	8,535	399	**8,136**	–
	1,087,523	713,053	**374,470**	179,033
Expenses for issue of debentures and raising other loans			**13,434**	11,016
			387,904	190,049

Company

	Balance for amortization December 31 2004	Balance for amortization December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands
Deferred expenses		
Expenses for issue of debentures and raising loans and others	**13,434**	11,016

(1) Investment in cellular communication frequencies in third generation technology by Pelephone – see Note 8D(3).

(2) Acquisition of operations –

a. BezeqCall Communications acquired an operation from Nortel networks Israel (Sales and Marketing) Ltd., to obtain independent capability for providing maintenance, support and installation services to its customers. In addition, it entered into a transaction for the acquisition of the operations of Newkol Ltd., which provided NEP services for Coral exchanges and value added services for business customers.

b. In December 2003 Bezeq International acquired all the rights in the operations of Infonet, including expansion of the deployment of global communications networks and access to a wider range of advanced and quality communications services.

NOTE 11 – TAXES ON INCOME

A. GENERAL

The Income Tax Law (Adjustments for inflation), 5745-1985, effective since the 1985 tax year, introduced a method of measuring operating results for tax purposes on a real basis. The various adjustments required by this law are intended to bring about taxation on the basis of real income. However, adjustment of the nominal profit in accordance with the tax laws is not always identical to the profit reported according to the accounting standards of the IASB. As a result, differences arise between the reported profit in the financial statements and adjusted taxable income.

On deferred taxes in respect of these differences – see Notes 2P above and 11D below.

B. INCOME TAX INCLUDED IN THE STATEMENTS OF OPERATIONS

Consolidated

	For the year ended December 31		
	2004	**2003**	**2002**
	Reported amounts	**Adjusted for the effects of inflation in shekels of December 2003**	
	NIS thousands	**NIS thousands**	**NIS thousands**
Current taxes	**(277,818)**	(220,452)	(216,192)
Deferred taxes	**(154,935)**	169,588	(10,786)
Adjustment of deferred taxes due to changes in tax rates	**(83,881)**	–	–
Taxes for prior years, net	**19,149**	2,851	19,645
	(497,485)	(48,013)	(207,333)

Company

	For the year ended December 31		
	2004	**2003**	**2002**
	Reported amounts	**Adjusted for the effects of inflation in shekels of December 2003**	
	NIS thousands	**NIS thousands**	**NIS thousands**
Current taxes	**(274,057)**	(216,941)	(214,062)
Deferred taxes	**(49,916)**	178,351	(44,466)
Adjustment of deferred taxes due to changes in tax rates	**(78,713)**	–	–
Taxes for prior years, net	**15,607**	5,077	28,887
	(387,079)	(33,513)	(229,641)

NOTE 11 – TAXES ON INCOME (CONTD.)

C. RECONCILIATION BETWEEN THE THEORETICAL TAX ON PRE-TAX ADJUSTED EARNINGS AND THE TAX EXPENSE IN THE BOOKS

Consolidated

	For the year ended December 31		
	2004	**2003**	**2002**
	Reported amounts	**Adjusted for the effects of inflation in shekels of December 2003**	
	NIS thousands	**NIS thousands**	**NIS thousands**
Tax computed at the regular tax rate	**(438,795)**	17,046	127,740
Increase (saving) in tax liability in respect of:			
Inflationary erosion of advance tax payments	**(1,585)**	2,227	(1,292)
Exempt income and capital gains	**2,270**	1,411	38,406
Non-deductible expenses	**(9,652)**	(9,737)	(6,831)
Utilization of losses and benefits from prior years for which no deferred taxes were recorded	**50,544**	–	–
Losses and timing differences for which deferred tax assets were not created	**(63,833)**	(33,926)	(400,592)
Taxes for prior years, net	**19,149**	2,851	19,645
Differences in the definition of equity and non-monetary assets for tax purposes	**24,441**	(27,511)	15,661
Adjustment of deferred taxes for different tax rates	**(83,881)**	–	–
Other	**3,857**	(374)	(70)
	(497,485)	(48,013)	(207,333)
Regular tax rate	**35**	36	36

Company

	For the year ended December 31		
	2004	**2003**	**2002**
	Reported amounts	**Adjusted for the effects of inflation in shekels of December 2003**	
	NIS thousands	**NIS thousands**	**NIS thousands**
Tax computed at the regular tax rate	**(345,696)**	972	124,024
Increase (saving) in tax liability in respect of:			
Inflationary erosion of advance tax payments	**(469)**	2,051	(1,230)
Exempt income and capital gains	**2,199**	1,275	38,407
Non-deductible expenses	**(9,022)**	(8,726)	(3,267)
Utilization of losses and benefits from prior years for which no deferred taxes were recorded	**12,250**	–	–
Losses and timing differences for which a deferred tax asset was not created	**(9,100)**	(7,678)	(435,353)
Taxes for prior years, net	**15,607**	5,077	28,887
Differences in the definition of equity and non-monetary assets for tax purposes	**22,177**	(25,755)	17,525
Adjustment of deferred taxes for different tax rates	**(78,713)**	–	–
Other	**3,688**	(729)	1,366
	(387,079)	(33,513)	(229,641)
Regular tax rate	**35**	36	36

NOTE 11 – TAXES ON INCOME (CONTD.)

D. DEFERRED TAXES

	Consolidated		Company	
	December 31 2004	December 31 2003	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Activity –				
Balance at beginning of year	**769,536**	593,498	**611,633**	429,467
Adjustment due to changes in tax rates	**(83,881)**	–	**(78,713)**	–
Charged to statement of operations for the year	**(154,935)**	169,588	**(49,916)**	178,351
Allocation of original difference to a tax asset	**21,354**	–	**–**	–
Acquisition of minority share in a proportionally consolidated company	**112,540**	–	**–**	–
Charged to statement of operations for prior years	**18,841**	6,450	**15,299**	3,815
Balance as at end of year	**683,455**	769,536	**498,303**	611,633

	Consolidated		Company	
	December 31 2004	December 31 2003	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Composition of deferred taxes –				
Difference between the adjusted value of fixed assets and other assets and their value for income tax purposes	**(575,497)**	(566,381)	**(230,732)**	(376,792)
Adjustment of materials and spare parts	**–**	2,784	**–**	–
Deductions and losses carried forward for tax purposes, net	**495,101**	365,184	**63,726**	61,600
Differences in the recognition of expenses relating to employee rights, doubtful debts and other	**763,851**	967,949	**665,309**	926,825
Total	**683,455**	769,536	**498,303**	611,633
Stated as follows:				
As part of current assets	**237,319**	208,797	**159,023**	170,213
As part of other assets	**446,136**	560,739	**339,280**	441,420
Total	**683,455**	769,536	**498,303**	611,633

Deferred taxes for companies in Israel are computed at the tax rate expected to apply on the date of the reversal of the provision – see Section E below.

NOTE 11 – TAXES ON INCOME (CONTD.)

E. AMENDMENTS TO THE INCOME TAX ORDINANCE

On June 29, 2004, the Knesset passed the Income Tax Ordinance Law (Amendment 140 and temporary provision), 5764-2004 (hereinafter – the Amendment). The Amendment provides a gradual reduction in the corporate tax rate from 36% to 30%, in the following manner:
During the 2004 tax year the applicable tax rate will be 35%, in 2005 the applicable tax rate will be 34%, in 2006 the applicable tax rate will be 32%, and from 2007 onwards the applicable tax rate will be 30%.

Current taxes and deferred tax balances as at December 31, 2004 are calculated in accordance with the new tax rates set out in the Amendment. The effect of the change on the consolidated financial statements for the beginning of 2004 is an increase in tax expenses on revenue in the statement of operations and a reduction in deferred taxes in the Company balance sheets in the sum of approximately NIS 79 million, and approximately NIS 84 million in the consolidated balance sheets.

F. Realization of the deferred tax asset is contingent upon the existence of adequate taxable income in appropriate amounts in the future. The deferred tax asset is included in the financial statements since, according to the Company's business plans, its realization is anticipated.

(1) The Company recorded a tax asset of approximately NIS 49,626 thousand in respect of an accumulated loss of approximately NIS 162,534 thousand, based on the assessment of Management that there is a high degree of certainty that these losses will be realized in the coming years. The balance of the losses and the deductions carried forward in respect of which no deferred taxes were charged due to the uncertainty regarding the possibility of its realization, is approximately NIS 26,000 thousand (2003 – NIS 21,237 thousand).

(2) As at balance sheet date, losses for tax purposes and capital losses of subsidiaries carried forward to the coming years total the adjusted amount of approximately NIS 3,070 million (2003 – NIS 121,231 thousand). In respect of losses amounting to approximately NIS 3,046 million, no tax asset was created by the subsidiaries.

(3) Pelephone recorded a tax asset of approximately NIS 431 million in respect of losses for tax purposes and a deduction for inflation carried forward to the next year which, as at the balance sheet date, total the adjusted amount of approximately NIS 1,360 million (2003 – NIS 1,686 million, in proportionally consolidated NIS 843 million). The net balance of the tax asset at Pelephone was recorded in accordance with the assessment of Pelephone's Management that there is a high level of certainty that these losses will be realized in the foreseeable future. Realization of the balance of these deferred taxes is contingent upon the existence of adequate taxable income in appropriate amounts in the future.

The balance of the losses and deductions carried forward to next year are linked to the CPI in accordance with the above-mentioned law.

G. FINAL TAX ASSESSMENTS

(1) The Company has final assessments up to and including 2000.

(2) Under an assessment agreement signed on January 30, 2003, between Bezeq International and the assessment officer concerning final tax assessments issued to Bezeq International for the years 1996-1999, Bezeq International paid approximately NIS 13.7 million, of which approximately NIS 2.9 million represents interest and linkage differentials. Bezeq International has final assessments up to and including 1999.

(3) Pelephone has final assessments up to and including 1999. A self-assessment filed by Pelephone for the year ended December 31, 2000 is considered as final.

NOTE 11 – TAXES ON INCOME (CONTD.)

G. FINAL TAX ASSESSMENTS (CONTD.)

(4) BezeqCall Communications has final assessments up to and including 2002. BezeqCall Communications has final deduction assessments up to 2002 (income tax and national Insurance).

(5) Self-assessments filed by DBS up to and including 1999 are considered as final.

H. VALUE ADDED TAX

(1) The Company files a consolidated Value Added Tax return together with its subsidiaries.

(2) Value Added Tax assessments were issued to the Company and a subsidiary in the amount of approximately NIS 26 million. The assessments have been appealed and are being discussed with the Value Added Tax authority. The financial statements include a provision of an amount which the Company considers appropriate.

NOTE 12 – BANK CREDIT

		Consolidated	
		December 31 2004	**December 31 2003**
		Reported amounts	**Adjusted for the effects of inflation in shekels of December 2003**
	Interest rate	**NIS thousands**	**NIS thousands**
Unlinked loans	6, Prime + 1.35	**88,102**	94,714
CPI-linked loans	7.25	**–**	50,000
		88,102	144,714

NOTE 13 – LONG-TERM LOANS

A. Composition

	Consolidated		Company	
	December 31 2004	December 31 2003	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Banks	**4,162,573**	2,406,686	**1,003,312**	1,344,520
Pension fund	**26,758**	49,990	**26,758**	49,990
Others	**233**	–	**–**	–
Supplier credit	**7,352**	11,350	**–**	–
	4,196,916	2,468,026	**1,030,070**	1,394,510
Less –				
Current maturities from banks	**1,304,916**	685,883	**473,578**	324,827
Current maturities from others	**31,066**	27,850	**26,758**	23,471
	2,860,934	1,754,293	**529,734**	1,046,212

B. LINKAGE AND INTEREST TERMS

		Consolidated		Company	
		December 31 2004	December 31 2003	December 31 2004	December 31 2003
		Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	Interest rate	NIS thousands		NIS thousands	
Loans in foreign currency					
US dollar (*)	LIBOR+(0.42-0.65)	**1,004,654**	1,235,280	**997,302**	1,223,930
Loans linked to the CPI	3.9 - 7.3	**2,122,825**	893,073	**6,010**	120,590
Pension fund	6.1	**26,758**	49,990	**26,758**	49,990
		2,149,583	943,063	**32,768**	170,580
Shekel/dollar loans(**)	2.33 – 3.51	**215,400**	109,475	**–**	–
Unlinked loans	7.13 – 7.31 Prime + (1.5-1.35)	**827,279**	180,208	**–**	–
		4,196,916	2,468,026	**1,030,070**	1,394,510

(*) These loans bear interest at LIBOR plus a margin.

(**) The loan is renewed every three months in a mechanism determined for three years. The interest is computed under two possible alternatives – a shekel track and a dollar track.

NOTE 13 – LONG-TERM LOANS (CONTD.)

C. REPAYMENT SCHEDULE

December 31	Consolidated NIS thousands	Company NIS thousands
2006	**1,142,130**	**497,423**
2007	**220,918**	**32,311**
2008	**120,827**	**–**
2009	**76,038**	**–**
2010 and thereafter	**24,060**	**–**
	1,583,973	**529,734**
	1,276,961(*)	**–**
	2,860,934	**529,734**

(*) Under a financing agreement signed between DBS and certain banks, long-term loans will be repaid in accordance with the loan schedule to be set on December 31, 2005 for a period of 8 years.

D. SECURITY

(1) Long-term loan agreements of the Company, aggregating NIS 964,540 thousand, include certain conditions upon the occurrence of which the lender may demand immediate repayment of the loans, including:

– A change (without the lender's consent) in the nature of the Company's business, which would have a materially adverse effect on its business, assets or financial condition.

– Non-repayment of a material amount of the loan that has fallen due, or violation of the undertakings or representations made by the Company.

– Abrogation or change of a provision of law that would prevent the Company's operations or the fulfillment of its undertakings.

– The Company ceases to manage its affairs or enters into receivership or bankruptcy proceedings, etc.

– Some or all of the lien-holders realize the liens on the Company's assets.

– A complete or material reduction of the Company's authority to administer its affairs as a result of the intervention of an authority or a change in the Company's tariffs that will have a material effect on the future receipts of the Company (in loans from foreign banks only).

– In respect of loans amounting to NIS 232,180 thousand, upon the occurrence of an event which allows a demand for immediate repayment of other loans of the Company.

– In respect of the remaining balance of NIS 732,360 thousand, upon the occurrence of an event which allows a demand for immediate repayment of other loans of the Company and of material consolidated subsidiaries or the failure of the Company to comply with the following financial covenants relating to the Group:

a. Net financial debt to Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) ratio of not more than 3 : 1.

b. Tangible shareholder's equity (consolidated shareholders' equity of the Company after certain adjustments, primarily deduction of goodwill and other intangible assets) totaling NIS 301,560 thousand must be at least 15% of total tangible assets.

NOTE 13 – LONG-TERM LOANS (CONTD.)

D. SECURITY (CONTD.)

(1) (Contd.)

b. (Contd.)

The Company believes that as at the balance sheet date, it is in compliance with these financial covenants.

Regarding the possibility of the realization of the above conditions, including a decrease in the voting rights of the State and the possibility of the complete opening of the communications market to competition – see Note 1.

The Company created a negative pledge in favor of the lenders.

(2) a. Bank loans and debentures of Pelephone are secured by an irrevocable undertaking in favor of the banks, whereby Pelephone created a negative pledge in favor of the banks. This undertaking includes, *inter alia*:

(1) That its debts will not exceed three times its shareholders' equity;

(2) That as long as its debts exceed its shareholders' equity by a ratio of 1.5, Pelephone will not distribute dividends and will not pay management fees to the shareholders;

(3) That its total debts will not exceed NIS 3.8 billion (linked to the known CPI in January 2002);

(4) That Pelephone will not encumber in any way, including by way of a floating lien or a fixed lien, of any kind or rank, any or all of its assets (as these may be from time to time), in favor of any third party, without obtaining the prior written consent of those who provided the credit.

As at the date of the financial statements, Pelephone is in compliance with its undertakings to the banks, the balance of which as at the balance sheet date is NIS 2,143 thousand.

b. Under the general license for cellular services, Pelephone may not sell, lease or pledge any of its assets which are used for performance of the license without the consent of the Minister of Communications, except –

(1) Encumbrance of one of the assets of the license in favor of a bank duly operating in Israel, for the purpose of receipt of bank credit, provided that it has notified the Ministry of Communications of the encumbrance it intends to record, whereby the encumbrance agreement includes a clause guaranteeing that in no case, will an exercise of the rights by the bank harm the provision of services under the license in any way;

(2) Sale of items of equipment at the time of an upgrading process, including sale of equipment by the trade-in method.

c. Bezeq International provided a negative pledge in favor of banks, whereby it may not encumber its assets without the bank's consent. As at December 31, 2004, Bezeq International has no obligations towards banks.

d. BezeqCall Communications provided a negative pledge and undertook to meet certain financial conditions in respect of loans from banking institutions, the balance of which as at the balance sheet date is approximately NIS 39 million.

NOTE 13 – LONG-TERM LOANS (CONTD.)

D. SECURITY (CONTD.)

(2) (Contd.)

e. The terms of loans received by DBS from banks, the balance of which as at December 31, 2004 is NIS 1,352 million, impose various restrictions, including a demand to comply with the following financial criteria: minimum total income, minimum operating surplus (as defined in the Financing Agreement), minimum operating surplus less investments in decoders (as defined in the Financing Agreement), maximum churn percentage, maximum total financing needs and supplier credit within a stated range. The values for compliance with these criteria vary and are measured every quarter. Failure to comply with the criteria entitles the banks to demand early repayment of the loans received by DBS. As at December 31, 2004, DBS is in compliance with these criteria.

E. LOAN PROCUREMENT EXPENSES

Deferred expenses for raising loans amounted to NIS 10,855 thousand (2003 – NIS 9,106 thousand). The expenses are stated after deduction of accumulated amortization amounting to NIS 8,457 thousand (2003 – NIS 5,557 thousand).

NOTE 14 – DEBENTURES

A. COMPOSITION AND TERMS

		Consolidated		Company	
		December 31 2004	December 31 2003	December 31 2004	December 31 2003
		Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	Interest rate	NIS thousands	NIS thousands	NIS thousands	NIS thousands
CPI-linked debentures issued to the public					
Debentures Series 1	4.5	–	69,587	–	69,587
Debentures Series 4 and 5 (1)	4.8 – 5.3	**850,847**	–	**3,410,936**	–
		850,847	69,587	**3,410,936**	69,587
Debentures issued to the public: In euro (2)	6.5	**1,717,622**	1,615,602	**1,717,622**	1,615,602
Debentures issued: Unlinked (3)	Bank of Israel interest + 0.5	**109,179**	500,372	**109,179**	500,372
Debentures issued to financial institutions and others:					
CPI-linked	3.9 - 5.95	**1,355,286**	706,965	**1,055,286**	706,965
Euro-linked	Libor + 0.8	**32,086**	30,209	**32,086**	30,209
		1,387,372	737,174	**1,087,372**	737,174
		4,065,020	2,922,735	**6,325,109**	2,922,735
Less – current maturities		**240,481**	598,153	**210,481**	598,153
		3,824,539	2,324,582	**6,114,628**	2,324,582

(1) The outstanding balance of the debentures is NIS 3,300,000,000 par value, of which NIS 850,000,000 par value were issued to the public. Regarding sale after the balance sheet date, see section d. below.

a. In a tender offer and public offering pursuant to a prospectus published on May 24, 2004, the Company issued 1,200,000,000 debentures (Series 4) of a par value of NIS 1 each, payable in four equal annual installments in each of the years 2008 through 2011. The interest set for these debentures is 4.8% per annum. Of these debentures, 400 million were allotted to Bezeq Zahav (Holdings) Ltd. ("Bezeq Zahav"), a wholly owned and controlled subsidiary of the Company just prior to the prospectus.

In addition, on May 20, 2004 the Company issued a series of 600 million debentures (Series 5) of NIS 1 par value each, of which 50 million were allotted to institutional investors and the remainder to Bezeq Zahav. These debentures are repayable in 6 equal annual installments in each of the years 2011 through 2016. The interest rate set for these debentures is 5.3% per annum. The debentures were listed for trading under the aforementioned prospectus.

b. On December 9, 2004 the Company issued to Bezeq Zahav 1,500 million debentures (Series 5) of NIS 1 par value each. The debentures are registered by name and are payable in six equal annual installments in each of the years 2011 through 2016, bear annual interest of 5.3% and are not secured by any lien.
The consideration in respect of the debentures was calculated at the market price of the debentures from the same series at the end of trading on December 9, 2004, and is NIS 1,650 million.

NOTE 14 – DEBENTURES (CONTD.)

A. COMPOSITION AND TERMS (CONTD.)

The debentures were listed for trading on the stock exchange, and trading in them will be subject to blocking restrictions pursuant to the Securities Law and to restrictions undertaken by Bezeq Zahav not to resell the debentures for any reason during the later of 12 months from the date of the allotment or until within three months from the date of sale of the State's holdings in the Company.

c. Bezeq Zahav financed the purchase of the above debentures by means of a loan granted to it by the Company for that purpose.

d. At the beginning of 2005, Bezeq Zahav sold 300,000,000 par value of debentures (Series 4) of the Company out of the debentures (Series 4) it purchased from the Company. The proceeds from the sale in the amount of NIS 323,750 thousand, was transferred to the Company by Bezeq Zahav as (partial) repayment of a loan extended to it by the Company for purchase of the above debentures (Series 4), in accordance with the loan agreement between the parties.

(2) The outstanding balance of the debentures is € 293,000,000.

(3) The outstanding balance of the debentures is NIS 109,330,000.

B. REPAYMENT SCHEDULE

	Consolidated	Company
	NIS thousands	NIS thousands
2006	**191,752**	**168,485**
2007	**1,822,826**	**1,799,559**
2008	**373,996**	**576,119**
2009	**309,616**	**511,739**
2010 and thereafter	**1,126,349**	**3,058,726**
	3,824,539	**6,114,628**

C. SECURITY

The debentures are not secured, except for a nominal lien. However, the Company has undertaken that as long as the debentures are outstanding, it will refrain from encumbering its property with other liens.

The lenders are entitled to demand the immediate repayment of the debentures in cases where the Company does not repay its loans or violates the terms of the debentures, if a significant attachment is imposed on its assets (and not removed within 60 days), if a receiver is appointed for the Company's assets or a liquidation order is given against the Company, if the Company ceases to manage its business or if another lien-holder realizes the lien it has on the Company's assets. In addition, some of the lenders, the balance of whose loans as at December 31, 2004 is approximately NIS 460,509 thousand, may demand immediate repayment of the debentures if the State's holdings in the share capital of the Company falls below 26%.

In addition, in respect of a balance of NIS 1,717,622 thousand of debentures listed on the Luxembourg bourse which were issued to the public and are linked to the euro, upon the occurrence of an event enabling demand for immediate repayment of other loans of the Company and of material subsidiaries as defined in the terms of the debentures (Pelephone is the only company meeting the definition of a material subsidiary in accordance with these debentures. it should be noted that DBS is not considered a material subsidiary as defined in the debentures), if the Company does not make the payments scheduled in respect of the debentures, if the Company or its material subsidiaries cease to manage their businesses or enter into receivership, liquidation proceedings and the like, and upon the occurrence of a number of additional events of non-compliance with the undertakings of the Company and its material subsidiaries, as set out therein.

NOTE 14 – DEBENTURES (CONTD.)

C. SECURITY (CONTD.)

Regarding the Company's application to the tax authorities for receipt of approval for exemption from the deduction of withholding tax from interest paid in respect of the above debentures, the Company reached an agreement with the assessment officer whereby it would be exempt from withholding tax from August 1, 2004 until the final repayment of the debentures. It was also agreed that where the ratio of debt to capital in the Company is greater than 1:1.5 debt to capital, the Company's financing expenses in the tax year would be adjusted for tax purposes but not by more than the amount of the financing expenses in respect of the debentures. This will be checked in the quarterly financial statements of the Company, and applied each quarter. In this regard, "debt" – any obligation bearing interest, linkage differentials or whose value changes as a result of changes in the interest or linkage differentials, except for an undertaking to the employees or former employees.

The Company believes that as at the balance sheet date, it is in compliance with all these conditions.

The Company has created a negative pledge in favor of the holders of the above debentures.

D. ISSUANCE EXPENSES

The deferred expenses in respect of the issuance of the debentures amounted to NIS 39,266 thousand (2003 – NIS 33,884 thousand) and are stated net of accumulated amortization of NIS 29,520 thousand (2003 – NIS 27,657 thousand).

NOTE 15 – TRADE PAYABLES

	Consolidated		Company	
	December 31 2004	December 31 2003	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Suppliers of goods and services	**1,671,261**	1,126,337	**648,218**	686,517
Current maturities of long-term supplier credit	**4,308**	4,379	**–**	–
	1,675,569	1,130,716	**648,218**	686,517
Including subsidiaries	**–**	–	**99,409**	24,206
Including a proportionally consolidated company	**–**	41,233	**–**	82,466

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

A. COMPOSITION

	Consolidated		Company	
	December 31 2004	December 31 2003	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Provision for early retirement (see D below)	**1,190,447**	1,300,493	**1,190,447**	1,300,493
Compensation for unutilized sick leave (see F below)	**47,196**	50,682	**47,196**	50,682
	1,237,643	1,351,175	**1,237,643**	1,351,175
Provision for severance pay (see B below)	**76,629**	53,634	**13,186**	12,628
Less – reserve in compensation fund	**41,702**	31,380	**–**	–
	34,927	22,254	**13,186**	12,628
	1,272,570	1,373,429	**1,250,829**	1,363,803
Stated as follows:				
In current liabilities	**592,474**	602,520	**592,474**	602,520
In long-term liabilities	**680,096**	770,909	**658,355**	761,283
	1,272,570	1,373,429	**1,250,829**	1,363,803

B. ELIGIBILITY OF EMPLOYEES UPON REACHING RETIREMENT AGE

(1) The liability of the Company and its investee companies for severance benefits to employees is fully covered by current payments to pension funds and insurance companies and by the above liabilities. The accumulated amounts in the funds mentioned above are not under the management or control of the companies and therefore, are not reflected in the balance sheet.

(2) The pension rights of the Company's employees with respect to the period of their employment in government service until January 31, 1985, are covered by a pension fund ("Makefet Fund") which assumed the Government's liability in accordance with an agreement between the Government, the Company, the New General Federation of Labor (Histadrut) and the Fund.

C. EMPLOYEE RIGHTS BEFORE RETIREMENT AGE

The Company's liability to pay severance pay to employees leaving their employment under conditions entitling them to such benefits is covered, in respect of the period from February 1, 1985, by current deposits in pension funds and with insurance companies, as stated in section B above. Severance pay in respect of the period of government service up to January 31,1985, is actually paid by the Company, and the amounts accumulated with the Makefet Fund with respect to this period are held in that Fund for use in connection with the employees' rights. For a small number of employees (employed under special contracts), the Company has a commitment to pay severance pay exceeding the amount accumulated in the employee severance pay fund.

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

C. EMPLOYEE RIGHTS BEFORE RETIREMENT AGE (CONTD.)

The liability of Group companies for pension and severance payments are mainly covered by current deposits in the employees' name in recognized pension and severance funds, and/or by acquisition of policies from insurance companies. The aforementioned deposited amounts are not included in the balance sheet since they are not under the control and management of the companies.

The severance pay liability included in the balance sheet represents the balance of the liability not covered by deposits and/or insurance policies as aforesaid, in accordance with existing labor agreements and in accordance with the wage components which the management of the companies believe entitle the employees to severance pay. In respect of this part of the liability, there is a reserve deposited in the Company's name in a recognized compensation fund. The reserves in compensation funds include linkage differentials and accrued interest, and are deposited in compensation funds in banks and an insurance company. Withdrawal from the funds is contingent upon fulfillment of the provisions of the Severance Pay Law.

Employees who transferred to the Company from government service ("transferred employees") and whose employment in the Company is ceased before reaching retirement age, are entitled, in certain conditions, if they so choose and under the provisions of the Civil Service Law (Retirees), to receive early pension benefits in lieu of severance pay. The cost of the early pension benefits (except for cases of sickness or disability up to retirement age), are to be borne by the Company. In recent years, most Company employees have retired under agreed early retirement plans, and accordingly the chances of realization of the above liability are slight. Accordingly, no provision has been made for it in the financial statements, other than a provision for the early retirement plan described below.

D. EARLY RETIREMENT PLANS

In September 2000, the Company reached an agreement with workers' representatives to extend the 1997 collective agreement on early retirement (the "Retirement Agreement"). Under the Retirement Agreement, 1,770 additional employees, of whom up to 300 are not transferred employees, were to take early retirement between April 1, 2001 and December 31, 2006 (with the option of extending the final date of retirement for certain employees through December 31, 2008). Similarly, in accordance with the provisions of the agreement, the Company may terminate the employment of employees on the severance pay track in excess of the aforementioned quota. According to the agreement between the Company and workers' representatives, the funds raised by the Company (See Note 20B.) will be used to finance the costs of retirement of employees under the Retirement Agreement. Therefore, it was agreed that the funds raised would be held, managed and invested by the Company as part of its total monetary balances, and that shortly before the Government ceases to hold control of the Company, the Company will transfer the retirement funds to an external body which would manage and invest the retirement monies. The financing round completed in 2003.

Under the retirement Agreement, 1,222 employees had retired from the Company through December 31, 2004.

The Company's Management does not expect any significant costs arising as a result of employees who retire under the severance pay track (if they retire) under the Retirement Agreement, or under any other framework, and therefore no provision has been made in the financial statements

In May 2003, the Knesset approved the Israeli Economic Recovery Plan (Legislative Amendments for Achieving Budgetary Targets and Economic Policy for the 2003 and 2004 Financial Years) Law, 5763-2003. This law includes, *inter alia*, an amendment to the Supervision of Insurance Business Law, 5741-1981, which relates to the old pension funds operating at a deficit, including the Makefet Fund. Under the amendment, the retirement terms of all members of these pension funds were made equal, in accordance with uniform articles which, amended by law, became valid on October 1, 2003, such that the rights of members of those pension funds who were a party to special pension agreements were harmed.

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

D. EARLY RETIREMENT PLANS (CONTD.)

On March 18, 2004, an amendment to the Retirement Agreement was signed between the Company), the New General Workers' Trade Union and the workers' representation under which certain amendments to the present Retirement Agreement were agreed upon with the aim of clarifying the uncertainties arising out of the amendment of the Supervision of Insurance Business Law. Amongst others, it was agreed that by September 30, 2004, 400 employees would retire, and it was also agreed that the retirement conditions of all transferred employees who take a pension under the Retirement Agreement as of September 2000, will remain in force despite the amendments to the Pension Law and the Company shall bear any additional costs that might be required. It was agreed that in the event that an alternative pension fund to the Makefet Fund is found, in which the status and rights afforded to the retirees under the Retirement Agreement are retained, then under this agreement the Company shall be entitled to contract with such a fund with the consent of the employees' representatives and receipt of approvals required by law. As at the date of these financial statements the Company is in the process of selecting an alternative body to the Makefet Fund in coordination with the employees' representatives and the Company, and the representatives have come to an appropriate collective agreement. In addition the parties agreed in the amendment to the agreement dated March 18, 2004, that they would enter into negotiations in order to regulate the retirement of the remainder of the employees through 2011 on one hand and the requirements of Management for organizational and other changes, on the other hand. A provision will be recorded in the financial statements if and when the negotiations develop into an agreement. As of the date of these financial statements the negotiations on which an agreement for an amendment to the Retirement Agreement will be based have not commenced..

On May 12, 2004, the Government Companies Authority, with the consent of the Commissioner for Wages, approved the amendment of the Retirement Agreement dated March 18, 2004.

On April 1, 2004, the Commissioner for Capital Markets, Insurance and Savings published a circular regarding "Employer-Financed Early Retirement in Old Pension Funds". According to the circular, the discount rate for capitalizing the cost of early pension was changed from 3.5% to 3% and the management fees were raised to 1.75%. As a result of these and additional updates, the Company recorded an additional provision of approximately NIS 105 million in its financial statements as at December 31, 2004.

E. Under the collective agreements applicable to labor relations in the Company and pursuant to the agreements with the Fund, Company employees who are transferred employees retain the option of retiring under one of two retirement tracks. The method of calculating the cost of early retirement of these employees is laid down in the provisions of several agreements and documents drawn up between the Company and Makefet Fund during the years 1990-1996, including a letter of understanding drawn up and signed by them in 1996. The Company contends that the Fund violated the provisions of the agreements in general and those of the letter of understanding in particular, in that when it calculated the costs of early retirement for transferred employees, it determined the data on the basis of the assumption that these employees had chosen the track with the higher cost of purchase, irrespective of the track those employees had actually chosen. According to an actuarial opinion prepared for the Company, the difference between the payments collected by the Fund from the Company according to its calculations and the rate of those costs had they been made, as the Company alleges, on the basis of the retirement track actually chosen by those employees, is a nominal cumulative amount of more than NIS 128 million, the reimbursement of which the Company is suing the Makefet Fund. On November 20, 2003, the Company filed another claim against the Fund for additional amounts of approximately NIS 80 million in respect of other components. The Makefet Fund submitted data on the previous retirees. On the basis of these data, together with the previous file, a revised actuarial opinion was prepared which quantified the total amount of the claim as at the date of its filing at approximately NIS 280 million. The Makefet Fund filed statements of defense in which it rejects the allegations of the Company and alleges that it acted in accordance with the agreements between it and the Company.

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

F. COMPENSATION FOR UNUTILIZED SICK LEAVE

The financial statements include a provision for compensation in respect of unutilized sick leave for all entitled employees, in accordance with the conditions laid down in the employment agreement.

NOTE 17 – OTHER CURRENT LIABILITIES

	Consolidated		Company	
	December 31 2004	December 31 2003	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
The Government of Israel in respect of royalties	**244,886**	204,768	**145,121**	153,110
Wages and salaries [1]	**397,666**	250,739	**286,360**	203,358
Provision for vacation pay	**113,144**	85,299	**73,370**	79,308
Governmental agencies	**102,229**	24,474	**15,635**	–
Accrued interest	**235,352**	106,647	**165,124**	92,959
Payables in respect of derivatives	**57,635**	65,304	**47,827**	65,304
Other accrued expenses	**166,086**	168,544	**103,519**	80,623
Current maturities in respect of prepaid income	**34,547**	24,830	**21,643**	17,578
Provision for claims in respect of salary and pension components	**50,595**	257,595	**50,595**	257,595
	1,402,140	1,188,200	**909,194**	949,835
Including subsidairies	**–**	–	**76,308**	–
[1] Including current maturities of a long-term loan from a pension fund	**26,758**	23,471	**26,758**	23,471

NOTE 18 – OTHER LONG-TERM LIABILITIES

	Consolidated		Company	
	December 31 2004	December 31 2003	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Prepaid income	**25,750**	27,544	**20,936**	27,544
Liabilities in respect of an onerous contract (1)	**9,247**	9,660	**–**	–
Liabilities in respect of derivatives	**438**	6,560	**438**	6,560
Checks payable	**11,940**	–	**-**	–
	47,375	43,764	**21,374**	34,104

(1) In the course of its business and as part of the setting up of Bezeq International and receipt of assets from the Company, Bezeq International entered into agreements granting it rights to use transmission equipment (old-generation undersea cables) for periods ending between 2016 and 2024. Under those agreements, Bezeq International is obligated to pay fixed monthly amounts, irrespective of the extent of the use it makes of those cables. The management of Bezeq International estimates that the unavoidable costs for compliance with those agreements exceed the anticipated financial benefit that will accrue to it from use of the undersea cables. This assessment, together with the decision of Bezeq International's management not to operate the undersea cables, formed the basis for charging a provision of NIS 9,660 thousand in the financial statements as at December 31, 2003. The balance of the provision as at December 31, 2004, which reflects the capitalized value as at that date of all the unavoidable costs that Bezeq International must pay the owners of the undersea cables until the end of the terms of the agreements is NIS 9,247 thousand.

NOTE 19 - CONTINGENT LIABILITIES

A. CLAIMS

Below are details of the status of contingent liabilities of the Company and investee companies as at December 31, 2004, in respect of which the maximum possible exposure is considerable.

(1) In September 1997 a claim was filed against the Company and the State in the Jerusalem Regional Labor Court. The claim was filed on behalf of 128 senior employees employed under personal employment contracts. The essence of the claim is the plaintiffs' allegation that since October 1, 1996 they have been entitled to a 33% salary increase, commensurate with the raise given at that time to Knesset members and senior civil servants whose salaries are linked to those of Knesset members. The total amount of the claim in respect of salary differentials is approximately NIS 12 million. In addition, delay differentials are claimed in respect of these amounts. The Company contended that it pays the plaintiffs' salaries according to the directives of the Government Companies Authority. The State joined as a party to the proceeding and filed a final opinion written by the Attorney General, which supports the position of the Government Companies Authority that there is no obligation to grant the senior employees the salary increment demanded. In a hearing on January 27, 1998 the State's representative stated that the Attorney General had given his decision that the Government Companies Authority had no obligation to order a 33% raise in the salaries of the senior employees, and that the Government Companies Authority had exercised its discretion reasonably on this matter when it decided not to accede to the claim. The claim was dismissed, as was the appeal filed against its dismissal. On May 23, 2004 the plaintiffs filed a petition in the Supreme Court, requesting that the decision of the National Labor Court be annulled. On June 23, 2004 the Company, through its legal advisers, filed a preliminary response to the petition, seeking its dismissal *in limine*.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(10 (Contd.)
A decision on these claims has not yet been made and a hearing is scheduled for March 22, 2005 in the Supreme Court. In the opinion of the Company, relying on the assessment of its external legal advisers, the prospects that the Supreme Court will not hear arguments on the petition itself but will dismiss it *in limine*, are high. Accordingly, no provision has been made in the financial statements in respect of this petition.

(2) a. In December 1998 the Antitrust Commissioner published notice that the Investigations Department of the Antitrust Authority ("the Authority") had completed an investigation it had carried out over the past year, regarding *prima facie* suspicion of restrictive agreements between Koor Industries, Telrad, Tadiran, the Company and a subsidiary company, BezeqCall Communications Ltd (“BezeqCall Communications”), concerning the supply of large exchanges (Public Switching) and Network End Point ("NEP") exchanges.

In the field of Public Switching, the Authority's investigation found, according to the notice, suspected collaboration between Telrad and Tadiran against the Company, and suspected restrictive practices between the Company, Koor, Telrad and Tadiran, which include a commitment by the Company not to purchase exchanges from a third vendor; division of purchases between Telrad and Tadiran according to a predetermined calculation, i.e. the ostensible pre-arrangement of the competition between the companies in relation to the Company and an undertaking by the Company not to purchase equipment from the two companies through tenders. It was suspected that these undertakings, or some of them, in the relevant circumstances, constitute violation of the provisions of the Antitrust Law. According to the Commissioner, from the findings of the investigation, it appears, ostensibly, that in fact the Company purchased exchanges from one vendor (Koor Industries) – at prices which were seemingly much higher than those the Company would have paid had it not restricted itself and had the entire market not been blocked to other equipment suppliers by the aforementioned arrangement.

In the NEP field, the findings of the Authority's investigation gave *prima facie* indication of a series of restrictive arrangements and attempted offenses in the NEP field, between BezeqCall Communications, Telrad and Tadiran.

On March 3, 2002 the Company and certain persons who were serving as its officers during the relevant period, were summoned to a hearing by the Antitrust Authority. The summons (which relates to the investigation of the public switching issue only) stated that the Authority was considering committing the Company for trial on the basis of offenses against the Antitrust Law.

The Company's legal advisers recommended that the Company not attend the hearing without all the relevant material having been submitted to them for study. Since not all the requested material was not submitted to the Company, the hearing was not held.

The Authority recently gave notice that it does not intend to file indictments in connection with this affair. However, the Authority also notified the Company that it was considering issuing a determination against the Company, under Section 43 of the Antitrust Law, concerning the public switching field, and that the Company was invited to attend a hearing on the matter. In reply, the Company gave notice that it refuses to attend the hearing, for the same reasons it refused to attend the hearing in connection with the intention to file an indictment against it.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(2) a. (Contd.)

The discussions between the Company and the Authority in an attempt to arrive at an agreed order (which would also preclude issue of the determination), were in vain, due to the Company's refusal to pay money to the State Treasury within the framework of the agreed order, unlike Telrad and Tadiran, which together paid NIS 8 million as part of an agreed order arrived at with the Authority in connection with the same affair. (It should be noted that under the same agreed order, the Commissioner gave notice that notwithstanding the suspicion of restrictive practices in the public switching market, competition in that market had not in fact been restricted, and therefore he had already previously decided not to file an indictment in the matter.)

In these circumstances, the Company filed a petition in the Supreme Court, in which it demanded that the Authority be directed to hold the hearing, to submit the security material to it before holding the hearing, and to refrain from issuing the determination. The Company's petition was dismissed on March 2, 2005, and following that decision the Company approached the Authority and requested that the hearing be held even without all the relevant material, before issue of the determination.

If the determination is issued against the Company following dismissal of its petition, the Company will be entitled to file an appeal in the Antitrust Tribunal. In such a case, the Company’s external legal advisers believe that the Company has worthy and good arguments against the determination. These arguments are based, in part, on the security aspects relating to the purchase of the public switching (combined with the "act of state" doctrine), partly on arguments relating to the management process and to the manner of exercise of management discretion, and partly on other arguments (such as the restrictive application by the courts of everything involved in the application of the Antitrust Law concerning vertical arrangements between customer and supplier, reliance on legal advice, the corporate connection between Telrad and Tadiran, reasons of equitable defense, etc.).

b. On September 21, 2004 a claim and an application for approval as a class action were filed in the Jerusalem District Court against the Company and several other defendants (including Telrad and Tadiran) and against the State of Israel-Ministry of Communications as a formal defendant. The claim was filed by the plaintiff under the Antitrust Law, and Article 29 of the Civil Procedure Regulations, 5744-1984. According to the plaintiff, the defendants unlawfully formed a number of cartels which divided up the communications exchange market in Israel and set the prices of the exchanges, where the Company was part to those agreements as a customer of Telrad and Tadiran. It is alleged that these arrangements gave rise to unnecessary expenses for the Company, resulting in an unjustified rise in the Company's tariffs in a cumulative amount of NIS 1,700 million. Since these proceedings are in their early stages, the external legal advisers of the Company are unable to assess the exposure of the Company arising from the claim, but in their opinion, the Company has good and worthy defense arguments against the claim, and accordingly, no provisions has been made in the financial statements in respect of the claim. If a determination is issued by the Authority, as referred to in section a. above, stating that the Company was party to a cartel in the field of public switching, and as long as that determination remains in place, it will constitute *prima facie* proof of the existence of an arrangement. However, if such a determination is issued, the Company will be able, as part of an appeal to the Antitrust Tribunal, to contest that determination. In the opinion of the Company's external legal advisers, the Company has good arguments in such an appeal.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(2) c. Applications by Company shareholders relating to the filing of claims against suppliers and/or officers:

In November 2000 an application was received from a Company shareholder, demanding that the Company take legal action against the abovementioned suppliers of communications equipment, and gave notice that in his estimation, the Company had suffered a loss of about NIS 392 million as a result of the cartel. In his application, the shareholder reserves the right to file a derivative claim pursuant to Section 194 of the Companies Law. The Company replied that it was monitoring developments in the matter, that it had requested the investigation material from the Authority and that it would formulate its position on the basis of the Authority's decision and any findings there might be. In November 2001 a similar application was made by another shareholder. The Company replied that it was still awaiting the decision of the Authority. On November 2, 2004 another similar application was made by a Company shareholder who believes that the Company should file an action in respect of losses caused by the suppliers. The Company replied that his application did not contain the factual and legal basis required under the Companies Law, and added that to the extent the Company explains, as part of the class action referred to in section b. above, or if information that comes to the Company shows that it has cause of action, it will be ready to institute proceedings to defend its rights.

In addition, on November 29, 2004 an application was received demanding that a claim be filed against whoever served in the Company as directors and/or as senior managers from the end of the 1980s to 2004 (inclusive), in which the officers would be required to compensate the Company in respect of all the excess payments made by the Company to its equipment suppliers and which, due to the omission of those officers, the Company is unable to claim from those equipment suppliers.
On January 30, 2005 the Company replied that is rejects everything stated and alleged in the demand, since the Company was not in a position which would enable it to formulate a reasoned and final stance on the matter of the public switching and that it has no cause of action against any of its officers.

(3) In March 1999 a claim was filed against the Company in the Jerusalem regional Labor Court by a group of employees who had been employed as non-permanent workers at the Ministry of Communications and were transferred to the Company when it commenced operations. The plaintiffs are requesting that the Labor Court determine that they are entitled to all the benefits which were granted to transferred permanent employees, graduates of Bezeq College and retired Ministry of Communications employees. In the hearing of the Company's application to dismiss, the parties reached agreement regarding partial dismissal and a narrowing of the claim in respect of some of its components, following which, exposure decreased in respect of the claim. During 2002 the plaintiffs withdrew their consent to narrow the claim. The Labor Court must now rule whether it approves the withdrawal of consent. In a preliminary hearing the parties agreed to split the hearing so that in the first stage the court would hear only the dispute on whether the plaintiffs have the status of "transferred employees". Based on the outcome of this stage, the plaintiff will give notice of continuation of the case proceedings. In the opinion of the Company the plaintiffs are not considered "transferred employees" and collective labor agreements differentiate between transferred employees and other employees regarding pension and other rights.

The issues raised in this claim are liable to have a broad effect on the Company. However, in view of the above agreements, exposure has been significantly reduced provided that the court does not approve the plaintiffs' withdrawal of consent. In any case, the Company, relying on its legal advisers representing it in this matter, estimates that the chances for the claim's success are low. Accordingly, no provision has been made in the financial statements in respect of this claim.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(4) On February 15, 2000 a claim was filed against the Company in the Jerusalem District Court in the amount of NIS 22 million. The plaintiff alleged in its claim that the Company violated its undertakings and representations to the plaintiff to purchase large quantities of equipment from it. The plaintiff further alleges that the procedure adopted for selecting the equipment which would be purchased by the Company was unlawfully managed, with infringement of the tenders laws and the rules of proper administration, with negligence and while exploiting the status of the Company as a monopoly or monopsony. With the agreement of the parties, the claim was transferred to an arbitrator, and on November 14, 2004 the arbitrator awarded the plaintiff compensation of approximately NIS 1 million, thereby ending the proceeding.

(5) Several claims are pending against the Company concerning the recognition of various salary components as pensionable components and the recognition of various components of the determining wage for severance pay as detailed below:

a. In September 2000, a claim was filed in the Jerusalem Labor Court against the Company by 2,423 retired employees of the Company, who were transferred from the Ministry of Communications to the Company when it commenced operations. The plaintiffs are requesting from the Labor Court declaratory relief which will determine that the payments they received for grossing up of tax, clothing allowance and incentive pay are regular salary which should be seen as part of their determining wage for the purpose of calculating their pension and for the payments made to them upon retirement, and should be included in the calculation of hour value and the calculation of the percentage increments. The plaintiffs are also seeking declaratory relief which will determine that their last determining salary for pension should be calculated according to the last salary paid to each of them for the last month of work, and not according to the average grade which each of them held. The Company filed a preliminary application for the claim to be dismissed and/or stricken *in limine*. The preliminary allegations made in that application are dismissal for limitation, strike for absence of material details, strike for absence of financial quantification and causal arguments relying on the retirement agreements.

On June 24, 2004 the regional Court gave its decision, in which the claim was stricken *in limine*. The Court ruled that the plaintiffs were not a homogenous group in that each of them has different data relevant to his claim, that the claim cannot be conducted as if it were a class action, it is a monetary claim which was not properly quantified, and it contains no facts and demands enabling it to be quantified. The Court also determined that the pensioners' organization is not a workers' organization as referred to in Section 3 of the Collective Agreements Law, that it is not an action in a collective dispute and that the consent of the organization is not sufficient for filing a claim in the name of each of the 2,423 plaintiffs. On October 10, 2004 this decision was appealed in the National Labor Court. In the appeal filed against the claim being stricken *in limine*, the Court proposed that the parties meet in an attempt to arrive at agreements concerning how an amended statement of claim should be filed. The case is scheduled for hearing.

b. On February 24, 2002 a "notice of a party to a collective dispute" ("the notice"), was received at the Company's offices, which was filed in the Jerusalem Regional Labor Court on February 21, 2002 by the New General Federation of Workers in the name of all Company employees. The applicant alleges that payments for grossing up of tax, the component of administrative call duty benefits and clothing allowances which were and are paid to Company employees are regular pay which form part of the determining salary of every employee, including for the matter of calculation of payments upon retirement, redemption of holidays, grants, acclimatization payments, percentage increments and hour value, and that various payments and provisions should be made in respect thereof, including for pension purposes. On October 20, 2002 the Attorney General gave notice that he would be joining the claim, and he later submitted his position that the application in all its parts should be rejected.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(5) c. A group of employees filed a claim against the Company in the Tel Aviv Regional Labor Court concerning the inclusion of a number of components as part of the determining pay for pension. The Company and the group of employees participated in a mediation proceeding, which was terminated, but the Company's management believes there is a chance that concurrently with the continued conduct of the legal proceedings, further contacts will be made to reach a settlement. The financial statements include a provision which management believes, based on the assessment of its legal advisers, reflects a possible settlement.

d. A number of other, individual claims are pending against the Company, filed by employees and former employees and concerning recognition of various salary components as pensionable components and recognition of various components as part of the determining salary for severance pay.

The wide-ranging effect of these claims is considerable, and could, under certain assumptions, reach an amount of approximately NIS 2.6 billion.

Concerning the risk assessment of the claims described in this section –

On July 14, 2003 the National Labor Court gave its decision on an appeal in another claim which was filed by 7 former employees of the Company, which recognized the component of administrative call duty benefits as a pension component, considering the factual circumstances in that case.

On October 13, 2004 the National Labor Court gave its decision in the appeal of dismissal of a claim filed by a former employee of the Company, the main thrust of which was a claim for the inclusion of the administrative call duty benefits and a jubilee grant as part of the determining salary for making various payments, including for pension purposes. The Court determined in its ruling that the source of the right to administrative call duty benefits is contractual and that the parties to the agreement may determine the terms of granting the right, its scope and its limits, and therefore, full validity should be given to the limits set forth in the Company's procedure, whereby the payment for the administrative call duty benefit is not considered as salary in any way insofar as rights deriving from agreements are concerned. Nevertheless, the decision determined that the administrative call duty benefits should be included in the determining salary for the calculation of rights under law (Hours of Work and Rest Law and the Annual Vacation Law). In the opinion of the Company's external legal advisers, this decision appears to close the door on the claim that the component of administrative call duty benefits should be seen as salary in every respect. In view of the above and in accordance with the resolution of the Board of Directors of the Company of October 28, 2004, the Company has reduced the provision it made in its financial statements in respect of the component of administrative call duty benefits by approximately NIS 145 million.

On January 17, 2005 the Supreme Court gave a decision in a petition (to which the Company is not a party) against a ruling of the National Labor Court that the grossing up of tax component (in respect of the value of use of a vehicle and in respect of reimbursement of telephone expenses) should be recognized as part of the determining salary for pension purposes. The Supreme Court vacated the decision of the National Labor Court and determined that the grossing up of the tax component paid as aforesaid is not part of the determining salary for pension purposes, since that component is secondary to the salary increment in respect of which the tax is grossed up, and it should be treated in the same way as a salary increment is treated. Since this petition refers to increments which are not part of the determining salary for pension purposes, the grossing up of tax component thereon is also not part of the determining salary for pension purposes.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(5) (Contd.)
Following this decision of the Supreme Court and in view of the opinion of the Company's external legal advisers that following the Supreme Court ruling there is a good chance that claims filed against the Company and relating to the grossing up of tax component can be dismissed, and after examining the salary components which are grossed for tax in the Company, it appears that the risk to which the Company is exposed in relation to recognition of the grossing up of tax component as a pensionable component in pending claims against it has been reduced considerably, and accordingly, no provision has been made in the financial statements. In view of the above, the provision of approximately NIS 62 million for the grossing up of tax component which was recorded in the books, has been cancelled.

No provision has been made in the financial statements in respect of other components subject to the above claims, , relying on the opinion of the Company's external legal advisers that the risk in respect thereof, cannot be assessed.

(6) On September 7, 2000, an action and an application for approval as a class action were filed against the Company in the Tel Aviv – Jaffa District Court, based on Article 29 of the Civil Proceedings Regulations, 5744-1984 ("Article 29"). The amount of the claim is estimated at approximately NIS 110 million. According to the plaintiff, the Company unlawfully collected "collection fees" from its subscribers for Company bills which were not promptly paid, before it had started any collection actions in connection with the plaintiffs' debt. According to the plaintiff, Article 2 of the Telecommunications Regulations (Arrearage interest and collection fees), 5747-1987 ("the Collection Regulations") authorizes the Company to collect collection expenses for a bill in arrears only if the collection action against the consumer has been initiated, and therefore the Company exceeded its authority. In addition, the plaintiff alleges that charging collection fees before taking any action is an administrative offense, fraud, under Section 56 of the Torts Ordinance (New Version), false representation, negligence, harm to the proprietary right, violation of legislated duty, unjust enrichment, and fulfillment of a contract in bad faith. There are two main reliefs requested by the plaintiff – declaratory, in which the Court is requested to declare that the collection of "collection expenses" by the Company in the circumstances described in the claim was unlawful and that the Company may not continue to collect such expenses in the future, and an "operative – financial" relief, for reimbursement of said amounts. On January 7, 2001 the Company filed its response to the application for approval of the claim as a class action, to which it attached a financial opinion of an auditor. In its response the Company alleges that Article 29 does not constitute legal grounds for filing class actions and therefore the application for approval should be dismissed *in limine*. Alternatively, the Company alleged that the claim does not meet the criteria of Article 29 for filing a class action. The Company also alleged in its response that it charges the collection expenses only to subscribers who have caused it to incur expenses due to arrears in payment, that the plaintiff's interpretation of the provisions of the Collection Regulations are groundless, and that it acted lawfully. On February 8, 2001 the plaintiff filed his reply to the Company's response.

On October 18, 2001 an additional class action was filed in the Tel Aviv – Jaffa District Court on the same matter as the above claim, unlawful charging of collection fees of Company bills not paid on time, before the Company had started any collection action. The plaintiff alleges that this action constitutes exploitation of the consumer's difficulties, in contravention of the Consumer Protection Law, 5741-1981 ("the Consumer Protection Law"), as well as unjust enrichment. The amount of the class action is estimated by the plaintiff at about NIS 21 million. On December 16, 2001 the court approved a suspension requested by the Company until after giving a decision on the application for approval as a class action of the first claim described in this sub-section, in view of the similarity of the causes of action in the two cases.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(6) (Contd.)
On February 20, 2003 the District Court approved the first action as a class action in the name of whoever was charged collection fees by the Company despite having paid the relevant bill before the Company commenced collection actions as explained in the statement of claim, from March 7, 1997 to the date of filing the claim. In its decision, the court determined that the Company's authority to collect collection expenses depends on the initiation of means of collection involving costs, and that the Company had not presented proof that retrieving the data of payment arrears, before any action is taken against them, involves costs. In addition, the court determined that Article 29, on which the application for approval relies, was suitable grounds for a class action. On March 17, 2003 the District Court suspended the proceedings in the claim until a decision on the application for leave to appeal which will be filed by the Company. On March 20, 2003 the Company filed an application in the Supreme Court for leave to appeal the decision to allow the action as a class action. In its application, the Company claimed, *inter alia*, that that the District Court's interpretation of the Collection Regulations is erroneous and disregards their language and purpose, and that even were its interpretation correct, the plaintiff would still have no cause against the Company since the Company collects the collection expenses by virtue of the Collection Regulations only from subscribers whose arrears require additional handling, which the Company would not have required had the payment been made on time.

The Company further alleged that the District Court erred when it determined that no proof was presented of the Company bearing expenses in relation to a bill that is not promptly paid before the elapse of 14 days arrears, since an affidavit of the Company was presented which described the expenses it incurs due to the fact of arrears, as well as a financial opinion on the same matter, which the court had disregarded in its decision.

On April 2, 2003 a precedent-setting ruling was given by the Supreme Court (in another case, to which the Company is not a party), stating that a class action cannot be filed by virtue of Article 29, where no specific arrangement is made in principal legislation for filing such action ("the A.S.T. Ruling"). It should be noted that an application for an additional hearing of this Supreme Court ruling was filed (and approved). Based on the above, the court ruled that the response to the Company's application for leave to appeal in the matter of the first action described in this sub-section would be postponed until a decision is given in the additional hearing in the other case. In the opinion of the Company, relying on the legal advisers handling the case on its behalf, the application for leave to appeal and the appeal itself have a reasonable chance of success. Accordingly, no provision has been included in the financial statements in respect of these claims.

(7) In September 2000 a claim and application for approval as a class action were filed in the Haifa District Court against the Company. The amount of the action cannot be assessed, and is estimated at more than NIS 795 million. According to the plaintiffs, the Company unlawfully collected from its subscribers a fixed payment for the lease of telephones which the Company made available to them, so they allege, since the telephones were supplied to subscribers without a specific lease agreement being made, without disclosure and proper publication of the fact that this was a "lease" transaction for an unlimited term, and also concerns the amount of the "lease fee" demanded and the continued collection of the "lease fee" even after the date on which the Company's subscribers had paid the "lease fees" in an amount equal to the full value of the telephones supplied. The plaintiffs further allege that the Company collected "lease fees" unlawfully in that it did not give its subscribers the choice of whether to "lease" or purchase the telephones and in that it did not inform them of the option to cease payment of the fixed lease fee in exchange for a lump-sum payment which of itself, according to the plaintiffs, is unlawful. The relief requested by the plaintiffs is mainly financial, for reimbursement of the aforesaid amounts.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(7) (Contd.)
In addition, on November 21, 2000 the Company received another class action which was filed in the Haifa District Court together with an application for approval as a class action. The amount of this claim is estimated at approximately NIS 254 million. It should be noted that the additional action makes claims which are similar or identical to those in the above action from September 2000.

On April 25, 2001 the plaintiffs' application for consolidation of the hearings in the two claims, was approved. On June 10, 2001 the plaintiffs filed an amended statement of claim and amended application for approval as a class action. Additional allegations were made in the amended statement of claim, *inter alia* concerning unlawful charging of "maintenance fees". The amount of the claim of all the plaintiffs is now estimated at more than one billion shekels. In its response, the Company claimed that the amounts were maintenance fees collected in connection with Company equipment which was made available to subscribers and that the charge and the rate of such charge were prescribed in law and covered the considerable costs to the Company for providing the service.

On June 10, 2003 the court dismissed the application for approval as a class action. The plaintiffs filed an appeal in the Supreme Court against this decision. On December 21, 2003 the Company filed a counter appeal in respect of non-ruling of reimbursement of legal fees in its favor in the decision that dismissed the amended application for approval.

In the hearing of the appeal on March 11, 2004, the parties acceded to the court's recommendation and agreed to mutual dismissal of the appeal and the counter appeal, thereby ending the proceeding.

(8) On September 28, 2000, three plaintiffs filed a claim and application for approval as a class action in the Tel Aviv District Court against the Company, Bezeq International and the other international communications operators. The plaintiffs estimated the amount of the claim in million of shekels per year.

According to the plaintiffs, commencing October 20, 1998, the Company unlawfully collected 17% VAT for some of the collect calls originating outside Israel and received by its subscribers in Israel (in which, according to the plaintiffs, the Company acts as a "collection pipeline" for the international operators to which the payment is due), in contravention of the VAT law and its regulations and in violation of a legislated duty, in a manner that breaches existing telecommunications agreements, while acting in bad faith in the fulfillment of such contracts and with negligent conduct. The plaintiffs make further allegations against the international operators concerning the collection of VAT in respect of calls made from abroad to Israel using phone cards. The plaintiffs estimate the total loss incurred by the group due to the unlawful collection of VAT for all the calls made from abroad to Israel in the relevant period (since October 20, 1998) at millions of shekels per year.

There are two main reliefs requested by the plaintiffs: declaratory, stating that each of the defendants violated its obligations under the contractual agreement between it and the member of the group with which it contracted, and financial, for restitution of said amounts (compensation for the loss incurred by the members of the group which the plaintiffs are requesting to represent, in the aforesaid amounts). The defendants filed their responses and Bezeq International filed an application for dismissal *in limine* of the application for approval as a class action. On June 18, 2001 the Attorney General gave notice that he would appear in this proceeding. On January 6, 2002 the Court decided to conjoin the Director General of the VAT authority as an additional defendant in the action and the application for its approval as a class action, and denied the application of Bezeq International for dismissal *in limine*. At a hearing on February 28, 2002, the plaintiffs' attorney clarified that the plaintiffs are not demanding independent relief from the communications companies, but rather, reimbursement of the VAT which the Director General of the VAT authority will pay them if the claim is successful.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(8) (Contd.)
The plaintiffs' attorney also proposed that the communications companies be considered formal defendants. In view of the A.S.T. Ruling, the Court decided on August 25, 2003 to strike the application for approval of the claim as a class action and therefore also the action itself.

On October 13, 2003 the plaintiffs filed an appeal against this decision in the Supreme Court. On April 18, 2004 the Supreme Court decided to suspend the proceedings in the case until after its decision in the further hearing in the matter of A.S.T. In the opinion of Bezeq International and the Company, relying on their external legal advisers, in the circumstances to date and taking note, *inter alia*, of the status of the Company (and of the other defendant communications companies) as a formal respondent, and noting the statements of the plaintiffs' attorney that there is no claim for independent relief against the communications companies (including, the Company) – no financial exposure of the Company seems likely in connection with this claim, (and if any such exposure exists, then it is minimal). In addition, the Company has credible defense arguments pertinent to the matter itself for refuting the action. Accordingly, no provision has been made in the financial statements in respect of this claim.

(9) In September 2001, an application was filed in the Tel Aviv District Court for approval of a class action against the Company. The plaintiffs allege that in view of certain amendments to the Telecommunications Regulations, the maximum payment that could be collected from a Company subscriber who called a Pelephone subscriber in off-peak hours during the period between October 2000 and December 31, 2000, was lower than the amount actually collected. The applicants estimate the amount of the claim, as at the date of filing the application for approval of a class action, at about NIS 44 million. The Company filed a response to the application for approval, in which it alleged mainly that it simply acts as a non-discretionary collection contractor and that the conditions required for approval of the claim as a class action have not been met. On May 12, 2002 the Company's request to conjoin Pelephone as a party to the proceeding was allowed. On August 29, 2002 Pelephone filed a response to the application for approval as a class action, to which it attached confirmation from the Ministry of Communications that the plaintiffs' interpretation does not reflect the intention of the formulator of the Regulations. The parties filed their summations in the application for approval of the class action. On January 14, 2005 the Court gave its decision denying the application for approval. To the best of the Company's knowledge, the plaintiff intends to appeal.

(10) a. In March 2003 a statement of claim was filed in the Tel Aviv District Court against the Company, the Broadcasting Authority and the State of Israel by various plaintiffs from Moshav Porath in the Sharon region, including the estates of deceased persons, for compensation due to physical harm pursuant to the Torts Ordinance. The statement of claim alleges violation of legislated duties and acts and/or failures allegedly perpetrated by the defendants jointly and/or severally in connection with the operation of the Hillel broadcasting station, which is located near the homes of the plaintiffs. It is also alleged that as a result, the plaintiffs were subjected to illegal radiation from the broadcasting station causing bodily harm, which in the most part, had ended in the death of some of the plaintiffs.

The amount of the claim stated by the plaintiffs is "more than NIS 15 million", and the same claim notes that the plaintiffs will also petition to split the reliefs sought so that they will reserve the right to sue later for other financial damages which are not bodily harm, such as damage to crops and loss of value of land. According to the notice of the plaintiffs' lawyer, which was given before the claim was filed, this claim is an initial claim and it is intended that additional claims of other residents who have been harmed by radiation from the Hillel station will be filed later.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(10) a. (Contd.)

The Company filed a statement of defense to which it attached expert opinions in occupational medicine and non-ionizing radiation safety, which state, *inter alia*, that there is no causal connection between the broadcasts of the Hillel station and the alleged cancer of the plaintiffs. The plaintiffs filed a response in which they argue against the Company's experts and their opinions. In the opinion of the Company, relying on its external legal advisers, whose opinion is based on the expert opinions mentioned above, the chances of the claim being dismissed are greater than the chances that the claim against the Company will be allowed. Accordingly, no provision has been included in the financial statements in respect of this claim.

It should be noted that following an application for dismissal *in limine* filed by the Company, a partial decision was given in favor of the Company, denying the claim of five plaintiffs who died before the Company commenced operation of the station.

The Company is reserving its arguments against the other defendants, the State of Israel and the Broadcasting Authority. These arguments relate mainly to the fact that the station was operated by the Company for and on behalf of the other defendants, in accordance with directives and operational requirements of the other defendants or any of them, and that the Company acted in accordance with the provisions of any law and with the directives of the various authorities, including those which were responsible for the broadcasting activity from the station.

b. On June 13, 2004 another claim was filed in the Tel Aviv District Court by 25 plaintiffs from Moshav Porath and Moshav Ein Vered, including 11 heirs of the estates of deceased persons, against the Company, the Broadcasting Authority and the State of Israel, for compensation in respect of bodily harm (18 of the plaintiffs are suing the Company, the Broadcasting Authority and the State, and 7 plaintiffs are suing only the Broadcasting Authority and the State).

The additional claim alleges violation of legislated duties and acts and/or failures allegedly perpetrated by the defendants jointly and/or severally in connection with the operation of the Hillel broadcasting station, which is located near the homes of the plaintiffs. It is alleged that as a result, the plaintiffs were subjected to illegal radiation from the broadcasting station causing bodily harm, which had ended in the death of some of the plaintiffs.

The amount of the compensation demanded in the additional claim has not been estimated (although the claim is in the jurisdiction of the District Court, i.e. more than NIS 2.5 million), and the compensation is based on financial and non-financial damages items which are listed in respect of each plaintiff, together with punitive compensation. The claim also states that the plaintiffs will petition to split the reliefs sought so that they will reserve the right to sue later for other financial damages which are not bodily harm allegedly caused, and that this refers to damage to crops, loss of value of land, deterrence of potential investors and the like. According to the plaintiffs, these damages amount to "in excess of millions of shekels", but have not yet been calculated. The Company filed a statement of defense on October 31, 2004.

At this stage, the legal external advisers of the Company are still unable to assess the chances of the Company's defense against the claim. Nevertheless, since the claim is similar in essence to the first claim mentioned above, the Company’s external legal advisers expect (subject to the aforesaid) that the chances that this claim will be dismissed are greater than the chances of it being allowed, and accordingly, no provisions has been included in the financial statements in respect of these claims.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(10) (Contd.)
It should be noted that on December 31, 2003 the Company ceased all broadcasts from the station, as demanded by the State and the Broadcasting Authority, and since that date the site no longer serves as a broadcasting site.

(11) In January 2002 a claim for payment of monetary compensation of approximately NIS 56 million and for writs of mandamus were filed in the Tel Aviv - Jaffa District Court by an international communications operator against the Company and Bezeq International. The claim makes allegations concerning the process of customer allocation to the international communications operators. According to the plaintiff, it is entitled to compensation from the Company and from Bezeq International in respect of postponement of implementation of the allocation process, in respect of diverting those being allocated to Bezeq International by unlawfully including them in the coordinated listing and removing them from the customer allocation process, and in respect of losses it sustained due to the method of the voice announcement of the possibility of dialing from card-operated public telephones. Alternatively, the plaintiff alleges that it is entitled to reimbursement of access fees which it paid to the Company under an interconnect agreement which was allegedly imposed upon it unlawfully. The plaintiff also requests that the court give orders directing investigations and accounts be made in relation to certain actions in the allocation process and for changing the order of the voice announcement in public telephones so as to ensure, in its opinion, equality among the international operators. On April 22, 2002 the Company filed a statement of defense, in which it denied the allegations of the plaintiff. In the statement of defense the Company claimed, *inter alia*, that postponement of the date for completing the allocation process derived, among other things, from objective failures and difficulties.

The Company also alleged that in the subscriber survey its role was purely technical, and involved nothing more than collating the data and preparing a file of those who participated. The Company relied, for this purpose, on data conveyed to it by the three international operators, and was extremely careful in processing the data and even on its own initiative, beyond the call of duty, identified errors that had occurred in them (insofar as these were apparently reasonable to discover, by means of the systems at its disposal).

In addition, the Company filed a third party notice against the Ministry of Communications in the full amount of the claim. In the notice the Company alleges, *inter alia*, (as in the statement of defense) that in all its actions relating to the allocation process, the Company acted as the agent and long arm of the Ministry of Communications and under its instruction, that the Ministry of Communications devised, planned and supervised the allocation process, directed it and dictated the manner of its implementation and the timetables for each stage of its implementation, and to the extent that it was flawed in any way, the Ministry of Communications is exclusively responsible.

Bezeq International also filed a statement of defense and a third party notice.

On July 3, 2002 the plaintiff filed its reply. On October 14, 2002 the Ministry of Communications filed a statement of defense to the third party notice filed against it by the Company and Bezeq International. As at the date of signing the financial statements, the claim had not yet been heard. The Company and Bezeq International, relying on their external legal advisers, are unable, at this stage, to estimate the chances and the implications of the claim. Accordingly, no provision has been made in the financial statements in respect of this claim.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(12) In January 2002 the Company received a letter of demand from a supplier, in which it was alleged that an order issued by the Company to the supplier for a total sum of about NIS 31 million, is valid. According to the Company, the order was contingent upon suspending conditions which were not fulfilled, and therefore the order is not valid. About a year ago the supplier sent the Company a letter to which it attached a draft statement of claim for approximately 2 million Euro and the Company replied to that letter, rejecting the supplier's allegations and repeating its own allegations. In the opinion of the Company, relying on the legal advisers who are handling the demand on its behalf, the chances of the Company's defense should a claim to be filed against it in this matter, cannot be estimated. Accordingly, no provision has been included in the financial statements in respect of this claim.

(13) In February 2002 a claim and application for recognition as a class action were filed against the Company in the Tel Aviv District Court, concerning reimbursement of a commission which the plaintiff alleges was collected unlawfully, for calls in Israel from a public telephone operated by means of a BezeqCard. The amount of the class action is estimated by the plaintiff at about NIS 15 million as at the date of filing the claim. Summations have been filed in the matter of the application for recognition as a class action and the case is awaiting a decision on that application. On February 23, 2004 the Telecommunications Regulations (Payments for telecommunications services listed in the addendum to the Law) (Amendment of the 5759-1999, 5760-2000 and 5761-2001 regulations), 5764-2004 were published, in which the Telecommunications Regulations (Payments for telecommunications services listed in the addendum to the Law) were amended for the years 1999-2001. In the opinion of the legal advisers who are handling the claim for the Company, following the above amendment, the basis for the claim and the application for recognition as a class action has been removed, and accordingly, no provision has been made in the financial statements in respect of this claim.

(14) On July 25, 2002 the Company received a claim for monetary and declaratory relief together with an application for recognition as a class action by virtue of both Article 29 of the Civil Proceedings Regulations and the Antitrust Law 1988 – 5748 ("the Antitrust Law"), which had been filed in the Tel Aviv - Jaffa District Court against the Company. The plaintiffs, who contend that they are Company subscribers or use its services, allege that the Company unlawfully collects interest on arrears, as defined in a directive concerning Accountant General's interest rates, in respect of arrears in payment for services provided by other communications providers, which are included in the invoice which the Company issues to its subscribers. The plaintiffs allege that the Company may collect such interest only in respect of arrears in payment for the telecommunication services provided by the Company itself. They further allege that the Company does not transfer to the other communications providers the full amount of interest on arrears it collects, and that by collecting the additional arrearage interest, the Company enriched itself unlawfully at their expense and perpetrated an administrative offense against them. The plaintiffs are requesting declaratory relief including for the Company's exploitation of its monopolistic status and that the Company be directed to reimburse the interest on arrears that it allegedly collected unlawfully. If approved as a class action, the total amount of the claim is estimated by the plaintiffs to be in the tens of millions of shekels.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(14) (Contd.)
On February 11, 2003 the Company filed its response to the application. Its arguments are that since it is the one which bears the costs of collecting the bill from the subscribers, there can be no dispute that it is entitled to interest for arrears in payment of the bills both legally by virtue of the Adjudication of Interest and Linkage Law and by virtue of the licenses of the other communications providers, that according to a practical interpretation of the interest regulations it is entitled to collect the additional arrearage interest at the rate prescribed in those regulations. In addition, the Company argued that the basic assumption of the plaintiffs, that the arrearage interest under the interest regulations is necessarily higher than the arrearage interest under the licenses of the communications providers and/or under the Adjudication of Interest and Linkage Law, is unfounded and incorrect. In this context the Company showed that in calculating the damages, the plaintiffs have disregarded several benefits that the Company grants its subscribers, as a result of which some of the plaintiffs suffered no damages and some suffered damages that were much lower than alleged in the claim, and in any case the plaintiffs in the class action suffered no damages and therefore cannot serve as appropriate plaintiffs in a class action, that Article 29 cannot serve as legal grounds for filing a class action, and that the filing of the action is tainted with serious delay which is sufficient for its dismissal.

Following the A.S.T. Ruling, the plaintiffs filed an agreed claim in January 2004 and an amended application for approval from which the parts relating to Article 29, and causes of action the source of which was not the Antitrust Law, had been stricken. The Company filed its amended response on May 3, 2004, and summations have been scheduled for filing. In the opinion of the Company, relying on its external legal advisers, the chances of the claim and the application for approval cannot be estimated at this stage, and therefore no provision has been included in the financial statements in respect of this claim.

(15) On December 22, 2002 a financial claim for grant of a declaratory order and injunction, together with an application for recognition as a class action, were filed in the Tel Aviv-Jaffa District Court against the Company. The plaintiffs, who contend that they are subscribers of cellular communications providers, allege that the Company is misleading the consumer public regarding calls to 1-800 or 1-700 numbers, into thinking that such numbers are toll-free calls, whereas in fact, the consumer who calls such a number from a cellular telephone is charged by the cellular companies for air-time for those calls. According to the plaintiffs, in so doing, the Company is perpetrating torts according to the Consumer Protection Law (deception of the consumers, including deception in advertising, exploitation of the distress of consumers and refraining from disclosure of essential information to consumers), and all the members of the group represented in the action (all the consumers who called 1-800 or 1-700 from a cellular telephone during the seven years prior to the date of filing the claim) have consequently sustained losses. The estimated amount of the claim is approximately NIS 700 million, which includes compensation for financial loss, non-financial damages and punitive damages. The court is also requested to give temporary and permanent injunctions against the Company, to cease misleading consumers and to refrain in the future from advertising or making any other representation liable to mislead consumers regarding the price of such calls. On March 27, 2003 the Company filed its response to the application for approval, in which it alleged, *inter alia*, that no transaction was made between it and the plaintiffs, that the advertisements did not make representations towards the plaintiffs and that all the representations of the Company were correct. In addition, the Company contended that the claim does not meet even one of the conditions required under the Consumer Protection Law for its approval as a class action.

The case is in preliminary proceedings. In the opinion of the Company, relying on its external legal advisers, the chances and implications of the claim cannot be estimated at this stage, and therefore no provision has been made in the financial statements in respect of this claim.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(16) On April 24, 2003 a statement of claim was filed in the Tel Aviv-Jaffa District Court, titled "Derivative Claim" (a claim filed by a shareholder or director of a company in the name of the company, with the approval of the court). The claim was filed by a shareholder of the Company against 20 directors and certain senior managers who served in the Company during October and November 2000 ("the Officers") and against the Company. The statement of claim alleges as the main cause of the action, the negligent conduct of the officers in the "Pelephone-Shamrock transaction". In that transaction, the shares of Motorola Israel Ltd. in Pelephone Holdings L.L.C., a corporation registered in the U.S.A. ("the Foreign Corporation"),were sold to in consideration of approximately $591 million.

On June 12, 2003 the Company filed an application for the dismissal *in limine* of the claim, citing as its reason that the plaintiff had not filed a preliminary application for approval of his claim as a derivative claim, as required by law. Concurrently, the Company filed an application for extension of the date for filing a statement of defense until a decision was given on the application for dismissal *in limine*. The Company's application to extend the date was allowed. A similar application for dismissal *in limine* was also filed by the officers. On January 8, 2004 the plaintiff filed an application requesting, *inter alia*, leave to file a preliminary independent application for approval of the claim as derivative, and on that basis he requested denial of the applications for dismissal *in limine*. On January 15, 2004 the court determined that the plaintiff may file an independent application for approval of the claim as derivative, and the Company would be required to file its response to that application. The plaintiff was granted an extension for filing the application until April 1, 2004, but by that date he had not done so. On May 17, 2004 the plaintiff filed an application to strike the claim in *limine*, without an order for costs. The claim was stricken, thereby ending the proceeding.

(17) On May 27, 2003, a statement of claim was received at the Company's offices together with an application for recognition as a class action, which were filed against the Company in the Tel Aviv-Jaffa District Court. The plaintiff who describes himself as "a private internet user" alleges in his claim that the Company refuses to install splitters for high speed internet lines of the broadband ADSL/frame relay type used for internet service in condominiums, and does so, allegedly, in order to increase its profits. The plaintiff, who is seeking to represent all the internet users in Israel, further alleges that the Company's refusal to install the splitters causes losses of thousands of shekels each year to every private internet user, since the connection of a number of tenants in a condominium on one telephone line using such splitters would considerably reduce the fees paid to the Company by each consumer. The pretexts for the claim as they appear in the statement of claim, are cited by virtue of the Antitrust Law, the Torts Ordinance and the Unjust Enrichment Law and not by case law. The plaintiff also alleges fraud and material deception under the Consumer Protection Law. The amount of the claim is estimated by the plaintiff at NIS 2.5 billion (NIS 10,000 per consumer), which he alleges is the loss sustained by the plaintiffs. The plaintiff also petitions that the Company be charged, in addition, with special and punitive damages, and for an order for the Company to give accounts for all private internet users in respect of the amounts received from them from the time each user started using the service until the date of the reply. The stage of evidentiary hearings has ended and the case is scheduled for written summations. The main points of the Company's arguments are that there is no basis in law for obligating it to connect a number of users on one "broadband" and that the service and the tariff collected by the Company for it were approved by the Ministry of Communications. In the opinion of its external legal advisers, the Company has credible arguments in its defense. Nevertheless and relying on its legal advisers, the Company is unable, at this stage, to estimate the chances of the claim, and accordingly no provision has been made in respect of the claim in the financial statements.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(18) On June 5, 2003, a statement of claim was received at the Company's offices together with an application for recognition as a class action, which were filed in the Tel Aviv-Jaffa District Court against the Company by two of its subscribers. According to the allegations in the statement of claim, the Company overcharged its subscribers by NIS 0.021 (plus VAT) compared with the charge set in the regulations for calls from Company subscribers to subscribers in the cellular networks of Cellcom and Pelephone, during the period (estimated) from June 1996 to August 31 of that year. The plaintiffs allege that in so doing, the Company violated the ban on misleading consumers as laid down in the Consumer Protection Law, breached duties under the Contracts Law, the Torts Ordinance and the Sale Law as well as unjust enrichment. The group in whose name the claim is filed is defined by the plaintiffs as "a group of Bezeq subscribers in Israel who dialed to subscribers of Cellcom and Pelephone in June, July, August 1996" and estimated by them as numbering more than four million subscribers. (It should be noted that at the relevant time, the Company's subscribers numbered about 2.5 million.) Based on the estimation (which is erroneous, as aforesaid) of the number of subscribers and the average "loss" to the plaintiffs (NIS 7.5), the plaintiffs estimate the amount of their claim at about NIS 30 million and are claiming compensation in respect of that loss. A calculation made by the Company found that the difference between actual collection and collection by the applicants' method amounts to about NIS 6 million. Alternatively, the plaintiffs are requesting that the court recognize the claim as a claim for declaratory relief or as a claim for a mandamus against the Company. Concurrently, and according to the statement of claim, claims for similar causes were filed against Cellcom and Pelephone, where the claim against Pelephone was dismissed by the District Court. An appeal against the dismissal of the application against Pelephone was also dismissed on January 5, 2004. The application for approval as a class action was denied with consent on February 17, 2004, and subsequently the statement of claim accompanying it was stricken, thereby ending the proceeding.

(19) Keren Makefet was instructed by the Capital Markets Division at the Ministry of Finance to fulfill the undertakings it had made in connection with the change in the retirement tracks of about 600 Company retirees, contingent upon the Company paying Keren Makefet NIS 50 million. The Company notified Keren Makefet that it is demanding the continued implementation of the agreement that enabled transfer from one retirement track to another at no additional cost to the Company, since Keren Makefet had undertaken not to impose any additional cost on the Company. Subsequently Keren Makefet stopped allowing Company retirees to transfer from one track to another and also ceased complete or partial performance of the retirement agreement with regard to pensions paid in respect of April 2002. On January 11, 2004, a claim was filed in the Tel Aviv Regional Labor Court by 66 retirees who had retired under the retirement agreement of November 1997, alleging that they had elected to receive their pensions under Track B since the personal agreement signed with them under that track embodied a promise of amendment of the wage that determines their pensions in accordance with the "Yellow Note" agreement (i.e. additional payment of up to NIS 650 per employee).

According to the plaintiffs, that promise had not been kept, and therefore a collective agreement was signed on April 2, 2001, which was intended to enable employees to transfer from Track B to Track A. The plaintiffs contend that the April 2001 agreement was applied to only about 70 employees of the 600 or so who wished to exercise their right under it. The claim is consequently for enforcement of the April 2001 agreement. The claim, which was filed initially by 66 retirees, was broadened when, with the approval of the court, other retirees were added to bring the total to 264 retirees. After a preliminary hearing on December 5, 2004, the Company and Makefet filed applications for dismissal of the claim, and alternatively, for is quantification. The plaintiffs responded to the applications, and the Company is now awaiting the decision of the court. It is the opinion of the Management of the Company, relying on its external legal advisers, that the Company is not at risk of actual legal exposure in respect of the claim, in view of Makefet's undertaking not to impose upon the Company any additional cost for application of the agreement. Accordingly, no provision has been made in respect thereof in the financial statements.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(20) At the beginning of July 2004 an action for declaratory relief against Keren Makefet, the State of Israel and the Company, was filed in the Tel Aviv Regional Labor Court by the Organization of Bezeq Retirees and six of its members. The action alleged that the defendants breached agreements for binding arrangements that were made upon the transfer of the employees from the civil service to the Company. According to the plaintiffs, the uniform code under the Economic Recovery of Israel Law should not be applied to them as retirees, and alternatively, the defendants or any of them must compensate them for application of the uniform code. The Company filed an application for dismissal of the claim *in limine*, citing as its reasons, *inter alia*, that the claim is not quantified, and that in the amendment to the retirement agreement from March 18, 2004, the Company undertook that the rights of employees who retired from the Company commencing from the date of application of the uniform code, would not be harmed. The plaintiffs responded to the application, and the Company is awaiting the decision of the court. In the opinion of the external legal advisers of the Company, there are weighty preliminary arguments for dismissal of the action, and there is only low risk that the action will actually impose a financial cost on the Company. Accordingly, no provision in respect of this claim is included in the financial statements.

(21) During 2004, various claims were filed in the Regional Labor Courts in Tel Aviv and Be'er Sheva, against the Company and/or Makefet, by a number of employees who retired from the Company with a disability pension due to their medical condition. Against a background of the pension reforms, these employees were called for a repeat medial examination and were notified of a reduction to their pension, initially of 50%. In their claim, the employees are demanding payment of a full disability pension. A procedural agreement has been drafted between the parties, in which the applications for temporary reliefs have been consolidated into the main case, and until that main case is decided, Makefet will pay advances to supplement the pension to its full rate and the Company will pay Makafet compensation for insurance of half of the salary. If the claim against Makefet is allowed, this compensation will be returned to the Company. In the opinion of the Company, relying on its external legal advisers, the claim has a reasonable chance of being allowed against Makefet and dismissed against the Company, and therefore no provision has been included in the financial statements.

(22) On October 19, 2004, a claim together with an application for its recognition as a class action was filed in the Tel Aviv District Court. The statement of claim alleges that the Company adds VAT to the arrearage interest it collects from its subscribers in respect of arrears in payment, thereby generating over-collection, in contravention of the law, since the arrearage interest of the Accountant General at the Ministry of Finance, which the Company is entitled to collect, includes the VAT component. The claim is grounded, *inter alia*, on the Antitrust Law - 1988 and the Consumer Protection Law - 1981. The amount of the claim against the Company is estimated by the plaintiffs at approximately NIS 87 million (if it is ruled that the ground for the action is only the Consumer Protection Law - 1981, the amount of the claim is estimated by the plaintiffs at about NIS 56 million). In the opinion of the external legal advisers of the Company, the Company has worthy arguments of defense. Nevertheless, they are unable to assess, at this stage, the chances of the action and therefore, no provision has been included in the financial statements in respect of this claim.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(23) On February 10, 2005, the Company received a claim and an application for its approval as a class action which were filed in the Haifa District Court. The statement of claim alleges that the Company's charges for internet access in the "WOW Extra" and "WOW" campaigns in the summer of 2004 and in its calculations, constituted deception, fraud, unjust enrichment and overcharging. The plaintiff also alleges that the acts and/or failures of the defendant constitute a criminal offense under the Consumer Protection Law - 1981, and a tortuous offense. In addition, the plaintiff requests discovery of facts. The grounds for the action are based on the Consumer Protection Law, and the preliminary estimated amount of the class action is NIS 96 million. The plaintiff reserves the right to amend the amount of the claim and to increase it after receipt of the data it has requested. In the opinion of the Company's external legal advisers, it is not possible to assess the chances of the defense in the case at this stage, and therefore no provision has been included in the financial statements in respect of this claim.

(24) In November 1997 a claim was filed in the Tel Aviv-Jaffa District Court, together with an application to recognize the claim as a class action, against the Company, Bezeq International, the Chairman of the Board of Directors of Bezeq International and the then CEO of Bezeq International. The claim alleges, *inter alia*, that the Antitrust Commissioner had determined that Bezeq International had unfairly exploited its status in the international calls market and had implemented a deliberate policy of misleading the public on the subject of overseas call tariffs when it refrained from clarifying to the public that only those who registered as Bezeq International subscribers would enjoy the reduced tariffs. The amount of the class action is estimated by the plaintiffs at approximately NIS 50 million. In December 1997 the Company was struck from the claim. On June 19, 2001, the District Court decided to deny the application for approval as a class action. On September 20, 2001, the decision of the District Court was appealed in the Supreme Court. On October 28, 2001, Bezeq International filed an application to strike the appeal *in limine*. The parties filed their summations.

(24) (Contd.)
In a hearing in the Supreme Court on July 15, 2003, the Supreme Court explained that the District Court had erred procedurally, since it should have decided only on the application to join another plaintiff to the class action and not on the question of denial of the application for approval of the claim as a class action. Accordingly, the appeal was allowed. The case was returned to the District Court and instead of a hearing, the plaintiff's summations were filed on May 16, 2004, and on January 2, 2005, Bezeq International filed its summations on the question of approval of the claim as a class action and on the question of establishment of the plaintiffs' personal cause of action. The legal advisers of Bezeq International believe that there is a reasonable chance that Bezeq International will be able to argue convincingly for denial of the application for approval of the claim as a class action, and therefore no provision has been included in the financial statements in respect of this claim.

(25) On September 16, 2001, a revised statement of claim and an application for recognition as a class action were filed against Bezeq International and the State of Israel. The plaintiff alleges that the tariffs for international telecommunication services during the period from May 10, 1996 to July 8, 1997, were exorbitant and unreasonable, while exploiting the status of Bezeq International as a monopoly, against a backdrop of reducing prices as the international calls market was opening up to competition. On February 18, 2002ה Bezeq International filed its response to the court, in which it rejected the allegations of the plaintiff and alleged that the conditions for allowing the claim as a class action had not been established. The Court allowed the request of the applicant to study the financial statements of Bezeq International for the relevant period and the minutes of the meetings of its board of directors from the same period. On December 25, 2003, the court allowed the application by virtue of the Antitrust Law and not by on the basis of a cause arising from the Unjust Enrichment Law, and approved the claim as a class action. On January 14, 2004, the daily press included an item about the decision to approve the claim as a class action under Chapter F of the Antitrust Law. On January 15, 2004, an application was filed in the District Court for a stay of implementation of the decision.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(25) (Contd.)
On February 2, 2004, the plaintiff filed its reply to the application, requesting its dismissal *in limine.* On February 2, 2004, the plaintiff filed an appeal in the Supreme Court against the decision of the District Court relating to the cause prescribed in the Unjust Enrichment Law . At the request of the State and Bezeq International, in February 2004 the District Court agreed to delay implementation of its decision on approval of the claim as a class action until the decision of the Supreme Court on the application for leave to appeal filed by Bezeq International (see below). Following applications for leave to appeal filed by the State and Bezeq International in the Supreme Court on this matter, the Supreme Court determined, on March 7, 2004, that their applications must be answered, and accordingly, on May 9, 2004 the plaintiff filed its reply to the applications of Bezeq International and the State for leave to appeal. The hearing of the class action and the two applications for leave to appeal were consolidated into one case, the parties filed their summations, and the Court has scheduled a hearing to complete the arguments orally on March 22, 2005.

The Company believes, based on the assessment of Bezeq International and its legal advisers, that if the action is eventually approved also by the Supreme Court as a class action and if it is allowed, the amount of the action is liable to reach hundreds of millions of shekels. However, the legal advisers of Bezeq International estimate that Bezeq International has good arguments against the decision of the District Court, and Bezeq International therefore decided not to include a provision in respect of this claim in the financial statements.

(26) On March 3, 2003, a claim was filed against Bezeq International by a systems vendor for approximately NIS 18.5 million. According to the vendor, Bezeq International unlawfully canceled an agreement to supply and install a customer care and billing system, and it is suing for enforcement of the agreement with Bezeq International and compensation for the losses deriving from the delay in the project, and alternatively – if the claim for enforcement is not allowed – compensation in respect of all the losses it sustained as a result of breach of the contract. On May 26, 2003, Bezeq International filed a statement of defense and a statement of counter-claim in the amount of NIS 10 million, in which it alleged that the contract was canceled because the vendor violated the undertakings it made in the contract. On September 14, 2003, the vendor filed a reply to the counter-claim, in which it denied the allegations of Bezeq International. At the request of the vendor on January 20, 2004, that a date for the pre-trial hearing be set, the Court recommended that the parties use the time until the per-trial hearing for a mediation proceeding. The parties were in contact in order to decide on the identity of the mediator, but were unable to reach agreement. The pre-trial hearing is scheduled for March 15, 2005. The legal advisers of Bezeq International are unable, at this stage, to estimate the chances of the claim. And accordingly, no provision has been included in its financial statements in respect of this claim.

(27) In December 2000 a claim was filed in the Tel Aviv-Jaffa District Court against Pelephone by the State of Israel for royalties allegedly payable for the period from January 1994 to February 1996. The amount claimed is estimated at approximately NIS 260 million (including principal, linkage differentials and interest).

The State's claim is based, *inter alia*, on the following: summary of a meeting between Motorola, the Company and the Ministers of Communications and Finance on March 3, 1993, concerning the provision of cellular services by means of a joint company of Motorola and the Company, commencing on January 1, 1994; the original license of the Company, by virtue of which Pelephone operated from the time of its establishment; the license to provide cellular services that was granted to Pelephone on February 7, 1996 , which was valid from January 1, 1994; the Telecommunications Order (Reduction of the percentage of royalties and imposition of the requirement to pay royalties),- 5754-1994 ("the Royalties Order"); the Royalties Regulations; unjust enrichment.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(27) (Contd.)

In March 2001 Pelephone filed a statement of defense in which it argued, *inter alia*, that the Royalties Order was void from the date of its issue since it exceeded authority and was unreasonable, and alternatively it was void from the date on which Cellcom won the tender for a second cellular operator; and there is no reason for payment of royalties for the period preceding receipt of the license, and the license cannot constitute a source for charging royalties, and in any case – not retroactively; the Royalties Order does not apply to monthly subscription fees; Pelephone cannot be liable under the memorandum of understanding of March 3, 1993, which set out a general principle but does not supersede secondary legislation, and in any case, Pelephone was not a party to that understanding. On this administrative matter, arguments cannot be based on contracts laws or unjust enrichment laws.

The statement of defense claimed that the amount should be reduced by the sum paid by Pelephone to the State, as aforementioned, , in 1996an amount paid by the Company to the State in respect of the period from January 1, 1994 to October 10, 1994 as part of a compromise agreement between them (dated November 29, 1995), and additionally, an additional sum claimed by the State in respect of royalties for fixed monthly fees, even though the Royalties Order does not apply to this component, should be deducted from the amount claimed. Accordingly, the true dispute, in the opinion of Pelephone, is over NIS 70 million. Pelephone believes, relying on the opinion of the external lawyers who are handling the claim, that the chances of a good defense are real and that the provision it has made in its financial statements is appropriate.

In a counter-claim filed by Pelephone together with the statement of defense, it claims reimbursement of approximately NIS 66 million (principal, interest and linkage up to March 1, 2001) in respect of the amount it paid to the State in 1996.

Before the hearing of the claim and the counter-claim, the parties agreed to transfer the matter to a mediation proceeding, which commenced in 2002 and during which an outside examiner was appointed to check the revenue components on which royalties are payable for the period of the claim and which affect the amount of the original claim. The results of that examination were submitted in September 2004, and found that the maximum amount of royalties on the revenues of Pelephone from January 1, 1994 to February 7, 1996 is only approximately NIS 118 million, of which approximately NIS 23 million relate to the period January – October 1994.

In the opinion of Pelephone's management, relying on the opinion of its external legal advisers who are handling the claim, Pelephone has a good defense. Pelephone's financial statements include a provision which the management believes is appropriate, and will suffice if indeed Pelephone is required to pay any amount in the claim / mediation proceeding.

On February 16, 2004, the Company provided an undertaking to Pelephone, as approved by the Board of Directors on February 12, 2004, that if the mediation proceeding fails, the Company will pay Pelephone any sum it is ordered to pay to the State, if charged in a peremptory decision in respect of royalties for revenues from the provision of cellular services during the period from January 1, 1994 to October 10, 1994. According to the Company, it paid the State for the period under the settlement agreement of November 29, 1995, between it and the State. The undertaking to indemnify is subject to the presentation of the Company's arguments in the proceeding and the consent of Pelephone for the Company to join the action as a third party should the Company request to do so. The Company estimates that the risk of it being ordered to pay is low, and accordingly, no provision has been made in its financial statements.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(28) In July 2001 a claim was filed in the Tel Aviv-Jaffa District Court against Pelephone. The plaintiffs allege that Pelephone's pre-paid service constitutes infringement of a patent of the plaintiff's company. Among the reliefs claimed are that Pelephone be directed to cease and desist from infringing the patent, be ordered to submit a report on the number of cards, revenues and profits, etc., received in respect of the sale of the cards, and ordered to pay NIS 100,000 in compensation. The proceeding in the District Court has been frozen until a decision in a parallel proceeding before the Registrar of Patents, for a ruling on whether the patent is valid is issued. At this stage, Pelephone is unable to estimate the outcome and the implications of the claim.

(29) In September 2001 a claim was filed in the Ramallah District Court by the General Palestinian Public Communications Co. Ltd. ("Paltel"), against Pelephone and another cellular company.

The plaintiff alleges that its license grants it, *inter alia*, the full right and authority to set up, operate, supply, sell and manage services and stations for telephone communication, both landline and cellular, for the supply of fixed and cellular communications services for an extended period, part of which being granted exclusivity. According to the plaintiff, it commenced providing cellular communications services in September 1999, and despite its requests to the defendants, they are continuing to provide cellular communications services to the inhabitants of the West Bank and the Gaza Strip, without restraint and without a license from the Palestinian communications authority, thereby violating various provisions of the law, prejudicing the exclusive rights of the plaintiff and causing it losses and damages. The reliefs requested are a permanent judicial injunction preventing the defendants from providing communications services in the areas of the Palestinian National Authority and a financial action for NIS 676 million from Pelephone alone.

Pelephone denies both the allegations of Paltel and the jurisdiction of any court in Ramallah to hear any such claim. On the issue itself Pelephone's position is that it acted and acts in accordance with the provisions of an interim agreement between the State of Israel and the PLO. Procedurally, Pelephone argues that the Palestinian court in Ramallah has neither territorial nor material jurisdiction to hear a claim of this kind.

Pelephone learned that the Ramallah Court may have given a decision on the aforementioned claim. According to the Order referred to above, enforcement of decisions given by a court of the Palestinian Authority may only be executed if approved by the Commissioner for Legal Aid at the Ministry of Justice. Pelephone considers that such a ruling – if made – was made without jurisdiction, contrary to public order and contrary to the provisions of the interim agreement and the Extension of the Effect of the State of Emergency Regulations Law (Judea, Samaria and Gaza Strip, jurisdiction for offenses and legal aid), -1967. If an attempt is made to submit this ruling for the approval of the Commissioner or to enforce it in any way, Pelephone will act to prevent such approval and/or enforcement of the ruling and/or proceedings for execution or to cancel them for the reasons set out above, which formed the basis of the Commissioner's decision to prevent the claim being served on Pelephone in the first place, and additionally due to the fact that the very hearing of the claim in the Ramallah Court without the process having been served in accordance with the Order and the Agreement, constitutes a breach of the agreement and harm to the sovereignty of the State of Israel, and that any ruling handed down in such a claim has no force. Accordingly, no provision in respect of this claim has been included in the financial statements.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(30) In November 2002 an application was filed for leave to appeal the decision of the Tel Aviv District Court from October 1, 2002, which denied the application of the applicants for approval of their claim against Pelephone as a class action. The statement of claim was based on the applicants' allegation that throughout the years when Pelephone was a monopoly in the cellular telephone market, it abused that status and collected exorbitant prices for all its services. The applicants were therefore seeking to order Pelephone to make restitution to its customers of the excess profits it collected and which allegedly amount to the total of the claim (NIS 12 billion). On February 2, 2003, Pelephone responded to the application for leave to appeal. In the opinion of Pelephone and its legal advisers, Pelephone has good defense arguments, although the chances of the appeal cannot be assessed at this stage, and accordingly, no provision has been made in the financial statements in respect of this claim.

(31) In December 2002 a claim was filed in the Tel Aviv-Jaffa District Court against Pelephone and against another cellular company, together with an application for its approval as a class action, in the amount of approximately NIS 4 billion, of which approximately NIS 2.4 billion is against Pelephone.

The claim relates to amounts collected by Pelephone and another cellular company for incoming calls from May 5, 1996 to October 2, 2000. The applicants, through their lawyers, base their claim on the following allegations:

a. Every cellular operator is a monopoly in the incoming call service to its network. Pelephone and the other cellular operator abused their monopoly status in that they set high and unfair prices for the incoming call service to their networks. The correct and fair tariff for the incoming call service is 25 agorot per minute, and not as collected in the past by Pelephone and the other cellular company or as stipulated today in the Telecommunications Regulations (Payments for interconnect), 5760-2000.

b. Pelephone and the other cellular company violated obligations legislated under the authority of the Telecommunications Law, their licenses and the duty of good faith which require a reasonable price for a telecommunications service for which no price is set.

In July 2003 Pelephone filed its response to the application. Pelephone and its legal advisers believe that Pelephone has a good defense, but are nevertheless unable, at this stage, to estimate the chances of the claim. Accordingly, no provision was made in the financial statements in respect of this claim.

(32) In April 2003 an application was filed in the Tel Aviv-Jaffa District Court for approval of a class action in a total amount of approximately NIS 90 million against all the cellular companies. The applicants allege that the three cellular companies formed a cartel among themselves for the collection of a tariff of 38 agorot plus VAT for SMS messages coming in to the network of each of them. The plaintiffs allege that this is a uniform, coordinated, exaggerated, unreasonable and unfair tariff. The period to which the claim relates is March-June 2002 through the date of filing the claim. Pelephone believes, relying on its legal advisers, that it has good arguments for defense against the claim, however at this stage, its chances cannot be assessed. Accordingly, no provision has been made in the financial statements in respect of this claim.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(33) On December 9, 2003, a claim was filed against Pelephone in the Tel Aviv-Jaffa District Court together with an application for approval as a class action, in the amount of approximately NIS 317 million. The plaintiffs allege that since June 2003 they have suffered a high percentage of dropped calls and blocked calls, exceeding the threshold set in Pelephone's license. The plaintiffs are seeking restitution of the monthly subscriber fees collected from them from June 2003 until the date of filing the claim, and recognition of the claim as a class action for a group of 1,900,000 subscribers.

The plaintiffs further allege that Pelephone does not comply with subscribers' requests to disconnect them on the date it is required by its license to do so, and accordingly, they are seeking reimbursement of the monthly subscriber fees starting from the date of the request for disconnection until the date of actual disconnection. It is also alleged that Pelephone makes termination of the service to a subscriber conditional upon payment of a penalty of NIS 1,000 per handset.

Pelephone contends that it meets all the service quality indices referred to in its license (which are not measured per subscriber) and the applicants have not established cause of action since the applicants did not request permanent disconnection from Pelephone's services and made their request to disconnect contingent upon conditions which contradict the cellular agreement. Pelephone argues further that it does not make disconnection from the service conditional upon a payment, but acts in accordance with the contractual agreements with it, and that the payment is not a penalty but is for cellular handsets purchased by the plaintiffs by installments. In addition, Pelephone has filed an application for dismissal *in limine* of the application and the action, since they are based on Article 29 of the Civil Proceedings Regulations, 5744-1984. On the recommendation of the Court, in June 2004 the plaintiffs struck the claim and the application for approval as a class action.

(34) On May 13, 2004, a petition was filed in the Supreme Court by the municipalities and local planning and building committees in Herzliya and Ramat Hasharon against the Government of Israel, the National Planning and Building Council, the Minister of Health, the Interior Ministry, the head of the Noise and Radiation Abatement Department at the Ministry of the Environment, the Attorney General, the Future Generations Commissioner and the cellular companies, among them Pelephone. The petition attacks the provisions of the National Outline Plan for Small Communications Installations, Part A (NOP 36), its legality and the manner of its implementation in the field. The petition was heard on July 5, 2004, at which the Supreme Court of Justice ruled to stay the hearing until a later date and to rule on the continuation of the proceedings in the light of a supplementary notice to be submitted by the State Attorney's office within three to four months.

The notice will relate to the Government's position on legislation on the subject of non-ionizing radiation. No date has been set for a further hearing of the petition. At this stage, Pelephone is unable to assess the chances and the implications of the petition.

(35) On December 3, 2002, an application was filed in the Tel Aviv-Jaffa District Court for recognition of a claim as a class action against DBS, the Council for Cable and Satellite Broadcasts and the Ministry of Communications, in connection with the broadcasts of the Channel 5+ sports channel. According to the applicants, the broadcasts of Channel 5+ contravene the terms laid down in the approval issued by the Council for its broadcasting while stripping Channel 5 of its content, in contravention of the aforementioned approval. The applicants, who wish to sue DBS for deception, violation of fiduciary duty and good faith under a contracted agreement, fundamental breach of the contract between DBS and its customers and unjust enrichment, estimate the amount of the claim at approximately NIS 126 million up to the date of its filing and an additional amount of approximately NIS 10.5 million for each month from the date of filing the claim until the date on which the decision is handed down.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(35) (Contd.)
In the opinion of the legal advisers of DBS, it is difficult, at this stage, to estimate whether the claim will be approved as a class action, and if it is approved, what its chances will be. Accordingly, no provision has been made in respect of this claim.

(36) On February 21, 2005, an application was filed in the Tel Aviv-Jaffa District Court against DBS, concerning payment the plaintiff makes to the electricity consumption of installations used to receive DBS's broadcasts. Together with the claim, an application was filed in the court for its approval as a class action, since it concerns thousands of condominiums in which DBS's equipment is installed and which pay for the consumption of electricity of those installations.

According to the plaintiff, about 200,000 households pay a monthly charge of NIS 1.4, from which he concludes that since the start of its operation (which the plaintiff contends is 6 years), DBS should be ordered to pay approximately NIS 20 million.

In the opinion of the legal advisers of DBS, it is difficult, at this stage, to estimate whether the claim will be approved as a class action, and if it is approved, what its chances will be. Accordingly, no provision has been made in respect of this claim.

(37) In 1995, the Company, together with others and through a joint venture company, submitted bids in tenders of the Government of India for the construction of a basic communications system in India. Letters of intent and draft concession agreements for development of the basic telephone system in four provinces, for which the joint venture company in which the Company has a share won the tender, were submitted to the joint venture company .The joint venture company did not sign the letters and drafts because in its opinion, *inter alia,* these documents did not correspond to the terms of the tender. At the time of the tender the joint venture company gave the Indian Ministry of Communications bank guarantees of which the Company’s share was 273 million rupees (approximately NIS 26 million). The Indian Ministry of Communications demanded foreclosure of the guarantees at the end of June 1996. On September 19, 1997, the court in India gave a permanent injunction preventing the Indian Ministry of Communications from foreclosing on the guarantees. At the end of October 1997 the Indian Ministry of Communications appealed the decision preventing the foreclosure. During 2003 the proceeding was stricken "for inaction" and an application was filed to revive the proceeding. In the opinion of the Indian lawyer who is handling the case on behalf of the Company, since the proceeding is still in its preliminary stage, its outcome cannot be reasonably assessed with any accuracy, and therefore no provision has been included in the financial statements. It is noted that the Company has no activities in India at this time.

(38) For possible demand for early repayment of bank loans, see Notes 13D and 14C.

(39) Miscellaneous claims - Various claims are pending against the Company and the Group Companies in the normal course of business. It is the opinion of the Company’s’ Managements that the latent risk in each of these claims will not cause material financial losses beyond the amounts included in the financial statements.

The amounts of the claims referred to above are adjusted (without the addition of interest) in terms of shekels of December 31, 2004.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

B. COMMITMENTS

(1) Lease and Rental Contract Commitments

Forecast contractual rent for the coming five years computed according to the rent in effect on December 31, as follows:

For the year ended December 31	Consolidated NIS thousands	Company NIS thousands
2005	**223,409**	**63,524**
2006	**177,073**	**62,565**
2007	**143,671**	**61,834**
2008	**110,047**	**56,653**
2009 and thereafter	**266,989**	**131,780**
	921,189	**376,356**

(2) DBS is committed to agreements to purchase broadcasting rights which amount to approximately NIS 87 million as at December 31, 2004 (2003 – approximately NIS 149 million).

(3) DBS entered into an agreement to lease space segments of the Amos 1 satellite. The agreement commenced on April 14, 1999 and ends on the earlier of June 30, 2009 or the end of the life of the satellite. In addition, DBS entered into an agreement on May 16, 2001, to lease space segments on the Amos 2 satellite. The lease period will end on the earlier of twelve years after the date of the satellite's launch or at the end of the satellite's life. The satellite was launched in April 2004. The contractual annual lease fees during the next five years as stated in the aforementioned agreements, amount to NIS 482 million

(4) In March 2004 DBS entered into an outsourcing agreement with Ness A.T. Ltd. (hereinafter – Ness), whereby DBS transferred the management of its information systems and project implementation (hereinafter – the Service) to Ness. In addition, DBS transferred to Ness's ownership certain equipment in respect of which the Service is provided and which will, be returned to DBS's ownership at the end of the agreement. The term of the agreement (subject to early termination rights contingent upon payment) was defined as eight years commencing April 1, 2004, and at the end of the term of the agreement it will be extended automatically for a further five years. During 2004, the payments made by DBS to Ness amounted to approximately NIS 14 million. The contractual consideration for 2005 will be approximately NIS 20 million.

(5) In winning a tender for frequencies, Pelephone committed to paying license fees in the amount of NIS 225 million to the Ministry of Communications in six installments (see Note 8D(3)).

On March 16, 2004 Pelephone accepted the proposal of the Ministries of Communications and Finance concerning a reduction of NIS 33 million from the original payment stipulated in the tender, against –

a. payment of the remainder of the balance of the license fee in the amount of approximately NIS 99 million, during 2004; and

b. return of the aforementioned frequencies to the State, in order that that Pelephone will not have to pay frequency fees from 2003 onwards. In addition and concurrently, Pelephone was granted a right to a future allocation of these frequencies, at which time Pelephone would complete payment of the reduced amount. plus the frequency fees in respect of the relevant period, and all plus linkage differentials and interest as is customary

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

B. COMMITMENTS (CONTD.)

(5) (Contd.)
Between March and August 2004 Pelephone paid the balance of the license fees – approximately NIS 99 million.

On May 4, 2004, Pelephone received a letter from the Ministry of Communications, advising that according to an amended calculation made by the Ministries of Finance and Communications, the amount that Pelephone will be required to pay at the time of allocation of the frequencies in the future, is NIS 51 million rather than NIS 33 million as agreed in March 2004. Pelephone has not yet submitted its position to the Ministers.

(6) In May 2004 Pelephone signed an agreement for upgrading sites with EVDO technology. The contract value is about $44 million, and the upgrade will be carried out during 2004-2005.

(7) In January 2005 Pelephone won a tender issued by the Accountant General at the Ministry of Finance (hereinafter – the AG), to provide cellular services to the various government ministries for a period of three years, commencing April 2005. The tender includes an option for the AG to extend the agreement for a further three years. Under the agreement, Pelephone will supply cellular subscriber equipment to about 25,000 subscribers. The costs of acquiring the subscribers in the AG transaction, approximately NIS 30 million in respect of the supply of subscriber equipment, will be charged at the time of the agreement to the statement of operations.

(8) In February 2004 Bezeq International entered into an agreement with Mediterranean Nautilus Limited (hereinafter – Med Nautilus) for acquisition of an irrevocable right of use of undersea cable capacity. In addition, the agreement grants Bezeq International options for an additional purchase of an irrevocable right of use of undersea cable capacity from Med Nautilus. Some of the options were exercised during 2004, and the others over a period of one year starting in June 2006.

(9) On September 30, 2004, Bezeq International was notified by the American company Verio of termination of the agreement between the companies and the halting of the provision of the host server management service which had been provided to Bezeq International by Verio. According to Verio, the reason for the termination was Bezeq International's breach of the agreement. On October 7, 2004 Verio ceased the service to Bezeq International and deleted the content of the host servers it had operated. As a result, the site hosting service that Bezeq International had provided to its customers was terminated. Bezeq International commenced immediate action to have the service resumed.

Bezeq International made sweeping compensation in the form of three months' service free of charge for customers of the site hosting service who were subscribers to Verio's service on the date it was terminated. The amount of this compensation is not material.

Through the date of approval of the financial statements, a small number of customers had demanded additional compensation, and two claims were filed against Bezeq International. The total amount of these demands is also not material.

At this stage it is not possible to estimate the extent of additional exposure for Bezeq International in this context.

(10) For commitments to purchase fixed assets, see Note 9F.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

C. SECURITIES, LIENS AND GUARANTEES

(1) The Company has provided guarantees to third parties in the amount of approximately NIS 777 thousand.

(2) In May 2003, the Company, upon the demand of the Ministry of Communications, provided a bank guarantee in the amount of $10 million in connection with its general license for performing telecommunications operations and providing telecommunications services.

(3) The Company provided a guarantee amounting to up to NIS 70 million to banks in connection with credit granted to subsidiaries.

(4) Regarding guarantees provided by the Company with regard to its investments in India, see Note 19A(37).

(5) The Company provided a guarantee of approximately NIS 10 million for a consolidated company, in respect of a bank guarantee of approximately NIS 33 million that DBS provided in favor of the State of Israel. The guarantee is valid until December 31, 2010.

(6) In February 2002, upon the demand of the Ministry of Communications, Bezeq International provided a bank guarantee of $2 million for fulfillment of all the terms of the license to provide international telecommunications services. In December 2004, again at the demand of the Ministry of Communications, Bezeq International provided a bank guarantee of approximately NIS 320,000 for fulfillment of the terms of a special license granted to Bezeq International for a marketing trial. As at the balance sheet date, Bezeq International provided additional bank guarantees in a total amount of approximately NIS 1,500 thousand.

(7) BezeqCall Communications provided a guarantee of approximately NIS 6 million for third parties

(8) Pelephone gave a guarantee to third parties of approximately NIS 74 million, of which approximately NIS 46 million to the Ministry of Communications in connection with the tender for third generation frequencies for cellular telephones.

(9) To secure its obligations, DBS provided documentary credit and guarantees amounting to approximately NIS 73 million (including a bank guarantee of NIS 33 million in favor of the State of Israel).

(10) Regarding another guarantee provided in connection with the Company's investments in DBS, see Note 8E.

(11) Regarding securities, liens and stipulations given by the Company and investee companies in connection with loan covenants, see Notes 13D and 14C.

NOTE 20 – SHAREHOLDERS' EQUITY

A. SHARE CAPITAL

	Registered		Issued and fully paid up	
	December 31 2004	December 31 2003	December 31 2004	December 31 2003
	No. of shares	No. of shares	No. of shares	No. of shares
Ordinary shares of NIS 1 par value each	**2,625,000,000**	2,625,000,000	**2,605,045,611**	2,605,045,611

B. In a framework agreement signed on January 13, 2002 (including amendments to that agreement which were signed later) between the State and the Company, it was agreed that capital would be raised by way of a private placement of the State's shares in the Company in accordance with Sections 15A and 15C(b) of the Securities Law, 5728-1968 (in one sale or several sales). Concurrently with the sale of the shares, the Company would allot shares to the State in consideration of the amount received by the State for its shares less a margin of 1%, where the total number of shares to be allotted to the State by the Company would not exceed, at any point in time, the number of shares sold by the State and the State's holdings in the Company would not fall below 30% - 40%. The proceeds from raising the capital were designated for financing the costs involved in the retirement of Company employees.

The agreement also stated that if the State were to sell shares in a total number exceeding the limit of the registered share capital of the Company at that date and the registered capital of the Company did not comprise sufficient shares for their allotment to the State, then the Company's obligation to allot shares to the State against receipt of the consideration for them would be postponed until not later than 120 hours from the time of the Company increasing its share capital.

Pursuant to the framework agreement, on July 24, 2003 the State approached several institutional bodies and requested offers for the purchase of 86,500,000 ordinary shares of NIS 1 par value each of the State's shares in the Company. Subsequently, on July 29, 2003, the State sold those shares to Gmul Sahar Underwriters Ltd. (which offered the highest price) at a price of NIS 4.338 per share. Accordingly, on July 30, 2003 the Company allotted the entire balance of its un-issued registered capital to the State at that time, a total of 23,342,462 ordinary shares of NIS 1 par value each, in consideration of NIS 101,261,807. On October 23, 2003, the registered capital of the Company was increased by 190,000,000 shares, increasing it to 2,625,000,000 shares (this was subsequent to the cancellation, at the beginning of February 2003, of registered capital of 130,000,000 shares in accordance with a decision of the General Meeting of the Company as this capital was not allotted as part of raising capital on the terms prescribed). Immediately after increasing its registered capital, the Company allotted to the State, on October 30, 2003, the balance of the shares in respect of those sold by the State to Gmul Sahar Underwriters Ltd, as well as additional shares in accordance with the framework agreement (a total of 64,398,076 additional shares). The proceeds from this additional allotment amounted to NIS 279,364,943.

On November 12, 2003 the State once again approached institutional bodies, requesting offers for the purchase of 130,000,000 ordinary shares of NIS 1 par value each which the State held in the Company ("the Transaction Shares"). In addition, an option was granted to purchase up to 30,000,000 additional shares of the State and not less than 10,000,000 such shares, at the share price offered by the bidder for the Transaction Shares.

Subsequently, on November 18, 2003, the State sold the Transaction Shares to UBS Securities Israel Ltd. ("UBS"), which had submitted the highest bid, as well as 15,000,000 additional shares of NIS 1 par value each after UBS gave notice of partial exercise of the option, all of them at a price of NIS 4.82144 per share.

NOTE 20 – SHAREHOLDERS' EQUITY (CONTD.)

A. SHARE CAPITAL (CONTD.)

B. (Contd.)

Part of this share sale was also in accordance with the framework agreement described above between the State and the Company and accordingly, on November 18, 2003 the Company allotted 105,647,535 shares to the State. The proceeds from this allotment amounted to NIS 509,373,249.

After completion of the sale of the State's shares and allotment of Company shares to the State, the raising of NIS 890 million of capital (NIS 878 million net of the margin) was completed.

C. On June 1, 2004 the State of Israel offered, pursuant to a prospectus of the Company of May 24, 2004, 156,000,000 ordinary shares of NIS 1 par value each of the Company (approximately 5.99% of the Company's issued capital). In the public offering, 70,671,100 ordinary shares of NIS 1 par value each were sold (approximately 2.71% of the Company's issued capital) at a price of NIS 4.921 per share, and the State's holdings in the Company as at December 31, 2004 amount to approximately 46.38%.

D. On January 27, 2003, the Special General Meeting of the Company approved the recommendation of the Board of Directors of January 2, 2003, for the distribution of a cash dividend to holders of Company shares recorded in the Register of Shareholders at the end of the business day on February 5, 2003. The ex-date was February 6, 2003, and the date of payment was February 20, 2003. The cash dividend, amounting to approximately NIS 190,000 thousand, represents a dividend of 7.8784 agorot per share.

NOTE 21 – REVENUES FROM TELECOMMUNICATION SERVICES

Consolidated

	For the year ended December 31		
	2004	2003	2002
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Revenues from communications services –			
Domestic fixed–line communications - traffic	**1,567,631**	1,990,649	2,263,292
Fixed fees	**2,501,250**	2,289,868	2,106,944
Cellular telephone	**2,699,876**	1,989,970	2,094,288
International communications and internet services	**771,290**	683,037	662,767
Multi-channel television	**529,838**	–	–
Installation and sale of equipment to subscribers	**825,390**	590,866	526,594
Other	**89,448**	74,851	93,528
	8,984,723	7,619,241	7,747,413
Other revenues	**285,081**	362,027	316,067
	9,269,804	7,981,268	8,063,480

Company

	For the year ended December 31		
	2004	2003	2002
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Revenues from communications services – Domestic fixed–line communications Traffic	**1,590,671**	2,006,567	2,285,628
Fixed fees	**2,354,700**	2,184,650	1,978,721
Total revenues from fixed-line communications	**3,945,371**	4,191,217	4,264,349
Cellular telephone	**414,740**	428,149	546,130
International communications	**126,856**	134,212	135,794
Installation and sale of equipment to subscribers	**169,508**	144,338	152,212
Other	**97,472**	80,105	99,077
	4,753,947	4,978,021	5,197,562
Other revenues	**205,744**	252,540	249,506
	4,959,691	5,230,561	5,447,068

NOTE 22 – OPERATING AND GENERAL EXPENSES

Consolidated

	For the year ended December 31		
	2004	**2003**	**2002**
	Reported amounts	**Adjusted for the effects of inflation in shekels of December 2003**	
	NIS thousands	**NIS thousands**	**NIS thousands**
Salaries and related expenses –			
Operational	**1,565,471**	1,648,413	1,645,885
General and administrative	**549,869**	304,465	335,885
Total salaries and incidentals	**2,115,340**	1,952,878	1,981,770
General expenses	**996,323**	733,412	728,051
Materials and spare parts	**643,013**	597,676	599,736
Consumption of content from satellite services	**200,469**	–	–
Cellular telephone expenses	**700,890**	480,536	473,141
Building maintenance	**352,430**	352,405	351,683
Services and maintenance by sub-contractors	**341,999**	250,220	255,484
International communications expenses	**228,936**	159,478	152,184
Motor vehicle maintenance expenses	**144,630**	118,050	96,613
Collection fees	**39,357**	36,160	34,819
	5,763,387	4,680,815	4,673,481
Less – wages charged to investment in fixed assets (1)	**198,297**	195,515	147,548
	5,565,090	4,485,300	4,525,933

Company

	For the year ended December 31		
	2004	**2003**	**2002**
	Reported amounts	**Adjusted for the effects of inflation in shekels of December 2003**	
	NIS thousands	**NIS thousands**	**NIS thousands**
Salaries and related expenses			
Operational	**1,122,381**	1,206,623	1,254,861
General and administrative	**271,310**	241,206	269,738
Total salaries and incidentals	**1,393,691**	1,447,829	1,524,599
General expenses	**341,977**	342,492	304,480
Materials and spare parts	**114,443**	93,601	65,724
Building maintenance	**315,074**	322,099	324,031
Services and maintenance by sub–contractors	**205,192**	207,843	205,919
International communications expenses	**27,105**	10,685	4,943
Motor vehicle maintenance expenses	**111,359**	101,597	82,842
Collection fees	**36,904**	35,916	34,736
	2,545,745	2,562,062	2,547,274
Less – wages charged to investment in fixed assets (1)	**198,297**	195,515	147,548
	2,347,448	2,366,547	2,399,726

(1) Commencing February 2003, following the establishment of a new reporting system in the Company which allows precise measurement of the direct costs of employees in the Engineering Division and the Technology Systems Division, the Company capitalized an additional sum for self-constructed fixed assets. The additional amount for the period ended December 31, 2004 is approximately NIS 50 million (2003 – NIS 46 million).

NOTE 23 – FINANCING EXPENSES, NET

Consolidated

	For the year ended December 31		
	2004	2003	2002
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Expenses in respect of long-term liabilities			
Debentures	**(319,522)**	(395,393)	(395,659)
Loans	**(121,329)**	(21,015)	(122,413)
	(440,851)	(416,408)	(518,072)
Income in respect of deposits and investments	**195,243**	249,677	21,597
Income (expenses) in respect of derivatives	**(12,250)**	(806)	331,500
Short-term bank credit	**(2,699)**	(33,470)	(7,515)
Interest income from income tax	**–**	–	5,866
Other income, net	**43,028**	43,485	1,308
	(217,529)	(157,522)	(165,316)

Company

	For the year ended December 31		
	2004	2003	2002
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Expenses (income) in respect of long-term liabilities			
Debentures	**(315,175)**	(395,393)	(395,659)
Loans	**(20,774)**	43,618	(92,114)
	(335,949)	(351,775)	(487,773)
Income in respect of deposits and investments	**194,761**	248,629	23,004
Income in respect of derivatives	**3,834**	21,024	325,515
Interest income from income tax	**–**	–	8,810
Other income, net	**44,138**	19,750	13,310
	(93,216)	(62,372)	(117,134)

NOTE 24 – OTHER INCOME (EXPENSES), NET

Consolidated

	For the year ended December 31		
	2004	2003	2002
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Provision for claims for salary and pension components (1)	**207,000**	(195,000)	–
Provision for employee severance benefits upon early retirement (2)	**(105,000)**	(419,016)	–
Write-off and impairment of fixed assets (3)	**–**	(327,295)	–
Provision for impairment and other liabilities in respect of investments in other companies	**(26,000)**	(42,908)	(10,143)
Provision for decrease in value of investment in convertible debentures (4)	**–**	–	(1,209,312)
Amortization of goodwill	**(35,135)**	(1,032)	(111)
Capital gain from sale of operation (5)	**35,033**	–	–
Capital gains, net	**7,338**	1,634	12,739
Other	**(3,556)**	439	123
	79,680	(983,178)	(1,206,704)

Company

	For the year ended December 31		
	2004	2003	2002
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Provision for claims for salary and pension components (1)	**207,000**	(195,000)	–
Provision for employee severance benefits upon early retirement (2)	**(105,000)**	(419,016)	–
Write-off and impairment of fixed assets (3)	**–**	(198,686)	–
Provision for impairment and other liabilities in respect of investments in other companies	**(26,000)**	(36,110)	(10,254)
Provision for decrease in value of investment in convertible debentures (4)	**–**	–	(1,209,312)
Capital gain from sale of operation (5)	**35,033**	–	–
Capital gains, net	**5,674**	1,570	12,254
Other	**(6,803)**	294	130
	109,904	**(846,948)**	**(1,207,182)**

(1) See Note 19A(5).
(2) See Note 16D.
(3) See Notes 9F, 9G and 9H.
(4) See Note 8D(1).
(5) See Note 9C.

NOTE 25 – EARNINGS PER SHARE (CONSOLIDATED AND COMPANY)

	For the year ended December 31		
	2004	**2003**	**2002**
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	**NIS thousands**	**NIS thousands**
Primary and diluted earnings (loss)	**620,825**	(437,836)	(912,775)
Weighted number of shares in primary earnings and diluted earnings	**2,605,046**	2,444,891	2,411,658

NOTE 26 – BUSINESS SEGMENTS

The Company operates in various segments of the communications sector, with each company in the Group operating in a separate business segment.

Each company provides services in the segment in which it operates by means of the fixed assets and the infrastructure it owns. The infrastructure of each company is used for providing its services only. Each of the companies in the Group is exposed to different risks and yield opportunities, primarily in relation to the technology and competition in the sector in which it operates.

Each company in the Bezeq Group is a separable component, since each company's business is the provision of service or group of related services, and each company is exposed to different risks and yield opportunities from those of other components.
Based on the above, the business segments of the Bezeq Group are as follows:

- "Bezeq", The Israel Telecommunication Corp. Ltd.– Domestic fixed-line communications.
- Pelephone Communications Ltd. – Cellular telephone.
- Bezeq International Ltd. – International communications and internet services.
- D.B.S. Satellite Services (1998) Ltd. – Multi-channel television.

The other companies in of the Group are presented in other sections.

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

A. Business Segments

Consolidated

	For the year ended December 31, 2004						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	Reported amounts						
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues							
Revenues from external sources	4,736,756	2,966,486	797,735	529,838	238,989	-	9,269,804
Inter-segment revenues	222,935	8,493	18,704	12,304	80,387	(342,823)	-
Total revenues	4,959,691	2,974,979	816,439	542,142	319,376	(342,823)	9,269,804
Segment results	971,016	379,328	118,223	(85,381)	8,362	-	1,391,548
Financing expenses							(217,529)
Earnings after financing expenses							1,174,019
Other income, net							79,680
Earnings before income tax							1,253,699
Income tax							(497,485)
Earnings after income tax							756,214
Equity in losses of affiliated companies				(126,630)	(8,143)		(134,773)
Minority share in losses of a consolidated company					(616)		(616)
Net earnings							620,825
Identified assets	8,589,680	4,775,659	598,090	1,364,941	235,240	(206,476)	15,357,134
Investment by equity method					70,308		70,308
General assets							4,744,539
Total consolidated assets							20,171,981

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

A. Business Segments (contd.)

Consolidated

	For the year ended December 31, 2004						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	Reported amounts						
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Segment liabilities	1,412,990	858,943	233,113	595,229	133,360	(200,811)	3,032,824
General liabilities							9,673,390
Total consolidated liabilities							12,706,214
Capital investments	850,005	588,002	116,938	160,134	173,353		
Depreciation and amortization	1,502,354	418,925	117,316	162,029	18,978		

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

A. Business Segments (contd.)

Consolidated

	For the year ended December 31, 2003					
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Others	Adjustments	Consolidated
	Adjusted for the effects of inflation in shekels of December 2003					
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues						
Revenues from external sources	5,023,754	2,021,807	689,378	246,329	–	7,981,268
Inter-segment revenues	206,807	5,568	13,958	40,236	(266,569)	–
Total revenues	5,230,561	2,027,375	703,336	286,565	(266,569)	7,981,268
Segment results	906,619	96,013	90,001	72	644	1,093,349
Financing expenses						(157,522)
Earnings after financing expenses						935,827
Other expenses, net						(983,178)
Earnings before income tax						(47,351)
Income tax						(48,013)
Loss after income tax						(95,364)
Equity in losses of affiliated companies	(2,280)			(341,054)		(343,334)
Minority share in losses of a consolidated company				862		862
Net loss						(437,836)
Identified assets	9,903,468	2,258,000	527,565	213,574	(106,196)	12,796,411
Investment by equity method				240,667		240,667
General assets						3,051,686
Total consolidated assets						16,088,764
Segment liabilities	1,609,316	500,091	270,031	126,516	(102,649)	2,403,305
General liabilities						6,840,517
Total consolidated liabilities						9,243,822
Capital investments	815,382	524,644	114,456	201,670		
Depreciation and amortization	1,776,279	394,203	99,868	7,498		

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

A. Business Segments (contd.)

Consolidated

	For the year ended December 31, 2002					
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Others	Adjustments	Consolidated
	Adjusted for the effects of inflation in shekels of December 2003					
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues						
Revenues from external sources	5,241,263	1,958,582	670,449	193,186	–	8,063,480
Inter-segment revenues	205,825	7,642	8,272	29,444	(251,183)	–
Total revenues	5,447,088	1,966,224	678,721	222,630	(251,183)	8,063,480
Segment results	979,807	(62,672)	108,023	(8,615)	644	1,017,187
Financing expenses						(165,316)
Earnings after financing expenses						851,871
Other expenses, net						(1,206,704)
Loss before income tax						(354,833)
Income tax						(207,333)
Loss after income tax						(562,166)
Equity in losses of affiliated companies	(5,851)			(347,765)		(353,616)
Minority share in losses of a consolidated company		2,850		157		3,007
Net loss						(912,775)
Identified assets	10,046,942	2,258,690	685,059	189,419	(120,838)	13,059,272
Investment by equity method				382,717		382,717
General assets						2,788,566
Total consolidated assets						16,230,555
Segment liabilities	1,520,047	858,703	327,518	95,437	(116,771)	2,684,934
General liabilities						6,955,541
Total consolidated liabilities						9,640,475
Capital investments	854,512	471,603	136,389	286,513		
Depreciation and amortization	1,925,472	505,539	83,242	4,898		

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

B. Distribution of The Group's Revenues

The table below provides additional information about the distribution of revenue in the Group according to customer use. The costs relating to this revenue cannot be allocated since expenses relating directly to them are impossible to identify, nor can they be allocated on a reasonable basis.

	For the year ended December 31		
	2004	**2003***	**2002***
	Reported amounts	**Adjusted for the effects of inflation in shekels of December 2003**	
	NIS millions	**NIS millions**	**NIS millions**
Telephony – domestic calls, fixed fees and installations	**3,329**	3,549	3,682
Cellular telephone	**3,128**	2,199	2,188
Internet	**773**	643	543
International communications	**599**	562	582
Transmission services and data communication	**608**	648	730
Fixed line infrastructure and maintenance works	**230**	298	272
Multi-channel television services to subscribers	**530**	–	–
Others	**73**	82	66
Total	**9,270**	7,981	8,063

* Reclassified

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

A. The Company is a “mixed company” under the control of the State of Israel, and transacts a significant volume of business, in the ordinary course of its operations, with government ministries, agencies and companies, banks and their related companies. The business transacted is primarily the provision of telecommunications services and the execution of development work, as well as the receipt of various types of services, and their description involves numerous difficulties in view of the wide range of entities concerned and the large volume of transactions (which are primarily, as noted, the provision of the Company's services). It is not practicable to determine the identity of these interested parties involved in such transactions, nor to make a distinction in the recording thereof. The Securities Authority, pursuant to its authority under the Securities Regulations (Preparation of annual financial statements), 5753-1993, exempted the Company from detailing its transactions with interested parties (exemption for 2004 is dated February 15, 2005), other than extraordinary transactions. The exemption is given for transactions with the State and its agents. In the opinion of the Company, the exemption is not harmful to the affairs of the investor in Company securities.

B. In July 2002 the Company reached an agreement with the Ministry of Defense on behalf of the State of Israel, for the provision of telecommunications services by the Company.

The main points of the agreement, which was approved by all of the Company’s authorized bodies as required under the Companies Law for a transaction with a controlling interest, are as follows:

(1) The Company will provide telecommunications services to the IDF at a special discounted rate of approximately 28% for services which the Company provided to the IDF prior to signing the agreement and at 14% for services which did not exist or which the Company did not provide for the IDF prior to signing the agreement. Based on the volume of the services which the Company provided to the IDF prior to the date on which the agreement took effect, the discount in respect of the services under the agreement is not materially different from the discount which was granted pursuant to the memorandum by which the parties acted prior to signing the agreement.

(2) The Ministry of Defense undertakes to purchase Company services for which the consideration will be at least approximately NIS 81.2 million (excluding VAT) for each year of the commitment, and additionally to order from the Company cabling and communications infrastructure development works inside IDF bases which are used to provide the Company's services, for which the consideration will not be less than 80% of the total financial volume of Ministry of Defense orders for such infrastructures for the IDF in each year of the commitment.

(3) The agreement ends and exhausts all the disputes between the parties up to April 1, 2001, including the disputes which were brought before the special professional committee ("the Gabai Committee"), but excludes the matter of an 18% discount which the Ministry of Defense deducted from payments which the Company collected for other communications providers.

(4) Ownership of the infrastructures inside IDF bases at the end of the agreement term will remain with the Ministry of Defense and ownership of infrastructures outside the IDF bases will remain with the Company.

(5) The term of the contract is from the date of signing the agreement – July 21, 2002, until March 31, 2005 (under the terms of the agreement, retroactive accounting was carried out starting from April 1, 2001, subsequent to which the Company received a refund in an immaterial amount).

As at the date of publication of the financial statements, negotiations with the Ministry of Defense for a new agreement for the provision of communications services for the period commencing April 1, 2005, are at an advanced stage.

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

B (Contd.)

On December 16, 2003 the Company filed a claim in the Tel Aviv District Court against the Ministry of Defense for payment of approximately NIS 57 million in connection with a dispute in the matter of a discount of 18% deducted by the Ministry, as referred to in item (3) above, and on March 16, 2004 the State filed a statement of defense. On May 17, 2004 the Company filed its response. As proposed by the Court, the parties agreed to refer the case to a mediation proceeding, but eventually decided to try to resolve their differences out of court. As at the date of publication of the financial statements, a settlement is being formulated between the parties, and no provision has been included in the financial statements in respect of this claim.

C. Regarding guarantees to related parties, see Note 19C.

D. **TRANSACTIONS WITH INVESTEE COMPANIES (COMPANY)**

	For the year ended December 31		
	2004	2003	2002
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Consolidated companies			
Revenues –			
Interconnect and access fees	**48,320**	38,515	33,403
Services, royalties and commissions	**92,688**	52,940	34,400
Rent and usage fees for buildings and equipment	**4,034**	541	578
Expenses –			
Purchase of services	**46,221**	47,092	30,641
Interest	**–**	–	6
Proportionally consolidated company			
Revenues –			
Interconnect and access fees	**37,533**	58,458	68,559
Services, royalties and commissions	**103,790**	41,425	47,954
Rent and usage fees for buildings and equipment	**10,341**	6,818	11,953
Interest	**1,240**	–	–
Expenses –			
Purchase of services	**3,901**	2,481	4,854
Interest	**–**	551	–
Affiliated companies			
Revenues –			
Services, royalties and commissions	**8,063**	2,812	4,947

For balances with investee companies, see the relevant notes.

For loans to investee companies and the terms of those loans, see Note 8 and Note 14A(1).

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

E. BENEFITS FOR DIRECTORS AND THE CEO

	For the year ended December 31		
	2004	**2003**	**2002**
	Reported amounts	**Adjusted for the effect of inflation in shekels of December 2003**	
	NIS thousands	**NIS thousands**	**NIS thousands**
Total cost of compensation of the CEO and the Chairman of the Board *	**1,574**	1,678	1,648
Number of employees	**2**	3	2
Compensation of members of the Board of Directors who are not Company employees**	**1,663**	1,695	1,554
Number of directors receiving compensation	**13**	16	19

* The cost in respect of 2003 includes payment of severance pay to the CEO in the amount of approximately NIS 152,000, and in respect of 2002 includes payment of severance pay to the Chairman of the Board in the amount of approximately NIS 100,000.

** Compensation for directors in a proportionally consolidated company is stated at the proportional share of the Company (50%) for the period in which that company was proportionally consolidated.

The Company holds an insurance policy for the directors and officers of the Company. The maximum insurance is $150 million per event and for the period (of 12 months) and up to an additional 20% for legal expenses. On August 5, 2004 the Audit Committee of the Board of Directors of the Company approved the extension of the insurance policy for 12 months, until July 31, 2005. The extension was approved by the general meeting of the shareholders. In addition, the Company will indemnify officers in an amount not exceeding $50 million per officer for a financial obligation imposed upon them in any matter connected with the Company's prospectus from February 27, 1998, and which is not covered by the insurance policy.

On December 3, 2003 the general meeting of the shareholders of the Company approved a commitment to indemnify officers of the Company in the matter of the framework agreement?? signed between the Company and the State, including in connection with an allotment of shares to the State by virtue of that agreement. The commitment was limited to NIS 890,000 thousand (the amount of the capital raising), linked to the CPI published after the capital was raised in accordance with the framework agreement??.

On May 13, 2004, the general meeting of shareholders of the Company approved an undertaking to officers on the subject of indemnification and insurance, as follows:

(a) An undertaking by the Company regarding the extension of a loan to officers to finance reasonable litigation expenses in legal proceedings, and an undertaking by the Company to acquire an insurance policy for officers at a reasonable cost.

(b) Grant of notes of indemnity in advance to officers of the Company on the following matters:

1. The claim of a shareholder holding 15% or more of the share capital of the Company. The total extent of the indemnity will not exceed $150 million plus $30 million for legal expenses (a claim of this kind was excluded in the officers insurance policy of the Company).

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

E. BENEFITS FOR DIRECTORS AND THE CEO (CONTD.)

(b) 2. Any matter relating to the prospectus for an offer for sale of securities of the Company by the State of Israel and an offering by the Company, which was published at the end of May 2004. The total extent of the indemnity (including in respect of the advance undertakings to indemnify which were given up to publication of the prospectus and in respect of advance undertakings to indemnify which are to be given, if at all, immediately prior to transfer of control in the Company by the State) shall not exceed 25% of the Company's shareholders' equity (according to the financial statements for 2003, linked to the CPI of November 2003).

On April 20, 2004, the Board of Directors of the Company resolved that the Company would indemnify the employees of the Group who took part in preparation of the prospectus to be published in May 2004, who are not officers of the Company, in respect of financial liability that would be imposed upon them and in respect of reasonable litigation expenses that they might face, with respect to the prospectus, similar in form to the indemnity given to officers.

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

A. DERIVATIVES

The Group is exposed to credit and currency risks during the normal course of its business, and uses derivatives to minimize its exposure to these risks.

The Group has an excess of monetary liabilities over monetary assets in or linked to foreign currency in the amount of approximately NIS 3,402 million, of which the excess of current liabilities over current assets is approximately NIS 1,004 million. The excess of current liabilities is covered by forward exchange contracts, as described in section C below. The Group has revenues in foreign currency from international telecommunications.

As at December 31, 2004, the excess of CPI-linked monetary liabilities over CPI-linked monetary assets amounted to approximately NIS 3,743 million, of which the excess of current liabilities over current assets was approximately NIS 553 million. As stated in Note 1B, most of the Company's tariffs are subject to government regulation and are revised annually in accordance with the increase in the CPI, net of an efficiency factor.

The Company has limited commitments in derivatives, which are intended solely for purposes of hedging. Regarding the Company's commitments to execute forward exchange contracts as at December 31, 2004 – see section C below.

B. CREDIT RISK

At December 31, 2004, most of the cash and cash equivalents, as well as bank deposits, are deposited in large Israeli banks. Short-term investments primarily represent investments in government bonds and bank deposits, while a small part is invested in debentures of companies traded on the stock exchange in Israel. Accordingly, Management does not expect significant losses deriving from credit risks.

The Group's revenues derive mainly from providing services to customers in Israel. Management reviews customer debts on a current basis and the financial statements include specific provisions which, in Management's opinion, adequately reflect the loss inherent in doubtful debts. The exposure to credit risk in connection with customers is limited, considering their large number.

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (CONTD.)

C. CURRENCY RISK

The Company and the consolidated companies manage their exposure to currency risk deriving from fluctuations in foreign currency exchange rates in respect of assets, liabilities and cash flows denominated in foreign currency. The Group acts to minimize the currency exposure by forward transactions in foreign currency and by purchasing currency options. Hereunder the details of the derivatives of the Company and consolidated companies as at December 31, 2004:

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (C0NTD.)

C. CURRENCY RISK (CONTD.)

Consolidated

(1) Forward currency transactions - hedging transactions

	Purchased currency	Currency payable	Last repayment date	Amounts receivable	Amounts payable	Fair value	Book value
				NIS millions		NIS millions	
Currency exchange transactions at predetermined interest rates –	Dollar	CPI-linked shekel	February 2005	45	53	(8)	(8)
	Euro	CPI-linked shekel	October 2005	159	131	28	28
Forward transactions at predetermined currency exchange rate (excluding premium/discount) **-**	Dollar	Shekel	December 2005	1,168	1,236	(56)	(68)
	Euro	Shekel	December 2005	1,336	1,307	45	48
	CPI-linked Shekel	Shekel	January 2006	654	661	(2)	(0.7)

(2) Forward currency transactions - non-hedging transactions

	Purchased currency	Currency payable	Last repayment date	Fair value	Scope of commitment
				NIS millions	
Options purchased (Call)	Dollar	Shekel	April 2005	0.4	122
Options purchased (Put)	Dollar	Shekel	April 2005	(0.25)	(44)

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (C0NTD.)

C. CURRENCY RISK (CONTD.)

Company

(1) Forward currency transactions - hedging transactions

	Purchased currency	Currency payable	Last repayment date	Amounts receivable	Amounts payable	Fair value	Book value
				NIS millions		NIS millions	
Currency exchange transactions at predetermined interest rates –	Dollar	CPI-linked shekel	February 2005	45	53	(8)	(8)
	Euro	CPI-linked shekel	October 2005	159	131	28	28
Forward transactions at predetermined currency exchange rate (excluding premium/discount) **-**	Dollar	Shekel	December 2005	817	869	(43)	(39)
	Euro	Shekel	December 2005	1,336	1,307	45	48
	CPI-linked Shekel	Shekel	January 2006	654	661	(2)	(0.7)

D. INTEREST RISK

The Company takes loans at variable interest rates, and therefore its financial results (financing expenses) are exposed to the risk of changing interest rates. The Company also has loans at fixed interest rates which are exposed to possible changes in their fair value.

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (C0NTD.)

E. FAIR VALUE OF FINANCIAL INSTRUMENTS

The book value of cash and cash equivalents, short-term investments, trade receivables, other receivables, other current assets, most of the long-term liabilities, trade payables and accrued expenses, are equal or are close to their fair values. The fair value of loans from banks is also close to their book value since they bear interest at roughly the market rate.

Hereunder the differences between the amount recorded in the books and the estimated fair value:

	December 31, 2004	
	Book value	Fair value
	NIS thousands	NIS thousands
Debentures:		
Issued to the public	850,847	903,950
CPI-linked	1,355,286	1,479,089
Euro-linked	1,717,622	1,958,668
Unlinked, issued to others	109,179	109,907
Euro-linked, issued to others	32,086	34,872
CPI-linked loans	1,458,441	1,495,044
Unlinked loans	214,702	221,872
Foreign currency loans	1,004,645	997,882

The fair value of debentures issued to the public is based on their market price. The fair value of the other liabilities presented above is based on the present value of the cash flows related to those liabilities.

NOTE 29 – LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 2004

Consolidated

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
			Reported amounts			
	NIS Thousands		NIS Thousands			
Assets						
Cash and cash equivalents	30,373	1,301	–	–	1,425,433	1,457,107
Short-term investments	171,029	24,757	–	476,622	*615,401	1,287,809
Trade receivables	33,296	–	–	–	2,081,774	2,115,070
Other receivables and debit balances	519	75,982	–	8,038	8,173	92,712
Investee companies	–	–	–	16,414	(12,330)	4,084
Investments, long-term deposits and debit balances	69,048	35,261	–	256,986	478,397	839,692
	304,265	137,301	–	758,060	4,596,848	5,796,474
Liabilities						
Short-term bank credit	–	–	–	–	88,102	88,102
Current maturities of long-term liabilities	604,548	–	–	868,063	72,786	1,545,397
Trade payables	572,048	52,795	1,182	–	1,049,544	1,675,569
Other current liabilities	66,401	44,829	–	169,147	1,087,216	1,367,593
Long-term loans	743,130	–	–	1,425,268	692,536	2,860,934
Other long-term debentures	–	1,749,709	–	2,038,438	36,392	3,824,539
Employee severance benefits	–	–	–	–	1,272,570	1,272,570
Other long-term liabilities	9,247	–	–	437	11,941	21,625
	1,995,374	1,847,333	1,182	4,501,353	4,311,087	12,656,329

Company

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
			Reported amounts			
	NIS Thousands		NIS Thousands			
Assets						
Cash and cash equivalents	4,262	1,301	–	–	1,322,168	1,327,731
Short-term investments	171,029	24,757	–	476,622	*613,512	1,285,920
Trade receivables	11,724	–	–	–	959,042	970,766
Other receivables and debit balances	286	75,982	–	103,215	9,697	189,180
Investee companies	–	–	–	2,560,089	–	2,560,089
Investments, long-term deposits and debit balances	60,312	35,261	–	229,614	203,196	528,383
	247,613	137,301	–	3,369,540	3,107,615	6,862,069
Liabilities						
Current maturities of long-term liabilities	469,572	–	–	141,701	72,786	684,059
Trade payables	1,590	52,795	1,182	–	592,651	648,218
Other current liabilities	48,622	44,829	–	145,829	648,271	887,551
Long-term loans	527,730	–	–	2,004	–	529,734
Other long-term debentures	–	1,749,708	–	4,328,527	36,393	6,114,628
Employee severance benefits	–	–	–	–	1,250,829	1,250,829
Other long-term liabilities	–	–	–	437	–	437
	1,047,514	1,847,332	1,182	4,618,498	2,600,930	10,115,456

* Including mutual fund participation certificates of approximately NIS 138 million consolidated and in the Company.
For details of forward exchange contracts for covering exposure to foreign currency, see Note 28C.

NOTE 29 – LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 2003

Consolidated

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
	Adjusted for the effects of inflation in shekels of December 2003					
	NIS Thousands		NIS Thousands			
Assets						
Cash and cash equivalents	39,179	1,798	–	–	1,913,373	1,954,350
Short-term investments	164,190	18,319	–	887,423	*270,409	1,340,341
Trade receivables	31,448	–	–	(3,433)	1,639,608	1,667,623
Other receivables and debit balances	1,614	113,023	–	20,387	22,460	157,484
Investments, long-term deposits and debit balances	61,306	56,352	–	249,509	330,646	697,813
	297,737	189,492	–	1,153,886	4,176,496	5,817,611
Liabilities						
Short-term bank credit	–	–	–	50,000	94,714	144,714
Current maturities of long-term liabilities	210,192	–	–	609,661	464,183	1,284,036
Trade payables	278,999	3,512	32	–	848,173	1,130,716
Other current liabilities	65,318	43,542	–	83,833	972,417	1,165,110
Long-term loans	1,130,183	–	–	516,759	107,351	1,754,293
Other long-term debentures	–	1,645,811	–	569,725	109,046	2,324,582
Employee severance benefits	–	–	–	–	1,373,429	1,373,429
Other long-term liabilities	16,220	–	–	–	–	16,220
	1,700,912	1,692,865	32	1,829,978	3,969,313	9,193,100

Company

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
	Adjusted for the effects of inflation in shekels of December 2003					
	NIS Thousands		NIS Thousands			
Assets						
Cash and cash equivalents	2,725	1,798	–	–	1,891,995	1,896,518
Short-term investments	164,190	18,319	–	887,423	*270,316	1,340,248
Trade receivables	9,189	–	–	–	1,012,078	1,021,267
Other receivables and debit balances	1,057	113,023	–	21,695	29,105	164,880
Investments, long-term deposits and debit balances	61,306	56,352	–	237,506	231,078	586,242
	238,467	189,492	–	1,146,624	3,434,572	5,009,155
Liabilities						
Short-term bank credit						
Current maturities of long-term liabilities	210,192	–	–	321,462	391,326	922,980
Trade payables	3,666	3,512	32	–	679,307	686,517
Other current liabilities	65,318	43,542	–	44,308	779,089	932,257
Long-term loans	1,013,737	–	–	32,475	–	1,046,212
Other long-term debentures	–	1,645,811	–	569,725	109,046	2,324,582
Employee severance benefits	–	–	–	–	1,363,803	1,363,803
Other long-term liabilities	6,560	–	–	–	–	6,560
	1,299,473	1,692,865	32	967,970	3,322,571	7,282,911

* Including mutual fund participation certificates of approximately NIS 129 million consolidated and in the Company.
For details of forward exchange contracts for covering exposure to foreign currency, see Note 28C.

NOTE 30 – CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES

A. ACCOUNTING PRINCIPLES USED FOR STATING DATA IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES

1. These financial statements were prepared on the historical cost basis.
2. These financial statements include the data of the Company alone, without presentation of consolidated statements, as required under accepted accounting principles.
3. The Company's investments in investee companies are stated on the basis of their historical cost.

B. BALANCE SHEETS

	December 31 2004	December 31 2003
	NIS thousands	NIS thousands
Assets		
Current assets	**3,954,529**	4,621,820
Materials and spare parts	**130,922**	151,911
Investments, long-term deposits and debit balances	**569,800**	651,798
Investment in investee companies	**6,379,360**	1,397,803
Fixed assets	**4,899,478**	5,234,511
Other assets	**631,477**	917,553
	16,565,566	12,975,396
Liabilities		
Current	**2,833,945**	3,161,852
Long-term	**7,324,091**	4,166,181
	10,158,036	7,328,033
Shareholders' equity	**6,407,530**	5,647,363
	16,565,566	12,975,396

NOTE 30 – CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES (CONTD.)

B. STATEMENTS OF OPERATIONS

	For the year ended December 31		
	2004	2003	2002
	NIS thousands	NIS thousands	NIS thousands
Revenues from telecommunications services	**4,959,691**	5,285,062	5,523,013
Costs and expenses			
Operating and general expenses	**2,347,448**	2,397,800	2,440,957
Depreciation	**1,178,829**	1,334,060	1,362,889
Royalties to the Government of Israel	**145,318**	182,181	187,596
	3,671,595	3,914,041	3,991,442
Operating income	**1,288,096**	1,371,021	1,531,571
Financing expenses, net	**(93,216)**	(45,667)	(173,769)
Earnings after financing expenses	**1,194,880**	1,325,354	1,357,802
Other income (expenses), net	**112,836**	(806,725)	(1,317,364)
Earnings before income tax	**1,307,716**	518,629	40,438
Income tax	**(573,572)**	(195,754)	(236,439)
Net earnings (loss) after income tax	**734,144**	322,875	(196,001)
Equity in earnings (losses) of investee companies	**26,023**	(285,464)	(423,341)
Net earnings (loss)	**760,167**	37,411	(619,342)

NOTE 30 – CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES (CONTD.)

C. STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

	Share capital	Capital reserves	Dividend proposed after the balance sheet date	Retained earnings (loss)	Total
	NIS Thousands				
Balance as at January 1, 2002	2,411,658	3,432,994	–	(306,226)	5,538,426
Changes in 2002					
Net loss	–	–	–	(619,342)	(619,342)
Dividend proposed after the balance sheet date	–	–	190,000	(190,000)	–
Balance as at December 31, 2002	2,411,658	3,432,994	190,000	(1,115,568)	4,919,084
Changes in 2003					
Net earnings	–	–	–	37,411	37,411
Dividend paid	–	–	(190,000)	–	(190,000)
Allotment of shares	193,388	687,480	–	–	880,868
Balance as at December 31, 2003	2,605,046	4,120,474	–	(1,078,157)	5,647,363
Changes in 2004					
Net earnings	**–**	**–**	**–**	**760,167**	**760,167**
Balance as at December 31, 2004	**2,605,046**	**4,120,474**	**–**	**(317,990)**	**6,407,530**

NOTE 32 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD.

1. Pelephone Communications Ltd.

A. Balance Sheet

	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands
Current assets	**1,413,049**	1,264,002
Long-term trade receivables	**278,778**	199,136
Investment in investee companies	**4,084**	2,253
Deferred income taxes	**106,503**	238,367
Fixed assets	**3,093,675**	2,977,528
Other assets, net	**334,028**	339,506
	5,230,117	5,020,792
Current liabilities	**1,794,413**	1,761,626
Provision for losses of investee company	**–**	5,372
Long-term liabilities	**1,305,674**	1,386,774
Shareholders' equity	**2,130,030**	1,867,020
	5,230,117	5,020,792

NOTE 32 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

1. PELEPHONE COMMUNICATIONS LTD. (CONTD.)

B. STATEMENTS OF OPERATIONS

	For the year ended December 31		
	2004	2003	2002
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Revenues from Pelephone services, sales and services	**4,412,344**	4,054,749	3,932,448
Cost of Pelephone services, sales and services	**3,238,533**	3,238,098	3,455,141
Gross profit	**1,173,811**	816,651	477,307
Sales and marketing expenses	**469,353**	470,935	466,053
General and administrative expenses	**145,334**	152,447	153,856
	614,687	623,382	619,909
Operating profit (loss)	**559,124**	193,269	(142,602)
Financing expenses, net	**(99,597)**	(143,786)	(92,895)
Other income (expenses), net	**3,645**	(167)	1,468
Earnings (loss) before income tax	**463,172**	49,316	(234,029)
Tax benefit (income tax)	**(153,400)**	(18,289)	74,038
Earnings (loss) after income tax	**309,772**	31,027	(159,991)
Minority share in losses of a consolidated company	**–**	–	5,704
Company's equity in losses of investee companies	**(9,080)**	(6,224)	(654)
Net earnings (loss)	**300,692**	24,803	(154,941)

NOTE 32 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

2. DBS SATELLITE SERVICES (1998) LTD.

A. BALANCE SHEET

	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands
Current assets	**124,393**	107,188
Broadcasting rights, net	**140,496**	128,334
Fixed assets, net	**1,102,066**	1,124,158
	1,366,955	1,359,680
Current liabilities	**595,229**	1,862,403
Long-term liabilities	**1,299,138**	31,858
Loans from shareholders	**2,661,540**	2,271,283
Capital deficit	**(3,188,952)**	(2,805,864)
	1,366,955	1,359,680

NOTE 32 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

2. DBS SATELLITE SERVICES (1998) LTD. (CONTD.)

B. STATEMENTS OF OPERATIONS

	For the year ended December 31		
	2004	2003	2002
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Revenues from DBS services	**1,027,992**	842,374	659,902
DBS operating expenses	**1,013,403**	1,012,159	1,069,204
Operating profit (loss)	**14,589**	(169,785)	(409,302)
Sales and marketing expenses	**133,511**	109,859	117,108
General and administrative expenses	**72,240**	84,691	114,825
	205,751	194,550	231,933
Loss from ordinary operations	**(191,162)**	(364,335)	(641,235)
Financing expenses, net	**(171,522)**	(179,608)	(47,178)
Other expenses, net	**(3,200)**	(11,201)	(20,715)
Net loss	**(365,884)**	(555,144)	(709,128)

NOTE 32 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. BEZEQ INTERNATIONAL LTD.

A. BALANCE SHEET

	December 31 2004	December 31 2003
	Reported amounts	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands
Current assets	**226,434**	149,765
Long-term investments and debit balances	**23,552**	12,704
Fixed assets	**355,439**	375,703
Other assets	**18,106**	2,695
	623,531	540,867
Current liabilities	**239,133**	276,061
Long-term liabilities	**181,982**	180,881
Shareholders' equity	**202,416**	83,925
	623,531	540,867

NOTE 32 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. BEZEQ INTERNATIONAL LTD. (CONTD.)

B. STATEMENTS OF OPERATIONS

	For the year ended December 31		
	2004	**2003**	**2002**
	Reported amounts	**Adjusted for the effects of inflation in shekels of December 2003**	
	NIS thousands	**NIS thousands**	**NIS thousands**
Revenues from international telecommunication services	**816,439**	703,336	678,729
Operating expenses	**503,379**	431,066	380,106
Gross profit	**313,060**	272,270	298,623
Marketing, general and administrative expenses	**194,837**	188,299	190,599
Operating income	**118,223**	83,971	108,024
Financing income (expenses), net	**(4,301)**	(21,830)	1,583
Earnings after financing	**113,922**	62,141	109,607
Other income (expenses), net	**4,656**	(128,580)	34
Earnings (loss) before income tax	**118,578**	(66,439)	109,641
Tax benefit (income tax)	**822**	(3,489)	(10,539)
Earnings (loss) after income tax	**119,400**	(69,928)	99,102
Company's equity in earnings (losses) of an affiliate	**1,440**	(619)	(24,187)
Net earnings (loss)	**120,840**	(70,547)	74,915

Appendix A – List of Group Companies

	Percentage control and ownership as at	
	December 31 2004	**December 31 2003**
	%	**%**
Consolidated Companies		
Bezeq International Ltd.	**100**	100
DBS Satellite Services (1998) Ltd. (1)	**49.8**	–
Pelephone Communications Ltd. (2)	**100**	–
GoNext Ltd. (3)	**100**	–
Bezeq Zahav (Holdings) Ltd.(4)	**100**	–
BezeqCall Communications Ltd. (formerly Bezeq Bit 1995 Ltd.) (5)	**100**	100
BezeqCall Ltd. (5)	**100**	100
Bezeq Globe Ltd. (6)	**–**	100
Bezeq On Line Ltd. (7)	**100**	100
GoldNet Communication Services – registered partnership (8)	**74.9**	74.9
B-One General Partnership (9)	**100**	67.5
Proportionally Consolidated Companies		
Pelephone Communications Ltd. (2)	**–**	50
GoNext Ltd. (3)	**–**	50
Affiliated Companies		
Stage One Venture Capital Fund (Israel) L.P. (an Israeli Limited Partnership) (hereinafter – the Fund) (10)	**100**	100
Stage One Capital Investments L.P. (an Israeli Limited Partnership) (hereinafter – SOCI) (10)	**27**	27
The International Company for Undersea Cables Ltd. (ISCC) (11)	**50**	50
Aphrodite B.V. Amsterdam (12)	**67**	67
D.B.S. Satellite Services (1998) Ltd. (1)	**—**	49.8
Infogate Online Ltd. (13)	**8.12**	22.9
Pointer Ltd. (14)	**–**	11.5
Walla! Communications Ltd.(15)	**44.97**	36.7
Adanet for Business Group Ltd.(16)	**50**	50
Companies that are not investees		
Ambez Ltd. (formerly Comfinet Ltd.)	**17**	17
Xpert Integrated Systems Ltd. (17)	**16**	16
Personeta Inc.	**0.6**	2
Exent Ltd.	**3.5**	6.2
Atrica Inc.	**0.34**	0.85
Num4net (18)	**4.45**	–
Nexus Telocation Systems Ltd (14)	**6**	–
Venture Capital Funds that are not affiliated		
Eurofund 2000 L.P	**14.4**	14.4
B.R.M. Capital Fund L.P	**–**	2.8

(1) See Note 8E.

(2) See Note 8D.

(3) On March 16, 2000 Pelephone signed an agreement for the establishment of GoNext Ltd. (hereinafter – GoNext). The principal operations of GoNext are the set-up and operation of the portal with a link to cellular mediation. The consolidated financial statements include consolidation of the statements of GoNext, which is controlled by Pelephone. On December 29, 2004 Pelephone and GoNext agreed that Pelephone would waive and pardon the balance of its right in GoNext, in the amount of NIS 64,970 thousand, less a current debt balance between the two companies. As a result of this waiver, a capital gain was generated at GoNext, enabling GoNext, for the first time, to allocate the surplus cost created at the time of purchase of half of the shares in GoNext in 2002, to a deferred tax asset.

Appendix A – List of Group Companies (Contd.)

(4) See Note 14A (1).

(5) Commencing July 1, 1997, the operations of the two companies were consolidated and BezeqCall ceased its operations.

(6) The company ceased operation commencing July 1, 1998. In 2000 the company decided on voluntary liquidation. The voluntary liquidation proceedings were completed in January 2005 with the liquidation of all of the company's overseas subsidiaries.

(7) The company was founded in December 2000 and commenced operations in 2001. The company provides Call Center Outsourcing services.

(8) In 2002, following exercise of the Put option with AT&T, the Company's holding in the partnership increased to 54%. In March 2003 Malam Systems Ltd. ("Malam") notified the Company of exercise of a Put option it had towards the Company, to sell 20.9% of its holdings in the partnership. In May 2003, on receipt of the required approvals, for changing the holdings in the partnership and on payment of consideration of approximately NIS 6.4 million by the Company, the Company's holdings in the partnership increased to 74.9%, while the holdings of Malam in the partnership decreased to 25.1%.

(9) See Note 8H. The partnership was not consolidated in the financial statements for lack of materiality.

(10) The Fund is a venture capital fund, all of whose management rights are held by SOCI, and the Company has rights in profits only. SOCI's management is implemented by an investments committee in which the Company has no control. As the Company does not control SOCI (nor its management of the Fund), the investments are stated by the equity method. The Company undertook to invest the sum of $20 million in the Fund, of which approximately $15 million was invested by the end of 2004.

(11) ISCC – The Company maintained an undersea cable that it had laid. The Company's equity in the costs of the equipment and its maintenance is charged to fixed assets and to maintenance expenses. In February 1997 use of the undersea cable was halted. In January 1999 the Board of Directors resolved on the voluntary liquidation commencing March 31, 1999.

(12) With the sale of Aphrodite's investment in Emitel and transfer of the profit as a dividend to the Company, Aphrodite ceased its operations and was sold. The shares were transferred in February 2005.

(13) Infogate develops and supplies ASP concept computer communication services in which computers in a broadband network are connected to a central server and receive various services from that server. In January 2005 an additional dilution decreased the Company's holding in Infogate to 6.49%.

(14) In April 2004 the Company signed a share swap contract with Pointer Ltd ("Pointer"), an affiliated company, and the conversion of the loans and capital notes given to Pointer in exchange for shares and options of Nexus Telocation Systems Ltd. ("Nexus"), which is traded on Nasdaq in the U.S.A. The transaction was closed June 28, 2004. The value of the shares that the Company received is approximately NIS 7 million, which was recorded by Pelephone against a capital gain from realization of holdings in an affiliated company.

(15) See Note 8F.

(16) See Note 8G.

(17) In 2001, the Company invested approximately NIS 40 million in Xpert Integrated Systems Ltd. ("Xpert"), in consideration for 16.26% of the capital of that company, as well as options which will enable it to increase its holdings to 19.53%. Xpert is involved in the construction and provision of integration services in the communications field (primarily IP networks) and data security. In 2004 a provision of NIS 26 million was recorded for impairment, in accordance with Standard 15 of the IASB.

(18) Num4net develops technology for providing interconnect services for information.

PVI Actuarial Ltd. 58 Rambam, Ra'anana 43602
Tel: (09) 743 1932 / Fax: (09) 741 1189 / dengelma@zahav.net.il

27 February, 2005

Bezeq, The Israel Telecommunications Corp. Ltd.
15 Hazvi Street
Jerusalem

Dear Sir,

Re: Reserve in respect of early retirement
for the balance sheet as at the end of 2004

Actuarial Qualifications

Name: David Engelmayer, Actuary
Education: Qualified actuary – Fellow of the Society of Actuaries in the USA
Member of the Academy of Actuaries in the U.S.A.
Full member of the Association of Actuaries in Israel
M.Sc. in Applied Mathematics, Columbia University, New York
Consent: The actuary consents to publication of the reserve for early retirement

General

As requested, we have prepared a calculation for the liability of Bezeq with regard to future early retirements. Currently there remain 990 employees in the potential group, of whom 493 are transferred workers and 497 are not transferred workers. As directed by you, we used a table of remaining expected early retirement for 548 employees under the early retirement agreement reached with the Workers Committee. Of these 548 retirees, 105 will be non-transferred workers and 443 will be transferred workers.
This calculation does not relate to other types of retirement, such as retirement due to death or disability. The calculation was prepared on the basis of data supplied to us, relying on the data and principles of the calculation in the aforementioned agreement.

The retirement schedule for the 548 employees is:

Retirement Year	Retirees
2005	125
2006	200
2007	105
2008	118
Total	548

The retirement of the transferred workers and non-transferred workers is proportional to the total (i.e. about 82% transferred and 18% not transferred), for each calendar year.

The actuarial obligation was calculated using a statistical model which reflects the average expected early retirement costs in each future year.

Effects of the pension reform
The pension agreement provides two systems for determining pension rights for retirees among the transferred workers:
Track A – which was determined on the basis of the assessment pension rules in the civil service, i.e. the pension will be determined on the basis of the average of the grades in the last three years prior to the retirement and updated according to the rules for civil servants. The pension in this track is linked to the cost-of-living increments and the wage agreements in the economy.
Track B – was determined on the basis of the Makefet bylaws, i.e. it sets the pension according to a relative salary average called the "averages method", taking into account the best 25 years (hereinafter: "**the Averages Method**"). A pension in this track is linked to the CPI on the dates on which a cost-of-living increment was given in the economy.

In June 2003, as part of the reform of the pension funds, the Knesset passed a law that cancels agreements that benefit the workers and the employers. This included cancellation of the calculation formulae that had applied until the date of the reform between Bezeq and the Makefet Fund, which regulate the accounting in respect of a worker taking early retirement.
In the litigation between Bezeq, the Capital Market, Insurance and Savings Division of the Ministry of Finance and the Makefet Pension Fund, the parties reached consensus that for the population that retired up to 01.10.2003 (exclusive) the same cost calculation method would apply as for those who retired prior to 01.06.2003. Makefet, for its part, agreed to recognize the company's retirees after 1.10.2003 as pensioners of the Fund if the company would pay the costs in accordance with circulars 2000/1 and 2000/6 of the Capital Markets Division.

Starting on 1.10.2003, the standard bylaws apply to members of the Makefet Fund, and the Makefet Fund, for its part, may not grant benefits beyond the standard bylaws. This includes the matter of CPI linkage.

Several principal points from the pension fund reform:
- Cancellation of the Bezeq-Makefet agreement (the alpha formulae).
- The retirement age for men and women will rise gradually to 67 and 64 respectively.
- Contributions will rise gradually, for the worker from 5.5% to 7% and for the employer from 12% to 13.5%.
- The rights of the workers will be calculated by the Averages Method according to the 35 best years only (cancellation of Track A).
- The worker will pay up to 1.75% management fees from any pension, on a graduated scale (this does not affect the cost of early retirement).
- The pension will be inflation adjusted only after a cumulative inflation increase of 4.25% or every two years – whichever is the earlier.

Calculation assumptions
- Pension circular 2004/8 for early retirement.
- Retirement age: rising gradually to 67/64
- Discount rate: 3.0%
- Management fees: 1.5% of early retirement cost, and 3.5% in respect of lost contributions as a result of the employee's early retirement.

- Mortality of active persons and disabled persons: as per circular 2000/1
- Persons who become disabled: as per circular 2000/1
- Marriage percentage: as per circular 2000/1
- Age differences: 4 years
- Orphans and parents: as per circular 2000/1
- Retirement grants according to an agreement between the Workers Committee and Bezeq from 2000
- Salary increases in Track A at 4% per year up to early retirement. Additionally, in keeping with Bezeq's instructions, we have assumed an immediate one-off 1.9% increase in Track A salaries.[1]
- Salary increases in Track B at 1.5% per year up to early retirement
- A worker may take early retirement only if he has accumulated 20 years seniority and he is more than 50 years old.
- The distribution of transferred / non-transferred workers is 443 / 105 (respectively)
- Every year, the retirees retire on 1 July of that year, with the exception of 2005 when the retirements are assumed to occur on 1 October, as per Bezeq's instructions.
- Under the standard bylaws, the average wage in the economy does not continue to increase for the purpose of determining the pension of a "frozen" member of the pension fund.

Changes in the calculation since the previous valuation

- The bonus pension payable under Track A is calculated assumed employment of 100%, and not on the basis of the weighted average employment percent as was previously the case. The impact of this alteration is an increase of 1.0 M NIS in the cost of early retirement.
- The non-transferred employees' pension accrual is based on the old tables, according to the relevant table for each employee, and not on the accrual table under the new standard byelaws. The impact of this alteration is an increase of 0.8 M NIS in the early retirement cost.

Results of the calculation

The cost of early retirement in respect of 548 retirees who will retire between 2005 and 2008, based on the distribution in the table above, amounts to NIS 820.1 million (NIS 665.3 million for Makefet; NIS 151.8 million for grants; NIS 3.0 million for standard deviation). This compares with 1,191.7 M NIS last year. The reduction arises from the retirement of 370 employees (309 transferred employees and 61 non-transferred employees) who were included in last year's report.

We have added one standard deviation to the assessment in respect of uncertainty of who are the workers who will actually retire and when during the year they will retire. We note that use of an average as a cost estimate is on the conservative side as the approach of Bezeq is to offer early retirement to the longer-serving employees in the potential population. The cost of early retirement for long-serving employees, despite the higher salary, is lower because the time to official retirement is shorter.

Penalty in respect of excess years: pension circular 2004/8 demands that if a worker who takes early retirement would have attained 35 years seniority prior to full retirement, the

[1] The impact of this increase is an increase in the cost of early retirement of 16.2 M NIS.

pension fund should be compensated in an amount equal to the excess of contributions (in respect of those years) over the 35 year grant that the fund would have paid the retiree. This calculation was made on an assumption of full implementation of the reform – retirement ages up to age 67/64, contributions rising to 20.5%. We have assumed that the basis for the contributions is the Track A salary, which is closer to the actual salary of the employee from which the contributions are paid. On the other hand, we have assumed that the 35 year grant is based on the Track B salary, according to the new byelaws. This is a conservative assumption as it raises the level of the future contributions and reduces the value of the grant.[2]

Miscellaneous – Comparison of quarterly data

- The salary for Track A rose by an average of 1.1%, which is consistent with the model's assumed 4% p.a.
- It must be noted that Makefet alone calculates the data regarding employees' salary according to the new byelaws. For transferred employees the Track B salary rose by 3.6% on average, while for non-transferred employees there was a decrease of 1.6% on average. It is unclear what is the source of this differential development. The overall average increase is 1.1%, which is significantly higher than the model's assumption of 1.5% p.a. (approximately 0.4% per quarter).
- The employees' seniority increased by a quarter of a year for most employees.
- The salary for Histaglut grant rose by 2.7% on average, whilst for the other grants the salary rose by 5.7% on average.

Yours sincerely,

David Engelmayer, Actuary

[2] A court ruling has recently been published, regarding the claim of Bezeq employees against Makefet Pension Fund, stating that retired employees are entitled to receive the 35 year grant on the basis of their last salary, and not on the basis of the pensionable salary under the new byelaws. It is not clear whether this ruling applies also to the fine for the excess years according to pension circular 2004/8. The conservatism, if any, in the calculation is 4.6 M NIS.

Appendix: Assessment of balance sheet reserve – discount interest 3.0%, circular of the Capital Market Division including a penalty in respect of excess years

Potential Pool Of Early Retirees **990**

Scheduled Leaves:

Retire Year	Total Leaves	Senior Management			Transferred Employees			Non-Transferred Employees			Total			
		Number	Reserve	Grants	Number	Reserve	Grants	Number	Reserve	Grants	Number	Reserve	Grants	Total
2005	125	0	0.0 M	0.0 M	1	1.2 M	0.3 M	0	0.0 M	0.0 M	1	1.2 M	0.3 M	1.5 M
2006	200	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0.0 M
2007	105	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0.0 M
2008	118	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0.0 M
2009	0	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0.0 M
2010	0	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0.0 M
Total	548	0	0.0 M	0.0 M	1	1.2 M	0.3 M	0	0.0 M	0.0 M	1	1.2 M	0.3 M	1.5 M

Other Leaves:

Retire Year	Total Leaves	Senior Management			Transferred Employees			Non-Transferred Employees			Total			
		Number	Reserve	Grants	Number	Reserve	Grants	Number	Reserve	Grants	Number	Reserve	Grants	Total
2005	125	0	0.0 M	0.0 M	100	139.8 M	31.5 M	24	10.1 M	4.5 M	124	149.9 M	36.1 M	186.0 M
2006	200	0	0.0 M	0.0 M	162	224.5 M	48.8 M	38	15.5 M	7.1 M	200	240.0 M	55.8 M	295.8 M
2007	105	0	0.0 M	0.0 M	85	120.4 M	24.4 M	20	8.1 M	3.8 M	105	128.5 M	28.1 M	156.6 M
2008	118	0	0.0 M	0.0 M	95	136.7 M	27.3 M	23	9.1 M	4.3 M	118	145.7 M	31.6 M	177.3 M
2009	0	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0.0 M
2010	0	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0.0 M
Total	548	0	0.0 M	0.0 M	442	621.4 M	131.9 M	105	42.7 M	19.6 M	547	664.1 M	151.6 M	815.7 M

Total Leaves:

Retire Year	Total Leaves	Senior Management			Transferred Employees			Non-Transferred Employees			Total			
		Number	Reserve	Grants	Number	Reserve	Grants	Number	Reserve	Grants	Number	Reserve	Grants	Total
2005	125	0	0.0 M	0.0 M	101	141.0 M	31.8 M	24	10.1 M	4.5 M	**125**	**151.1 M**	**36.3 M**	**187.4 M**
2006	200	0	0.0 M	0.0 M	162	224.5 M	48.8 M	38	15.5 M	7.1 M	**200**	**240.0 M**	**55.8 M**	**295.8 M**
2007	105	0	0.0 M	0.0 M	85	120.4 M	24.4 M	20	8.1 M	3.8 M	**105**	**128.5 M**	**28.1 M**	**156.6 M**
2008	118	0	0.0 M	0.0 M	95	136.7 M	27.3 M	23	9.1 M	4.3 M	**118**	**145.7 M**	**31.6 M**	**177.3 M**
2009	0	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	**0**	**0.0 M**	**0.0 M**	**0.0 M**
2010	0	0	0.0 M	0.0 M	0	0.0 M	0.0 M	0	0.0 M	0.0 M	**0**	**0.0 M**	**0.0 M**	**0.0 M**
Total	**548**	**0**	**0.0 M**	**0.0 M**	**443**	**622.6 M**	**132.2 M**	**105**	**42.7 M**	**19.6 M**	**548**	**665.3 M**	**151.8 M**	**817.1 M**

Chapter D – Additional Details About the Corporation

Chapter D – Additional Details About the Corporation

1. Summary of the Quarterly Statements of Operations for the Year Ended December 31, 2004 (in NIS millions)

	2004				
	Total	Quarter 4	Quarter 3	Quarter 2	Quarter 1
Revenues	9,269.8	2,775.5	2,473.5	2,011.6	2,009.2
Costs and expenses	7,878.3	2,492.4	2,127.0	1,648.9	1,610.0
Operating income	1,391.5	283.1	346.5	362.7	399.2
Financing expenses	217.5	80.9	67.9	38.0	30.7
Other expenses (income), net	(79.7)	29.2	(131.9)	(7.5)	30.5
Equity in losses of investee companies	134.8	4.1	1.4	64.4	64.9
Net earnings	620.8	103.9	242.7	106.3	167.9

2. Use of Proceeds from Securities with Reference to the Application of the Proceeds According to a Prospectus

An offer for sale and issuance through a prospectus was published on May 24, 2004. The proceeds from the offering will be applied as decided by the Company from time to time in accordance with its needs, including, taking into account the necessity of replacing loans by early repayment. As at the date of approval of the financial statements, there has been no requirement to replace such loans (except for a loan of NIS 5 million which was repaid by the Company before its due date).

3. List of Investments in Subsidiaries and Affiliated Companies as at the Balance Sheet Date*

Company name	Name of holder	Type of share	Number of shares	Total n.v.	Rate of holding in %	Adjusted cost in NIS thousands	Adjusted balance sheet value in NIS thousands
Pelephone Communications Ltd.[1]	Company	Ordinary NIS 1	302,460,000	302,460,000	100%	2,576,727	3,158,992
Bezeq International Ltd.[2]	Company	Ordinary NIS 0.1	1,000,000,000	100,000,000	100%	306,361	375,438
BezeqCall Communications Ltd.	Company	Ordinary NIS 1	35,537,220	35,537,220	100%	51,767	54,654
Aphrodite B.V. Amsterdam[3]	Company	Ordinary 1000 NLG	26.64	NLG 26,640	66.60%	0	0
DBS Satellite services (1998) Ltd[4].	Company	Ordinary NIS 1	14,455	14,455	49.80%	1,603,601	240,303
Bezeq Online Ltd.[5]	Company	Ordinary NIS 1	85,000	85,000	100%	23,375	24,271
Bezeq Zahav (Holdings) Ltd.[6]	Company	Ordinary NIS 1	999,999	999,999	100%	2,560,089	2,560,089
GoNext Ltd.[7]	Pelephone	Ordinary NIS 0.1	100,000	10,000	100%	0	0
Walla! Communications Ltd.[8]	Bezeq International	Ordinary NIS 1	12,275,719	12,275,719	44.97%	74,003	14,418
BezeqCall Ltd.[9]	Company	Ordinary NIS 0.1	400,000,000	40,000,000	100%	0	3,904

1 Through August 26, 2004, shares in Pelephone Communications Ltd. (hereinafter "Pelephone") were held by the Company and a company from the Shamrock Holdings of California Group (hereinafter "Shamrock") in equal shares – 50% each. On the aforementioned date, Bezeq exercised an option that it held to purchase Shamrock's holdings in Pelephone. Following exercise of the option, Pelephone is wholly owned by the Company.

2 Bezeq International includes an investment of NIS 168,725 thousand which was extended as a CPI-linked shareholders' loan. The loan is interest-free, and its repayment date will be set ten years after the date of its receipt.

3 Aphrodite B.V. Amsterdam was sold. The shares was transferred on February 3, 2005.

4 DBS Satellite Services (1998) Ltd. includes an investment of NIS 1,603,601 thousand by means of loans. Of this, NIS 979,956 thousand in loans linked to the known CPI, NIS 177,447 is in loans linked to the known CPI and bearing 5.5% interest, and NIS 446,198 thousand is in loans linked to the known CPI and bearing 11% interest.

5 Bezeq Online Ltd. includes an investment of NIS 1,048 thousand, extended as a shareholders loan. The loan is linked to the CPI and is interest-free.

6 A loan was extended to the subsidiary Bezeq Zahav (Holdings) Ltd. for financing the purchase of debentures Series 4 and 5 as issued to it.

7 On December 29, 2004, Pelephone Communications Ltd. and GoNext Ltd. agreed that the Company would waive and irrevocably relinquish a credit balance at its disposal at GoNext in the amount of NIS 64,970 thousand, less the current debit balance between the two companies.

8 Walla! includes an investment of NIS 5,755 thousand in the form of shareholders' loans from Bezeq International. The loans are linked to the CPI and are interest-free.
In March 2004, Bezeq International purchased 7,073,980 option warrants of Walla! in consideration of NIS 1,414 thousand, which was offset from the balance of the shareholders' loans. During 2004 Bezeq International exercised 3,786,940 warrants for a consideration of NIS 6,816 thousand, which was offset form the balance of the shareholders' loans. Following the exercise, the percentage of Bezeq International's holding in Walla! increased as shown above.

9 BezeqCall Ltd. – an inactive company.

* A. The process of voluntary liquidation of Bezeq Globe Ltd. was completed on January 31, 2005, after liquidation of all its overseas subsidiaries.

B. Adanet Business Group Ltd. – Adanet and its subsidiaries are in the process of a temporary liquidation or temporary receivership.

4. Changes in Investments in Subsidiaries and Related Companies During the Report Period

Date of change	Essence of change	Company name	Reported amounts in NIS thousands
6.2004	Shareholders' loan*	Bezeq Zahav (Holdings) Ltd.	950,000
12.2004	Shareholders' loan	Bezeq Zahav (Holdings) Ltd.	1,608,181
12.2004	Linkage differentials	Bezeq Zahav (Holdings) Ltd.	1,908
8.2004	Purchase of shares	Pelephone Holdings	272,400
9.2004	Shareholders' loan	Pelephone Holdings	1,766,037
12.2004	Liquidation of company	Pelephone Holdings	(2,033,720)
12.2004	Investment in shares	Pelephone	2,033,720
12.2004	Deletion of investment account	Bezeq Globe	(1,987)
1.2004	Shareholders' loan	DBS	10,946
2.2004	Shareholders' loan	DBS	17,852
3.2004	Shareholders' loan	DBS	3,688
4.2004	Shareholders' loan	DBS	35,000
5.2004	Shareholders' loan	DBS	20,700
6.2004	Shareholders' loan	DBS	3,500
7.2004	Shareholders' loan	DBS	72,000
8.2004	Shareholders' loan	DBS	30,000
9.2004	Shareholders' loan	DBS	15,000
10.2004	Shareholders' loan	DBS	30,000
11.2004	Shareholders' loan	DBS	37,000
12.2004	Shareholders' loan	DBS	31,000
12.2004	Linkage differentials and interest	DBS	39,548
12.2004	Linkage differentials and interest	Bezeq International Ltd.	(337)

* Subsequent to the date of the report and through the date the financial statements of the subsidiary Bezeq Zahav (Holdings) were published, 300 million nominal value Series 4 debentures were sold. The proceeds from the sale, NIS 325,750 thousand, were transferred to the Company by Bezeq Zahav (Holdings) as partial repayment of the loan.

5. Revenues of Subsidiaries and Related Companies and Revenues of the Corporation therefrom as at the Balance Sheet Date (in NIS thousands)

Company name	Earnings (loss) before tax	Earnings (loss) after tax	Dividend	Management fees	Interest
Pelephone Communications Ltd.	463,172	300,692	18,841	0	1,654
Bezeq International Ltd.	118,578	120,840	0	0	0
BezeqCall Communication Ltd.	3,554	3,500	0	0	0
BezeqCall Ltd.	0	0	0	0	0
DBS Satellite Services (1998) Ltd.	(365,884)	(365,884)	0	0	1,018
Bezeq Online Ltd.	(83)	72	0	0	1,005
Bezeq Zahav Holdings Ltd.	0	0	0	0	30,585
Walla!	3,611	3,611	0	0	0
GoNext	63	63	0	0	0

6. Stock Exchange Trading – Listed Securities – Dates and Reasons for Termination of Trading

Date	Security No.	Security name	Quantity	New balance
3.6.2004	2300051	Debentures Series 4	1,200,000,000	1,200,000,000
3.6.2004	2300069	Debentures Series 5	600,000,000	600,000,000
14.12.2004	2300069	Debentures Series 5	1,500,000,000	2,100,000,000

As at the date of publication of the periodic report, the subsidiary Bezeq Zahav (Holdings) Ltd. holds 100,000,000 debentures Series 4 and 2,050,000,000 debentures Series 5.

7. Payment to Senior Officers

Cost of salary	2004 reported amounts
Vice President – Headquarters Division	2,902,419 [1]
Deputy CEO	2,045,171 [2]
Director	1,346,565 [3]
Vice President – Headquarters Division	878,824 [4]
CEO	789,402

[1] Including payments for early retirement, NIS 2,147,242.
[2] Including payments for early retirement, NIS 1,300,435.
[3] Serves as Chairman of the Board of Pelephone Communications Ltd.
[4] Including payments for severance pay, NIS 172,926.

8. Salary and Benefits

(A) In 2004, the members of the Board of Directors (except for the Chairperson and directors who are Company employees) received remuneration, salary and incidental expenses amounting to NIS 1,663 thousand (the compensation for directors at Pelephone is stated at the proportional part of the Company (50%) for the period in which Pelephone was proportionally consolidated).

(B) The cost of the salaries of the CEO and the Chairperson in 2004 was NIS 1,574 thousand.

9. Shares and Convertible Securities Held by Interested Parties in the Corporation, a Subsidiary or an Affiliated Company, as Close as Possible to the Date of the Report

	Name of holder	Type of security	Quantity of convertible securities	Quantity of shares	Value in NIS par value	Percentage of holding in control and in equity %
1.	State of Israel	Ordinary		1,208,311,449	1,208,311,449	46.38
2.	Zeevi Communications Holdings Ltd.*	Ordinary		459,331,617	459,331,617.00	17.63
3.	DE Dirot Elite Ltd.**	Ordinary		3,097,697	3,097,697.00	0.12
4.	Barak Avraham (member of the Board)	Ordinary		30	30.00	

* Zeevi Communications Holdings Ltd. holds 459,331,617 shares of Bezeq. On November 12, 2002, a receiver was appointed to this company, Adv. Alex Hartman, who is authorized to exercise the rights in respect of the Bezeq shares in accordance with the ruling and approval of the court. It should be noted that this company belongs to the Zeevi Group, and that another company of the same group, DE Dirot Elite Ltd., (as specified in Section 3) holds another 3,097,697 shares of Bezeq.

** DE Dirot Elite Ltd. is a member of the Zeevi Group, where another company in the same Group, which is in receivership as aforesaid, holds 459,331,617 shares of Bezeq.

10. Registered Capital, Issued Capital and Convertible Securities

The registered capital is 2,625,000,000 shares of NIS 1 par value each.

The issued capital is 2,605,045,611 shares of NIS 1 par value each, having equal rights.

There are no dormant shares, there are no convertible securities.

11. Registered Address of the Corporation

Address: 15 Hatzvi Street, Jerusalem 91010
Telephone: 02-539-5333 (CEO) 03-626-2200 (Company Secretary)
Fax: 02-537-8184
Email: shimonn@bezeq.com (Company Secretary)

12. Directors of the Corporation

A. (1) Name: **Miriam (Miki) Mazar*** ID No. 007160179

(2) Date of birth: 20.10.1935

(3) Address: 29 Leissin Street, Tel Aviv

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees:
Organization, Billing/Computerization, Issuances/Privatization, Finance, Assets, Appointments (Chair), By-Laws, Security (Chair).

(6) Outside Director: No

(7) Employee of the Corporation, subsidiary, related company or interested party: Yes (Chairperson of the Board of Directors since 1.1.03)

(8) Date of commencement of tenure as a director: 15.6.1998**

(9) Education and employment during the past five years and details of the corporations in which she serves as director: Academic, lawyer.
D.B.S. Satellite Services (1998) Ltd.
Pelephone Communications Ltd.
Since 2003 – Chairperson of the Board of Bezeq
1984-2003 – Member of Tel Aviv-Yafo City Council
1993-1999 – Head of Legal Services for the City Council
1993-2003 – Chairperson of Tel Aviv-Yafo City Council
12/1996-2003 – Chairperson of Dan Urban Association for Sewerage and Quality of the Environment
1999-2003 – Chairperson of the Urban Corporations Committee – Tel Aviv-Yafo Municipality
2001-2004 – Member of the Board of EL AL

(10) Related to another interested party in the Corporation: No.

* Ends her term of office on 6.3.05.

** Except for a short break. Current term commenced on 6.3.02.

B. (1) Name: **Dalit Braun** ID No. 022416929

(2) Date of birth: 19.6.1966

(3) Address: 6 Simtat Hatavor, Tel Aviv

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees:
Billing/Computerization (Chair), Organization, Audit, Issuances/Privatization, Marketing, Investments and Strategy, Insurance

(6) Outside Director: No

(7) Employee of the Corporation, subsidiary, related company or interested party: No.

(8) Date of commencement of tenure as a director: 18.9.2002

(9) Education and employment during the past five years and details of the corporations in which she serves as director:
M.B.A. – Tel Aviv University
LL.M. – European Business Law, Anglia University, UK
B.Sc. – Industry and Management, Technion
Since 1996, CEO of RAD Binat Assets & Services
Director at Bazukan Integrations Ltd.

(10) Related to an interested party in the Corporation: No.

C. (1) Name: **Avraham Barak** ID No. 3055795-3

(2) Date of birth: 30.1.1950

(3) Address: 11, Tidhar Street, Ramat Gan

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees:
Audit, Finance (Chair), Assets, Marketing, Investments and Strategy, Appointments, Market Risk Management

(6) Outside Director: No

(7) Employee of the Corporation, subsidiary, related company or interested party: No.

(8) Date of commencement of tenure as a director: 12.10.1997*

(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BA Economics and Computer Sciences – Bar Ilan University
Pelephone Communications Ltd.
Since 2001- CEO of Yissum Development & Research Co. at the Hebrew University of Jerusalem
As CEO of Yissum, serves as a director in Novagali, Syndromex, Sensogenm Novia and DBT
1995-1999 – Melrose Investments (Israel) Ltd. – private business
Director at Melrose Investments (Israel) Ltd., Hagoshrim Kayaks Ltd., Newport Orchards Ltd., Ilanot Carmel Ltd., Ilanot Carmel Investments (1993) Ltd., Avraham Barak & Co. Consulting Services Ltd., Extra Maofim Ltd., Extra Capital Markets Ltd., Emerald Management & Underwriting Ltd., Lightcom (Israel) Ltd., Lightcom S.A.

(10) Related to an interested party in the Corporation: No.

* Except for a short break. Current term commenced on 9.4.02.

D. (1) Name: **Benny Vaknin** ID No. 63127542

(2) Date of birth: 5.12.1950

(3) Address: 42 Hatayassim Street, Ashkelon

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees:
Issuances/Privatization, Marketing, Investments and Strategy, Subscribers.

(6) Outside Director: No

(7) Employee of the Corporation, subsidiary, related company or interested party: Yes.

(8) Date of commencement of tenure as a director: 9.4.2003

(9) Education and employment during the past five years and details of the corporations in which he serves as director:
B.A. Law – Tel Aviv University
BA Economics and Business Administration – Hebrew University of Jerusalem
1991-2003 – Mayor of Asheklon.
Since 2003 – Chairman of the Board of Pelephone
Director in M.Y. Holdings Ltd., Hahevra Lemeshek Vekalkala, Ashkelon Information Industries

(10) Related to an interested party in the Corporation: No.

E. (1) Name: **Yigal Cohen-Orgad*** ID No. 7703143

(2) Date of birth: 30.8.1937

(3) Address: 9 Frenkel Street, Ramat Aviv, Tel Aviv

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees:
Billing, Audit (Chair), Issuances/Privatization, Finance, Assets, Marketing, Investments and Strategy

(6) Outside Director: Yes

(7) Employee of the Corporation, subsidiary, related company or interested party: No.

(8) Date of commencement of tenure as a director: 26.1.2004

(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BA Economics and Education
Chairman of the Executive Committee of the Judea and Samaria Academic College
Director – Israel Electric Corporation
Self-employed – Construction project manager

(10) Related to an interested party in the Corporation: No.

* Director with accounting and financial expertise

F. (1) Name: **Blanche Kay** ID No. 048202717

(2) Date of birth: 19.3.1930

(3) Address: 10 Mania and Israel Street, Tel Aviv

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees:
Organization, Audit, Finance, Assets (Chair), Subscribers, By-laws, Security.

(6) Outside Director: Yes

(7) Employee of the Corporation, a subsidiary, related company or interested party: No.

(8) Date of commencement of tenure as a director: 23.11.2000*

(9) Education and employment during the past five years and details of the corporations in which she serves as director:
MGr Law Degree – Hebrew University of Jerusalem
Since December 2002 – Chairperson of Judicial Appeal Committee – District Court
Mediator in legal cases in various courts
1973–1994 Judge (retired)
Chair of the Public Committee for Investigation of the Functioning of the Second Authority for Radio and Television
1995-1998 – Founder and President of the Israel-Jordan Chamber of Commerce, now a member of management.
2000-2003 – Director, Dead Sea Shore Development Company
From 2002 – Outside director of Optima Enterprise & Investments

(10) Related to an interested party in the Corporation: No.

* Except for a short break. Current term commenced on 26.1.2004.

G. (1) Name: **Hava Shechter*** ID No. 051907178

(2) Date of birth: 23.4.1954

(3) Address: 11 Ahimeir Street, Tel Aviv

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees:
Issuances/Privatization (Chair), Billing/Computerization, Finance, Marketing, Investments and Strategy, Appointments, Market Risk Management (Chair), Insurance

(6) Outside Director: No

(7) Employee of the Corporation, subsidiary, related company or interested party: No.

(8) Date of commencement of tenure as a director: 17.11.1999**

(9) Education and employment during the past five years and details of the corporations in which she serves as director:
MBA - Tel Aviv University
BA Economics – Tel Aviv University
1996-1999 – Ramot Shechter & Co. Investment House Ltd.
1999 – H. Schechter & Co. Investment House Ltd.
Director in Tashan Ltd. and XOR Ltd.

(10) Related to an interested party in the Corporation: No.

* Director with accounting and financial expertise.
** Current term commenced on 18.11.2002.

H. (1) Name: **Rachel Kremmerman-Meridor** ID No. 001464031
(2) Date of birth: 30.7.1937
(3) Address: 36 Be'eri Street, Tel Aviv
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees:
Audit, Finance, Bylaws, Marketing, Organization (Chair)
(6) Outside Director: No
(7) Employee of the Corporation, subsidiary, related company or interested party: No.
(8) Date of commencement of tenure as a director: 14.11.2001*
(9) Education and employment during the past five years and details of the corporations in which she serves as director:
LLB – Hebrew University of Jerusalem
MBA-MEI – Swinburn University, Australia
Consultancy, management and publishing – private.
1982-2004 – Director in Wood Veneer Concern – listed on the American stock exchange
Director in Ramid – Mamgoret, Marzit Real Estate Management, Metrage – commercial space holding company, member of the plenum of Israel Broadcasting Association, Mifal Hapais – member of the Advisory Council
(10) Related to an interested party in the Corporation: No.
* Except for a 3-month break. Current term commenced on 1.3. 2005.

Notes: 1. At the General Meeting on December 7, 2004, Mr. Azriel Nevo was approved to serve as a director. As at the date of publication of the statements, the letter of appointment had not yet been received, as is required under Regulation 92(G) of the Company articles of association.
2. On December 31, 2004, Ms. Shoshana Weinshel also served as director in the Company – Ms. Weinshel resigned her office on February 17, 2005.

13. Senior Officers of the Corporation

1. Name: **Amnon Dick** ID No. 51770568
Date of birth: 20.11.1952
Position in the Company: President & CEO
Position in a Subsidiary of the Company or in an interested party of the Company:
Director of Pelephone Communications Ltd.
Director of D.B.S. Satellite Services (1998) Ltd.
Related to a senior officer or to an interested party: No
Education and business experience over the past five years:
BA Economics – Tel Aviv University
MBA Business Administration – Tel Aviv University
2001-2003 – Businessman and consultant to overseas companies
1997-2001 – Chairman and CEO of Elite International.
Date of commencement of tenure as an officer: 17.8.2003

2. Name: **Avi Patir** ID No. 007705866
Date of birth: 10.10.1948
Position in the Company: Deputy CEO
Position in a Subsidiary of the Company or of an interested party of the Company:
Director in BezeqCall Communications Ltd.
Related to a senior officer or to an interested party: No
Education and business experience over the past five years:
BA Electrical and Electronics Engineering – Technion Haifa
MA Electrical and Electronics Engineering – Columbia University, New York

2002-2004 – CEO America-Israel Paper Industries Group
1996-2002 – CEO Barak International Services Company Ltd.
Date of commencement of tenure as an officer: 16.5.2004

3 Name: **Ron Eilon** ID No. 059211772
Date of birth: 27.5.1965
Position in the Company: CFO
Position in a Subsidiary of the Company or in an interested party of the Company:
Director in Pelephone Communications Ltd.
Director in D.B.S. Satellite Services (1998) Ltd.
Related to a senior officer or to an interested party: No
Education and business experience over the past five years:
BA – Economics
MBA – Finance
Outside director in Otsarit
1999-2003 – CFO at MIRS, Motorola;
1996-1999 – Deputy Commissioner for Budgets, Ministry of Finance;
Date of commencement of tenure as an officer: 2.3.2003

4 Name: **Ari Bronstein** ID No. 024455404
Date of birth: 30.7.1969
Position in the Company: VP Economics and Business Development
Position in a Subsidiary of the Company or in an interested party of the Company:
Director in Xpert Systems
Director in Bezeq International Ltd.
Related to a senior officer or to any interested party: No
Education and business experience over the past five years:
BA – Management and Economics
MA – Accounting and Finance
Stage One Venture Capital Fund – Chairman of Investment Committee
Eurofund Venture Capital Fund – Member of Investment Committee
Koor Tadiran Pensions – Outside director and Chairman of Investment Committee
1999-2000 –Business Analysis Manager at Comverse
Since 2000 – Manager of the Financing and Investment department of the Company
Date of commencement of tenure as an officer: 7.1.2004

5. Name: **Michel Heibert** ID No. 068200203
Date of birth: 26.10.1956
Position in the Company: Deputy VP Engineering and Planning
Position in a Subsidiary of the Company or of an interested party of the Company: None
Related to a senior officer or to an interested party: No
Education and business experience over the past five years:
BA – Electronic Engineering – Ben Gurion University
EMBA – Strategy – Hebrew University of Jerusalem
2003-2004 – Manager of the Access Networks Engineering Division – Engineering and Planning Section – Bezeq
1998-2003 – Manager of the Access Networks Division – Engineering and Planning Section – Bezeq
Date of commencement of tenure as an officer: 12.8.2004

6. Name: **Raz Heiferman** ID No. 67614339
Date of birth: 25.1.1949
Position in the Company: VP Information Technology
Position in a Subsidiary of the Company or of an interested party of the Company:
Director of Bezeq On-Line Ltd.
Related to a senior officer or to an interested party: No
Education and business experience over the past five years:
BA – Economics and Statistics
MA – Business Administration.

1992-1997 – Contahal Ltd. Last position – Manager of the Technology and Software Engineering Division
Date of commencement of tenure as an officer: 16.3.1997

7. Name: **Rami Hazan** ID No. 058657354
Date of birth: 28.5.1964
Position in the Company: VP Sales and Marketing
Position in a Subsidiary of the Company or of an interested party of the Company: None
Related to a senior officer or to an interested party: No
Education and business experience over the past five years:
BA – Social Sciences – Open University
2001-2004 – VP and Manager of the Customer Division at Bezeq International
2000-2001 – VP Customer Service at Bezeq International
1999-2000 – Manager of the Call Center Division at Beeper Communications Ltd.
1997-1999 – Manager of Sales and Distribution CMS CompuCenter Ltd.
Date of commencement of tenure as an officer: 1.11.2004

8. Name: **Danny Oz** ID No. 054299953
Date of birth: 16.6.1956
Position in the Company: Comptroller and Deputy CFO
Position in a Subsidiary of the Company or of an interested party of the Company:
Director in Bezeq International Ltd.
Related to a senior officer or to an interested party: no
Education and business experience over the past five years:
BA – Economics and Accounting – Hebrew University of Jerusalem, Licensed CPA
EMBA – Integrative Management – Hebrew University of Jerusalem
Date of commencement of tenure as an officer: 1.9.1998
As of September 1998 – Company Comptroller

9. Name: **Danny Friedman** ID No. 014684385
Date of Birth: 17.9.1959
Position in the Company: Internal Auditor
Position in a Subsidiary of the Company or of an interested party of the Company: None.
Related to a senior officer or to an interested party: No
Education and business experience over the past five years:
BA – Accounting – Hebrew University of Jerusalem
BA – Economics and Statistics – Hebrew University of Jerusalem
MA – Economics and Statistics – Hebrew University of Jerusalem
CIA – Certified Internal Auditor (USA)
CISA – Certified Information Systems Auditor (USA)
1987-2004 – Chief Auditor, Finance at Bezeq.
Date of commencement of tenure as an officer: 18.12.2003

10. Name: **Alik Romm** ID No. 054063938
Date of birth: 8.5.1956
Position in the Company: VP Management Resources
Position in a Subsidiary of the Company or of an interested party of the Company: None
Related to a senior officer or to an interested party: No
Education and business experience over the past five years:
BA – Social Science
2001-2003 – VP at Keter Plastics;
1999-2001 – CEO at ORS
1992-1999 – VP Human Resources and Information Systems at Israel Chemicals Ltd.
VP Human Resources and Information Systems of the Bromide Group
Date of commencement of tenure as an officer: 1.12.2003

Note: The list of senior officers includes the office holders according to the definition of "holder of a senior position" in the Securities Regulations (Periodic and immediate reports), 5730-1970. The office holders who are not included under that definition but are included in the definition of an officer in the Companies Law, 5759-1999, are not included in the above list (even though they answer directly to the CEO), and they are: managers of operating divisions, General Counsel, Company Spokesperson and Company Secretary.

14. The Auditors of the Corporation

KPMG Somekh Chaikin – Certified Public Accountants (Isr.)
Address: 17 Ha'Arba'a Street
Millenium Tower KPMG
Tel Aviv 64739
Tel.: 03-684-8000

15. Change in the Memorandum or Articles of Association

On December 7, 2004, the General Meeting approved the amendment of Article 92(D) of the Company's articles of association, as follows: "After the words: 'on March 31, 1999' a comma will be added, after which the words 'except Regulation 6(3)' will be inserted."

16. Recommendations and Resolutions of the Directors Concerning a Change in the Articles of Association (Board of Directors Resolution from November 4, 2004)

Amendment to Article 92(D) of the Company's articles of association, as follows: "After the words: 'on March 31, 1999' a comma will be added, after which the words 'except Regulation 6(3)' will be inserted."

(This resolution was approved by the General Meeting on December 7, 2004.)

17. Special Resolutions of the General Meeting

Appointment of outside directors: Ms. Blanche Kaye, Mr. Yigal Cohen-Orgad (resolution from January 26, 2004): The General Meeting approved the appointment of Ms. Blanche Kaye and Mr. Yigal Cohen-Orgad as outside directors.

Approval for making a commitment in respect of indemnity and insurance (resolution from May 13, 2004):

A. The Meeting granted the Company approval to make a commitment to officers in the Company who were company officers at the time a commitment was made, in respect of indemnity, or who were in office during the seven years preceding that date, to grant a loan for financing reasonable litigation expenses in a proceedings in which an officer is sued by another person, including a derivative action, the purpose of the proceeding being the imposition of personal liability for an act he performed in his capacity as an officer in the Company, subject to compliance with the terms set out in Section 3 of the letter of indemnity attached to the resolution and in Section 263 of the Companies Law, 5759-1999. The undertaking under this section is irrevocable.

   The loan will become a grant if a competent court does not impose liability on the officer in a preemptory decision. If the loan does not become a grant, the officer will be required to repay it plus linkage differentials based on the consumer price index, immediately if he is required by the Company, in writing, to do so.

B. The Meeting granted the Company an approval to make a commitment to the officers that it would do its utmost to ensure that the insurance cover for events covered by an officers' insurance policy, which the Company took out in July 2003, would be maintained for seven years, provided that the cost of the insurance premium is reasonable. Agreements with insurers for the purchase of insurance policies as aforementioned, will be brought for the approval of the competent bodies of the Company (including the General Meeting), as required under any law.

C. The Meeting granted the Company an approval to make an *a priori* commitment to officers in the Company, who were in office at the Company at the time a commitment was made, in respect of indemnity or who were in office during the seven years preceding that date, to indemnify them for any expense or financial liability which is imposed on an officer as a result of an act he performed in his capacity as an officer in the Company, due to a claim by a shareholder who held, at any time during the fours years preceding the date on which the commitment to indemnify was given, 15% or more of the issued share capital of the Company, in respect of events that occurred during the seven years that

preceded the commitment to indemnify. The indemnity will be given under the terms set forth in the notice of commitment to indemnify, which was attached to the resolution.

D. The Meeting granted the Company an approval to make an *a priori* commitment to officers in the Company to indemnify them for any expense or financial liability which may be imposed on an officer following a proceeding which is brought against him relating to a prospectus of an offer for sale of the securities of the Company by the State of Israel and an issuance by the Company, which should have been published in May 2004. The indemnity will be given under the terms set out in the notice of commitment to indemnify, which was attached to the resolution.

Approval for a one-time personal remuneration to the Chairperson (resolution from May 13, 2004): The Meeting approved a one-time, personal remuneration for 2003 to the Chairperson of the Board in the amount of 1.2 salaries (NIS 49,385).

Approval for an issuance of shares* (resolution from May 13, 2004): The Meeting approved an issuance of shares and/or securities convertible to shares up to the limit of the registered capital of the Company (19,954,389 shares) as part of the Company prospectus, which should have been published in May 2004.

(* In the event, the issuance was not made.)

Purchase of an officers liability insurance policy (resolution from September 14, 2004): The General Meeting approved the purchase of an officers liability insurance policy from Clal Insurance Company Ltd., the main points of which were set out in the appendix to the resolution.

Approval for remuneration to the Chairperson of the Board (resolution from December 7, 2004): The Meeting approved remuneration to the Chairperson of the Board in the amount of two salaries (approximately NIS 90,000), as part of the resolution concerning remuneration for employees who participated in the preparation of the prospectus of the Company in May 2004.

Approval for directors' remuneration (resolution from December 7, 2004): The Meeting approved remuneration for directors (who are not outside directors) for participating in meetings of the Board of Directors and its committees in accordance with the Government Companies Regulations (Rules governing remuneration and expenses for outside directors in government companies), 5754-1994, as may be amended from time to time, and with a classification of a level 10 company. The remuneration per meeting, commencing February 2004, is NIS 1,185 (including VAT).

Amendment of Article 92(D) of the Company's Articles of Association (resolution from December 7, 2004: As aforesaid in Section 16 above.

Approval for remuneration for the Chairperson of the Board (resolution from March 1, 2005): The Meeting approved remuneration to the Chairperson of the Board in the amount of 1.2 salaries (approximately NIS 49,400).

Election of directors (resolution from March 1, 2005): The Meeting elected Ms. Rachel Kremmerman to serve as director in the Company.

18. Transactions Requiring Special Approvals

Injection of funds into D.B.S. Satellite Services (1998) Ltd. (resolution from March 30, 2004 amended on May 10, 2004):

The approval of the overall investment framework of Bezeq in D.B.S. Satellite Services (1998) Ltd. ("DBS") beyond the investments approved by the Board of Directors up to the adoption of this resolution, is based on the findings of a report by the firm of consultants Singer & Even and the business plan, which was prepared by DBS's Management and presented to the Board of Directors. The investment will be approximately NIS 440 million (approximately 98 million dollars) and will be made gradually according to the needs of DBS as in its business plan, over a period of two years (until the end of 2005).

Continuing investments in DBS will be made by way of new shareholders' loans (preferable), linked to the CPI, bearing 11% annual interest. The Company will receive warrants per share. All of this will performed within the framework of the existing agreements between the shareholders and DBS.

Note: Following this resolution, an additional resolution was adopted for a current injection of funds into DBS in accordance with the aforesaid framework approval, and on February 17, 2005, the Board of Directors adopted a resolution that it stands behind its resolution from March 30, 2004 (as amended on May 10, 2004), to continue to invest in DBS according to the approved business plan, together with other shareholders and financial institutions.

Receipt of loan for the purpose of investing in DBS (resolution from January 20, 2005):

The Company will obtain a loan from a institutional body in the amount of NIS 15 million (with an option to the lender to lend the Company an additional NIS 15 million within one year from the date of the loan). The Company will invest the loan in DBS, as part of the Company's shareholders' loans to DBS.

Undertaking in respect of a loan from an institutional body to DBS (resolution from February 17, 2005):

A commitment by the Company to repay the loan from an institutional body to DBS in the amount of NIS 15 million (with an option of an additional NIS 15 million). The commitment is contingent upon the occurrence of certain events, given a positive value of DBS according to a pre-determined formula. Performance of the transaction is subject to the execution of final agreements on the matter. This resolution replaces the resolution from January 20, 2005, set out above.

19. Valid Insurance Policies and Indemnities

The Company has an officers' liability insurance policy. The insurance ceiling is $ 150 million per event and for the period (twelve months), in addition to up to $30 million for legal expenses in Israel.

During 2004 commitments were made to indemnify directors and officers in the following subjects:

1. Making a commitment of indemnity for any expense or financial liability which is imposed on an officer following a proceeding filed against him in respect of the Company's prospectus from May 2004. The indemnity will be given on the terms set out in the letter of commitment to indemnify, which was attached to the resolution.
2. Making a commitment to indemnify officers in the Company who were in office at the Company at the time the commitment to indemnify was made or who were in office during the seven years preceding that date, for any expense or financial liability imposed on an officer due to a claim by a shareholder who held, at any time during the four years preceding the date on which the commitment to indemnify was given, 15% or more of the issued share capital of the Company. The indemnity will be given on the terms set out in the notice of commitment to indemnify, which was attached to the resolution.
3. Making a commitment to officers in the Company who were in office at the Company at the time a commitment was made in respect of indemnity or who were in office during the seven years preceding that date, to grant a loan for financing reasonable litigation expenses in a proceeding in which he is sued by another person, including a derivative action. The loan will become a grant if a competent court does not impose liability on the officer in a peremptory decision.
4. Making a commitment to officers that the insurance cover for events covered by an officers' insurance policy, which the Company purchased in July 2003, will be maintained for seven years, provided that the cost of the insurance premium is reasonable.

It should be noted that in the past, the Company granted indemnity to officers in the following areas:

A. A letter of indemnity in respect of the issuance through a prospectus from 1998.

B. A letter of indemnity for a draft of the prospectus which was submitted to the Securities Authority in 1999.

C. A letter of indemnity for Y2K risks.

D. A letter of indemnity in respect of an issuance of shares, in everything relating to the framework agreement from January 13, 2002.

Date

"Bezeq" The Israel Telecommunication Corp. Limited

Name and title of the signatories:
Adv. Miriam (Miki) Mazar, Chairperson of the Board
Amnon Dick, CEO