

August 14, 2006



"Bezeq" The Israel Telecommunication Corp. Limited

Restated Annual Report for 2005*

Chapter A – Description of Company Operations

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

Chapter C – Financial Statements (Restated)

Chapter D – Additional Details About the Corporation

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

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

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Chapter A – Description of Company Operations

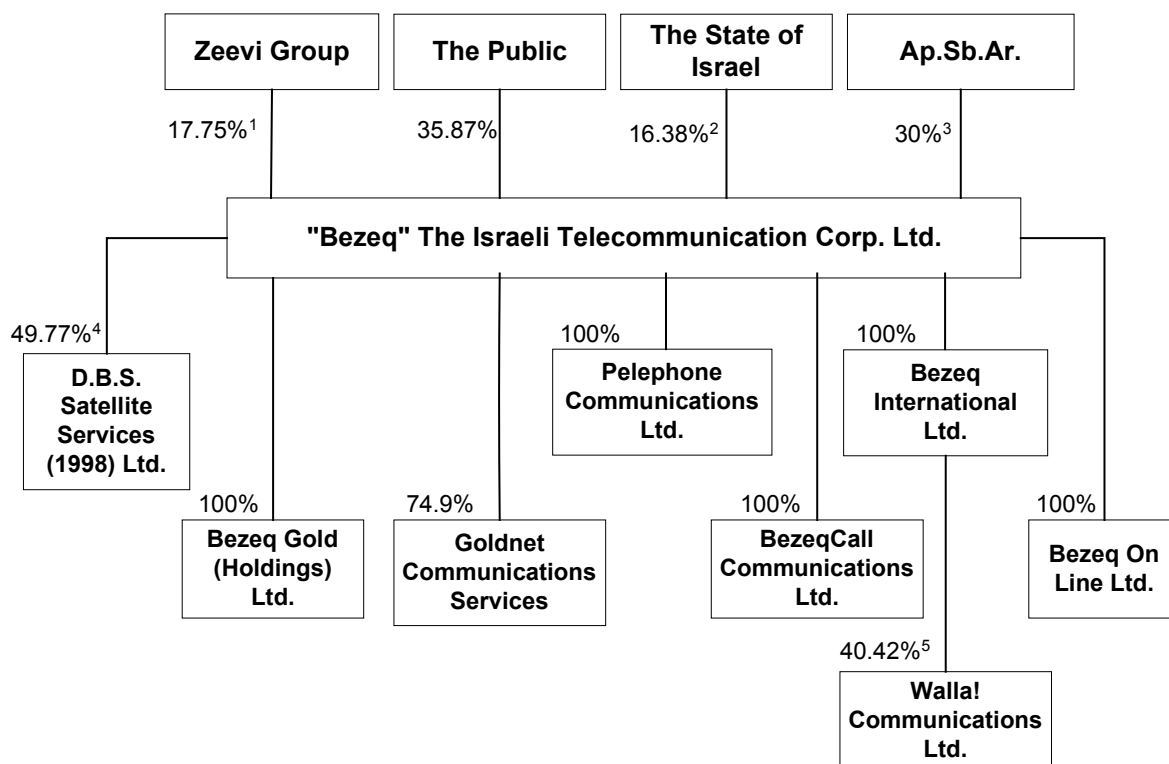
1. Description of General Development of Group Operations

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, 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 Company was founded as a government company in 1980 and has been privatized over a period of years. The Company is a public company, the shares in which are traded on the Tel Aviv Stock Exchange.
- 1.1.4 Following completion of the sale of 30% of the State's holdings in the Company to Ap.Sb.Ar. Holdings Ltd. (“**Ap.Sb.Ar.**”) on October 11, 2005, Ap.Sb.Ar. holds 30% of the shares in the Company, as well as an option to purchase up to 10.66% of the shares in the Company that are held by the State.

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:



1.1.5 Mergers and Acquisitions

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

On January 2, 2005, the Antitrust Commissioner conditionally approved the merger between the Company and DBS (increase of the Company's holdings in DBS to more than 50%). A year after the approval, the grant of the approval of the merger expired and requires a new consent.

For a detailed description of the developments in this area, see Note 8E to the Company's financial statements for the year ending December 31, 2005, 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. These holdings were sold for a total consideration of approximately 31 million dollars.

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

² For the option granted to Ap. Sab. Ar. to purchase up to approximately 10.66% of the State's shares, see section 1.3 below; for employee options, see section 2.9 below.

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

⁴ The Company has option warrants (and/or is entitled to receive option warrants) as at the date of publication of this periodic report, to increase its holdings of DBS to approximately 58.36% pro rata its investments.

⁵ At full dilution 33.66%

As a result of this, the Company recorded a capital gain in the full amount of the consideration which was received, in the sum of approximately NIS 139 million (of which, NIS 35 million was in 2004 and NIS 104 million was in 2005). The taxes applied to these capital gains will be at the tax rates commonly applied to capital gains in Israel.

In this regard, see Note 9C to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

Satellite Communications Operations

On February 14, 2006, the Company signed a memorandum of understanding (MOU) with a foreign investor regarding the sale of the Company's satellite communications operations (Inmarsat and BezeqSat) and assets related to such operations, in consideration for nine million US dollars.

Completion of the transaction is contingent upon execution of a final agreement between the parties, and upon consents and approvals, both internal and external, including by the competent organs of the parties, of the Ministry of Defense, the Ministry of Communications and the Antitrust Commissioner.

If the transaction is completed, the Company is expected to record a capital gain in respect of it of approximately NIS 30 million (before tax).

In this regard, see Note 9F to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

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 Company's financial statements for the year ended December 31, 2005, included in this periodic report).

1.2.1 Fixed-line domestic communications

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 mobile radio-telephone services (cellular communications), 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 Others

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 terminal equipment and private exchanges. Total revenues from this sub-segment in 2005 amounted to approximately NIS 249 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 2005 amounted to approximately NIS 55 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 2005 amounted to approximately NIS 32 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 On June 1, 2004, via the Company's prospectus of May 24, 2004, the State of Israel offered 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.

1.3.2 In 2005, the State of Israel completed the process of sale of the core of its control of the Company, pursuant to the decision of the Ministerial Committee on Privatization, dated July 19, 2004, to the effect that the State's holdings of the Company would be sold by way of private sale of 30% of the share capital of the Company and the grant of options to purchase a further 10.66% of the share capital of the Company.

The State chose Ap.Sb.Ar., which offered NIS 4,237,000,000 for 30% of the share capital of the Company (781,513,683 shares) and an option to purchase an additional 10.66% of the shares of the Company (277,697,862 shares) as preferred offeror. Transfer of the State's holdings to Ap.Sb.Ar. required the receipt of consents under all laws, including the consent of the Prime Minister and the Minister of Communications, under the Communications (Telecommunications and Broadcasts) Law, 5742-1982 (the “**Communications Law**”) and the Communications (Prescription of Essential Service Provided by Bezeq – the Israel Telecommunications Corp. Ltd.) Order, 5757-1997 (the “**Communications Order**”), and the consent of the Antitrust Commissioner under the Antitrust Law, 5748-1988.

Following the “industrial espionage” incident (see in this regard section 2.20.3 below) and disputes that have arisen between the State and Ap.Sb.Ar. regarding the effect of that incident on the Bezeq Group, on July 7, 2005, the Parties reached an agreement regarding various demands made by Ap.Sb.Ar. as conditions of completion of the transaction. Based on a notice from the Government Companies Authority, this agreement has implications on the exercise price of the options received by Ap.Sb.Ar., to the extent that such might relate to and result from the above incident, plus the accrual of interest on the transaction price up to completion of it. For this matter, see the Company's Immediate Reports dated July 10, 2005 and July 14, 2005.

On October 11, 2005 (after obtaining all of the consents required under the law), the aforesaid transaction was completed under the conditions set out in the agreement for sale of the State's holdings in the Company between the State of Israel and Ap.Sb.Ar. (and the holders of interests therein) of such date.

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

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

According to information provided to the Company:

A. Pursuant to the agreement with the State, Ap.Sb.Ar. purchased 30% of the State's shares in the Company and an option for the purchase of up to 277,697,862 of the State's shares in the Company (constituting approximately 10.66% of the share capital of the Company), on the conditions set out in the above agreement, as set out in the Company's immediate reports dated July 14, 2005 and October 16, 2005. The option is exercisable up until the first day of business 48 months after October 11, 2005 (the date of completion of purchase of the Company's shares).

- B. Pursuant to this agreement, Ap.Sb.Ar. shall be entitled to request that the State vote together with it (under the limitations set out in the agreement regarding certain matters) in respect of the 10.66% of the shares in the Company held by the State in respect of which Ap.Sb.Ar. has an option to purchase, and in respect of the 1.01% that will remain in the State's possession during the period commencing on October 11, 2005 (the date of completion of the transaction) and ending at the end of the option exercise period, and in respect of the 4.71% of the Company's shares held by the State and designated for allotment to employees of the Company (see Section 2.9.6 below) – for such period or until transfer of title to such shares to the Company's employees, whichever is the earlier.

As a result of completion of the transaction, the Company has been released from certain limitations that had been imposed upon it as a company under the control of the State of Israel, including repealed and/or amendment of part of the provisions of its articles of association, which are similar to certain provisions of the Government Companies Law, 5735-1975. Likewise, the articles of association of the wholly owned subsidiaries of the Company were also amended, such that, *inter alia*, provisions regarding the number of members of the board of directors and the proceedings of appointment of them, and the composition of committees of the board of directors were amended, and provisions relating to the Government Companies Law (contained in the articles of association of former government subsidiaries) were repealed. Further to such, the directors of the Company's subsidiaries were replaced such that directors were appointed from the ranks of senior management of the Group, subject to the rules of structural separation in the Group.

1.4 Distribution of Dividends

- 1.4.1 In 2004 and 2005, the Company did not distribute a dividend to its shareholders.
- 1.4.2 Pursuant to a resolution of the board of directors of March 1, 2006, resolutions regarding the distribution of dividends are to be passed specifically with respect to the Company's financial results, its financial status and other relevant circumstances and data. This resolution replaces previous resolutions regarding dividend policy.
- 1.4.3 On March 1, 2006, the board of directors of the Company resolved to recommend to the general meeting of shareholders of the Company to distribute a cash dividend to the shareholders of the Company, in the total sum of NIS 1,200,000,193, constituting, as at the date of the distribution, NIS 0.4606446 per share, and 46.06446% of the issued and paid-up share capital of the Company. Under the resolution, the rate of the dividend to actually be paid will be set in accordance with the issued and paid-up share capital of the Company at the end of business on April 2, 2006 (the "Effective Date"). The dividend shall be paid to those shareholders of the Company who are listed on the register of shareholders of the Company at the end of the Effective Date. The "ex" date shall be April 3, 2006 and the payment date shall be April 16, 2006. Withholding tax is to be deducted from this dividend in accordance with the provisions of the law.

A special general meeting of shareholders of the Company on the agenda of which is to be approval of distribution of the dividend to the shareholders of the Company as aforesaid has been convened for March 23, 2006.

- 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.

Further to such, it was clarified to the participants in the privatization proceeding by the Director General of the Government Companies Authority, in a letter dated April 19, 2005, that the position of the Government Companies Authority is that no restrictions will be imposed on the purchase of the core control preventing him from initiating and implementing a distribution with the approval of a court in accordance with Section 303

of the Companies Law, 5759-1999 (reduction of capital). In addition, the Company received a copy of a letter which was sent to the Director General of the Government Companies Authority on April 17, 2005 by the Chairman of the Company Workers Organization, in which the Chairman of the organization informs that participants that the Company Workers Organization sees a distribution pursuant to Section 303 of the Companies Law as contrary to the arrangements with the Company employees and that any attempt to reduce the capital will meet the strong opposition of the employees. However, a document of principles executed between Ap.Sb.Ar. and the Workers Organization prior to transfer of control from the State to Ap.Sb.Ar. (see Section 2.9.5 below), contained reference to the issue of reduction of capital and agreement might be reached with the Workers Organization in this regard.

1.5 Financial Information on the Group's Areas of Activity

1.5.1 2005:

	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	4,457,189	4,413,421	795,176	1,200,865	232,035	–	11,098,686
From other areas of operation in the segment	266,545	14,854	21,488	20,997	104,511	(428,395)	-
Total	4,723,734	4,428,275	816,664	1,221,862	336,546	(428,395)	11,098,686
Total attributed costs:							
Costs not constituting revenues in another area of operation	3,811,200	3,779,328	641,192	1,224,599	325,289	–	9,781,608
Costs constituting revenues from other areas of operation	61,261	182,782	77,494	96,798	10,060	(428,395)	-
Total	3,872,461	3,962,110	718,686	1,321,397	335,349	(428,395)	9,781,608
Operating income	851,273	466,165	97,978	(99,535)	1,197		1,317,078
Total identified assets as at December 31, 2004	8,217,243	4,834,849	683,068	1,348,813	254,166	(185,581)	15,152,558
Minority percentage in the segment					25.1% (GoldNet)		

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

1.5.2 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 attributed 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% (GoldNet)		

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

1.5.3 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% Goldnet		

* 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.

The Israeli communications market is characterized by a high level of concentration and a complex structure of cross-ownerships which are a fertile ground for the setting up of a number of communications groups operating on the basis of marketing cooperation between a number of companies and/or joint holdings for the supply of inclusive communications services, whilst exhausting the marketing and operating advantages that such a structure permits. Given the regulatory limitations imposed upon the group in the context of generation of cooperation between all of the members of the Group, the Group will have difficulty providing appropriate responses to threats stemming from this sort of competitive structure.

2. Fixed-Line Domestic Communications – “Bezeq” – The Israel Telecommunications Corp. Limited (“the Company”)

2.1 General Information Regarding the Area of Operations

2.1.1 Area of activity and changes affecting it

The Company has a general license for the provision of fixed-line domestic communications services. 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; maintenance and development of infrastructures; internet access services between users and ISPs; and other activities, including sale of terminal 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 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.

2.1.2 Legislative and regulatory restrictions and special constraints

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

The tariffs for the Company's main activities are subject to strict regulation under various provisions of the law. The tariffs are updated and change from time to time in regulations, *inter alia*, according to recommendations of the Committee for the Regulation of Bezeq's Tariffs. Recently, on June 1, 2005, the tariffs were amended. The interconnectivity tariffs were reduced as of September 1, 2005, and as of November 1, 2005, some of the Company's tariffs were amended in order to retain “rounded” tariffs, following the reduction of the VAT rate. For these updates, see section 2.16.1. (For a description of the updating mechanism, see Note 1E(1)A to the Company's financial statements for the year ended December 31, 2005, which are included in 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 (see Section 2.16.8 below), the Pharmacists Regulations (Radioactive Elements and their Products), 5740-1980 and the Non-Ionized Radiation Law, 5766-2005 (see Section 2.15 below).

With regard to this Section, see also Section 2.16 below.

2.1.3 Changes in the volume and profitability of the activity

	2005	2004	2003	
Revenues (NIS millions)	4,724	4,960	5,230	
Operating income	851	971	907	
Average monthly revenue per line (NIS) (ARPL) ⁽¹⁾	102	107	111	
Number of active subscriber lines as at the end of the year (thousands)	2,857	2,897	2,914	
Total minutes of use in Israel (incoming outgoing) (millions)	21,485 ⁽²⁾	23,278 ⁽²⁾	28,837	

⁽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. 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 7.8 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). For developments in competition in the various domestic fields, see Section 2.6.

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, such as voice services, video transmission services and network services with organizational applications over the internet infrastructure (ERP, CRM, etc.).

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

The development of standardization in this area makes it possible to use the infrastructure owned by the Company which is currently in place in order to provide higher quality telephony services than in the past as an alternative to the telephone line services that the Company supplies to its customers.

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. In addition, wireless technology is being developed which opens the gateways for providing services that compete with the Company's services, in the area of voice calls as well as data communications and broadband internet, without the need to invest heavily in land-based access infrastructure.

D. 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 operations and changes therein

- A. The ability to offer reliable communications systems at a competitive price based on a cost structure that is adjusted to the frequent changes in the Company's business environment.
- B. The ability to maintain innovation and technological leadership, and to translate those into advanced, reliable applications of value to customers, within short response times.
- C. Technological and marketing innovation.
- D. Efficacy of internal and external sales systems and distribution channels.
- E. The ability to provide high quality commercial and technical service to customers of the Company.
- F. 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.
- 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 such

The main entry barrier in the domestic fixed-line communications market is attributable to the need for substantial investments in technological infrastructure and complementary systems until economies of scale are achieved, and from the high costs involved in establishing marketing, sales and customer support systems. In recent years the traditional entry barriers to the Company's areas of activity have been to a great extent removed, as a result of the following factors: Technological improvements, a decline in prices of infrastructure and equipment; 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 Communications Order based on section 4D of the Communications Law; its obligation to some of its employees as part of collective bargaining agreements; long-term agreements with infrastructure providers; large investments requiring a long time to ROI; and an obligation to repay long-term loans taken to finance the investments.

2.1.8 Alternatives to and changes in sectoral products

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

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

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

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

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

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

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

In the field of telephony, 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 of 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 at the date of publication of this periodic report, a license as aforesaid has been given to 012 Telecom Ltd. Furthermore, according to the amendment of the Communications 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. In November 2004, The Ministry of Communications issued a policy paper on the provision of telephony services over broadband access services (by the Company and by HOT), the policy being subject to a hearing. Likewise, the Ministry of Communications 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. With regard to this matter, see Section 2.6.4 below.

Competition in the sector is dependent on a variety of factors, including: development of competition with HOT, 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 their competitors; mergers and joint ventures between companies that compete against companies in the Group; financing of the universal service; new services the Company will be allowed to provide; tariff policy and the amount of flexibility the Company is given in offering service packages, including along with subsidiaries etc.

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

2.2 Products and Services

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

2.2.2 Telephony

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

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

The Company currently operates approximately 13,900 public telephones around the country that are operated by biodegradable prepaid cards ("Telecard"), billing a Bezeqcard or calling collect. In 2005, draft regulations were compiled, designed to ease the obligation of deployment of public telephones, but the draft was not approved by the

Knesset Economics Committee, which resolved that the Ministry of Communications should submit a revised draft.

In 2003, the Company submitted a request to the Ministry of Communications to terminate its Bezeqcard service (post-paid calling cards) and received the Ministry's agreement to such in principle. Some time later, the Ministry changed its view and on June 7, 2005, the then Minister of Communications handed down a ruling that the Company would not be allowed to cease providing the Bezeqcard service.

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

The Company's telephony services are among the main services provided by the Company, and in recent years they have been on a downward trend, in terms of both use and revenues. This is due primarily to the alternative services offered by the cellular companies and use of cellular phones 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 2005, the Company had approximately 800,000 ADSL subscribers (compared with approximately 650,000 subscribers at the end of 2004 and approximately 771,000 subscribers as at September 30, 2005), amounting to approximately 65% of the broadband internet market in Israel (based on items in the Israeli media regarding the number of subscribers who are not subscribers of the Company).

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

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

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. As at the end of 2005, there were 77 such lines.

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, and provision of rights to use underwater cables.

B. Satellite and broadcasting services

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

Likewise, the Company provides users over a broad geographical area around the world with various kinds of mobile satellite communications services (such as: telephony, data communications and facsimile services) by operating a ground station for the provision of Inmarsat services in the Ella Valley. These services are granted by virtue of an agreement with Inmarsat Ltd. (which operates a satellite network that covers most of the world, land, air and sea). With respect to the Inmarsat Station, see Section 1.1.6 and Note 9F to the Company's financial statements for the year ended December 31, 2005, 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 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 sub-networks for various customers (such as the Ministry of Defense, cable television companies, radio and television broadcasting companies, cellular operators, international communications carriers, local authorities, municipalities and government agencies).

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. The Company also provides billing and collection services to another (sixth) carrier, on similar conditions, although no agreement has been signed with it. 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 enforcement of collection. Additionally, the Company provides collection and sales services to terminal equipment resellers 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 million and as a percentage of total revenues) over the past three years:

	2005		2004		2003	
	NIS millions	% of revenues	NIS millions	% of revenues	NIS millions	% of revenues
Telephony	3,093	65	3,223	65	3,462	66
Internet	550	12	505	10	440	9
Transmission and data communication	691	15	674	14	692	13
Other services	390	8	558	11	636	12

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) around the country.
- 2.5.2 The Company primarily markets its services through advertising in the mass media and telesales centers, customer managers and through a system of independent marketers that includes ISPs, sales centers working by an outsourcing model, D2D and resale 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 the service the Company provides to 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 that the Company might comply with such. As at the date of publication of this periodic report, the standards have not been adjusted as aforesaid.
- 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 (hereinafter 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, interconnectivity fees for termination of the calls on said networks would not be paid. For additional information on this, see Note 1E(1)D to the Company’s financial statements for the year ended December 31, 2005, which are included in this periodic report.

Competition with HOT is increasing, and is expressed, *inter alia*, in offers by HOT which combine broad band internet, telephony and cable television, aimed mainly at households. In addition, HOT markets telephony services to business customers. According to media reports, HOT’s telephony service has more than 80,000 customers, as at the end of 2005.

Following the adoption of the recommendations of the Kroll Commission, which was appointed to set guidelines for competition in the area of fixed-line telecommunications, and the accompanying legislative amendments, as of September 2004, the Minister is 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. On December 25, 2005, such a special general license was granted to 012 Telecom Ltd. (in the Golden Lines Group). To the best of the Company’s knowledge, Cellcom and GlobeCall have also applied to the Ministry of Communications to obtain such a license.

VOB⁶ Service Policy

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**”). According to the policy paper, the intention was to enable VOB services to 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.

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 then Minister of Communications, demanding another thorough investigation of the matter, along with careful study of all aspects and its significant implications. The Company once again 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

⁶ Voice Over Broadband

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.

The Ministry of Communications has, *inter alia*, notified the Company and its subsidiaries on 20.4.05 that in completing preparation of the policy and following study of the remarks submitted in response to their enquiries, it is considering making an amendment to the policy paper so that the Company or a subsidiary of the Company will be able to provide VOB services after the Company's market share in fixed-line domestic telephony in a particular customer segment falls below 85%. In addition, the Ministry intends to set two review dates, in November 2006 and November 2007, to look into the possibility of permitting the Company or a subsidiary of the Company to provide VOB services even if the Company has not lost 15% of that market share, noting the developments in competition in the field of telephony.

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

The hearing of this matter at the Ministry of Communications has not yet finished.

Concurrent with publication of the policy document regarding VOB, trial licenses were granted for marketing of VoIP services in return for payment to a number of entities, including Golden Lines, Barak 013 and Bezeq International (which was recently extended to the end of August 2006, the notice of extension stating that if the policy that is set does not allow Bezeq International to provide VOB services, then the trial license will expire).

Following a joint discussion at the Ministry of Communications between the Company and the carriers wishing to operate this service, the Ministry of Communications issued a directive to activate the dialing directions and numbering ranges allocated for use of the trial marketing licenses on the Company's network. In another letter from the Ministry of Communications, it was clarified that the Company will not bear "expenses in kind" of the trial, and that if additional payment is determined as part of the VOB policy, that payment will apply retroactively also for the trial period. As at the date of publication of these Reports, dialing directions have been opened to three licensees (one of which is the subsidiary Bezeq International Ltd.) and the Company is in advanced negotiations with another trial licensee for connecting it up to the Company's network.

See also Sections 3.7.2 and 4.1.5 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 the private sector.

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. Completion of the transaction by Partner to acquire the operations of Med-1, if and when completed, might make competition in this field stronger, whilst harming the Company's revenues from services that it provides to Partner.

In September 2005, the Accountant-General published a tender for the provision of data communications services to government ministries and adjunct units in an amount that covers a significant portion of the data communications market in Israel. The Company filed an administrative petition, applying to cancel or amend the tender. The court dismissed the application to cancel the tender, but cancelled a principal condition which related to the method of weighting the price of offers and instructed the Accountant General to rethink the issue, and to examine the Company's allegations. Following the judgment, the Company asked the Accountant General to summon representatives of the Company who might plead for it. The Accountant General dismissed the Company's application to make claims before him, and sent an amended decision regarding the price weighting. The date for submission of bids was set down for March 1, 2006. Likewise the Company filed an appeal in the Supreme Court against the judgment, and an application to stay execution, claiming that not only had the Court ruled in the judgment that the tender was being held in contravention of the principles of tender laws, and was harmful to equality, confidentiality and competition, but the final decision did implement the aforesaid findings in such a way as to ensure that the harm to the Company would be reduced. The Supreme Court ruled that the Accountant General should submit his response to the application to stay execution by March 2, 2006, and should make reference therein to the possibility that the envelopes submitted not be opened prior to the date of ruling on the appeal, and that hearing of the appeal be brought forward.

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. Recently, the declining trend in the number of voice minutes over the Company's network has flattened out *inter alia* as a result of a slow-down in the rate of growth of the cellular companies. 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 14% 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 declared its intention of entering competition in the market for domestic communications, under certain conditions, and has recently submitted, to the best of the Company's knowledge, an application for a special general license for provision of domestic fixed-line communication services. 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 could 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 onto 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 Communications 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 have been unified.

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

Notwithstanding the Company's position, and to the best of its knowledge, that of other licensees, that it is not possible to meet the timetables prescribed in the draft transferred to the licensees, including the Company, a numbering plan to implement number portability was signed by the Ministry on August 22, 2005. In this regard, see the Company's immediate report dated August 24, 2005, and Note 1E(1)F to the financial statements of the Company for the year ending December 31, 2005, included in this periodic report.

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

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

will facilitate customer transition from the Company's network to the networks of its competitors, is liable to adversely influence the Company's ability to compete.

No response has been obtained to the Company's letters to the Ministries of Communications and Finance. On December 18, 2005, the response of the Minister of Finance to the Company's letter of December 13, 2005 arrived, stating that he saw no room to postpone implementation of the law in this regard. On January 1, 2006, the chairman of the forum of carriers wrote to the Minister of Finance requesting a hearing for all of the carriers regarding the timetables, and proposing to amend the law so that final implementation be postponed by one year. On January 12, 2006, the Company responded to the letter from the Minister of Finance, noting that he undertake to hold a hearing for the carriers. The Company also suggested that the law be amended so that the Minister of Communications be given authority to postpone implementation of the plan until at least the end of 2007.

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

B. Other potential competing infrastructures

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

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. Note that some municipalities are attempting to create an alternative to the laying of pipelines by communications licenses, via the infrastructure held by such municipalities.

On January 31, 2006, the Ministry of Communications published a request to receive public positions regarding the policy of allocation of frequencies to the wireless access network by February 28, 2006. According to the Ministry, following applications from existing licenses and commercial entities for allocation of frequencies for the purpose of operating a wireless access system in order to provide a variety of fixed-line communications services, the Ministry is considering amending its policy on allocation of frequencies for the purpose of operating wireless access systems, which will enable the provision of fixed-line communications services.

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.

The Company's assessment that real competition will develop in the market, harming market segments, rests on frequent technological developments and breakthroughs in the various fields of communications. Technological progress is expected to enable competing companies to introduce technology quickly at a relatively low cost, which will enable supply of telephony and data communications services over private and public IP networks, as well as via advance cellular infrastructure, and advanced generation wireless infrastructure.

Another competitive factor is the "Bezeq-bypass networks". There are two main types of bypass networks: (1) those built on the Company's infrastructure –

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

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, among other reasons, to increase the volume of use of subscriber lines, respond to customer requirements and enhance the image of technological innovation. The Company invests in improving and modernizing its infrastructure in order to be able to provide its subscribers with advanced services and products.
- B. The Company took action to introduce broadband (high-speed) internet services using ADSL technology and is working to 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 its services and to preserve its customers, and since the end of 2005, these activities have been run as a special project, which focuses solely on them.
- 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 disputes the position taken 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 rescission of the existing agreements and the calling in of the guarantee pending hearing of the case.

On March 28, 2005, the High Court of Justice ruled that the interim order staying rescission of the agreements between the Company and business customers be left in place pending further ruling. However, in the same ruling, the High Court of Justice stated that there was nothing to prevent forfeit of the sum of NIS 8 million by the Ministry of Communications, out of the bank guarantee given to it by the Company. As at the date of publication of this report, the Ministry of Communications has not taken any action relating to forfeit of the guarantee. "Hot-Telecom" has been joined as a respondent in the petition. On November 17, 2005, a hearing was held in the petition, and as at the date of publication of this report, a ruling has yet to be handed down.

- 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 achieving its marketing and business-related goals. Notwithstanding the foregoing, the Company's ability to make adjustments in its expenses in the short and medium term is limited due to its cost structure, which mainly comprises rigid short- and medium-term costs. These costs consist principally of depreciation expenses and expenses related to salary and benefits. Furthermore, the Company has other operating costs such as infrastructure maintenance and leasing as well as maintenance of buildings, which are also rigid short-term costs.
- I. At the end of 2005, a change administration was set up at the Company in order to implement changes in the organizational structure of the Company, the purpose of which was to make the Company more compliant with a competitive market, by focusing on customers, and achieving operational and procedural efficiency.
- J. The Company is looking at how it will integrate itself into a process which is hitting most of the communications companies around the world, to deploy a unified infrastructure, under a network topology known as the Next Generation Network (NGN) for transmission of voice communications, high-speed internet communications and content, leisure and entertainment applications.

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. Tariffs that are among the cheapest in the world.

Negative factors

Regulation

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

A. Obligation of structural separation

Under its license, the Company must maintain full structural separation, in the form set out in the license, between itself and those subsidiaries and affiliated companies that are specified in the license. 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. There is also a separation between the Company's operations and those of Pelephone due to the conditions of the merger approved by the Antitrust Commissioner.

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 tariff flexibility

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

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 packages containing all communications services.

D. Universal service obligation

The Company is obligated to provide universal service to the entire public in 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 this universal service, so that a carrier that does not provide service to any party requesting it will pay into the fund through which the universal service will be funded.

E. Cross-subsidy

Due to regulation, the Company's 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 yet the competition relies on Bezeq's infrastructure and takes advantage of the access subsidy (such as VOB Services), so the negative impact of this factor has grown.

Labor relations

The Company's labor relations make flexibility of its operations and its ability to deal with competition more difficult. 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.

Cost structure

The Company's cost structure is based on a relatively high component of hard expenses which will be difficult, in the immediate future, to adjust to the increasingly harsh conditions of competition.

Competition

The extent to which competition impacts on the Company (including positive implications) and on its revenues is dependent on a variety of factors, including the following: the rate at which competition with the cable partnership and other domestic operators develops; increased competition with cellular operators; the final policy set regarding provision of telephony services over broadband infrastructure; the ability to

leverage the synergy between companies in the Group and the flexibility the Company will be given to offer joint packages of services and to determine its tariffs; tariff erosion; approvals for new services, and allowing the Company to implement applications, services and transfer of content enabled via advanced technology (such as: IPTV), combination of fixed-line and mobile services; financing of the universal service; changes in licenses; symmetry in structural separation obligations; implementation of economies of scale; the ability to retain and increase its portion in the various areas in communications.

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. Terminal Equipment

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

2.7.3 Computing

The Company's IT system supports four central areas:

A. Marketing issues

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

B. Information systems for engineering infrastructures of the telecommunications networks

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

C. Information systems for management of Company resources

Support management, control and maintenance of the expenses of the Company, financial information (including budget and controls), procurement and inventory

processes, property, real estate, human resources and wage controls, vehicle fleet, Company projects, etc.

D. Cross-organization systems

Support decision-making processes via a data warehouse system (DWH) operated by the Company. The Company also has an internet site which provides information regarding the Company's services, and allows for the presentation of information regarding 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 infrastructure, computers and various other kinds of equipment) and the information system (software, applications, information systems, etc.). The hardware system includes a central computer, a collection of servers, information storage units, a communications network and a collection of terminal stations which serve all of the 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 amounts of data. The system is made up of a large number of systems, some of them old systems developed many years ago, operating on central computers, and some of them modern systems developed and implemented in recent years, operating in open computer environments.

2.7.4 Real Estate

A. General

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

The Company owns or has long-term leases over some 415 real estate assets around the country. The total area over which the Company has full title or capitalized long-term lease rights (including joint long-term lease rights), amounts to some 710,000 m² of land, of which some 370,000 m² is built up. Six of these properties are in Israeli settlements in Judea and Samaria, approximately 7,000 m² in area, with a total of 500 m² being built up.

In addition to those properties, there are another 14 properties, with a total area of 1,585,000 m², 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 long-term, 66 of them 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 some 126,000 m² of built-up land on plots totaling close to 130,000 m² (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 2.17.2(c) below).

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

Furthermore, the Company holds some 75 properties in Israeli settlements in Judea, Samaria and the Gaza Strip, in a total area of approximately 10,500 m² of land, on which about 1,800 m² 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 development, and can be exploited further.

The Company leases about 130 land assets, with a total area of 77,000 m², of which 72,000 m² are built-up, from various lessors.

The Company has easements (rights of way, etc.) over other real estate (i.e. in order to erect transmitters and deploy cables). The Company also has about 330 concentration rooms at its disposal (rooms for cables and installations for the purpose of neighborhood communications), with a total area of approximately 4,400 m², 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 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 (by 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 leases that will be renewed every two years. 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 at the date of publication of this periodic report, of the abovementioned assets, the Company has returned 10 assets to the ILA.

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 the properties under long-term lease, 66 are held jointly by the Company and 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 2.17.2(c)). Note that over the years (both before and after the Settlement), the Company has sold approximately 20 assets (in whole or in part) out of the properties under long-term lease, such that as at the date of this periodic report, there are approximately 200 assets in this group of assets.

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 (as at the date of publication of the periodic report, approximately 20 lease contracts for assets under this category have been signed between the Company and the ILA); the Company's rights in properties are to be long-term 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 long-term 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 long-term 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 of developing and exploiting those of its land assets which are currently undeveloped or partially undeveloped, for instance by exploiting additional building rights, amending plans under the Planning and Building Law, or sale of assets. 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 license 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 Trade Marks

The Company uses trademarks that reflect its products and services.

As of the date of this periodic report, the Company has approximately 50 trademarks registered in its name at the Registrar of Patents and Trademarks. The main trade marks are:

“**Bezeq**” – Company name.

“**B BEZEQ**” – Company logo.

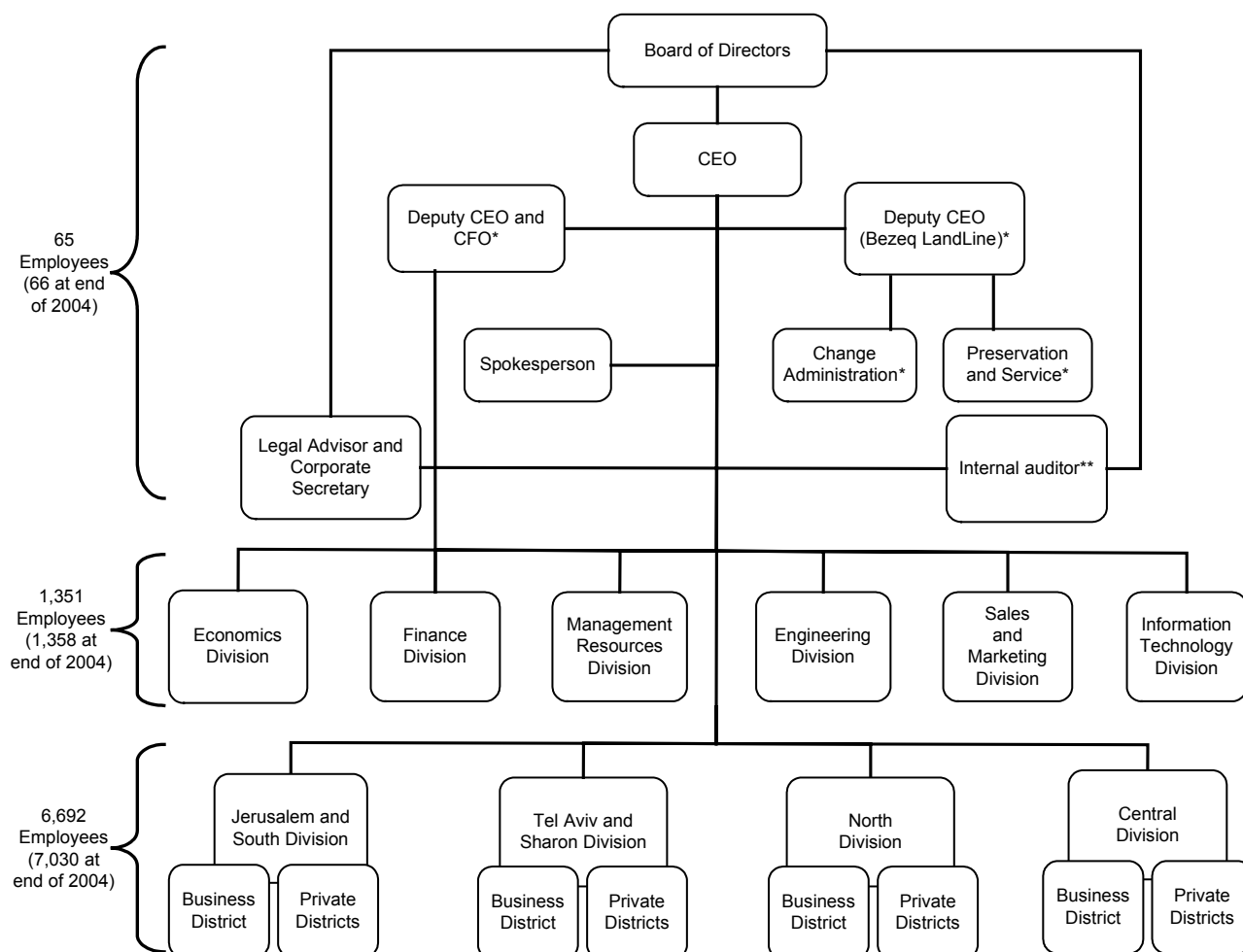
“**WOW**” – access to the Company's high speed internet services.

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 Capital

2.9.1 Organizational structure and personnel based on organizational structure (as of December 31, 2005)



* As of the end of 2005.

** Pursuant to a resolution of the board of directors of the Company, in terms of organizational structure, the auditor reports to the chairman of the board of directors.

The Company is working in coordination with the workers' organization in order to bring about a change in the Company's organizational structure, with the aim of making the Company compatible with the competitive market in which it operates, by focusing on the customer and achieving operational and procedural efficiency. In this context, a change administration is working in the Company on concentrating and coordinating the change plan, responsible for designing the new organizational structure, for designing the new processes, for determining the necessary human resources and job descriptions, and for preparing the implementation and adaptation plan. The change administration is also responsible for defining indexes and goals and coordinates the work of all of the Company's improvement teams operating on a variety of core issues.

2.9.2 Personnel according to employment framework

Employment Framework	Number of Employees		Description of Employment Framework
	As at December 31, 2005	As at December 31, 2004	
Contracts for senior executives	84	87	Managers excluded from application of the Company's collective bargaining agreements. Their terms of employment are set in personal agreements.
Permanent	3,995	4,079	Employees employed through collective bargaining agreements.
Inclusive salary agreements and personal contracts	1,012	942	Employees employed through personal contracts that are not part of the collective bargaining agreements.
Ranking contracts	264	185	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	36	39	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	2,702	3,104	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	15	18	Employees employed through personal contracts for a period of up to 5 years in a track that will result in permanent status.
Total	8,108	8,454	

2.9.3 Orientation and retirement of employees from January 1, 2005 through December 31, 2005

Employment Framework	Intake	Retirement
Senior Contracts	6	11
Permanent	–	133
Ranking contracts	–	7
Age contracts	–	3
Temporary	–	3
Overall salary contracts	42	62
Generation 2000	643	818
Total	<u>691</u>	<u>1037</u>

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 2005 was approximately 38,000 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's total investment in training activity in 2005 amounts to approximately NIS 4.2 million and approximately NIS 1.73 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. A rights anchoring agreement dated September 4, 2000 (see Section 2.17.4(c) below) provides that all collective bargaining agreements, including arrangements and binding procedures, are to remain in force until December 31, 2006.

It should be noted that in the agreement regarding the sale of the core control of the Company, Ap.Sb.Ar. undertook to act to the best of its ability, by virtue of its holdings in the Company, 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. Furthermore, even before completion of the transfer of the State's holdings in the Company to Ap.Sb.Ar., a document of principles was signed between Ap.Sb.Ar. and the workers' organization in preparation for a detailed agreement between the Company and the workers' organization (the "document of principles"), which contains reference to changes in the organizational structure of the Company relating to retirement and/or firing of employees, employee rights, reduction of capital whilst maintaining the Company's financial strength, and employee remuneration. As at the date of publication of this report, negotiations have been commenced between management of the Company and the workers' organization regarding these matters.

Following the change in control of the Company, on January 3, 2006, a letter was sent from the Ministry of Finance to the Company confirming that the Company was exempt from the provisions of section 29 of the Elements of the Budget Law (in force as of October 11, 2005, which was the date of transfer of control in the Company from the State to Ap.Sb.Ar.). Upon receipt of the aforesaid exemption, the Company is no longer linked to the public sector in terms of conditions of employment of workers. The Company intends to adopt a wage policy that will accord with the Company's ability and its performances.

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

2.9.6 Employee reward schemes

On November 15, 2005, the Company published an outline of an offer of the State's shares to employees of the Company. The offer is for up to 122,697,648 options, exercisable for up to 122,697,648 shares of the Company held by the State of Israel and

constituting approximately 4.71% of the shares in the Company, and exercisable in three equal portions after approximately two years, three years and four years following the date of allotment. In this regard, see Note 1G to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

In addition, in the document of principles set out in clause 2.9.5 above, Ap.Sb.Ar. Undertook to act to sign an agreement stating, *inter alia* and subject to execution of an inclusive agreement under such document of principles, the Company will issue options for the purchase of approximately 4% of the shares in the Company to employees (not including senior management), at a reduced exercise price of 80%.

2.9.7 Company officers and senior executives

As of the date of this periodic report, the Company has 13 directors and 15 senior executives.

The two external directors currently on the board of directors of the Company receive remuneration in accordance with the Companies (Rules Regarding Remuneration and Expenses for External Director) Regulations, 5760-2000. Following the change in control of the Company, and the termination of office of the directors who acted for the Company prior to the transfer of control (with the exception of the external directors), remuneration is no longer paid to directors in accordance with the Government Companies Regulations.

For the management agreement between the Company and a management company held by the shareholders of Ap.Sb.Ar., see Note 27 to the financial statements of the Company for the year ended December 31, 2005, included in this periodic report.

Members of senior management are employed under personal agreements.

2.10 Raw Materials and Suppliers, Purchase of Equipment and Suppliers

2.10.1 The main raw materials used by the Company are: exchanges, copper cable, fiber-optic cables, transmission equipment, data communications systems and equipment, servers, routers and XDSL routers. The Company purchases most of the equipment required for its communications infrastructures from Israeli companies connected with communications equipment manufacturers from around the world. The Company purchases hardware and software from a number of main suppliers. Most of the equipment purchased for data communications, switching, transmission and radio systems 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 2005 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 until the end of March 2007.	Approximately 6%
Public switching equipment	Alcatel	1. Purchase agreement until 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 5%
Transmission equipment	Supplier D	Framework agreement for purchase and maintenance until the end of March 2006.	Approximately 12%
IP/VPN – IT equipment and integration work	Supplier E	Framework agreement that can be extended each year until the end of 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 2005:

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

2.12 Investments

For information on investments in subsidiaries, see Note 8 to the financial statements for the year ended December 31, 2005, which are included in this periodic report. See also Sections 3 and 4 in Chapter 4 of this periodic report.

2.13 Financing

2.13.1 Average interest rate on loans

As at 31 December 2005, the Company is not financed by any 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 + 0.62%
Non-banking sources	CPI linked NIS	4.71%
	Euro	6.43%
	Non-linked NIS	Bank of Israel interest + 0.5%

2.13.2 Limitation on receipt of credit

A. With respect to limitations on Company loans – see Notes 13 and 14 to the Company's financial statements for the year ended December 31, 2005, 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	856	CPI-linked NIS

2.13.4 Credit received after December 31, 2005

The Company has not taken any loans since December 31, 2005.

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, 2005):

Type of linkage	Change mechanism	Financial scope	Interest range in 2005	Current interest rate
Dollar and dollar-linked	Libor – USD	564	2.13%-4.75%	3.94%-4.75%
Euro and Euro-linked	Libor – EUR 6M	30	2.13%-2.2%	2.13%
Shekel	Bank of Israel interest	36	3.5%-4.1%	4%

Note:

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

2.13.6 Credit rating

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

Rating Agency	Rating	Changes in Rating	Type of Credit Rated
Maalot	AA	March 28, 2005 – AA rating received (no change in rating) May 10, 2005 – rating on watch list, where agency will examine the affect of transfer of control of the Company and the business and financial strategies implemented by the purchase of the core control of the Company on the Company's rating, its conclusions to be published at the end of the examination process.	All series of debentures*
Midrug	Aa1 (Watch List)	March 24, 2005 – Rating changed from Aa1 (Watch List) to Aa1 (Negative). May 16, 2005 – rating moved to Watch List for examination of possibility of downgrading rating.	Debenture series (4) and (5)
Standard & Poors	BBB+	May 10, 2005 – rating moved to Creditwatch, with negative implications. October 11, 2005 – rating downgraded to BBB and to remain on Creditwatch, with negative implications. February 28, 2006 – rating remains at BBB+ and rating taken off Creditwatch. Negative rating outlook.	Eurobonds

Rating Agency	Rating	Changes in Rating	Type of Credit Rated
Moody's	Baa1	March 7, 2003 – change of rating from A3 (Stable) to A3 (Negative). October 11, 2005 – rating downgraded to Baa1 and kept on review for possible further downgrade. February 6, 2006 – rating left at Baa1 and outlook stable.	Eurobonds and other foreign bonds

* 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 (2006) and sources of financing

The Company is expected to repay some of its loans in 2006. 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.

2.13.8 Liens and guarantees

For information regarding the Company's liens and guarantees, see Note 19C to the Company's financial statements for the year ended December 31, 2005, 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, 2005, which are included in this periodic report.

2.15 Environmental Protection

2.15.1 Regulations on facilities emitting electromagnetic radiation and proposed legislation

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 to regulations or conditions stipulated in the permit is cause for cancellation or suspension of the permit.

2.15.2 The Non-Ionized Radiation Law, 5766-2006

On January 1, 2006, the Non-Ionized Radiation Law, 5766-2005 (the "**Law**") was published in *Reshumot*, having been passed by the Knesset on December 20, 2005. The commencement of most of the provisions of the Law was set down for one year following publication.

The Law regulates the handling of sources of electromagnetic radiation (hereinafter: "Radiation Source"), the erection and operation of them and supervision of them. *Inter alia*, the Law provides that the erection and operation of a radiation source will require a permit; imposes penal provisions and severe provisions with respect to liability of officers; imposes recording and reporting obligations on a permit-holder and grants the Commissioner for Radiation supervisory powers, including with respect to the conditions of the permit, cancellation of the permit and removal of the Radiation Source. Note that the Company's installations, such as broadcast installations or wireless communication installations, are included under the definition of Radiation Source.

The Law also sets out provisions regarding broadcast installations for cellular communications (hereinafter: "**Cellular Installations**") only, under which regulations are to be made within one year of publication of the Law, regarding safety distances from cellular installations and regarding the procedures for applying for building permits for cellular installations.

The Law includes Amendment No. 75 to the Planning and Building Law, 5725-1965, which provides that a planning institute is to be entitled to demand, as a condition for

the grant of permits to erect cellular installations, deeds of indemnity against claims for compensation under section 197 of the Planning and Building Law, 5725-1965, and until provisions are made in this regarding the National Outline Plan, such demand shall be in accordance with the guidelines of the National Planning and Building Council. This provision applies as of the date of publication of the Law.

Further to the aforesaid amendment of the Planning and Building Law, on January 3, 2006, the National Planning and Building Council decided to instruct the local planning committees that, as a condition for the grant of a permit for a cellular installation, they must demand that an applicant for such a permit give a deed of indemnity at a rate of 100% of compensation payments that the committees may be charged with in claims under section 197 of the Planning and Building Law, if so charged, for harm due to the erection of a cellular installation. The form of the deed of indemnity was attached to that decision. The decision is in force until provisions are made in this regard in the National Outline Plan, NOP 36.

For the decision of the National Planning and Building Council of January 3, 2006 regarding the method of amending NOP 36 as aforesaid, see Section 2.16.11(d) below.

The Company is getting ready to adjust its work practices and the licensing of its installations to the provisions of the Law.

For the references in the Law and the implications of the Law to cellular installations, see also 3.18.1.3 below.

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

2.15.4 With regard to claims filed regarding the Hillel broadcasting station – see Note 19A(8) to the financial statements for the year ended December 31, 2005, which are included in this periodic report.

2.16 Limitations and Regulation of Company Activity

The Company is subject to a series of laws which limit its commercial operations. The main body which supervises the Company's operations as a communications company is the Ministry of Communications.

On April 6, 2005 a letter was sent to the Director General of the Government Companies Authority by the Director General of the Ministry of Communications, containing clarification for the parties that participated in the process of privatizing the Company. As set out in the document, it contained explanations of the main questions raised by the entities that participated in the privatization process, based on the Ministry's present policy of promoting competition in communications and in the provisions of the law and existing licenses, and noted that such should not be grounds for expectation or reliance on the part of the participants.

The main points of the clarifications in the document appear in an immediate report of the Company dated April 11, 2005. As the Company noted in that report, it believes that the clarifications contained in the Ministry of Communications Clarification Document did not significantly reduce the regulatory uncertainty in which the Group and the Company operate. In addition, in the Company's opinion, there has been no progress in a number of issues, the examination of which the Ministry of Communications announced in its clarification document, and it has given notice to the Ministry that these delays are making it difficult for the Company to make preparations for the increasing state of competition.

In this regard, see also Note 1E(1)G to the financial statements of the Company for the period ended December 31, 2005.

2.16.1 Regulation of Company tariffs

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

A. During the course of 2005, there were statutory amendments regarding the Company's tariffs, as follows:

1. On April 11, 2005, an amendment to the Communications Law was published under the Economic Policy for Fiscal 2005 (Legislative Amendments) Law 5765-2004, which prescribed a uniform supervision mechanism (tariffs to be

set by the Minister of Communications with the consent of the Minister of Finance) regarding the Company's supervised services.

2. This mechanism was set out in Section 15, which provides that "the Minister, with the consent of the Minister of Finance is authorized to determine by regulation the payments for services provided to subscribers by the Licensee." (Hereinabove and hereinafter: the "supervised services").
 3. In an Order dated May 31, 2005, the application of the Supervision of Prices of Commodities and Services Law, 5755-1996 was cancelled, having previously applied to part of the supervised services and having prohibited a person from selling a service during the course of his business at a price that is different from the price fixed.
- B. The tariffs for the Company's supervised services, stipulated in the aforesaid 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.
- C. Pursuant to section 15A of the Communications Law, if tariffs are stipulated for the supervised services under the above Section 15, the Minister may, with the consent of the Minister of Finance, approve the request made by the Licensee for an "alternative payment basket" for a package of services.
- D. Under Section 17 of the Communications Law, "a Licensee may request a reasonable payment for a telecommunications service for which no payment is stipulated in Section 15." For these types of services provided by the Company (including broadband internet access service, business access, etc.) the Company sets tariffs and informs the Ministry of Communications of them in accordance with its general license. For additional provisions in the general license regarding tariffs, see Section 20.16.2C below.

2.16.2 The Company's general license

The Minister's policy paper

On March 31, 2004 a comprehensive and far-reaching amendment was made to the Company's general license, by virtue of which the Company, *inter alia*, operates. The then Minister of Communications attached a policy paper to said amendment regarding the ability of the Company to offer discounts for size and service packages. On January 9, 2005, non-significant 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 Communications Law. Such size discounts will be determined by way of an alternative basket of payments according to Section 15A of the Law. The discount shall not apply to the services for which discounts higher than 10% are set today in the regulations.

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

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

In the clarification letter sent by the Ministry of Communications in April 2005 to bidders in the process of privatizing the Company (see preamble to Section 2.16 above), the Ministry stated that the reporting format for measuring market volume would include, as well as the central parameter of revenue, other relevant parameters as well such as numbers of subscribers, lines, call minutes, etc.

On February 22, 2006, the Ministry of Communications notified the Company, HOT and 012 Telecom of its intention to activate a current reporting mechanism, as of May 15, 2006, regarding various parameters on the basis of which the Company's market share would be determined. The Company intends to hold an urgent discussion with the Ministry of Communications in order to clarify issues relating to the method of calculating measurement of the market share, and relief that may be given to the Company upon the loss of such market share. In the Company's opinion, immediate clarification and regulation of these matters are essential if it is to be able to cope with competition.

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 company⁷, 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 Communications Law, the Company shall not

⁷ Parent company, subsidiary, interested party, affiliated company, related company or partner.

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

For the numbering plan and number portability, see Section 2.6.5A 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.

With respect to the dispute between the Company and Cellcom on payment of interconnectivity fee, see Note 1E(2)A to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

H. Arrangements in the field of security

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

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

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

For the Bill to amend Section 13 of the Communications Law so that the prisons service be included as part of the security forces, and to add section 13A to the Communications Law dealing with the power of the Minister of Communications to instruct a licensee in terms of emergency, see Section 2.16.12 below.

I. Liability and insurance

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

J. Control and reporting

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

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

K. Miscellaneous matters

The general license includes "cross-ownership" restrictions.

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

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

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

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

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.

On July 14, 2005, the Company's general license and the licenses of other operators were amended. The amendment to the license prescribed that the Company must act in accordance with the Israeli Standard regarding reliability of bills and due disclosure in telephone accounts. In addition, provisions that are different from those in the aforesaid standard were prescribed regarding rounding off of sums in bills. Under the amendment, the provisions of the standard regarding due disclosure in telephone bills will come into force by October 14, 2005, whilst provisions relating to reliability of billing will come into force by January 14, 2006. The Company's license was amended in this manner, despite the fact that the Company expressed its opinion to the Ministry that there is no room or justification for the standard in its proposed format, and certainly not for changing it, by adopting it in the license, into a binding standard, bypassing the statutory mechanism set out in the Standards Law. Likewise, the Company clarified that implementation of the standard involves investment of considerable resources, technical difficulties and the effecting of broad based changes to core systems, which cannot be done at the same time as implementation of the number portability program, and that it needs a longer period of time to implement the standard. The Company is prepared to implement the standard in accordance with the amendment of its license, however, at the same time, it contacted the Ministry of Communications and gave notice to it that it would not be able to meet the dates set out for implementation of the standard under the amendment of the license, and asked that the matter be presented to the Ministry in order that the Company's request for a longer preparation period may be re-examined. On October 16, 2005, the Director General of the Ministry of Communications notified the general licensees, including the Company, that in light of the importance of the matter to consumers, there would be no delays in implementation of due disclosure. In this regard, on November 28, 2005, the Company once again gave notice to the Ministry that the components required under the standard appear in the bill issued by the Company, with the exception of one particular component, which shall be supplemented upon completion of development of the Company's billing system, within about a year, as it had warned prior to amendment of the license, due to technological realities and specific difficulties. In the interim period, until completion of such, the Company publishes its principal call tariffs in a prominent manner which, in its opinion, causes it to be in compliance with the purpose of the standard.

2.16.3 Royalties

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

The regulations that entered into effect on January 1, 2001, Telecommunications (Royalties) Regulations 5761-2001 (hereinafter: the "Royalties Regulations"), expanded the revenue base on which royalties must be paid, while at the same time gradually reducing the rates. Under the regulations, any party that received a general telecommunications license for the provision of fixed-line domestic services (including the Company), international telecommunications services and cellular services must pay royalties on revenues (without VAT) from the subscriber services in the Schedule to the regulations, including revenues from these services in Judea, Samaria and the Gaza Strip (except for areas in the Palestinian Territory) and including revenues from the provision of these services to the security forces under Section 13 of the Law. The revenues on which royalties must be paid as stipulated in the Schedules 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 terminal 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. Thus, for instance, from April 1999 through to 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 licenses and asked the Company to reconsider its position and transfer a total of approximately NIS 17 million to the Ministry by January 1, 2005. The Company replied to the Ministry of Communications that it maintained its legal stance and that the Ministry had not given reasons for its decision, and had not responded to the claims and data presented in this regard by the Company to professional staff at the Ministry. The Company also requested an urgent meeting with the Director General of the Ministry of Communications regarding this matter, and that the payment demand be stayed until such meeting is held. On February 19, 2006, the Ministry of Communications' response was sent to the Company stating that the Ministry of Communications sees no reason to hold additional discussions on the matter and asking that the Company provide it immediately with the royalty payments as aforesaid. In this regard, see also Note 19A(20) to the Company's financial statements for the year ended December 31, 2005, included in this periodic report.

With respect to the amendment of the Royalties Regulations regarding compensation for the "Bill and Hold" arrangement with HOT, see Note 1E(1)D to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

The Economic Policy Law, published on April 11, 2005, imposes license fees and royalties to the collection of fees under the Communications Law and The Wireless Telegraph Ordinance (New Version) 5732-1972 (hereinafter: the "Telegraph Ordinance") and the Tax Ordinance (Collection) 1929. The significance of the amendment is the addition of a means of enforcing said payments.

On May 2, 2005, the Company received a copy of a letter dated April 20, 2005 sent by the Director General of the Ministry of Communications and the Deputy Supervisor of Budgets at the Ministry of Finance to the Director General of the Government Companies Authority, setting out the position of the Ministries of Communications and

Finance on the matter of the obligation of the holders of international telecommunications licenses and of fixed-line domestic telecommunications licenses to pay royalties. According to the letter, following the recommendations of the committee for formulating policy and rules for opening fixed-line communications to competition, against the background of the proceeding for sale of the State's Holdings in the Company and as part of the preparations for the implementation of the number portability service throughout the entire telecommunications sector, the Telecommunications (Royalties) Regulations are to be amended by the Ministries and brought for the approval of the Minister of Communications, the Minister of Finance and the Knesset Finance Committee, as required by law, so that commencing January 1, 2006, a reduction of 0.5% will be made each year in the rate of the royalties paid by those licensees until reaching a rate of 1% in 2010. As at the date of publication of this report, the Regulations have not yet been made. On December 22, 2005, the Company sent a letter in this regard to the Director General of the Ministry of Communications and to the Commissioner for Budgets at the Ministry of Finance, asking for them to intervene in the immediate application of the aforesaid amendment, so that the date of determination for commencement of the gradual reduction of the rate of royalties would be January 1, 2006, as required. The Company is also waiting for an amendment to the Royalties Regulations to the effect that an exemption be given, as of January 1, 2004, from payment of royalties for revenue from certain data communications services under competition, as the State had undertaken to the Court in a hearing of the petition submitted by the Company against it.

2.16.4 Authority with respect to real estate

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

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

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

2.16.5 Immunities

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

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

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

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

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

- (1) By non-provision, delay, restriction or discontinuance of telecommunications services and accessory services as arises out of an intentional act of the Immune Licensee insofar as such act is necessary to the performance of a telecommunication operation or the provision of a telecommunications service;
- (2) 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. (Under the Civil Wrongs Ordinance, in any action other than negligence, a public servant will have a defense if the act was within the lawful field of their authority or was committed by him in good faith and he understands that he was acting within the scope of his lawful authority).

2.16.6 Regulations and rules under the Communications Law

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

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

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

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

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

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

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

The Commissioner's declaration of the Company as a monopoly constitutes *prima facie* evidence of the terms thereof in any legal proceeding, including criminal proceedings. Therefore, a plaintiff - being a person or consumer organization - who seeks to sue the Company - 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 before 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 wanted to withdraw the aforementioned appeal, and on November 18, 2004, the appeal was expunged.

- 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.

Since September 1998, the Company employs an officer to oversee internal compliance with the Antitrust Law, 5748-1988 (hereinafter: the "Antitrust Law").

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

2.16.8 The Wireless Telegraph Ordinance

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

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

The frequency fees were raised in 1999, some by 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 42 million (appropriate provisions have been included in the financial statements).

2.16.9 Proposed legislation regarding termination of contractual relations

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

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 a Schedule 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 Schedule those types of transactions which, if rescinded unilaterally, could cause injury to the consumer, such as a basic telephony service.

2.16.10 Bill regarding class actions

The Knesset is currently in the process of legislating regarding class actions, as part of a government bill and a private member's bill. The above Bills cancel the individual causes of action for filing class actions set out in individual laws, expand the possibility of filing class actions greatly, and it is the Company's position that they do not impose appropriate barriers that might enable the filtering required to prevent wasting of resources caused by sham claims. The Company and other entities have contacted the chairman of the Constitution, Legislation and Justice Committee and the Speaker of the Knesset and have expressed their opinion that the drafts of the above Law are severely harmful to potential defendants and might expose all of the large commercial bodies in Israel to unnecessary claims of immense size, thereby shaking the foundations of the entire economy.

2.16.11 Establishment of communications installations - National Outline Plan 36

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

B. NOP 36A

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 for Radiation regarding 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 a permit from the Commissioner on Radiation regarding all of the 74 small broadcasting installations erected under a permit issued prior to the approval of NOP 36A to the relevant licensing authorities, building permits have been obtained for 51 other broadcasting installations in accordance with NOP 36A, and the Company is working to receive permits from the relevant licensing authorities for a further 23 small broadcasting installations. Due to intensive activities being done at the Company regarding the obtaining of permits, and due to the termination of operation of certain installations, the number and class of sites change from time to time.

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

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 under 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 has submitted its objection to the inclusion of said provision in NOP 36B.

D. General

For Amendment No. 75 of the Planning and Building Law, 5725-1965, which includes a requirement to deposit deeds of indemnity for cellular communications broadcast installations, and the decision of the National Building and Planning Council of January 3, 2006 given in respect thereto, see Section 2.15.2 above, and sections 3.18.1.3 and 3.18.3.3 below.

The decision of the National Planning and Building Council of January 3, 2006 also provided that a committee of drafters of the NOP, in a new composition which has been prescribed, would examine the recommendations of the committee of directors general of the relevant government Ministries, regarding the deployment of cellular broadcasting installations under NOP 36A, with reference to the issue of indemnity, would recommend the making of amendments to the issue of the deed of indemnity under NOP 36A, and the decision that it comes to regarding indemnity would apply, *mutatis mutandis*, to NOP 36B as well.

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

2.16.12 Bill to amend Section 13 of the Communications Law

On November 22, 2005, the Ministry of Communications sent general licenses, for their comments, a bill to amend Section 13 to the effect that the prisons service be included as part of the security forces, and to add a Section 13A to the Communications Law regarding the power of the Minister of Communications to give instructions to a licensee during emergencies. This comes after a discussion in the Economics Committee of the Knesset, held after the Bill had passed first reading. On November 24, 2005, the Company provided the Minister of Communications with its comments, to the effect, *inter alia*, that extreme situations and other situations included in the definition of "emergency" should be distinguished, that the licensees should be heard and that the provisions regarding payments as a result of performance of the provisions should be amended.

2.17 Substantial Agreements

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

2.17.1 Debentures

A. 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.

B. 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. The debentures were issued prior to the Prospectus to institutional investors and to Bezeq Zahav Holdings and listed for trade according to the Prospectus.

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

On March 30, 2005, another addendum to this deed of trust was signed between the Company and the Bank Mizrahi Trust Company Ltd. for the issue of NIS 286,967,000 par value debentures in the same series.

C. 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 annum. The interest is paid in annual installments, on August 8 each year, from August 8, 2001 through August 8, 2007.

2.17.2 Real Estate

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

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

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

See Section 2.7.4C above.

C. Agreement between the Company and the Israel Postal Authority

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

2.17.3 Various agreements with DBS and its other shareholders

A. 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.

2.17.4 Labor agreements

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

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

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

For information regarding this agreement, see Note 16D(1) to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

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

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

For this, see also Section 2.9.5 above.

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

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

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. Agreements regarding 'encouragement of growth' (May 22, 2003 and May 3, 2005)

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. Under the agreement, wages of Company employees were reduced in the period following July 2003.

On May 3, 2005, a special collective bargaining agreement was executed between the Company, the Workers' Organization and the Histadrut. Under that agreement, a one-time grant was paid to employees of the Company after completion of the sale of the State's holdings in the Company, in the amount of part of the sum of the reduction of wages under the Israeli Economy Recovery Plan Law, and under the collective bargaining agreement to encourage growth in the economy.

F. Contract dated April 17, 2005 with substitute body replacing the Makefet Fund with respect to early retirement arrangements for Company employees

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

In addition, on June 28, 2005, an agreement was entered into between Harel Insurance Company Ltd. ("Harel") and the Company. The contract regulates payment of pensions for early retirement and provisions for old-age and survivor pensions deriving from legislative amendments under the Israeli Economy (Recovery Program) Law for employees who retired from the Company from the end of 2003 / beginning of 2004 and/or who will retire from the Company in accordance with the special collective agreement for retirement of September 2000 as amended on March 18, 2004 and on April 17, 2005. Following execution of the agreement with Harel, the special collective agreement between the Company, employee representatives and the General Trade Union as aforesaid was amended on the same date (June 28, 2005).

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

In this regard, see also Note 16D(1) to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

For a description of all of the Company's collective bargaining agreements, see Section 2.9.5 above.

2.18 Legal Proceedings

For information regarding legal proceedings, see Note 19 to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

2.19 Business Strategies and Goals

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 as the leading telecommunications company in Israel, while providing end-to-end solutions to business customers and creating a user experience for private customers, and providing quality service and business excellence.

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

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

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

Business customers

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

Private customers

- A. Continuing to penetrate broadband and improving infrastructures to increase bandwidth;
- B. Providing differential pricing tracks;
- C. Strengthening the positioning of the Company's telephony services, while focusing on advanced applications and penetration of advanced terminal equipment.

Network:

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

- A. The Company is examining the issue 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 real estate potential.
- B. The Company is examining a policy that will allow a significant increase in bandwidth to customers by bringing the fiber closer to the customer home and integrating new technologies.

Changing organizational structure

For the Company's plans regarding changes to its organizational structure, see Sections 2.6.6(i) and 2.9.1 above.

2.19.3 Development trends in Company activities

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

- B. The Company is working towards integrating itself in IP (Internet Protocol) applications. It has therefore set up an IP network to serve as a platform for the services it currently provides and the additional services it plans to offer in the future.
- C. The Company is 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 part of 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 set out in Section 1.3.2 above, in 2005, the State of Israel completed the process of sale of the core of its control of the Company, pursuant to the decision of the Ministerial Committee on Privatization, dated July 19, 2004, to the effect that the State's holdings of the Company would be sold by way of private sale of 30% of the share capital of the Company and the grant of options to purchase a further 10.66% of the share capital of the Company.
- 2.20.2 Upon completion of the privatization process and the Company's changing from a 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 have been removed.
- 2.20.3 The "Industrial Espionage" Incident
- 2.20.4 In May, 2005, the media published that the Israel Police Force was conducting an enquiry regarding "industrial espionage" via computer systems in which, according to such publications, the subsidiaries of the Company – Pelephone, Bezeq International and DBS – were also involved. As a result, senior employees of those subsidiaries were called in for inquiry and/or to give evidence. In response to that: (1) Pelephone notified that neither it nor its employees had any connection to the obtaining of information by unlawful means, that it and its employees were surprised by the publications and that they would cooperate with the Police in order to clarify the facts in the incident. (2) Bezeq International gave notice that it would provide the Police with all assistance required, and that it would not have assisted or touched material obtained in unlawful ways. And (3) DBS gave notice that if offenses were committed against the law, they were committed in express contravention of its instructions and that it had not sufficed with entry into an oral contract with the investigation company, but rather, had had the investigation company sign an unequivocal undertaking to act only in accordance with

the law, and the investigation company had undertaken that it and all those taking part in the agreement with it would act in accordance with the law. For this, see also Sections 19A(41) below.

It should be noted that a number of senior employees of the Company were summoned immediately after publication of the incident to give evidence to the Police regarding confidential documents of the Company which were found in the possession of competitors, and to evaluate the level of damage expected to be incurred by the Company as a result of such. The Company examined the matter and took immediate steps in order to reduce the danger of information being taken out of the Company as best it could.

On the implications of this incident on the privatization of the Company, see Section 1.3.2 above.

With respect to legal proceedings as a result of this incident – see Note 19A(40) to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

2.21 Risk Factors

A. Mounting 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 – has also 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 adversely affects its 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 Supervision of Prices for Commodities and Services Law. 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 Organization 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. 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. 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, and this gives rise to high management overheads. The Company is, at this stage, unable to offer joint service packages together with said companies. Due to the coming into being of communications groups in this field, which are not restricted in respect of such joint ventures, the level at which this risk factor affected the Company's operations has risen with the development of competition.

G. 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 legislative proceedings on the matter of class actions see Section 2.16.10 above).

For a description of the legal proceedings, see Section 2.18 above, which refers to Note 19 to the Company's financial statements for the year ended December 31, 2005, included in this periodic report.

H. 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 exchange rate fluctuations. That said, the Company has not fully neutralized its exposure to exchange rate fluctuations, by converting its liabilities denominated in foreign currency and/or linked to the consumer price index, to shekel-denominated liabilities.

I. Electromagnetic radiation and licensing of broadcast installations

The issue of electromagnetic radiation emitted from broadcasting installations is regulated both in the Pharmacists Regulations, in the Non-Ionized Radiation Law, 5766-2006 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 obtain permits to build and operate its various broadcasting installation, however, the difficulties it faces in this activity, including difficulties related to the change in policy maintained by the various relevant organizations, 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.

J. Frequent technological changes

The field of communications is characterized by frequent technological changes and shortening of the economic lifespan of new technology. These trends mean that the entry barriers are lowered for new competitors, that depreciation rates increase and in certain cases, technology might become obsolete as might the networks owned by the Company, the cost of investment in which is still recorded on its balance sheets.

Risk Factor 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 / licensing of broadcast installations		X	
Frequent technological changes		X	
Special Risks Faced by the Company			
Exposure in legal proceedings		X	
Difficulties in labor relations	X		
Restrictions on relations between the Company and companies in the Bezeq Group	X		
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 field 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 terminal equipment, and the operation and maintenance of equipment and systems in the cellular communications field. Pelephone's revenues include, *inter alia*, the charging for MRT communications customers (payments for call minutes, regular subscriptions, added value services and migration services, payment for the sale of terminal equipment and in respect of terminal equipment services) and revenues from other communications providers for interconnect (see sub-paragraph 3.18.2).

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 license

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 permitted to collect from its subscribers are regulated 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

Pursuant to its license and to the Bezeq Regulations (Royalties), 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 specified in the Regulations, foremost among which are: revenues from interconnect, payments transferred to the owner of an MRT operator for migration services, revenues from the sale of terminal equipment and bad debts related to revenues on 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%. 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%. As at the date of this periodic report, these Regulations have not yet been made.

3.1.2.4 Environmental 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):

	2005	2004	2003
Revenues (NIS millions)	4,428	4,412	4,055
Operating profit (NIS millions)	472	559	210
Number of subscribers at end of period ⁸ (in thousands)	2,343	2,132	1,955
Average use minutes per subscriber (MOU) per month	341	330	325
Average monthly revenue per subscriber (NIS) (ARPU)	139	153	160

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 – 2005 among the "youth" community, which today stands at more than 30%.

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 in a reduced manner, and as of July 2005, the service is able to be marketed in full, without limitation. This service enables subscribers to initiate calls at the press of 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(2) to the Company's financial statements for the year ended December 31, 2005, 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 terminal equipment supporting GSM/UMTS which will permit the reduction of prices of terminal 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:

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

⁸ Subscriber data relate to active subscribers having received or made at least one call in the past six months.

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 from this field 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.

VoIP technology-based telephony services are likely to be substitutes for cellular services in areas where local wireless networks provide coverage.

3.1.9 Structure of competition in the sector and changes therein

Until the end of 1994, Pelephone was Israel's sole cellular company (until the end of 1993 – by virtue of the company's license and on its behalf⁹). 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**"). As of 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 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

⁹ The change was actually made in April 1994 and was applied with retroactive effect to the beginning of 1994.

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 2004 and 2005, revenues from value added services constituted some 7% - 8% correspondingly, of its revenues from Pelephone services and terminal equipment services. 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. At present, more than 70,000 subscribers use 3rd generation services.

- 3.2.2 Pelephone provides roaming 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. During 2005, Pelephone began supply of dual handsets which support CDMA and GSM technology. The handsets will provide an additional solution to roaming services in other countries where the network is not CDMA.
- 3.2.3 Pelephone offers its customers ongoing repair service, against a monthly payment, providing warranty for the cellular telephone.
- 3.2.4 Pelephone offers its customers various types of mobile telephone and auxiliary accessories (hereafter – terminal equipment). With the launch of the 3rd general EVDO technology services, Pelephone commenced providing its customers, in 2004, with terminal 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):

	2005		2004		2003	
	NIS millions	% of revenues	NIS millions	% of revenues	NIS millions	% of revenues
Revenues from Pelephone services and terminal equipment services	3,704	84%	3,773	86%	3,506	86%
Revenues from the sale of terminal equipment	724	16%	639	14%	549	14%
Total	4,428	100%	4,412	100%	4,055	100%
Percentage of gross profit	23%		26%		20%	

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 youth, consumers of "mobile entertainment" and multimedia services (see Clause 3.1.4).

As at the end of 2005, 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 approximately 3,500 independent sales, service and marketing personnel, approximately 100 points of sale (some of which are operated by Pelephone employees and others of which are operated by independent resellers) and 38 service and sale points around the country, which deal in service and sale to customers, handling of faults, repair of handsets and sale of services and handsets, and in addition, there are also service representatives for the business sector.

Pelephone's subscriber service system includes 10 call centers which provide information, service on various matters, technical support, data regarding customer billing and general information.

Up 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.

At the end of 2005, these two divisions were unified into a single customer and private sector service division. Purpose-based service and sales operations are integrated at all points of contact with customers.

3.7 Competition

3.7.1 Pelephone faces fierce competition from the 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 real prices throughout the market. 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, 2005, Pelephone has approximately 2.3 million subscribers. To the best of Pelephone's knowledge, as at December 31, 2005, Cellcom has approximately 2.5 million subscribers, Partner has approximately 2.4 million and MIRS has approximately 370,000 subscribers¹⁰.

3.7.2 On June 3, 2004 the Communications (Telecommunications and Broadcasts) (Processes and Conditions for Obtaining a General Special License) Regulations 5764-2004 were published. Under the aforementioned Regulations, an application may be filed for a special general license, i.e. for a license for the provision of domestic fixed line telecommunications services, which does not involve an obligation to provide service to the entire public everywhere in Israel. Pelephone, as a subsidiary of 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.

The Company's license imposes restrictions on it in all matters pertaining to cooperation with its subsidiaries. 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 carriers.

The Ministry of Communications some time ago gave notice, as part of a process of final formulation of its policy regarding the field of licensing of supply of telephony services by way of a broad band access service (VOB), of its intention not to permit the

¹⁰ 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.

companies in the Bezeq Group (including Pelephone) to take part in this field so long as the Company's portion of the fixed-line domestic telephony field in the segment of certain customers does not fall below a given threshold, or earlier taking into account the situation of competition in the field, after an examination to take place at examination stations on the timeline and on prescribed dates. Pelephone objects to this policy and is of the opinion that it should be treated as an independent body, due also to the existence of the restrictions imposed upon it regarding joint marketing with the Company. Pelephone is waiting to present its arguments in a hearing before the Ministry of Communications. Pelephone has submitted an application to the Ministry of Communications for the effecting of a marketing trial of VOIP technology, and in response, the Ministry noted that it could grant Pelephone a license for such trial subject to conditions, that main ones of which would be a provision in the license that if at the end of the hearing the policy document is amended, such that Pelephone is prohibited from providing VOB services, the trial license shall expire. A draft of the license has been approved by the Ministry of Communications and upon provision of a guarantee by Pelephone in favor of the State, it will be given an experimental license. (In this regard, see also Section 2.6.1 above)

3.7.3 On March 22, 2005, the joint Finance and Economics Committee of the Knesset approved an amendment to the Communications (Telecommunications and Broadcasts) Law, 5742-1982 to the effect that the Minister of Communications is to prepare a numbering plan regarding number portability with respect to a general licensee for provision of MRT services and a licensee for domestic fixed-line communications services, and to instruct them regarding the implementation and activation of it by September 1, 2006 (this date may be extended to December 31, 2006). The licensee is to be required to provide number portability for any subscriber that may request such, and is to do all of the acts required for such purpose without any payment from the subscriber or from any licensee. Implementation of the number portability plan will impose costs on Pelephone, the complexity, scope and implications of which cannot yet be assessed. In addition to the anticipated costs as aforesaid, implementation of the number portability plan is expected to affect competition in the field. As at the date of writing this Report, Pelephone, and to the best of Pelephone's knowledge, the other cellular companies and the Company as well, are not in compliance with the timetables, and notice in this regard has been given to the Ministry of Communications from all of the companies. The Ministry of Communications has not given notice of any change in the timetables. (In this regard, see also Section 2.6.5 above).

3.7.4 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.

3.7.5 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 terminal equipment based on that technology, can make use of their terminal equipment also in other countries whose networks employ that technology and do not need to hire special terminal equipment.

3.7.6 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. Pelephone is subject to restrictions on entering into additional fields of activity and on expanding its customer service baskets, which do not apply to the competitors.
- B. There exists a restriction on joint activity with the Company in the marketing of joint service packages.
- C. CDMA technology does not enable as full enjoyment of roaming services as competitors provide.

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 season. 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, electronic equipment, computers and software systems, motor vehicles, terminal 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 – 2005 served primarily to replace and upgrade the network to 20001XR TT CDMA and EVDO technology.

3.9.1.2 Pelephone operates two communications networks using three technologies:

- A. Digital technology using CDMA2000 1XR TT. This is a state-of-the-art technology and its advantages are the ability to provide advanced services, greater capacity for talk calls and data for a given quantity of frequencies and fast data communications (up to 144KB). Today more than 99% 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 outdated technology which has not undergone network development processes and today less than 1% of Pelephone customers use cellular instruments making use of this technology.

The three technologies operate on the same frequency range allocated to Pelephone. At the beginning of 2002, the board of directors of Pelephone decided to upgrade the densely populated urban area to CDMA2000 1XR TT technology, using equipment manufactured by Nortel. 1XR TT 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 1XR TT 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 approximately 1,410 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 depreciation period of the equipment is determined on the basis of engineering opinions based, *inter alia*, on generally accepted practice in various other countries.
- 3.9.1.5 Pelephone's infrastructure equipment is manufactured by Nortel and Motorola. Each of Pelephone's digital switching networks is manufactured by Nortel, and 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.
- 3.9.1.6 At the end of 2003, the Pelephone Board of Directors resolved to upgrade the CDMA2000 1XRTT network to EVDO technology by means of the addition of a special-purpose carrier for data communications in the urban areas of Israel. This technology enables communication between the network and the terminal equipment at rates of up to 2,400 KSS and between the terminal 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 approximately \$44 million. Deployment of the network under the contract commenced in June 2004 and is to be concluded in the first quarter of 2006. Concurrent with the set up of the network, a portal was established for video services, enabling customers to watch live broadcast channels, to download music clips, entertainment and news files, etc. This portal is the key service using EVDO technology.
- 3.9.1.7 In 2005, Pelephone acquired equipment from Nortel, in a long-term transaction for 2005-2007, for the expansion of its network, including 150 sites and equipment to upgrade the capacity of the network. The transaction is for approximately 20 million dollars, of which the 2005 portion is approximately 11 million dollars. In addition, another transaction – for 4 million dollars – was also entered into with the purpose expanding capacity and making it comply with the 2006 plan.

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 subparagraph 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 are used by the company for 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. In this regard, see Note 8D(2) and Note 10 to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

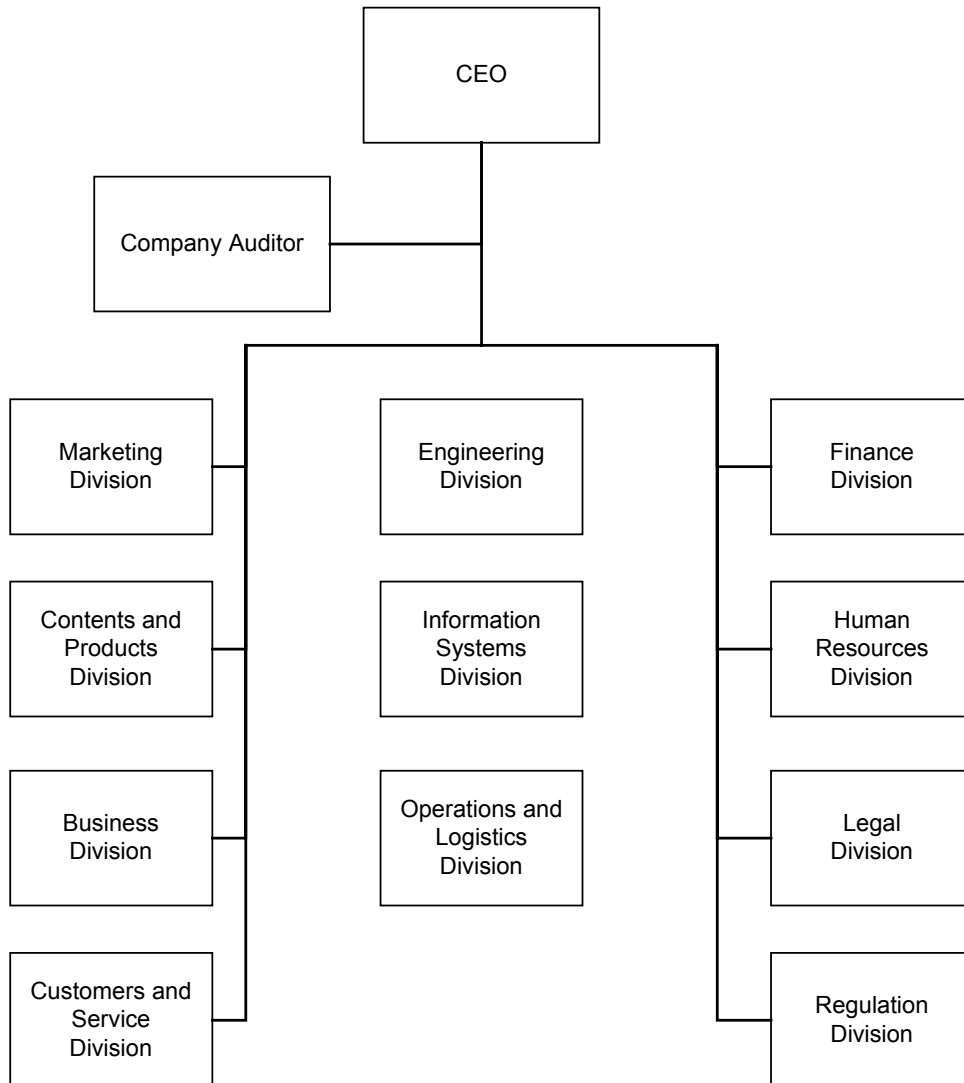
3.10.3 Trademarks

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

3.11 Human Capital

3.11.1 Organizational Structure

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



In the final quarter of 2005, a number of organizational changes took place at Pelephone:

The CEO of Pelephone ceased to hold office and was appointed CEO of the Company;

The Deputy CEO of Pelephone was appointed CEO of Pelephone;

The Senior VP Operations and Customer Services at Pelephone ceased to hold office and was appointed Deputy CEO of the Company;

The Chairman of the Board of Directors of Pelephone ceased to hold office;

The VP Terminal Equipment ceased to hold office and the Terminal Equipment Services Division was united with and taken over by the Logistics and Operations Division;

The organizational structure of Pelephone changed as a result of these changes, as set out above.

3.11.2 Table of organization

The following details the number of employees¹¹ in Pelephone in accordance with its organizational structure.

Division	Number of employees	
	31.12.05	31.12.04*
Headquarters and management	218	219
Marketing and Product Content Division	84	92
Customer Service and Private Sector Division	2,472	2,554
Business Division	390	375
Operations and Logistics Division	405	438
Engineering and Information Systems Division	571	556
Total	4,140	4,234

* Presented again (due to changes in organizational structure of company).

3.11.3 Changes in the number of employees during 2005

At the end of 2005, Pelephone's manpower stands at approximately 4,140, compared with approximately 4,230 at the end of 2004.

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 2005 and 2004 in respect of instruction and training amount to NIS 12 million and NIS 13 million, respectively.

3.11.5 Employee reward schemes

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 and in accordance with the type of work done by the employee.

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.

For changes to the board of directors following the change in control of the Company, see Section 1.3 above. Following the appointment of the CEO of Pelephone to the position of CEO of the Company, changes also took place to management of Pelephone.

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). Pelephone also maintains inventory of spare parts for the purpose of supplying repair services to its customers and an inventory of used handsets.

Total acquisitions of terminal equipment in 2005 amounted to NIS 958 million. Pelephone acquires the terminal 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 terminal equipment it supplies, the availability of the spare parts and the turnaround time for repairs.

¹¹ The number of employees represents the number of jobs as calculated by Pelephone (total work hours divided by monthly work-hour standard).

These agreements include a commitment to make acquisitions, which are implemented regularly by means of purchase orders.

If a contract with a particular terminal equipment supplier is discontinued, Pelephone may increase the quantity purchased from other terminal equipment suppliers or procure terminal equipment from a new terminal equipment supplier. If the replacement of a supplier is required, as aforementioned, the replacement shall not be immediate, and shall be subject to a special preparatory period for purchasing spare parts and accessories, including the repair capacity for all types of faults required, in order to enable the provision of service to customers as agreed.

Replacement of a supplier shall involve additional extraordinary expenses as a result of such equipping. The splitting of terminal equipment purchases between suppliers does not create significance dependency on any one supplier or equipment model.

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 2005, the inventory level stands at an amount of approximately NIS 199 million.

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

Pelephone provides service, warranty and maintenance for terminal equipment in accordance with the level of service and repairs 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 installments.

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

As at 2005, average customer credit amounts to NIS 1,234 million.

3.13.3 Credit from suppliers

Pelephone receives credit from its suppliers for periods ranging from 30 days to 90 days. As at 2005, average credit from suppliers and various creditors amounted to NIS 612 million.

3.14 Investment in Investee Companies and in a Partnership

As at September 30, 2005, Pelephone held 85% of the B-one partnership (hereinafter: the "Partnership"). At the end of the third quarter, it was resolved to wind up the Partnership. As of the fourth quarter, Pelephone has taken over management of the undertakings given by the partnership. See Appendix A (Section 8) to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

3.15 Financing

3.15.1 Pelephone's operations are financed out of shareholders' equity, long- and short-term bank loans, debentures and supplier credit.

The average interest rate in 2005 for undesignated loans was:

	Short-term loans	Long-term loans (including current maturities)
Banking sources:		
CPI-linked – NIS	–	4.89
Fixed shekel	4.48	7.18
Dollar	–	4.37
Non-banking sources:		
CPI-linked – NIS		4.65

3.15.2 Restrictions

3.15.2.1 Undertakings towards banks

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 total debts exceed shareholders' equity by more than 2, Pelephone shall not pay out dividends and shall not pay management fees to shareholders. If Pelephone is in breach of this undertaking, it shall, within 120 days of demand, be required to repay the bank all loans outstanding to the credit of the bank at such time, or, alternatively, to amend the breach by increasing its shareholders' equity or repaying Pelephone's loan in such a way that the aforesaid ratio is preserved;
- C. Total debts shall not exceed NIS 3.8 billion (linked to the CPI known as at January 2002). The sum of the debts shall be checked once every quarter in accordance with the financial statements that have been reviewed by accountants;
- D. Not to mortgage Pelephone's assets under a fixed or floating charge, in any manner or way, or of any kind or degree, without obtaining the bank's prior written consent to such;
- E. Not to provide Pelephone's shareholders or any third party whatsoever with any security or charge over the assets of Pelephone or any guarantee to secure credit received by the shareholders, without obtaining the bank's prior written consent to such;
- F. Not to grant Pelephone's shareholders any loan or credit without obtaining the bank's prior written consent to such;
- G. To provide the Bank various information, details and reports;
- H. If Pelephone is 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 Undertakings to foreign bank

Pelephone has given gave an undertaking to a foreign bank not to engage in any transaction or series of transactions under which assets are to 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 such the bank's consent. Likewise, certain instances were stipulated in which the bank may call for immediate repayment of 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 is in breach of its undertakings to comply with the financial criteria as aforesaid.
- (c) If Bezeq ceases to be a controlling shareholder in Pelephone and the lending bank is not convinced that such change does not materially effect Pelephone.
- (d) If any material change takes place in Pelephone.
- (e) If Pelephone pursues any unlawful activity.
- (f) In the event that a competent authority intervenes in the affairs of Pelephone.
- (g) If the management of Pelephone is removed from office or if Pelephone's power to manage its affairs 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 regarding 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 has a right to call in Pelephone's debts to 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 is insolvent or is found by a court to be insolvent.
- (l) If proceedings are instituted against Pelephone such as receivership, liquidation, settlement or arrangement with creditors.
- (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 Immediate repayment of the loan

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

3.15.3 Issue of debentures

On February 27, 2005, Pelephone issued NIS 500 million par value debentures, by way of private placement to institutional investors, in consideration for their par value. The debentures are linked to the CPI, bear annual interest at a rate of 4.4% and are to be paid out in 20 equal semi annual payments commencing as of September 2005.

On June 29, 2005, Pelephone issued NIS 333 million par value debentures, by way of private placement to institutional investors, in consideration for their par value. The debentures are linked to the CPI, bear annual interest at a rate of 4.55% and are to be paid out in 20 equal semi annual payments commencing as of January 2006.

At the time of issue of the debentures, trust deeds were executed by the Company, for the trusteeship of Union Bank of Israel Ltd., which is to act as trustee for the debenture-holders. Pursuant to this agreement, Pelephone undertakes to pay principal, interest and indexation differences in accordance with the terms of the debentures. The debentures are not secured by any charge, and the conditions of the negative pledge and the 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 charges are realized; (D) if an attachment is imposed on material assets of Pelephone; (E) if Pelephone ceases to exist or (F) if Pelephone discontinues its payments or serves notice of its intention to discontinue them. The trustee is entitled to take steps for immediate repayment in order to protect the debenture holders. The agreement moreover determines 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, 2005, Pelephone is meeting its commitments to the banks and to the debenture holders.

No loans have been taken out since December 31, 2005.

3.15.4 Credit limits

The credit limits assigned to Pelephone by Israeli and foreign banks amount of NIS 3.14 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, 2005, Pelephone had utilized NIS 1.35 billion of its credit limit at banks.

3.15.5 Guarantees and charges

See Note 19C to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

3.15.6 Variable interest

As at December 31, 2005, 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

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

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

Pelephone is due to repay a large portion of its loans during 2006, by way of short-term investments and current cash flow. If necessary, Pelephone will raise new loans from banking corporations and/or by raising capital on the capital market.

3.16 Taxation

See Note 11 to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

3.17 Environmental quality

3.17.1 Provisions relating to the Environment – see sub-paragraphs 1.18.1.3 and 3.22.G below.

3.17.2 Anticipated costs and investments

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

3.18 Restrictions on and Control of Pelephone's actions

3.18.1 Statutory restrictions

3.18.1.1 Communications Law and licensing obligation thereunder

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

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

Moreover, the Minister empowered to annul, restrict or suspend a license in a number of situations (see Section 3.18.3.1 below).

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

3.18.1.2 Wireless Telegraph Ordinance

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

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

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

3.18.1.3 Facilities emitting electromagnetic radiation

3.18.1.3.1 Existing regulations

The Pharmacists (Radioactive Elements and Products) Regulations 5740-1980, regulate, *inter alia*, relate to electromagnetic radiation in facilities emitting such radiation, and they are applicable to some of Pelephone's facilities. The setting-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 Legislation

On December 20, 2005, the Non-Ionized Radiation Law 5766-2005 was passed, the commencement of which, for regulating radiation licensing, was set down for January 1, 2007. The provisions of the Law require a re-examination of the Company's preparations regarding compliance with the conditions of the Law, a process which is due to be completed during the course of this year.

3.18.2 Controlled tariffs

Payments for interconnectivity:

The Telecommunications (Payments for Interconnectivity) Regulations 5760-2000 (hereinafter: the "**Regulations**") prescribe limitations regarding payments to be made or to be received from a domestic carrier or another MRT carrier under the Regulations. The tariffs for incoming calls to cellular telephones were scaled down gradually from October 2000 to January 2003. In December 2004, the following regulations were made:

- A. For the purpose of interconnectivity payments received from a domestic operator or from another MRT operator for completion of one traffic minute on an MRT network, the current tariff for call completion is to be scaled down gradually to NIS 0.22 in accordance with the following outline (tariffs do not include VAT):
 1. As of March 1, 2005, the current tariff of NIS 0.45 per traffic minute will be reduced to a maximum tariff of NIS 0.32.
 2. As of March 1, 2006, the tariff will be reduced to a maximum tariff of NIS 0.29.
 3. As of March 1, 2007, the tariff will be reduced to a maximum tariff of NIS 0.26.
 4. As of March 1, 2008, the tariff will be reduced to a maximum tariff of NIS 0.22.
- B. With respect to payments received from an international licensee for completion of traffic on an MRT network, the current tariff of NIS 0.25 for call completion will be reduced, as of March 1, 2008, to a maximum tariff of NIS 0.22.
- C. With respect to payments received from another MRT operator for the transmission of a short message (SMS) on an MRT network, the current tariff will be reduced, in two stages, so that as of March 1, 2005 the current tariff of NIS 0.285 per SMS will be reduced to a maximum tariff of NIS 0.05, and as of March 1, 2006, the aforementioned tariff will be reduced to a maximum tariff of NIS 0.025.
- D. The tariffs in paragraphs (A) to (C) above will be revised once a year, commencing March 1, 2006, in accordance with the rate of change of the Consumer Price Index.
- E. For the purpose of calculating payment for call completion to an MRT network, as of January 1, 2009, the charge will be made in accordance with segments of one

second (unlike the current charging system which enables charging per segments of up to 12 seconds). Consequently, as of January 1, 2009, the payments payable by the MRT operator for interconnect services to a domestic operator's network will also be revised.

- F. Later, the Ministry of Communications intends to examine whether there are justifiable grounds for enabling MRT operators to collect initial payment in respect of the creation of a call.
- G. During the past few months, a hearing took place concerning the intention to restructure the tariff to the consumer for an MRT call in such a way that, as of 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 interconnectivity component. This matter was examined by a joint team from the Ministry of Communications and the Ministry of Finance, with the assistance of Prof. Reuven Gronau. No official decision has been made in this regard.

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: Tariffs are set out in agorot. Prices are rounded off and do not include VAT.

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

3.18.3 License and site licensing

3.18.3.1 Pelephone's license

The General License for the provision of MRT services granted to Pelephone on February 7, 1996 was for a period of 10 years commencing January 1, 1994, with an option of extending it for additional periods of 6 years each, under the conditions set forth in the license, consisting primarily of compliance with statutory conditions. Following the tender in which 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 September 9, 2002.

(For the arrangement with the State of Israel concerning right of use of frequencies, see Note 8D to the Company's financial statements for the year ended December 31, 2005, 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 Pelephone's license (hereinafter: in this Section – the licensee):

- A. Under certain circumstances, the Minister is entitled to modify the conditions of the license, to restrict it or to suspend it, and in certain instances to 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 on the licensee, nor may control in the licensee be acquired, either directly or indirectly, unless the Minister shall have given his consent beforehand.
- C. A shareholder in Telephone or a shareholder in an interested party therein may not charge his shares in such a way that realization of the charge 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 charge may not be realized except with the prior consent of the Minister.
- D. The licensee shall take steps to establish interconnectivity of the network to another public telecommunications network in the State of Israel (including towns, military sites, and military bases in the areas of Judea and Samaria and the Gaza Strip). The licensee is obliged to provide interconnect service on equal terms to any other operator and must refrain from any discrimination in implementing interconnectivity
- E. The licensee shall refrain from awarding preference in the provision of infrastructure services to a licensee being a company with an interest¹² over another licensee, whether for the payment for the service, whether in the conditions of the service, whether in its availability or otherwise.
- F. The licensee is not entitled to sell, to lease or to mortgage any of the assets used for the implementation of the license without the consent of the Minister of Communications, except for:
 - (1) Charging of any of the licensee's assets in favor of a banking corporation duly operating in Israel, for the purpose of obtaining bank credit, provided that notice shall have been served on the Ministry of Communications regarding the lien proposed to be made, whereby there is included in the mortgage agreement a clause ensuring that realization of rights by the banking corporation will not, in any event, result in any damage whatsoever to the provision of the services pursuant to the license.
 - (2) Sale of items of equipment during an upgrade procedure, including sale of equipment by the trade-in method.
- G. The director (under the license: the Director-General of the Ministry of Communications) or whoever he shall have empowered for the purpose of the license, is entitled to issue directives concerning 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 its telecommunications network devices enabling the application of such feature, as instructed by the director.
- H. During states of emergency, whoever shall have been statutorily empowered therefor shall have the authority to issue the licensee with certain instructions as to its mode of operation and/or mode of provision of services.

¹² "Company with an interest" - as defined in the Telecommunications (Processes and Conditions for Obtaining a General License for the Provision of Domestic Fixed Line Telecommunication Services) Regulations 5760-2000. These Regulations define a company with an interest as "a parent company, subsidiary, sister company, interested company, affiliate, related company or partner company" and each of these terms is defined in the Regulations.

- 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 tariffs, in certain cases.
- J. The license commits the licensee to a minimal standard of service, including setting up of service call centers, the determination of a maximum period for repair of malfunctions, an accounts collection procedure, 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), 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 specified in the Regulations, foremost among which are: income from interconnections, payments transferred to the owner of a foreign MRT operator for roaming services, revenues from sale of terminal 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 Minister of Communications and the Minister of Finance intend to amend the Telecommunications (Royalties) Regulations in such a way that as of January 1, 2006, there will be an annual decrease of 0.5% in the rate of royalties, until such is reduced to 1%.

For the purpose of implementing the above, the Ministries of Communications and Finance intend to apply to the Finance Committee of the Knesset to amend the Royalties Regulations accordingly.

Regarding a lawsuit filed by the State of Israel against Pelephone with respect to non-payment of royalties, see Note 19A(26) to the Company's financial statements for the year ended December 31, 2005, included in this periodic report.

3.18.3.2 Site licensing

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

The erection 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 erection and operation from the Ministry of the Environment (See Section 3.17.1 above)
- B. Approval of the Civil Aviation Administration in some cases.
- C. Approval of the IDF.

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

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

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

A number of sites established several years ago still do not have approvals from the Civil Aviation Administration and the IDF, even though the applications for the approvals have long since been 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 erection of a broadcasting site without obtaining a building permit constitutes a breach of the Planning and Building Law, 5725-1965, and in some instances, this has resulted in the issuance of demolition orders against sites or the filing of indictments or the 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, and/or conviction of office holders acting 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 demolition 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 terminal 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.

What is more, on December 20, 2005, the Non-Ionized Radiation Law, 5766-2005 was passed by the Knesset, the commencement of which, with respect to the regulation of radiation licensing, has been set down for January 1,

2007. Implementation of the provisions of the Law and the procedures that are to be prescribed under it will require Pelephone to make appropriate arrangements. In addition, the very fact that issue of operation permits under the Law is dependent upon a building permit will constitute yet another obstacle on the road to delaying the work involved in making the network compliant as set out above.

3.18.3.3 Set-up of Communications Facilities – National Outline Plan 36

The National Outline Plan for communications (hereafter: “**NOP 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.

NOP 36A is supposed to simplify and streamline 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. Approval of NOP 36A did not give rise to the regulation desired and many planning authorities have complained about the provisions of the plans, and principally, with regard to the following two matters:

- Removal of the planning discretion in their regions;
- Exposure of them to claims due to reduction of value under Section 197 of the Planning and Building Law, and failure to impose an obligation on the cellular companies to indemnify the committees for claims that might be made against the planning authorities.

This state of affairs caused no end of discussions between the cellular companies and the planning committees, which brought with it a multitude of claims in this area. Likewise, the planning committees have set out on an active trek to move to amend NOP 36A.

As a result of that, on February 1, 2005, the National Planning and Building Council adopted the following resolution:

- (1) No building permit shall be issued unless the applicant for a permit deposits a deed of indemnity with the local authority 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 on their land or on neighboring land the right to compensation from the local committee. The described amendment of NOP 36A is liable to subject Pelephone to an inconsiderable financial obligation 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 obligation or the extent thereof, and they will not, of course, result automatically from the decision of the national council to amend NOP 36A.
- (2) Further to the directives of the National Council as at August 3, 2004, the drafting committee will formulate an amendment to the NOP with respect to extension of the local committees’ discretion, and notification of the public.
- (3) When the draft resolution concerning extension of the discretion of local committees 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.

On July 24, 2005, the government of Israel resolved to defer approval of the resolution of the National Council for Planning and Building to amend National Outline Plan 36A dealing with the setting up of small and miniature broadcast facilities for the time being. The amendment revolved around

expansion of the discretion of local committees, provision of objection rights to the public and requiring companies to deposit undertakings to indemnify the planning committees for claims of devaluation of land. The cellular companies' portion of this indemnification was budgeted at 80% of the value of the devaluation and the balance is supposed to be borne by the local committees. The aforesaid postponement is intended to enable the committee of CEOs that was set up, to submit its conclusions within three months. The Committee submitted its conclusions to the government, which set out its recommendations, the main ones being:

- Creating a distinction between small and large sites, the licensing process for small sites being either via an exemption from license track or a fast licensing track, whilst for large sites, a complex licensing process will be required, including giving the public the opportunity to express its objections.
- A distinction is to be made between small and large sites with respect to the amount of indemnity required on the basis of the principle that: The greater the discretion of the planning authority and the integration of residents in the objection process, the greater the rate of indemnity.
- Likewise, implementation of the committee's recommendations requires an amendment to the Planning and Building Law, and therefore, it is not possible to estimate the timing of the end of this process. At the same time, the recommendations of the CEO Committee have been submitted to the National Council for the purpose of examining the integration of such recommendations into the National Outline Plan.

At the same time as all this, the Knesset has conducted a comprehensive amendment of the Planning and Building Law, as part of the Non-Ionized Radiation Law, under which it imposed an obligation to provide indemnity as a condition for the grant of a building permit, provided that such requirement is in accordance with the guidelines of the National Council which may be in force until provisions in this regard are set out in the National Outline Plan.

The National Council resolved, as an interim measure, to impose an indemnity obligation at a rate of 100% on the cellular companies, until any other prescription is made under NOP 36.

This state of affairs will have severe implications on the ability of the cellular companies (including Pelephone) to develop their networks, and the existence of an indemnification obligation will impose an inestimably heavy economic burden on them.

In recent weeks, the drafting committee of the National Council has held a series of discussions in order to formulate its recommendations for the Council's plenum regarding amendment of NOP 36, including the issue of indemnity and the rate thereof.

3.18.4 Standards

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

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

The 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 Note 19 to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

3.20 Business Strategies and Goals

3.20.1 Pelephone's principal strategic goals are:

- (1) Improve profitability;
- (2) Lead with third generation technology;
- (3) Create valuable brands in the field of mobile entertainment and in the private and business sector.
- (4) Increase market share;

3.20.2 Marketing strategy

As part of its marketing strategy regarding the activity of two distinct brands, in 2004 Pelephone completed 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 the components of which 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, an advanced 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 400,000 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.

Therefore, the Pelephone brand has been repositioned based on the values of: Simplicity, fairness, flexibility and innovative empowerment.

3.21 Development Outlook for the Coming Year

During 2006, a number of factors are expected to affect Pelephone's activities, the principal ones are as follows:

3.21.1 Continued reduction of interconnectivity fees

As noted in sub-paragraph 3.18.2, connectivity fees were reduced on March 1, 2006 from 32 agorot (excluding VAT) to 29 agorot (excluding VAT). Connectivity fees will subsequently continue to be scaled down annually, reaching 22 agorot (before VAT) on March 1, 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.

3.21.2 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. At the beginning of 2006, Pelephone has more than 70,000 3rd generation customers. The Company intends to continue penetration amongst its customers, and to continue distributing 3rd generation handsets.

3.21.3 Innovative added value services

In 2006, Pelephone is expected 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 (Push To Talk) 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 section 3.21 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 lead to non-realization of the expectations described above may derive from market behavior, activity by the competition, mode of penetration of new services and technological difficulties.

3.22 Risk Factors

A. Increasing 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 terminal 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 appliances 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 terminal 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 period of account. 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 hedge 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, 2005, 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 terminal 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 applies currency hedging 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. Terminal equipment – hedging is done vis-à-vis invoices payable or open orders, taking into account existing inventory levels, in accordance with forecasted changes in dollar exchange rates.

D. Regulation of tariffs

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 recognized as a class action applicable to all or a large proportion of those consumers. (for the legislative proceedings regarding class actions, see Section 2.16.10 above).

For legal proceedings to which Pelephone is a party, see Section 3.19 above.

F. Restrictions applicable to frequencies and disturbance in use of frequency 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 is also used by land based television broadcasts, and part of the range is also used for cellular communications using GSM technology. Due to the use of those frequency ranges, broadcasts by a number of television stations transmitting in the Middle East cause disturbances in the operation of Pelephone's aforementioned network. In some cases, these disturbances have reached a level that prevents high quality CDMA-technology communication in parts of the Pelephone network.

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

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

G. Electromagnetic radiation

Pelephone operates hundreds of transmission facilities that emit electromagnetic radiation (see Section 3.18.1.3 above). Pelephone is taking steps to ensure that the levels of radiation emitted by the aforementioned transmission facilities 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. Site licensing

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 Section 3.18.3.2 above.

Risk Factor 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 degree of effect of this risk factor on its activity.

4. International Communications and Internet Services – Bezeq International Ltd. (“Bezeq International”)

4.1 General

4.1.1 Structure and changes in area of operations

Bezeq International, a wholly-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”), and integration services under which the Company's business customers are offered total communications solutions (which include Data Services, Hosting Services and technical maintenance and support services for networks) (hereinafter: “Integration Services”).

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

4.1.2 Legislative and statutory restrictions applicable to Bezeq International

The Israeli communications market is regulated mainly by the Communications (Telecommunications and Broadcasts) Law, 5742 – 1982 (hereinafter: the “Communications 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 in force 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 (Royalties) Regulations 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 the past, Bezeq International conducted an investigation, as a result of which it emerged that the manner in which the royalties paid by Bezeq International had been calculated had been incorrect, 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 this update.

For the rate of royalties, see Section 2.16.3 above, regarding a letter from the Director General of the Ministry of Communications and the Deputy Commissioner for Budgets at the Ministry of Finance, dated April 20, 2005, regarding the anticipated gradual reduction of the rate of royalties.

4.1.3 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 Communications 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 Company Ltd. and 012 Golden Lines Ltd., and this led to a sharp fall in the prices of international calls and extensive growth in market volume. In April 2004 the Communications (Telecommunications and Broadcasts) (Procedures and Conditions for the Receipt of a General License for International Telecommunications Services) Regulations, 5764-2004 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.

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

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

the Internet, international telephony and fixed-line domestic telephony services. On February 7, 2006, the Ministry of Communications held a hearing in which Bezeq International was given an opportunity to make oral claims regarding the entry of the aforementioned policy amendment. Following the hearing, on February 8, 2006, the Ministry of Communications published a notice of its intention to ease the limitation on Bezeq International and to permit it to act in the field of VOB, under certain restrictive conditions. The inability of Bezeq International to offer a similar total solution in the event that, at the end of the day, it will not be allowed to provide VOB services, or substantial limitations are imposed upon it in this regard, might cause churn of existing customers in favor of the services of competitors, and might give rise to difficulties in getting new customers. Bezeq International is unable, at this stage, to estimate the effects of churn as aforesaid on the results of its operations and its financial condition. In this regard see also Section 2.6.1 above.

Implementation of the numbering and number portability plan (see Section 2.6.5 above) might require Bezeq International to make additional investments in infrastructure and equipment. Bezeq International cannot, at this stage, estimate the total extent of such investments.

4.2 Products and Services

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

4.2.1 Voice Services

In the Voice Services sector Bezeq International provides: International Direct Dialing (IDD) services to business and private customers; toll-free number services for business customers overseas; telephone card services enabling prepaid and postpaid dialing, mainly from overseas to Israel, for business and private customers; broadband telephony services (VOIP) on the basis of an experimental marketing license; and the 1809 service enabling dialing from Israel to overseas by dialing 1809. For this, see also Section 2.6.1 above.

4.2.2 Internet Services

In the Internet Services sector Bezeq International provides: internet access services to private and business customers, including terminal equipment and support, with an emphasis on fast broadband internet based on ADSL or cable infrastructures; Hosting Services – site storage and server services in a designated installation for business and private customers, including value-added services (such as monitoring and control); information security services, services securing customers' internet and LAN connections using the required terminal equipment or software, including monitoring; Data Services 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.

4.2.4 Integration Services

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

4.3 Revenues

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

	2005	2004	2003
Total revenues	817	816	703
Percentage of gross profit	35%	38%	38%

4.4 New Products

Following are descriptions of the principal new products launched in 2005:

- 4.4.1 Online file backup service for business customers.
- 4.4.2 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).
- 4.4.3 Hosted Exchange services – A managed e-mail service. The service is based on a model of providing remote managed solutions on the broadband infrastructure, which reduces a business's costs compared with the alternative of purchasing a server and licenses.
- 4.4.4 Mobile 014 services – This service enables convenient use of dialing from abroad to Israel from supporting cellular handsets, using a Bezeq International phone card.
- 4.4.5 Call Back service – A phone card service from overseas to Israel which enables the direction of a call to be reversed (Israel – overseas), thereby reducing costs.

4.5 Marketing, Distribution and Service

Bezeq International operates the following sales channels:

- 4.5.1 Recruitment center for internet and incoming voice call services providing solutions for demand, and recruitment center for internet and outgoing voice calls based on various files.
- 4.5.2 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 systems for resellers and dealers.
- 4.5.5 Yes@wow – a joint venture with DBS in 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 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 (in the market for voice services). 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 competition with international carriers, as set out in Section 4.1.5 above, has adversely affected Bezeq International's operations results and financial status.

4.6.1 Voice Services

- 4.6.1.1 In 2005 there were six competitors operating in the market: 014 Bezeq International (estimated market share 29%), 013 Barak (estimated market share 33%), 012 Golden Lines (estimated market share 27%), 015 Internet Zahav (entered the calls market in August 2004 – estimated market share

7%), 017 Netvision and 018 Xfone (entered the calls market in December 2004, the market share of each of them is estimated at approximately 2%).

4.6.1.2 General characteristics of competition in 2005:

- 4.6.1.2.1 About 50% of households make international calls at least once a month.
- 4.6.1.2.2 The various sectors are extremely important (emphasis on immigrants originating from the former USSR) and marketing operations are designed accordingly.
- 4.6.1.2.3 The product is a commodity.
- 4.6.1.2.4 The market is a price market (perception).
- 4.6.1.2.5 Lack of involvement from consumers, leads to difficulty in recruitment and customer loyalty retention owing to inertia.

During the last quarter of 2005, Golden Lines 012 Ltd., the holder of an international license and a competitor of Bezeq International in the area of voice services, obtained a special general license to provide domestic fixed-line telecommunications services and a license to provide domestic transmission services, via 012 Telecom Ltd., a company incorporated by it. These licenses give Golden Lines a competitive edge over Bezeq International in supplying internet and voice services, mainly in the business customer sector, since it is able to offer its customers comprehensive communications solutions which include domestic communications.

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 21%), Internet Zahav (estimated market share 16%), 012 Golden Lines (estimated market share 16%), and 013 Barak (estimated market share 12%).

4.6.2.2 General characteristics of competition in 2005:

- 4.6.2.2.1 72% of Israeli households are connected to the internet (90% of them have high-speed connections).
- 4.6.2.2.2 ADSL is the leading infrastructure (64% of high-speed internet connections)
- 4.6.2.2.3 In addition to image-promoting operations, the market is characterized by an aggressive campaign battle.

4.6.2.3 Developments in 2005:

- 4.6.2.3.1 Slow-down in rate of growth of high-speed internet compared with 2004.
- 4.6.2.3.2 Transition to broader access packages (1.5 Mb, 2 Mb and 5 Mb) – more than 50% of Bezeq International's customers are subscribers to access packages of 1.5Mb or more.

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, information security services and integration 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 34%.

4.6.3.3 Characteristics of the business arena in 2005

- 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 sale of product to sale of total communications 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 **Seasonal Fluctuations**

In general, the revenues and profitability of Bezeq International are affected in a minor way by the seasons of the year and holidays.

There are seasonal fluctuations in the following services:

- 4.7.1 Voice Services for the business sector – decrease in August and the Passover / Tabernacle 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 Facilities**

- 4.8.1 The international communication infrastructure constitutes an extremely material component in the total fixed assets of Bezeq International. International communications traffic is being transferred from and to Israel via underwater cable and international exchanges. Most of the communication volume is routed via the Med Nautilus and Lev cables the capacity of which is significantly greater than 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 Towards the end of 2004, Bezeq International signed an agreement with Veraz, to purchase SoftSwitch switches which, during the course of 2005, replaced the Alcatel S-12 voice switches (which, at this stage, are still being used as a non-substantial component in the Company's voice service systems). These switches are used to route

Bezeq International's voice traffic. The value-added services, including dialing cards, are based on an Intelligent Network (IN), which were also replaced in 2005 as part of the upgrade of its 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. During the course of 2005, the Company set up another site in London, England, via which advanced services are provided to its customers.

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

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

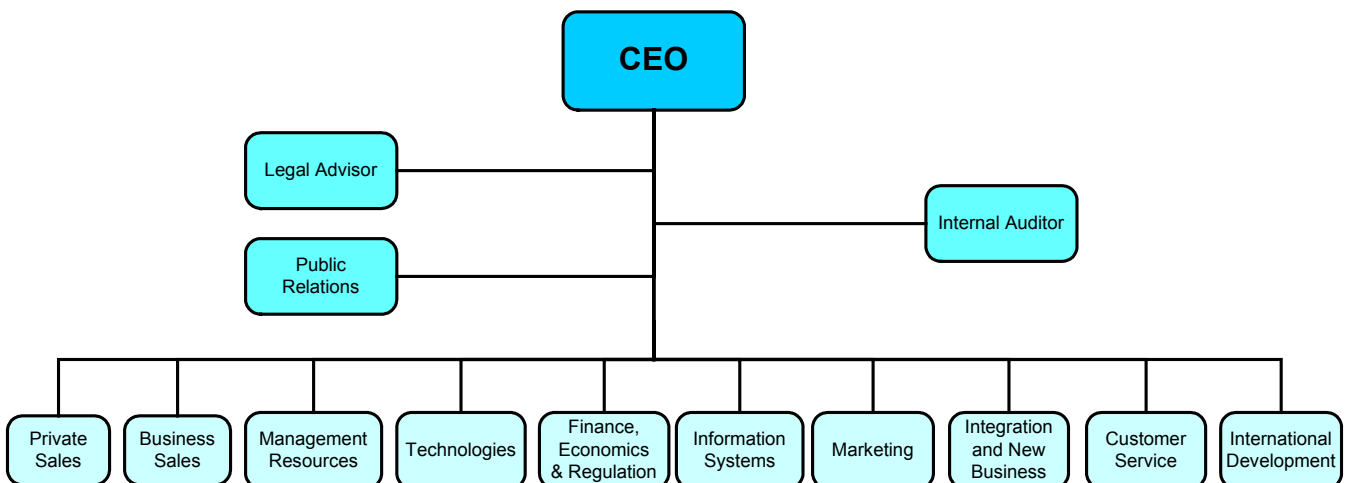
In December 2003 an agreement was signed by Bezeq International and Kardan Ltd. and Infonet Israel Ltd. (hereinafter: "Infonet"), whereby Bezeq International purchased the full rights to operate Infonet. As of April 2004, the results of Infonet operations are included in Bezeq International's results (see Section 4.18.2 below).

4.10 Human Capital

4.10.1 The number of employees of Bezeq International (company employees, personnel agency and outsourced workers) stands at 1,404, of which 286 are employed in headquarters (management, finances, management resources, marketing, information and technologies) and 1,118 are service and sales employees.

4.10.2 Organizational structure

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



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

4.10.4 Employees have a leasing arrangement enabling employees to receive vehicles at a cost determined in accordance with the terms of an agreement between Bezeq International and a leasing company.

4.10.5 Bezeq International invests resources in professional training in accordance with the type of employee and the field in which he or she operates, such as: management reserve given to department managers and professional staff, negotiations 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.

For changes in the board of directors, see Section 1.3 above.

4.11 Suppliers

- 4.11.1 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 substantial foreign carriers in terms of size and cost of traffic passing through them are: British Telecom, Rostelecom, Paltel, AT&T, 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 due to the classification of the Company's loans (see Section 4.15.3 below) as current liabilities. Bezeq International's surplus current liabilities over current foreign currency assets stemming from Bezeq International's contracts with foreign international communications carriers for the transmission of voice minutes and the purchase of data services (see Section 4.21A) was significantly reduced in 2005 as a result of Bezeq International's operations to close old invoices with them, and this considerably improved the deficit in working capital to the situation where Bezeq International had a positive working capital, which was cancelled out as a result of the aforesaid classification.
- 4.12.3 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 to customers

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

4.13.1.2 Equipment sold to 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, 2005, Bezeq International held 42.85% (33.94% under full dilution as at December 31, 2005) of the share capital of Walla! Communications Ltd. (hereinafter: "Walla"), an Israeli company whose shares are listed for trading on the Tel Aviv Stock Exchange, and which deals in the provision of internet services and the operation of internet portals; that follows the

exercise of option warrants (series 3) by the public during the fourth quarter of 2005. After the balance sheet date, and as at the date of publication of this periodic report, as a result of additional exercise of option warrants (series 3) by others, Bezeq International's holdings of Walla went down to 40.42% (33.66% under full dilution). The balance of Bezeq International's investment as at December 31, 2005 amounted to NIS 19.7 million, while its market value amounted to approximately NIS 88.3 million.

Walla recorded a profit for the first time in the third quarter of 2003. It finished 2004 with a net profit of approximately NIS 3.6 million, and it finished 2005 with a net profit of approximately NIS 12.3 million.

For additional details regarding Bezeq International's investment in Walla, see Note 8F to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report. Moreover, since November 2003, Walla's reports to the Israeli public can be found on the Securities Authority's Magna website.

4.15 Financing

- 4.15.1 As at the date of publication of this report, the Company has no liabilities to banking institutions and is not utilizing its approved line of credit.
- 4.15.2 Bezeq International registered a negative pledge in favor of banking corporations, under which it is prohibited from charging its assets without their approval.
- 4.15.3 The source of Bezeq International's finance in the past two years has been a positive cash flow from current operations.

Loans from the Company – during 2001 Bezeq International received from the Company non-interest-bearing, CPI-linked loans totaling \$38 million whose balance as at December 31 2005 and 2004 amounted to some NIS 173 million and NIS 169 million, respectively.

On February 1, 2006, having received the approval of management of Bezeq International that Bezeq International is able to repay the loan without such harming the running of its business, the board of directors of Bezeq International resolved to bring forward the date of repayment of the loan and to pay the sum of the loan, linked to the CPI, back to the Company on February 14, 2006.

- 4.15.4 Bank guarantees – pursuant to the requirements of the Ministry of Communications, Bezeq International provided a bank guarantee in the sum of 2 million dollars and NIS 1.4 million, for the fulfillment of all of the conditions of the license for the provision of international telecommunications services; and NIS 322,500 for the fulfillment of all of the conditions of the experimental marketing license to provide VoIP services. In addition, Bezeq International provided further guarantees in the sum of approximately NIS 2 million for the performance of various undertakings to its business customers.

4.16 Taxation

See Note 11 to the Company's financial statements for the year ended December 31, 2005, 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 Communications (Telecommunications and Broadcasts) Law, 5742-1982 and the general license for the provision of international telecommunications services.

Under the Communications 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 amend the terms of the license, add to them or detract 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 authorizes the Director-General of the Ministry of Communications to impose financial sanctions for various violations of the provisions of the law and of orders and directives issued by virtue thereof, and for violation of the license terms.

A recently introduced amendment to the provisions of the Communications Law permits the Minister of Communications to prescribe those 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 Communications 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 Interconnectivity payments

The Telecommunications (Payments for Interconnect) Regulations, 5760-2000 (hereinafter: the "Regulations") regulate the payments made to the domestic operator or the cellular operator.

With regard to payments to be made by Bezeq International, as an international licensee, for the completion of traffic on a cellular network, the present tariff of NIS 0.25 for completion of a call will be reduced from 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 Sections 2.16 and 4.1.2.2 above.

4.17.1.4 Standards

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 Joint Venture 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. During the course of 2002, the corporation wound up and the network is currently managed by BT. Bezeq International has an agreement for the distribution of BT's services in Israel, under which Bezeq International supplies FR technology managed network services, and IP based services.

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 provides for the efficient transfer of data between these sites. In December 2003 an agreement was signed by Bezeq International and Kardan Communications Ltd. for the acquisition of the operation of Infonet Israel Ltd., the Israeli representative of Infonet which provides international data communication and IP services on the Infonet network in Israel. The customer files were transferred to Bezeq International which received the equipment and rights to provide Infonet services in Israel, and it will provide technical support to all Infonet's global customers requiring services in Israel. This acquisition process enables Bezeq International to serve as a franchisee and strategic partner of Infonet in Israel and provide its customers with an expanded deployment of global communication networks and access to a wider range of advanced, high-quality communication services.

During the first quarter of 2005, Infonet was acquired by BT, as a result of which a restructuring took place under which the infrastructure used by the companies to provide their services to Israel was unified. At this stage, neither the acquisition nor the

restructuring have had any affect on the running of Bezeq International's business, nor on the sale by it of Infonet products.

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 the consent of the parties, the case was sent to conciliation proceedings. The conciliation proceedings were unsuccessful and the hearing was returned to the District Court. Preliminary discovery proceedings took place. The plaintiff filed an affidavit of evidence in chief on October 19, 2003, and an affidavit of evidence in chief was filed by Bezeq International on March 30, 2004. The matter is now in the stage of closing statements.

According to the advice of Bezeq International's legal counsel, a legal and factual analysis indicates that Bezeq International has good defense claims with respect to some of the supplier's allegations. Based on the above, and on understandings between the Company and Bezeq International as to the extent of Bezeq International's liability with respect to this claim, when finally ruled upon, management of Bezeq International assesses that the possibility that Bezeq International might be exposed to this claim is slim.

- 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.

The matter is in preliminary proceedings.

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, at this stage, to deny that the third party notice might be upheld, even in part, at the end of the day. 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.

On April 20, 2005, Alcatel took over management of the defense in the case on behalf of Bezeq International in connection with one of the systems which are the subject of the claim (which it supplied), pursuant to the provisions of the agreement between Bezeq International and Tadiran Communications Ltd. dated December 13, 1998 (Alcatel is standing in lieu of Tadiran for the purpose of this agreement). On July 17, 2005, statements of defense on behalf of Bezeq International and a third party notice, against supply of an additional system operated by Bezeq International and used for the supply of the services under the Claim. The statement of defense filed by such supplier claimed, *inter alia*, that the systems supplied to the Company do not infringe the patent under the claim, and that the respondent supplier does not owe the Company anything based on the provisions of the Law and the agreements between the Parties.

Bezeq International's legal counsel are unable to quantify the changes and risks involved in this claim, at this early stage of proceedings; however, given the fact that Alcatel has taken responsibility for the results of the claim, as far as the system that it supplied is concerned, and that it is reasonably probable that the claim will be dismissed or that the third party served on the supplier of the second system will be upheld, and that in any event, it is not possible to reasonably estimate the sum that Bezeq International will be charged with in the event that the claim is upheld and the third party notice is dismissed, no provision has been made for this claim in the financial statements.

- 4.19.4 On February 27, 2005, Bezeq International's general license for the provision of international telecommunications services (the "license") was amended by the addition of an appendix which dealt with access to erotic services (services offered via a telecommunications installation containing messages with sexual content) via the international dialing services supplied by Bezeq International. Under the provisions of this amendment (clause 58A of the license, Bezeq International must block outgoing call access to any telephone number dialed without a dialing prefix prescribed by the Ministry of Communications for an erotic service (1919 prefix), to the extent that the Ministry of Communications has given it notice, or it has become aware in some other way, that an erotic service is being offered via such number. In reliance upon the findings of the Supervision Report, which the Director General of the Ministry of Communications views as arousing a real suspicion that Bezeq International is in breach of the abovementioned conditions of its license, the Director General of the Ministry of Communications gave notice to Bezeq International that he was considering imposing a financial sanction upon Bezeq International, in the sum of NIS 2,257,500, based on the right afforded to him under the Communications (Telecommunications and Broadcasts) Law, 5742-1982 (the "Law"), in the event of breach of a condition of the license. Pursuant to the provisions of the Law, Bezeq International was given an opportunity of making claims in writing, in response to the charges of the Ministry, by September 6, 2005. In its Supervision Report, the Ministry of Communications raises suspicions that Bezeq International entered into an agreement with a foreign carrier to the effect that it would transfer traffic to such carrier to fictitious destinations outside of Israel, intended, in effect, for the providers of erotic services operating in Israel, and that such operator would redirect such traffic to Israel via Bezeq International's international telecommunications system; such that the profits from these calls would be divided up between Bezeq International and the aforesaid foreign carrier. More seriously, at the center of its conclusions in the Supervision Report, the Ministry of Communications alleges that it can be held, in reliance upon the findings of its investigations, that: "Bezeq International was an active party to the provision of erotic services via its international telecommunications system, and that in respect of the period from 2004 until January 2005, the Company effected short termination redirection of calls, without such calls ever leaving the boundaries of the country."

On October 17, 2005, Bezeq International filed its response to the Director General's above notice to the Ministry of Communications, in which it claimed, *inter alia*, that: Bezeq International has never provided any form of erotic services, does not and did not

have any commercial relations with suppliers of erotic content in Israel or overseas; Bezeq International has always been in strict compliance with the provisions of its license and the instructions of the Ministry of Communications and has acted effectively to block overseas destinations used for erotic services, to the extent that the Ministry of Communications has instructed it to do so; in any event, the Ministry of Communications has no real evidence that Bezeq International has breached the conditions of its license, and the charges against Bezeq International are based merely on groundless theories and baseless presumptions.

On February 13, 2006, the Ministry of Communications held a hearing in which Bezeq International was given an opportunity to make oral claims against imposition of the sanction. As at the date of this report, the decision of the Ministry of Communications regarding imposition of this sanction has not yet been obtained.

Management of the Company estimates that its arguments against the sanction are good and that it is unable to estimate the amount of the sanction if imposed. Therefore, the Company decided not to include this matter in its financial statements.

- 4.19.5 On the matter of the "industrial espionage" affair – On May 31 2005, three employees of Bezeq International were called in for questioning as part of the police investigation into industrial espionage by computerized means (a Trojan horse program). After being questioned, the employees were released with restrictions. Up to the date of publication of the interim financial statements, no proceedings have been instituted against Bezeq International and/or its employees relating to the above investigation. In this regard, see also Section 2.20.3 above and Note 19A(40) to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.
- 4.19.6 For further updates on legal proceedings, see Note 19 to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

4.20 Goals, Business Strategy and Expected Development

- 4.20.1 As part of the preparations for 2005, 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 Improvement and streamlining of its customer service setup.
 - 4.20.1.2 Retention of average fixed income per-customer.
 - 4.20.1.3 Development of alternative income sources for voice, internet and data.
 - 4.20.1.4 Adaptation of expense structure to the new revenue levels.
 - 4.20.1.5 Steady streamlining, *inter alia*, by defining indices and compliance with goals.
 - 4.20.1.6 Focus on and retention of customer base.
 - 4.20.1.7 Retention of leadership status via market share or leading margin.
 - 4.20.1.8 Achievement of profitability in data sector, thereby justifying volume of operations.
 - 4.20.1.9 Focused and differentiated operations based on value-added services.
 - 4.20.1.10 Assimilation of SoftSwitch and IN without harming service standards.
 - 4.20.1.11 Utilization of benefits deriving from IT investments.
- 4.20.2 Bezeq International's goals for 2006
 - 4.20.2.1 Retention of the company's profitability.
 - 4.20.2.2 Preparation for mergers in the industry and turning the threat into an opportunity.
 - 4.20.2.3 Retention of the company's leadership status via market share or leading margin.
 - 4.20.2.4 Progress on existing customer base, with emphasis on more efficient management of the churn prevention process.

- 4.20.2.5 Streamlining of customer service system and improving the Company's concept of service.
- 4.20.3 2005 was characterized by a continued increase of Bezeq International's operations in the field of supply of internet access services in general, and broadband internet in particular, including a variety of value added services and Datacom operations to international customers; in this way, Bezeq International continued its transition from an international call company to a global IP service carrier.
- 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, at this stage, until August 2006 and includes both 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 In 2005 Bezeq International improved its market position in all the areas of its operations. In the past year, Bezeq International put Infonet services into effect, having purchased the operations of that company so as to leverage its operations in the field of data.
- 4.20.6 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.
- 4.20.7 During the course of 2005, Bezeq International completed the upgrade of the technological systems that support the provision of voice and internet services, in particular the SoftSwitch and the IN systems. This upgrade enables the Company to offer its customers advanced services.
- 4.20.8 In 2005, Bezeq International reinforced its customer service system, which provides service and technical support to its business and private customers, by increasing the support staff and by implementing designated technological systems (CRM, Contact Center). As a result of this improvement in the customer service system, the Company won a service competition held by the Israeli Center for Management, in the category of continued service.
- 4.20.9 The above information is forward-looking and as such is not certain and might not become reality, in whole or in part. The forward-looking information is based on information that Bezeq International currently has as at the date of publication of this report, and contains estimates made by Bezeq International, its work assumptions or intentions, as at the date of publication of this report. The actual results are likely to be materially different from the results estimated or inferred from this information.

Management's forecast is based on forecasts related to the continued recovery in the Israeli market, continued penetration of broadband technology and continued growth in the number of internet users.

The above forecast 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.

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). However, 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 total effect of the change is charged to the capital reserve following application of the regulations regarding treatment of operations between corporation and a controlling party thereof in the financial statements. The date of repayment of the above loan was brought forward, and it was repaid to the Company on February 14, 2006.

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 supervision and regulation – for the application of the provisions of the Law and licensing policy and their effect on Bezeq International, see Sections 4.1.2 and 4.1.3.1 above.
- E. Anchor countries

Bezeq International undertook, in an official price list, to provide the cheapest rates for 4 countries (USA, Russia, France, Argentina) by the end of 2005. In light of this, Bezeq International's revenues were adversely affected following an update of its competitors' price lists.

- F. Transition to SoftSwitch and upgrade of the IN system

In 2005 Bezeq International replaced the switch and upgraded its intelligent network system. As a result of this, there is still a danger of faults which might cause harm to service.

- G. 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 legislative proceedings regarding class actions, see Section 2.16.10 above).

For legal proceedings to which Bezeq International is a party, see Section 4.19 above.

Risk Factor Summary Table

	Effect of Risk Factor on Bezeq International's Activity		
	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 infrastructure and technological changes	X		
Government supervision and regulation	X		
Special risks for Bezeq International			
Exposure in legal proceedings	X		
Anchor countries		X	
Transition to SoftSwitch switches and IN	X		
Dependence on suppliers	X		

5. Multi-channel Television – DBS Satellite Services (1999) Ltd. (hereinafter: “DBS”)

5.1 General Information on Field of Activity

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 from which broadcasts are transmitted to a domestic decoder in the subscriber’s home and connected to the television set.

Most of DBS’s income stems from subscription fees and additional payments made by viewers. As at December 31, 2005 DBS had 520,671 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

In the field of multi-channel subscriber television broadcasting in Israel (hereinafter: the “field of broadcasting”), two entities operate: DBS and three main cable television broadcast corporations, which are in the process of merging into one single corporation, and which now already operate as a single entity in most areas of operation, including marketing of broadcasts, acquisition of content, branding of joint operations and operation thereof, under the brand name “HOT” (hereinafter: the “**Cable Companies**”). To the best of DBS’s knowledge, in February 2006, an agreement was signed for the merger of the Cable Companies, which agreement requires various consents.

The field of broadcasting 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 broadcasting 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.

5.1.2 Statutory restrictions and special constraints

The Communications Law requires that a broadcasting license be obtained in order to transmit satellite television broadcasts to the public. In January 1999 DBS received the above-mentioned broadcasting license by virtue of the provisions of the law and pursuant to the Telecommunications (Proceedings and Conditions for the Grant of a Satellite Broadcasting License) Regulations 5758-1998 (hereinafter: the “Broadcast License”).

The broadcast license granted to DBS is valid until 2014. Thereafter it may be renewed for additional six-year periods.

For additional licenses granted to DBS, see Section 5.8.1 below.

Operations in the field of broadcasting are subject to licensing and supervision by the Ministry of Communications, in aspects defined in the Law and the broadcast licenses (which relate, mainly, to matters relating to competition, consumers, and technical and engineering aspects). Operations in this field are also subject to the Ministry of Communications policy in various areas, which relate to or connect with DBS’s current operations and fields in which it wishes to act, and which often have substantial effects on the operations of persons active in the field of broadcasting.

DBS’ and the Cable Companies’ broadcasting operations are also under the constant supervision of the Cable and Satellite Broadcast Council (hereinafter: the “Council”). The Council sets policy and makes rules regarding the content of broadcasts, the duty regarding original Israeli productions, the division of content into genres, broadcasting ethics, consumer protection and other matters in the area of broadcasting policy. The Council is also responsible for enforcing the various statutes relating to the field of broadcasting, for approving the channels that DBS wishes to broadcast, or to cease broadcasting, and is also authorized to amend the broadcast licenses of DBS and the Cable Companies under the conditions set out therein.

The Council has authority in the field of consumer protection, so that the setting of price lists, updating of price lists and offers to customers require its consent or the giving of prior notice (on the issue of DBS's activities being subject to legislation and to the supervision of the Ministry of Communications and the Council, see also section 5.14 below).

Changes may be made to the identity and nature of the persons supervising the operations of the players in the field of licensing and supervision of the field of broadcasting (including DBS's operations), at the initiative of the government, as follows:

- A. On October 30, 2005, the government decided to unify the operations of the Council, the Council of the Second Authority for Television and Radio, the Second Authority for Television and Radio and the Public Broadcasts Regulation Board (which provides professional and legal services to the Council) into a single unified commercial broadcasting authority, which is to be responsible for the regulation of all commercial television and radio broadcasts in Israel. To the best of DBS's knowledge, a government Bill has been prepared which is supposed to regulate this matter, however, it has not yet been submitted for voting in the Knesset plenum.
- B. To the best of DBS's knowledge, as at the date of this report, the government is looking into setting up a communications authority, which is to replace the Ministry of Communications and the authorities mentioned in section A above, and hold all of their powers, instead of the planned change as set out in section A above.

5.1.3 Developments in markets of the field of operations

During the course of 2005, demand from consumers and potential consumers to receive a "total service package" containing multi-channel television broadcasts and internet connection infrastructure services (at high speeds) developed as part of general developments in the field of communications. In DBS's opinion, this trend of increasing demand for a total service package is expected to increase and to include demand to include fixed-line telephony as part of the service package offered to potential television subscribers – demand which has recently begun to ebb (for the effect of this development, see also Section 5.6.5B below).

In August 2005, the government decided to require the Minister of Communications and the Minister of Finance to do all of the acts required such that no later than January 1, 2007, the television channels of the Israel Broadcasting Authority (Channel 1 and Channel 33), the commercial television channels (Channel 2 and Channel 10) and the Knesset Channel (Channel 99) would be distributed to the public freely, nationwide, via a terrestrial transmission service using digital technology, backed-up by a digital satellite system. As part of this discussion, various governmental authorities have been instructed to promote and implement the decision, and in this context, to publish a tender to select an entity to plan, set up and operate the terrestrial digital broadcast system, and the digital satellite distribution system. If the government decision set out in this sub-section is put into action, the broadcasts of these channels shall constitute a partial substitute for DBS's broadcasts. DBS has submitted its objection to the proposal to the Minister of Finance and the Minister of Communications, under which it has even requested to hold a hearing which. As at the date of publication of this periodic report, an oral hearing is being held for DBS, and it has been informed that a written hearing will be held on the issue. To the best of DBS' knowledge, as at the date of publication of this periodic report, the Ministry of Finance is preparing to draft a tender to select an entity to set up and operate the channel distribution system.

In addition, in August 2005, the government resolved to require the Minister of Communications and the Minister of Finance to do all of the acts required in order to enable the public, no later than January 1, 2007, to purchase a basic television services package from the multi-channel television companies (the cable and satellite companies) including connection to the distribution infrastructure of the Company's broadcasts, and reception of the television channels of the Broadcast Authority (Channel 1 and Channel 33), the commercial television channels (Channel 2 and Channel 10), the Knesset Channel (Channel 99), the Educational Channel (Channel 23) and the designated channels, without the consumer being required to purchase any other services from the multi-channel television companies. To the best of DBS's

knowledge, legislative amendments relating to implementation of this decision have been included in the memorandum for the proposed Budget Law for 2006, which is to be submitted to the Knesset following the elections for the 17th Knesset. DBS applied to the Ministry of Finance asking to hold a hearing in this regard, and as at the date of publication of this report, negotiations are being held between DBS and the Ministry of Finance.

In DBS's estimation, exercise of any of the above government decisions might harm DBS's revenues.

5.1.4 Technological changes that significantly impact on the area of activity

5.1.4.1 Technological developments and changes which have taken place in the field of digital broadcasting currently enable the provision of "personal television" services, which include bi-directional services that enable reciprocal communications between the individual subscriber and the service provider, and immediate provision of the service individually selected by the subscriber. The principal service in this field at present (even in Israel) is the provision of television services upon the immediate demand of subscribers, also known as Video on Demand (hereinafter: "VOD services"). As at the date of this report, VOD services are only provided by the Cable Companies and this has a substantial effect on competition in the field of broadcasting (in this regard, see Section 5.6.5A below).

5.1.4.2 Around the world, internet television content transmission services known as Internet Protocol Television (IPTV) has begun to be developed. These are video broadcasts transmitted via the internet, without using existing cable or satellite infrastructure, which enables consumers to view television broadcasts (including VOD services) via the internet. Recently, IPTV services were launched in Israel as well, although at the date of this report, to a very limited extent. The development of this technology and these services is expected to significantly affect the field of broadcasting, which is currently based on broadcast infrastructure.

5.1.5 Critical success factors in the area of operations and changes therein

DBS regards the following factors as critical to the success of its operations:

5.1.5.1 Differentiation, innovation and originality in 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 such purpose, ongoing investment is required in the area of purchase and innovation of the content of broadcast supplied to DBS customers.

5.1.5.2 Recently, a significant component of broadcasts, which is material to success in the field of broadcasting, is the ability to offer subscribers "personal" television services, in particular VOD services. This ability depends upon regulatory approvals and the enactment of statutes (see Section 5.6.5A below).

5.1.5.3 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.

5.1.6 Principal entry and exit barriers

5.1.6.1 The principal entry barrier derives from the burdensome regulation prevailing in the broadcasting sector, including the duty to obtain a license and the duty to operate in accordance with the relevant provisions of the law, pursuant to the provisions of the various licenses and the conditions of them, as well as the continuous supervision by the Ministry of Communications and the Council (see Section 5.14 below).

5.1.6.2 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 5.1.5.1 above), and pursuant to regulatory requirements and restrictions.

- 5.1.6.3 Principal exit barriers from the field stem from long-term agreements with suppliers (see Section 5.10 below); the large investments which require long periods of time to obtain returns; obligations to repay loans taken from financial entities given the need for considerable investments and obligations to provide service to subscribers of the broadcast supplier for the term of the contract with them.

5.1.7 Alternatives to and changes in sectoral products

With respect to DBS's broadcast and service package offered to customers, the following services may be classified as alternative products:

- 5.1.7.1 The variety of territorial channels and other channels broadcast for free to the Israeli public. These channels include Channel 1 (belonging to the Israel Broadcasting Authority), Channel 2, the commercial Channel 3 ("Channel 10 Israel"), the Knesset channel, Channel 23 belonging to Educational Television, the Music Channel ("Channel 24"), the Russian-language channel ("Israel Plus"), and the Shopping Channel.

For the initiative to set up a land-based and satellite-based digital broadcasting array for distributing various channels, see Section 5.1.3 above.

- 5.1.7.2 Internet television services – Internet Protocol Television (IPTV) (see section 5.1.4 above). DBS views IPTV services as a partial alternative to its broadcasts.
- 5.1.7.3 Video and DVD libraries. DBS views these services as being alternatives to part of DBS's services.

5.1.8 Structure of competition in the areas of operation and changes therein

The field of broadcasting is characterized by competition between the Cable Companies and DBS, including with respect to the components of operation set out in Section 5.1.5 above. The concentrated and complex ownership structure in the areas of content, communications and infrastructure in Israel is likely to cause groups throughout the chain of production, packaging and supply of content to move into positions of control. The Cable Companies which, together with the corporations related to them, have a broad deployment of advanced broadband infrastructure, and in which other communications entities are party to ownership, market and sell a package of services including multi-channel television services, high-speed internet infrastructure, and fixed-line telephony. . Sale of the service package with these three types of communications services (known as 'triple play') whilst DBS does not offer a similar package, constitutes a principal component in differentiating the offer to potential subscribers.

DBS, by cooperating with the Company, sells a service package that includes the multi-channel television services provided by it, and the Company's high-speed internet infrastructure, thereby providing a partial response to the 'triple' service package sold by the Cable Companies (for this joint venture, see Section 5.6.5B below).

5.2 **Products and Services**

DBS provides its subscribers with a wide variety of channels: Approximately 105 different video channels, more than twenty radio channels, about 15 music channels, approximately ___ service and interactive game channels and about 30 pay per view video channels.

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 and enrichment 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 acting to obtain approval to launch VOD services (See Section 5.6.5A below).

DBS sells its subscribers decoders, which are necessary in order to record its broadcasts. DBS also sells a decoder known as a PVR (Personal Video Recorder) under the brand name YesMax, which, in addition to receiving broadcasts, has the ability to record and suspend picture using a hard disk and which has excellent sound quality.

5.3 Revenues and Profitability of Products and Services

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

	2005	2004	2003
Revenues	1,222	1,028	842
Operating profit	132	15	(170)

5.4 New Products

DBS is currently in the final stages of developing supply of VOD services via DSL to its subscribers. However, launch of the service requires receipt of the appropriate regulatory approvals, which have not yet been obtained.

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 Points of sale 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, 2005, to the best of its knowledge, at around 36% 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 1990s, in the past under regional franchises under conditions of exclusivity, and at present under long-term broadcasting licenses which replaced the franchises during the course of 2002. At present, the Cable Companies operate as a single entity, as set out in Section 5.1.1 above. In November 1999, the Cable Companies were declared to be a monopoly in the field of broadcasts in the areas of the franchises under which they operated at the time, under the Antitrust Law, 5748-1988.

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 they use an analog broadcasting method, which does not allow viewing electronic broadcasts or tiering and supply of 'personal television' but rather, of one identical channel package (for further implications of this difference, see Section 5.6.4B below).

5.6.3 Characteristics of the current competition

After DBS achieved high rates of growth in subscribers during the first years of its operations, inter alia due to temporary regulatory concessions given to it and a considerable technological gap, together with high churn rates amongst subscribers of the Cable Companies, in 2005, there was a relatively slow increment in the number of DBS subscribers (in 2005, the number of subscribers increased by approximately 50,000).

	2005	2004	2003
Increase in number of subscribers	49,823	55,795	44,537
Rate of growth	10.7%	13.5%	9.4%

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.

(Including VOD services provided by the Cable Companies). Competition is also characterized by offers of other communications services as part of the service package (see Section 5.6.5B below). 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

In the estimation of DBS management, DBS has competitive edges, the principal ones being:

- A. DBS has a significant advantage in terms of the technical quality of satellite broadcasts, which stems from broadcasting using advanced digital technology, which contributes to the quality of the picture and also enables translation into foreign languages, at the subscriber's election. In addition, the subscriber's user interface during viewing is quick, fast and convenient compared with that of the Cable Companies. DBS recently began wide-screen broadcasts on a variety of channels, and Dolby digital broadcasts on a number pay per view channels. These broadcast methods enable subscribers to view broadcasts on wide-screen views.
- B. Another positive competitive factor stems from the fact that DBS's broadcasts are transmitted by satellite, and therefore, reception of the broadcasts is also possible in areas that are remote where there is no access to cable infrastructure.

However, DBS' competitive operations suffer from inferiority in a number of areas, the main ones being:

- A. Inferiority of infrastructure in terms of launching of services that require high-speed bi-directional infrastructure, in particular VOD services (See Section 5.6.5A below).
- 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 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, relating to the transfer of subscribers and use of the infrastructure installed in the homes of subscribers, 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). For the hearing being held by the Ministry of Communications with respect to cable wiring, see Section 5.14.3 below.

- D. 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 DBS's ability to compete (for further details regarding these restrictions, see Section 2.16.2B above).

5.6.5 Principal methods for coping with competition

A. VOD

DBS views the provision of VOD services and similar services, such as interactive games, internet games and applications integrating pictures and other similar services to be an integral part of the services of those operating in the field of broadcasting in the modern era, and as a significant component, as part of the total package of services offered to subscribers.

However, whilst DBS's competitors commenced providing VOD services to their subscribers at the beginning of 2005, as at the date of this report, DBS has not yet received the consent of the Ministry of Communications to provide such to its subscribers, as set out below.

The satellite broadcasting system, despite its technical qualities, suffers from an in-built inferiority with respect to infrastructure, compared with the fixed-line infrastructure of the cable companies. This inferiority stems from the fact that high-speed satellite broadcasting is unidirectional only (from the satellite to the subscriber's home) whilst the return track (from the subscriber's home to the broadcast center) is not a high-speed satellite track, but is via an ordinary (slow) telephone line which does not enable the transmission of communications necessary for providing VOD services, and due to the fact that the satellite line includes a uniform, collective broadcast, to all subscribers, and does not enable individual broadcasting in accordance with the individual demands of each and every subscriber, certainly not in the amount and at the availability required in order to launch personal television services, mainly VOD services, as is usual around the world, and recently, in Israel as well, via the Cable Companies.

Due to the inferiority of infrastructure as referred to above, DBS applied to make use of the fast bi-directional line owned by the Company – DSL (Digital Subscriber Line) and to provide its subscribers with VOD based on that infrastructure, since a technological experiment done on that infrastructure was successful in 2004. This use of DSL infrastructure requires the consent of the Ministry of Communications, which requested to examine the need to amend the Law regarding the scope of services that a satellite broadcast licensee may supply (and the prohibition imposed upon it to provide 'cable services'), as well as the policy regarding providing such consent.

Following applications by DBS to the Ministry of Communications to approve supply of the services to its subscribers on a commercial scale, on October 11, 2005, DBS received the response to the general counsel for the Ministry of Communications stating, *inter alia*, that receipt of a commercial license to provide such services would require statutory amendments and that the Ministry of Communications has not yet formulated its policy regarding the application. Therefore, as the response states, DBS's application for a commercial license for the provision of the aforesaid services, and a license to perform experimental marketing, is not possible at this stage. Pursuant to that position, on October 27, 2005, the Senior VP Economics and Budgets at the Ministry of Communications wrote to DBS and to a number of other entities in the communications sphere, including the Company, the Cable Companies and internet access licensees, asking for their responses to the issue, including issues relating to network capacity, the ability to use the network, and pricing of the service (hereinafter: the "Hearing").

On December 25, 2005, DBS provided its response to the Hearing, setting out, *inter alia*, the importance and urgency of providing the consent to commercial supply of VOD services to DBS subscribers, the policy considerations that supply provision of such consent and the importance of the VOD service as an integral part of the modern broadcasting world.

To the best of DBS's knowledge, a number of entities in the communications field, including the Cable Companies, expressed their objection to the Ministry of Communications granting consent to DBS to provide its subscribers with VOD services, in the Hearing. As at the date of this report, the decision of the Ministry of Communications with respect to the Hearing has been delivered to DBS. Based on the position taken by the Ministry of Communications and expressed above, even if it is decided, as a matter of policy, to approve the application, it will only be possible to launch VOD services after amendment of the Law in this regard, except in the context of limited technological trials which DBS has asked to hold, and in DBS' estimation, this will be permitted.

In DBS's opinion, approval of its application to launch VOD services using DSL infrastructure will provide a response to the competitive need for launching such services. On the other hand, in DBS' estimation, failure to obtain permission to grant VOD services will cause severe harm to DBS' ability to compete with the Cable Companies.

B. Total service package

As set out in Section 5.1.8 above, during the course of 2005, demand from consumers and potential consumers to receive a "total service package" containing multi-channel television broadcasts and internet connection infrastructure services (at high speeds), and, in the future, fixed-line telephony services, developed as part of general developments in the field of communications. As a result, DBS currently sells a service package, together with the Company, which includes broadcasts and infrastructure to connect to high-speed internet services. However, due to regulatory limitations in the Company's license regarding structural separation between the Company and its subsidiaries and certain affiliated companies, including DBS, and in particular with respect to the supply of fixed-line telephony services, contrary to the Cable Companies which sell their subscribers a "triple" service package (see Section 5.1.8 above), under which they can reduce the prices of fixed-line telephony, the Company is unable to reduce the prices of fixed-line telephony under such a package.

5.7 Fixed Assets and Facilities

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	1,994	840 sq.m. 07/2006 1154 sq.m. 07/2008
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 Terminal equipment

DBS installs a receiver dish and other terminal equipment in subscriber homes, among them, decoders used as a receiving and decoding unit for the reception signals, which constitute an infrastructure to the subscriber's television screen 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.

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 January 2014 or until the end of DBS's broadcast license, whichever is the earlier. This license is material to DBS's operations and constitutes the regulatory permit for the transmission of broadcasting messages from the broadcasting center to the broadcasting satellites and from them to subscriber homes.

5.8.1.4 License for the provision of uplink/downlink services to other communication licensees which is valid until July 2008. As at the date of publication of this report, DBS does not use this license.

5.8.2 Intellectual property assets

A. Trademarks

DBS owns a variety of trademarks designed to protect its various brands and services and also a number of trademarks which are in the process of being registered on the Register of Trademarks. The main 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.

B. Copyright organizations

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

and integration into the framework of its subscriber broadcasts. For these usage rights DBS pays the content copyright holders via the six official organizations in Israel, which collect the royalties owed to the owners of the intellectual rights pursuant to the general licenses (known as “blanket licenses”) granted to DBS. These payments are mostly based on a fixed payment, irrespective of the number of subscribers viewing the content (or listening to recordings, as the case may be), the rights to which have been purchased and sometimes on various pricing methods, including some which are dependent on the number of subscribers as aforesaid.

For some of the content that DBS purchases, it is also required to pay for the actual broadcast of the content.

DBS’s costs to such collection organizations in 2005 amounted to approximately NIS 11 million.

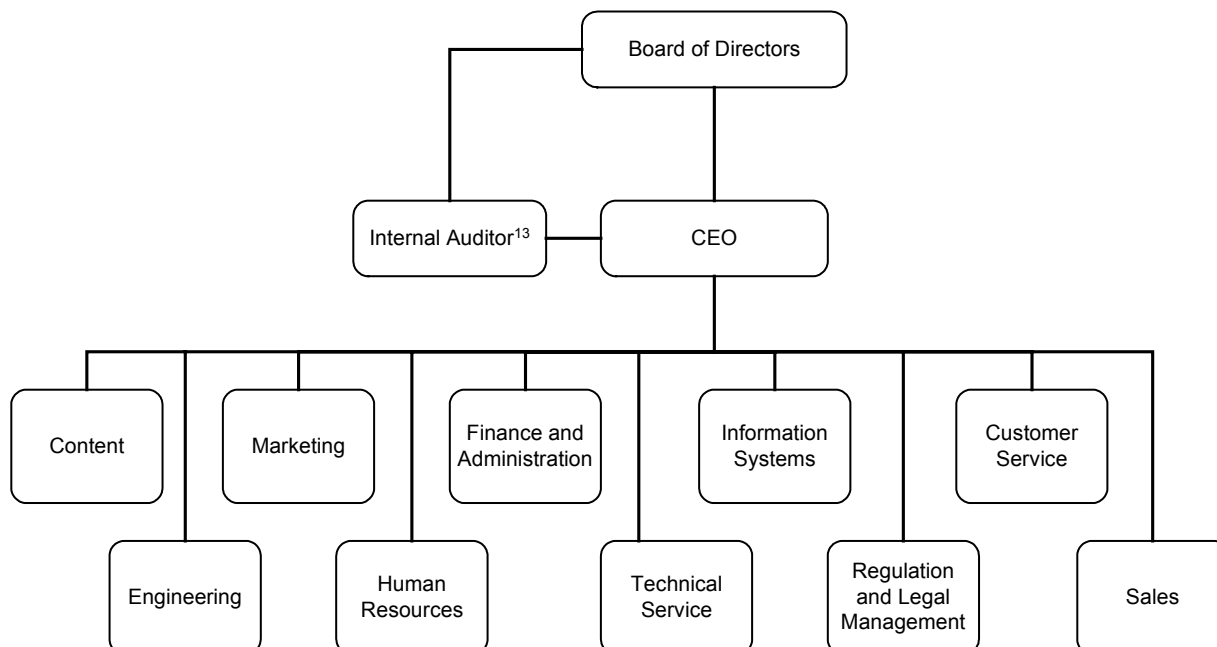
C. Investment in content

DBS purchased broadcasting rights for 2005 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 or purchases 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 2005 amounted to some NIS 408 million.

5.9 Human Capital

5.9.1 Organizational Structure

DBS consists of 8 divisions, each of which is headed by a vice president who serves as a member of DBS’s management. The divisions include marketing and sales, customer service, content, engineering, finance and operation, human resources, regulation and legal management and information systems, as depicted in the following chart



¹³ The auditor is an external auditor.

5.9.2 Headcount of DBS personnel by division

Division	Number of employees	
	As at December 31, 2004	As at December 31, 2005
Sales and Marketing	414	364
Customer service	1,143	1,051
Content	38	49
Engineering	63	68
Finance and Operation	91	109
Human Resources	10	13
Regulation and Legal Management	2	2
Information Systems*	6	24
Management	4	4
Total	1,771	1,684

5.9.3 Training and development of human capital

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

In 2005 DBS consolidated its 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

In 2005, DBS consolidated its customer service and technical service divisions into one division, called the Customers Division, and also consolidated the marketing and sales divisions into a single division.

5.9.5 Employee remuneration schemes

DBS has goal-oriented remuneration schemes 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).

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 or in accordance with the estimated number of future broadcasts of such programs.

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 (JCS). There is also dependence on the other supplier of sport content, Charlton Ltd.

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 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, 2005, customer credit amounted to approximately NIS 138,977 net.

5.11.2 Supplier credit

The average supplier credit period in 2005 was 134 days.

5.11.3 Deficit in working capital

As at December 31, 2005, DBS's deficit in working capital amounted to NIS 458,812 thousand.

In 2004 and 2005, DBS reduced its working capital deficit.

5.12 Financing

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 Institutional bodies

Loans provided to DBS by institutional bodies in 2005 are linked to the consumer price index and bear interest at an annual rate of 11%.

5.12.1.3 Banks

Short-term interest – the average interest rate for this credit for 2005 is 6.5%.

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

- A. Loans based on prime interest rates, the average daily interest rate for 2005 being 6.5%.
- B. Loans linked to the consumer price index, the average interest rate being 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 meeting the financial criteria are variable and are measured quarterly. Non-compliance grants the banks the right to demand early repayment of the loans and the right not to award DBS any further unused credit line. During the course of 2005, the banks completed providing the full credit facility to which DBS was entitled under the finance agreement (apart from a sum of approximately NIS 500,000), in return for provision of the shareholders loans by DBS' shareholders, at the rates required under the finance agreement (with the exception of shareholders' equity the provision of which the banks waived under an amendment to the finance agreement of December 2005) (in this Section: the "Amendment"). During the course of 2006, DBS is expected to commence gradual repayment of the bank credit that it has taken, until full repayment in 2013. As at December 31, 2005, DBS is in compliance with all of the financial criteria set out in the finance agreement (following a concession granted to DBS under the Amendment relating to the maximum supplier credit criterion).

In view of the forecasts of DBS management regarding its business results for 2006, DBS will be required to act to obtain the banks' approval to update the financial criteria in the finance agreement.

DBS is also in negotiations with the banks to resolve a dispute relating to insurance obligations set out 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 debentures issued to the public, if any), and restrictions on their repayment before repayment of the bank credit in full, or with respect to certain shareholders' loans before repayment of part of the bank credit, on the conditions set out in the finance agreement.

DBS is committed to repaying, by way of mandatory repayment, sums received with respect to the issue of shares or debentures to the public, from the sale or transfer of property and certain of DBS' cash flow surpluses, on such conditions and at such rates as are set out in the finance agreement. DBS is entitled to repay sums received with respect to the issue of shares or debentures to the public by way of early repayment, voluntarily, which might remain after effecting the abovementioned mandatory repayment, on such conditions and at such rates as may be set out in the finance agreement.

The finance agreement further sets out provisions regarding various reports that DBS must provide to the banks, including with respect to assessing its compliance with financial conditions.

The finance agreement sets out a list of events that constitute breach of it, and that entitle the banks, under conditions set out in the finance agreement, to make the bank credit immediately repayable.

DBS encumbered its assets and goodwill with a floating charge in favor of the banks and placed fixed charges over its rights in accordance with material agreements to which it is a party and the insurance rights to which it is entitled under the insurance policies issued to it.

DBS shareholders, with the exception of the Company, charged 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 charged 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 inferior to the bank credit. In view of the restrictions on the Company's ability to charge its assets as a result of the negative pledge created by the Company in favor of its creditors (see Notes 13 and 14 to the Company's financial statements for the year ended December 31, 2005, which are included in this Periodic Report), on November 23, 2000 the Company gave a guarantee of DBS's debts to the banks, provided that the amount which the banks receive in repayment by the Company of its guarantee does not exceed the value of its shares in DBS on the date on which the banks realize the shares which the other shareholders charged in their favor. The Company also gave an undertaking to sell its shares if the shares charged by the banks are sold. Pursuant to a deed of amendment of the guarantee of May 2, 2002, the Company consented that in the event of realization of the collateral given by the other shareholders the Company would waive repayment of the shareholders' loans it granted to DBS. The Company also consented that its guarantee would also apply, *mutatis mutandis*, to the options allotted to DBS and to the right to receive them.

The shareholders in DBS with the exception of Gilat DBS Ltd., gave an undertaking to the banks 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 2005

In 2005, DBS received shareholders' loans amounting to some NIS 82 million, loans from institutional entities in the sum of NIS 100 million. In addition, the banks increased their credit facility to DBS by approximately NIS 43 million. Increase of this facility included the sum of NIS 25 million provided to DBS in December 2005, as part of the Amendment. Under the Amendment, the additional credit as aforesaid is intended to be repaid within three years, at the rates set out in the Amendment, however, in the event of injection of shareholders' equity into DBS by its shareholders prior to the dates of repayment of the credit as aforesaid, DBS is required to repay the sum of the injection early. As at the date of this periodic report, DBS and the banks are in negotiations

towards signing a detailed amendment to the finance agreement which will fix the principles set out in the Amendment, as well as the arrangements that go along with it.

5.12.4 The Corporation's credit facility

DBS's credit facility is approximately NIS 1,465 million and it is used for the current operation and the granting of bank guarantees for DBS's operations. As at December 31, 2005 DBS had utilized NIS 1,421 million of this credit.

The credit taken by DBS from institutional entities (at a total rate of NIS 100 million) was received under loan agreements dated March 2005 and April 2005. This credit was taken on inferior repayment conditions compared with the bank credit, apart from exceptions that are similar to those which apply to the shareholders' loans provided by shareholders of DBS after April 1, 2004. In assurance of repayment of the loans to institutional entities, an undertaking was given by the Company (which is conditional, *inter alia*, upon DBS having a positive worth), as set out in Note 8E to the financial statements of the Company for the year ending December 31, 2005, which are included in this periodic report, and the banks that are financing DBS's operations agreed that in the event of exercise of the Company's shares in DBS by them, the financial entities shall be entitled to a proportionate part of the receipts of such, at the rate set out in the agreements. The institutional entities were also given an option to provide loans in an identical sum to that provided by them provided that the sums of the loans are required under DBS's business plan, and this option is exercised by them in full. Concurrent with these agreements, appropriate amendments were made to the finance agreement with the banks financing DBS's operations, the main point of which was to view the loans received from the institutional entities as shareholders' loans as aforesaid.

5.12.5 Need for raising of additional sources of capital

DBS's management is acting to obtain additional sources of finance in order to enable it to realize its plans for the coming year. If such sources are not obtained, DBS shall operate in accordance with an alternative business plan, based on the sources of finance available to it at present.

For details of the shareholders loans and for the position taken by the Ministry of Communications regarding limitations on the provision of shareholders loans by the Company, see Section 5.19B below and Note 8E to the Company's financial statements for the year ended December 31, 2005, included in this periodic report.

5.13 Taxation

See Note 11 to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

Following an audit of assessments for the years 2000-2003, DBS was issued assessments by the income tax commission in accordance with its best judgment. DBS has submitted an objection to the aforesaid assessments, but a date for hearing such objection has not yet been set down.

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. Primary 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 Communications Law and the regulations promulgated pursuant thereto. The Telecommunications (Proceedings and Conditions for Grant of Satellite Broadcasting License) Regulations, 5758-1998 (hereinafter: the "License Regulations"), determine the processes and conditions for receipt of a broadcasting license, and also various restrictions applicable to a licensee during the term of the license. The License Regulations prescribe, *inter alia*, suitability conditions for a satellite broadcasting licensee, relating to the direct or indirect holdings of the broadcasting licensee and the interested parties therein, in cable broadcasting franchisees, in franchisees pursuant to the Second Authority for Television and Radio Law, 5750-1990, and in proprietors of daily newspapers.

The Telecommunications (Television Broadcasts via Satellite) (License Fees and Royalties) Regulations, 5759-1999 determine the percentage of royalties and broadcasting license fees to be paid by the satellite broadcasting licensee to the state. Under these regulations, DBS is required to pay royalties at 3.5% of its revenues from the provision of broadcasting services in 2004 and thereafter. DBS applied to the Ministry of Communications and the Ministry of Finance seeking to cancel the obligation to pay the royalties, or at the least, to reduce the rate of them in accordance with the reduced rates recently prescribed for MRT licensees, international licensees and domestic fixed-line licensees. To the best of DBS's knowledge, a decision has not yet been handed down in respect of this application.

Under Section 6WW of the Communications Law, the license may prescribe the maximum prices that a subscriber may be billed. As at the date of this report, no such prices have been prescribed.

In accordance with the requirements of the broadcasting license and regulations determined by the Council, in 2004 and 2005 DBS shall invest in local productions an amount which is not less than 8% of its revenues from subscriber fees. According to a decision of the Council, in 2002 DBS was in compliance with its obligation to invest in local productions, except for approximately NIS 3,900,000 and under-investment of approximately NIS 7,800,000 in original quality productions, and in 2003, DBS had met the obligation to invest in local productions except for the sum of approximately NIS 370,000 and under-investment of approximately NIS 5,200,000 in original quality productions, however the Council allowed DBS to make up these shortfalls during 2004 and 2005 (with original quality productions). DBS notified the Council that it had met its local production obligations for 2004 (including the proportional part of completing past obligations), and the matter is currently being examined by the Council. According to a decision of the Council dated September 2005, the rate of investment of DBS's revenues in local productions during the years 2006 and 2007 will stand at 8% of such revenues.

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 Communications 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 Operations subject to broadcasting license

DBS's operations are subject to the provisions of its broadcasting license. The Communications Law, the License Regulations and the license stipulate a number of grounds on the basis of which the Minister of Communications can terminate, restrict or make the broadcasting license conditional, after consultation with the Council and the granting of a hearing to the broadcasting licensee, among them, violation of the provisions of the law or rules and regulations pursuant thereto, a material violation of the terms of the broadcasting license or a non-material violation which was not amended after a warning from the Minister or the Council, the cessation of broadcasts for an unreasonable period of time or the total cessation of broadcasts for 14 consecutive days, noncompliance of the licensee with the restrictions determined in relation thereto in the License Regulations, and the appointment of a receiver or temporary liquidator for the licensee or the issuing of a liquidation order, all pertaining to the licensee.

The Minister of Communications, in consultation with the Council, and after granting the broadcasting licensee an opportunity to make its arguments and considering the harm to its rights, may change the terms of the broadcasting license, *inter alia*, for the purpose of the goals stipulated in the license. In addition, the Council alone has concurrent authority to amend the broadcasting license, provided that the broadcast licensee is first of all given an opportunity to make claims.

5.14.3 Principal restrictions by virtue of the law and broadcasting license

The Communications Law and Broadcasting Regulations stipulated the following principal general conditions: the broadcasting license may not be transferred or attached; encumbrance of the broadcasting license, insofar as it may be encumbered under the law, requires prior written approval from the Minister of Communications; transfer, encumbrance or attachment of any of the assets of the broadcasting license

from August 2001 onwards, which were not granted advance permission in the license, require approval from the Minister of Communications, except for encumbrance of an asset in favor of a banking corporation; an encumbrance placed on any of the broadcasting licensee's assets shall not be realized unless as determined by the Minister of Communications; DBS's broadcasts under the broadcasting license, and the scope thereof, are subject to the Law (for the statutory restriction on VOD services, see Section 5.6.5A above); 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; conditions regarding whether the terminal equipment installed by DBS complies with standards.

The broadcasting license stipulates provisions regarding the types of payments that the broadcasting licensee may collect from its subscribers. The broadcasting license also stipulates that the list of prices that the broadcasting licensee collects from its subscribers for broadcasts and services shall be first submitted to the Council for approval, and that any amendment thereto shall be first submitted to the chair of the Council for approval. The Council does not intervene in DBS' tariffs but ensures that there is no bias or discrimination between subscribers or breach of the provisions of the law. With respect to reductions, discounts and promotions (for a restricted period), DBS is required to notify the chair of the Council no later than the date of publication or commencement, whichever is the earlier, and the chair may intervene if he finds them to be misleading to the public or as drawing distinctions between subscribers.

The broadcasting license sets out a number of provisions that relate to the content of DBS's broadcasts, including approval of the channels broadcast by DBS and amendments in respect of them by the Council (including the content of the Company's basic package), approval of the electronic program guide (EPG) which is part of DBS's digital service to its subscribers.

DBS is also required to transmit 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 to its subscribers. Under 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.

Pursuant to a decision of the Council dated January 2006, DBS, including its shareholders, are entitled to own up to 30% of the local channels broadcast in DBS’s broadcasts (compared with a 20% restriction that applies to the Cable Companies).

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

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

On August 16, 2004, DBS received a letter from the Director General of the Ministry of Communications in which he gave notice to DBS that given the extent of its breaches of the administrative orders, he intended to issue a demand to DBS to pay sanctions for 15 breaches out of all of the breaches committed by it, in the total sum of NIS 1,354,500. DBS objected to the imposition of such sanctions, and to date, no such letter of demand has been received.

On August 15, 2005, the Ministry of Communications gave notice to DBS and the cable companies that in light of their many breaches of the administrative orders, it has examined the issue and is currently considering repealing them *inter alia* in light of the mechanism for purchasing wiring set out in the Communications Law, which enables a subscriber to purchase the wiring in his home for NIS 120. On November 2, 2005, DBS submitted its position to the Ministry of Communications to the effect that the administrative orders should remain in force, whilst repealing the prior notice obligations set out therein which require the giving of notice to the party whose subscribers are disconnecting from their service. DBS also claimed that the statutory provision affording title to the multi-channel television provider over the infrastructure installed by it in the subscriber’s home should also be repealed. DBS claimed that at least, if this provision is to remain, then the proper interpretation of it ought not be to give the cable companies title to the wiring installed by them in private homes. DBS also claimed that the sum set out in the Law as the consideration to be paid for purchase of the wiring (NIS 120) has no basis and that should the provision remain in force, it should be reduced considerably. DBS further claimed that the arrangement being considered by the Ministry of Communications is deficient and has many faults, and will prevent the proper transfer of subscribers under it, and will harm competition. As at the date of this report, the results of the hearing have not yet been reported.

5.15 Substantial Agreements

Following is a summary description of the principal agreements likely to be considered as material agreements not in the normal course of business of DBS which have been signed and/or are valid in the period of the Periodic Report:

5.15.1 Agreement for the purchase of decoders

In August 2000 DBS signed an agreement for the purchase of decoders with Advanced Digital Broadcast Ltd. (hereinafter: “ADB”) and Eurocom Marketing (1986) Ltd. (hereinafter: “Eurocom”), in which Eurocom Communications Ltd., an interested party in DBS, is also an interested party (hereinafter: the “ADB Agreement”). Under the ADB Agreement, DBS purchased a minimum number of decoders from ADB and is also entitled to purchase additional decoders from time to time in accordance with a purchase order which DBS is to send to Eurocom. DBS is also responsible for the converters and support service thereof via Eurocom. 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. In 2005, DBS purchased decoders from Eurocom in the sum total of NIS 92 million. DBS also decided to continue at this stage to purchase additional decoders under the ADB Agreement.

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 1 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 satellite and it was granted an option to lease up to two and a half more space segments (and in a particular case, half a segment more) 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, DBS has not completed reducing its past debt, as required under the amendment to the agreement of May 2003.

The rental set out in the First Space Agreement consist of fixed annual rental for every space segment used by DBS.

The First Space Agreement regulated mechanisms guaranteeing reserve and backup in the event of satellite faults. *Inter alia*, it was prescribed that the satellite's reserve transponder used as backup for the satellite's entire capacity would serve as reserve capacity for DBS if the reserve transponder were used to restore any satellite capacity. HLL undertook to make available one space segment within six months and within a further three months another reserve space segment which would be used as reserve capacity for the satellite's entire capacity. In the event of a fault contemporaneous with another capacity DBS has priority for the restoration of the capacity that it has leased.

Second Space Agreement

In May 2000 DBS signed another agreement with HLL to lease space segments on the Amos 2 satellite, as amended in May 2003 (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 started 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 are to be used as reserve capacity for the leased capacity on Amos 2, and alternative capacity if the leased capacity becomes unusable, and awards DBS the right of first refusal to lease other space segments on Amos 2 under the terms specified in the agreement.

HLL has undertaken to act to extend the lease period for the space segments beyond the current lease period, and for this purpose to endeavor to station a subsequent satellite in a suitable position, with similar technical characteristics, so that it will not be necessary to make changes to the receiver systems of DBS subscribers, under the conditions determined in the agreement, until December 31, 2013, provided that an appropriate agreement for the continuation of the satellite's life is signed by the parties, as shall be determined in said agreement, pursuant to which DBS will lease at least 14 space segments in consideration of annual leasing fees under similar commercial conditions.

As at the date of this report, DBS leases 7 space segments on the Amos 1 satellite (out of the 8 segments under the First Space Agreement), due to a technical restriction

which prevented leasing of the eighth segment for a very long period, which required DBS to implement alternative permanent solutions. DBS is in negotiations with Aviation Industries regarding the obligation to lease the eighth segment, and the cost thereof. As at the date of this report, DBS is also leasing 6 space segments on the Amos 2 satellite. The rental in 2005 for the First Space Agreement and the Second Space Agreement amounted to approximately NIS 100 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. The provisions of the agreement were applied in January 2006, *mutatis mutandis*, to the advanced (second generation) version of the smart card. 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. During 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. During the course of 2005, the parties agreed to stop outsourcing certain of DBS' information systems, and to return them to DBS' management. As at the date of publication of this report, the parties are in negotiations to examine certain amendments to 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 Note 8E to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

5.15.6 Agreements with DBS shareholders – see Section 2.17.3

5.15.7 Agreements with institutional entities – see Section 5.12.4 above.

5.16 Joint Venture Agreements

5.16.1 DBS purchases annual internet access packages at high baud rates based on DSL infrastructure, and sells these packages to its subscribers together with its broadcasts and services to its subscribers (see Section 5.6.5B above).

5.16.2 DBS has a joint venture with Bezeq International Ltd., a subsidiary of the Company, for the supply of a basket of services including multi-channel television services (supplied by DBS), infrastructure connection to the internet and internet access services (supplied

by Bezeq International Ltd.). The venture operates under the brand name “yes-Wow”. As of 2005, the venture has been operating on the basis of customer retention only, and no marketing or sales efforts are being made via it.

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

5.17 Legal proceedings

- 5.17.1 On December 29, 2005, an application was filed in the District Court at Tel Aviv to approve a claim, filed originally against DBS in the Local Court at Kfar Saba, as a representative action under the Consumer Protection Law, 5741-1981, under which the following relief is sought: (a) the award of financial compensation to every subscriber with whom DBS contracted by telephone, without a written contract (the Applicant left prescription of the amount of the compensation to the discretion of the Court, whilst in his own personal claim, compensation in the sum of NIS 20,000 is sought); (b) financial compensation in the sum of the permits collected for each subscriber who in fact paid sums higher than those agreed upon by telephone with DBS’s service representatives; and (c) a declaratory order to the effect that each subscriber who contracts with DBS by telephone will also receive the arrangement in writing within 21 days.

DBS intends to submit an application to strike the application for approval of the claim as a representative action out *in limine*. At this initial stage, DBS is unable to assess the chances of success of the claim.

- 5.17.2 On June 1, 2005, Matav Cable Communications Systems Ltd., Tevel Israel International Broadcasting Ltd., Arutzei Zahav & Co, and Hot Telecom Limited Partnership (in this Section jointly: “HOT”) filed a claim in the District Court at Tel Aviv following the incident known as the “Trojan Horse Incident”. Under these proceedings, the Court is requested to award the following main remedies against DBS: An order against DBS and any person acting on its behalf in the past or in the present, declaring that HOT is the holder of rights in all of the commercial secrets (including information that is censored or privileged under law), obtained by DBS and/or any person acting on its behalf using illegal means contrary to the law; an order against DBS and any person acting on its behalf (including the Civil Intelligence Investigation Company) instructing them not to make any use of commercial secrets of HOT obtained by illegal means contrary to the law; an order instructing DBS and any person acting on its behalf not to transfer or delivery commercial secrets or information regarding them to any person; and an order instructing the transfer of all of the commercial secrets to a person to be appointed by the Court to collect the material and transfer it to HOT. The statement of claim does not include an application for any financial remedy. HOT gave notice that it reserves the right to update and add to the statement of claim.

Contemporaneous with the claim, HOT filed an application for temporary relief regarding the appointment of a receiver and injunctions with respect to HOT’s commercial secrets that are in the possession of DBS.

On June 30, 2005, DBS filed a statement of defense with the court, denying the claims made by HOT in the statement of claim.

On July 7, 2005, the court decided, with the consent of the parties, to give force of an order to DBS’s notice (given as part of its response to the application) stating that no use would be made of documents or information transferred to DBS by Civil Intelligence. In doing so, the court in effect dismissed HOT’s applications to appoint a receiver and to award a temporary injunction that would be broader than DBS’s undertakings.

On July 12, 2005, HOT filed an application to split remedies, so as to enable it to file a monetary claim against DBS under a separate action. In its application, HOT stated that at this stage, it is not yet possible to assess the financial damage caused to it as a result of the “theft of commercial secrets” that it alleges, since it is as yet unaware of the extent of the documents and information that had been given to DBS by Civil Intelligence. On September 18, 2005, DBS filed its response, in which it applied for the application to be dismissed. No ruling has yet been handed down on this application.

A date for hearing of the claim has not yet been set. At this stage, taking into account the fact that no financial claim has been filed yet, the fact that no ruling has yet been

made on the application to split remedies and the novelty and complexity of the legal questions arising under the claim, DBS's legal counsel are unable to assess the chances of the claim.

- 5.17.3 In January 2006, an arbitration ruling was handed down in mutual claims (which included financial remedies, declaratory remedies and mandamus orders) between DBS and Play TV Ltd. (hereinafter: "Play TV") with respect to broadcast on March 5, 2005 of a pornographic movie produced by Play TV (in this Section: the "Movie") on the Playboy channel broadcast by DBS.

The arbitration ruling states, *inter alia*, that Play TV breached the agreement between the Parties in broadcasting the Movie, and in its conduct after the dispute regarding it arose, however, such breach did not amount to fundamental breach and did not entitle DBS to rescind the agreement; that Play TV bear the full fine imposed upon DBS as a result of cancellation of the Movie; and that DBS pay Play TV for DBS' employees who had watched Play TV's channels at no charge as of June 2003, and that to the extent that DBS' information systems do not enable it to extract data regarding actual viewing, payment would be made as if the percentage of DBS employees who watched the channel was equal to the percentage of DBS' total subscriber population who watch the channel, as such was for each month.

Soon after award of the arbitrator's ruling, a dispute arose between the parties as to implementation of it, with respect to the question of payment for DBS's employees who viewed the channel, in insubstantial sums, and as a result, Play TV filed a request to the arbitrator on January 24, 2006 to clarify his ruling. As at the date of publication of this report, the parties are in negotiation for a financial settlement.

- 5.17.4 On September 27, 2004, Endemol Nederland B.V. and Endemol International B.V. (hereinafter jointly: "Endemol") filed a claim against DBS and Synergia Productions Ltd. (hereinafter: "Synergia") in the District Court at Tel Aviv. The statement of claim alleged that the television program "Project Y" broadcast by DBS and produced by Synergia was a copy of a format which Endemol claimed to have created. According to Endemol, Synergia and DBS had breached Endemol's copyright in the format, had been unjustly enriched at Endemol's expense, and had caused it immense damages. Consequently, Synergia and DBS were sued to pay Endemol the sum of NIS 8,222,156 (or alternatively, NIS 1,840,000 by way of compensation without proof of damage), and to provide Endemol with details of all of their revenue from broadcast of the Project Y program.

On December 15, 2004, DBS submitted its statement of defense, in which it applied to dismiss the claim *in limine* or alternatively, to dismiss it substantively, *inter alia* on the grounds that a "format" is not a work that is protected under Israeli law, and for that reason, "Project Y" does not constitute a copy of such alleged "format".

The parties are in advanced stages of proceedings, and pursuant to a ruling of the Court, the date for completion of such proceedings is the middle of April 2006.

DBS has included a provision on its books for exposure, as estimated by its legal counsel.

- 5.17.5 For other legal proceedings in which DBS is involved, see Notes 19 and 8E to the Company's financial statements for the year ended December 31, 2005, included in this periodic report, and Section 1.1.5 above.

5.18 Business Strategies and 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), to continue 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), and to expand its value added services, with an emphasis on providing VOD services to its subscribers (see Section 5.6.5A above). Additionally, in order to increase revenues from subscribers, the Company is operating to increase the scope of the contents sold to subscribers.

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). Realization of DBS's goals regarding launch of VOD services and personal television depend, in addition to the above, on obtaining the statutory and regulatory consents required for such (see Section 5.6.5A above).

5.19 Discussion of 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 consents from the Council and the Ministry of Communications. Failure by DBS to comply with the instructions and rules of regulatory entities might cause the Ministry of Communications to impose fines and to revoke licenses that DBS holds.

B. Regulation of additional sources of funding for DBS

The raising of sources of financing, under DBS's business plan for the coming year, is vital for its ability to meet its business plan and to enable it to repay the bank credit on time (failure to pay on time as aforesaid gives rise to grounds for making the bank credit repayable immediately, in accordance with and subject to the provisions and restrictions in the finance agreement (see Section 5.12.2 above)). For the regulatory restriction on raising funds from shareholders of DBS, see Note 8E to the Company's financial statements for the year ended December 31, 2005, included in this periodic report.

Failure to raise the funds might cause DBS to fail to comply with the financial criteria set out in the finance agreement, which constitutes grounds for making the bank credit immediately repayment in accordance with and subject to the provisions and limitations of the finance agreement (see Section 5.12.2 above).

C. Ability to offer integrated services

See clause 5.6.5B above.

D. Foreign currency and linkage differential 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 DBS's business results.

In addition, the loans that DBS has taken from banks and institutional entities are, in part, linked to the consumer price index, and therefore, a sharp increase in inflation rates might have a substantial effect on DBS'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 a 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. Should one of the broadcasting centers be damaged, DBS will transfer most of its broadcasts through the other broadcasting center, however, as at the date of this report, in the event of harm to DBS's broadcasting center at Kfar Saba, it will not be possible to transfer the broadcasts of DBS's independent channels via 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 5.10.1B 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.

- G.** DBS' broadcasts are based on an encoding of the broadcasts that are transmitted via satellite and the decoding of them by way of a smart card installed in the decoder at the subscriber's home (see Section 5.15.3 above). Defects in the encoding system, or a breach of it, might cause harm to broadcasts and to revenues from such.

Risk Factor Summary Table

	Extent of effect of risk factor on DBS operations		
	Large effect	Medium effect	Small effect
Licensing and Regulation regime – industry risk	X		
Regulation of additional sources of financing – special risk	X		
Ability to offer integrated services – special risk	X		
Exposure to changes in exchange rates and index – macro risk			X
Broadcasting center and satellites – special risk		X	
Technical inferiority compared with competition – special risk	X		
Encoding system – sector risk		X	

**Update to Chapter A (Description of Company Operations)¹⁴
of the Periodic Report for 2005 ("the Periodic Report") of
Bezeq, The Israel Telecommunication Corp. Limited ("the Company")**

(Update for the period March 1, 2006 to August 14, 2006)

1. Description of General Development of Group Operations

To Section 1.1 – Group Activity and Description of its Business Development

To Section 1.1.5 of the Periodic Report – Mergers and Acquisitions

On August 2, 2006 the Company and DBS filed merger notices to the Antitrust Commissioner ("the Commissioner"), concerning exercise of options for DBS shares by the Company, which would increase the percentage of the Company's holding in DBS from approximately 49.8% to approximately 58%. The Commissioner's approval for increase the Company holding in DBS to more than 50% has already been given (on certain conditions) in the past (on January 2, 2005), but expired one year later, and therefore the companies have submitted a renewed request for approval of the merger.

At the end of July 2006, the Company began examining a possible merger of the operations of the wholly-owned subsidiary BezeqCall Communications Ltd. (whose business is in network end points) and the wholly-owned subsidiary Bezeq International Ltd. (whose business is in internet, international calls and integration solutions for businesses). Such a merger, if and to the extent accomplished, would require approvals prescribed in law, among them of competent entities, the Ministry of Communications and the Antitrust Commissioner. It is noted that BezeqCall commenced negotiations for acquisition of another operation in its area of business. The scope of the transaction is estimated at approximately NIS 90 million. If the transaction is closed, it too will require approvals, among them the approvals of the competent organs of the parties.

To Section 1.1.6 of the Periodic Report – Sales

Further to immediate reports of the Company on April 10, 2006 and June 22, 2006, concerning examination of holdings in Walla! Communications Ltd. through the subsidiary Bezeq International, the Company announced in an immediate report dated July 19, 2006 that it had ended its contacts on this matter and is not currently acting for the sale of the holdings.

On April 30, 2006 an agreement was signed between the Company, Malam Systems Ltd. and Goldnet of the first part, and the subsidiary Bezeq International of the other part, for acquisition of all the operations of Goldnet by Bezeq International, in consideration of NIS 6.8 million, which will be divided between the Company (NIS 5.1 million) and Malam Systems (NIS 1.7 million). See also the update to Section 4.9 below.

Regarding a memorandum of understanding signed between the Company and a foreign investor concerning the sale of a satellite communication operation of the Company (Inmarsat and Bezeqsat) – the Company commenced negotiations with other potential buyers after the negotiations with the foreign investor failed to arrive at an agreement.

To Section 1.4 – Distribution of Dividends

Further to Section 1.4.3 of the Periodic Report concerning the resolution of the Board of Directors of the Company on March 1, 2006 to recommend to the general meeting of the shareholders of the Company to distribute a cash dividend to the shareholders of the Company in a total amount of NIS 1,200,000,193, which as at the date of the distribution constitutes NIS 0.4606446 per share and 46.06446% of the issued and paid up capital of the Company, a Special General Meeting of the shareholders of the Company on March 23, 2006 approved the distribution of the dividend. The dividend was distributed on April 16, 2006.

¹⁴ The update is pursuant to Article 39A of the Securities Regulations (Period and immediate reports), 5730-1970, and includes material changes or revisions which occurred in the business of the corporation in any matter which should be described in the Periodic Report. The update relates to the section numbers in Chapter A (Description of Company Operations) in the Period Report of the Company for 2005.

2. Fixed-Line Domestic Communications –

"Bezeq" – The Israel Telecommunications Corp. Limited ("the Company")

To Section 2.1 - General Information Regarding the Area of Operations

For Section 2.1.2 of the Periodic Report in on the subject of updating the Company's tariffs – on July 1, 2006 the Communications Regulations (Telecommunications and broadcasts) (Payment for telecommunications services), 5766-2006 and the Communications Regulations (Telecommunications and broadcasts) (Computation of payments for telecommunications services and their linkage) (Amendment No. 2), 5766-2006, came into effect. According to the regulations and based on the tariff update formula prescribed in the Communications Regulations (Telecommunications and broadcasts) (Computation of payments for telecommunications services and their linkage), 5763-2003, the average reduction of the controlled tariffs of the Company determined according to Section 15(a) of the Communications Law, applicable from July 1, 2006, is 0.36% (excluding the reduction of VAT by 1% which took effect on the same date). This reduction is based on a change of about 2.4% in the Consumer Price Index, less an average efficiency factor of about 2.7%. In addition, the Communications Regulations (Telecommunications and broadcasts) (Payment for interconnect) (Amendment), 5766-2006, whereby interconnect fees were reduced by approximately 2% (including the 1% VAT reduction), came into effect on the same date.

See also Note 1C(3) to the financial statements of the Company for the period ended June 30, 2006.

For the matter of Section 2.1.9 of the Periodic Report on the subject of grant of special general licenses for providing fixed-line domestic communication services – see the update to Section 1.2.6.1 and 2.6.4 below.

To Section 2.2 – Products and Services

The Ministry of Communications has informed the Company that its position is that the Company should have informed it about the provision of IP – Centrex services, which is a virtual private network service before starting to provide the service, and that therefore the Ministry is considering approval of the provision of the service by the Company and its terms. The Company explained to the Ministry that the service is included in its license. The Company replied to all the Ministry's questions and provided the information it requested.

In the matter of Section 2.2.2 of the Periodic Report – on March 7, 2006, the Ministry of Communications published a hearing for all the communication companies in connection with its intention that a united 144 call center would be operated for all the communication companies, with callers being able to obtain the telephone numbers of all the operators' subscribers in a single telephone call. Concurrently, a united website would operate for all the communication companies. In a letter of response submitted by the Company on March 26, 2006, the Company presented its position that the directory assistance service is auxiliary to the telephony services provided by the license holder; that entities that do not hold a general license should not be permitted into the sector and that the service should be retained in its present format as an auxiliary service to the services of the general license holder. The Company's position is that the demand for directory assistance services to be provided free of charge on the internet is unreasonable and disproportionate, places an unreasonable burden on the operators and compromises their rights of ownership. The directory assistance call center provided by the Company is already a "united call center" that provides information services about most telephony subscribers in Israel and, insofar as this depends on the Company – the call center will provide all the information about those telephony subscribers in Israel who request that the information about them be published for the public.

In the matter of Section 2.2.3 of the Periodic Report – internet access service – the number of the Company's ADSL subscribers as at June 30, 2006, is approximately 844,000 (compared with approximately 800,000 subscribers at the end of 2005).

To Section 2.6 – Competition

To the best of the Company's knowledge, negotiations are being held for the possible merger of Netvision, Barak and GlobeCall. Furthermore, according to news publications, Internet Zahav has purchased 60% of the shares in Golden Lines. On July 30, 2006, the Company applied to the Antitrust Commissioner requesting to state its position prior to the handing down of a decision in this matter. In this regard, see also updates to sections 4.6.1.1 and 4.6.2.1 below.

To Section 2.6.1 of the Periodic Report – Telephony

- A. As at the date of publication of this report, according to reports in the media, HOT's telephony service numbers over 125,000 customers.

On August 10, 2006 the Company, via its counsel, wrote to the Minister of Communications requesting the immediate enforcement of fulfillment of HOT's obligations and undertakings under the license, regarding the requirements of structural separation.

- B. A license for a paid marketing trial for VoIP services has also been issued to a subsidiary of Pelephone Communications Ltd. On this matter, see update to Section 3.7 hereunder.

On August 31, 2006, Bezeq International's trial license is due to expire, and it has applied to extend it. In this regard, see update to section 4.1.2 below. The trial license granted to Golden Lines was extended by half a year (until January 31, 2007).

- C. In the matter of Sections 2.6.1 and 2.6.4 of the Periodic Report on the subject of the issuing of special general licenses for the provision of fixed-line domestic communication services – to the best of the Company's knowledge, such licenses have been issued to GlobeCall Communications Limited Partnership, to Cellcom Fixed-Line Communication Services Limited Partnership and to 012 Telecom Ltd. The subsidiary Bezeq International Ltd. has submitted an application for such a license (see update to Section 4.1.2 below), and the subsidiary Pelephone Communications Ltd is also preparing for the submission of an application for a special general license for the provision of fixed-line domestic communications services (see update to Section 3.7 below). Likewise, to the best of the Company's knowledge, "Partner" and "Barak" have also filed an application for a special domestic carrier license.
- D. On March 16, 2006, the Company applied to the Ministry of Communications to conduct a marketing trial of paid VOB (despite its clear position that it is entitled to supply that service under its license), and received a negative reply.

To Section 2.6.3 of the Periodic Report – Transmission and Data Communication

On the subject of the Accountant General's tender for the provision of data communication services – on April 11, 2006 the Supreme Court decided to dismiss the appeal filed by the Company against the District Court's ruling and to order it to pay court costs. On July 27, 2006, the Company received a notice from the Accountant General that it had won the tender, the Accountant General having received, at his request, the approval of the Ministry of Communications to the Company's offer, on that date.

At the beginning of July 2006, Partner gave notice that it had completed purchase of the transmission operations of Med1 I.C.-1 (1999) Ltd.

To Section 2.6.4 of the Periodic Report – Competition from the Cellular Companies

In the matter of moderation of the downtrend in the number of voice minutes, *inter alia* as a result of the slowdown in the growth rate of the cellular companies, it is clarified that the downtrend in the number of fixed-line voice minutes is continuing in any event. This is due to the development of alternatives to these calls, mainly by means of internet-based calls. There has also been an increase in calls made from the domestic fixed-line networks to cellular networks.

In the matter of the appeal filed by the Company in 2001 in the Antitrust Court with regard to the Antitrust Commissioner's refusal to change the declaration of the Company's status as a monopoly in basic telephony service (fixed-line domestic telephony) – in the wake of the Company's petition that the Court expedite the hearing of the appeal, the Company agreed, acting on the Court's suggestion (in light of the time that has passed since it was submitted, together with an economic opinion), to withdraw the appeal, which was expunged on August 2, 2006. The Company is preparing to file a new and revised petition to the Antitrust Commissioner. In the Company's opinion, the cellular telephony market constitutes an alternative market to fixed-line telephony, and this fact is reinforced by new and up-to-date data that has accumulated during the period since the appeal was filed in 2001.

To Section 2.6.5 of the Periodic Report – Additional Factors that could affect Competition

- A. Numbering and number portability – during February/March 2006 there was a further exchange of letters with the Ministries of Communications and Finance on the matter of the operators', including the Company's, inability to meet the timetables that were set. The Company reiterated that it is preparing for the implementation of number portability but for real and technical reasons, it cannot meet the timetable set for implementation of the plan, and it reserves its legal rights in this matter.

In June 2006, the Company once again applied to the new Minister of Communications, asking the Minister to act to enact an amendment to the Communications Law in order to prescribe a reasonable timetable for implementation of number portability. On August 2, 2006, a letter was sent to the Company from the Supervision Department of the Ministry of Communications, containing a summary of supervision regarding the Company's compliance with the number portability plan. According to the claims made in that letter, the Company is not in compliance with the timetables set for implementation

of number portability, and the Company's explanations for such were not accepted. On August 8, 2006, a letter was sent by the Company in response to this letter, explaining that the summary of the discussion was not, in the Company's opinion, in accord with the spirit of the discussion on the matter, that the Ministry's good impression of the Company's acts was not expressed in the summary and that it had not been possible to commence making preparations earlier, prior to the formulation of a characterization plan, and prior to formulation of full characterization by the Ministry of Communications. On August 7, 2006, a letter was sent by the Chairman of the Number Portability Forum to the Minister of Communications, requesting the Minister to act to postpone the date of implementation of the plan.

Note that contemporaneous with its correspondence as aforesaid, the Company is making its best efforts and is investing considerable resources in order to advance implementation of number portability on its systems. Thus, for instance, the Company recently signed a memorandum of understanding stating that it would purchase a number portability system (LNP – Local Number Portability) for the Company's public switching network. Likewise, the Company is expected to sign an agreement in the coming days to implement an LSMS system for number portability, and simultaneously operations are being effected with various companies in order to make other adjustments to the Company's systems, which are required in order to implement number portability.

On April 23, 2006 a letter was received from the Deputy Director General for Engineering and Licensing at the Ministry of Communications, in which he suspends the use of certain ranges of the prefix 076, that was allocated for the Company's use, in the wake of information received by the Ministry indicating that the Company intends to use that allocation for the provision of a service which, ostensibly, has not yet been duly approved – the IP – Centrex service. On July 19, 2006, a letter was received from the director of numbering at the Ministry of Communications, canceling the suspension, following the Company's clarification that use would not be made of the IP-Centrex service in those ranges, until completion of examination by the Ministry of Communications. In this regard, see update to section 2.2 above.

- B. Additional potential competing infrastructures – on the subject of the allocation of frequencies (WIMAX) – the Company made it clear that its position is that there is no reason and no need to allocate these frequencies, which are a limited State resource, to operators who hold special licenses and who are not obligated to provide universal service. The Company believes that mainly due to the vital need of these frequencies for providing services in outlying areas, the top priority of the policy on the subject of frequency allocation for wireless access systems must be universal service and the creation of conditions that will make it possible to provide it.

Recently, the Municipality of Tel Aviv-Yafo wrote to the Ministry of Justice and to the Ministry of Communications regarding the laying of infrastructure by communications companies within its territory, and the use of the Municipality's infrastructure, in an attempt to receive authority and impose additional limitations on communications companies in this regard. The Company objects to the Municipality's position and shall provide a response to the Ministries of Justice and Communications.

To Section 2.6.7 of the Periodic Report – positive and negative factors affecting the Company's competitive status

In the matter of a lack of tariff flexibility – the Ministry of Communications has begun intervening in the marketing campaigns offered by the Company to the public. On April 5, 2006, the Ministry of Communications published a press release addressing the consumer public directly, whereby the legality of the Springtime Campaign that the Company launched a few days previously was being examined. In the Springtime Campaign, customers who buy a telephone and other equipment from the equipment suppliers participating in the campaign are entitled to 200 free call minutes per month for calls made between the Company lines, for a period of one year. The Ministry announced that it is possible that customers who purchase the telephones will not be able to realize the benefit. Previously, the Director General of the Ministry of Communications sent a letter to the Company stating that the campaign was launched without the Ministry's approval. In its reply, the Company noted its fundamental legal position, which was sent to the Ministry and had not yet elicited a response, whereby the Company does not need the Ministry's approval for marketing campaigns. However, without prejudice to this position on the part of the Company, the Company clarified that in any case the campaign in question does not fall under the category of an existing work procedure vis-à-vis the Ministry. After publication of the Ministry's press release, the Company demanded that the Ministry publish a denial or a correction. The Ministry failed to respond and continued to demand information, documents and data. The Company gave the Ministry documents and data, despite its position that the Ministry has no authority in this matter. In addition, the Company announced that it reserves the right to act in this matter. Subsequently, the Ministry of Communications announced its intention to foreclose on a guarantee in

the sum of NIS 7 million out of the bank guarantee of \$10 million that the Company deposited to guarantee fulfillment of the terms of its license.

On May 24, 2006, the Company submitted an appeal to the Minister of Communications against the decision. The appeal has been heard but no ruling has yet been handed down.

With respect to complaints by communications operators to the Ministry of Communications and to the Antitrust Commissioner against the Company, and applications to the Company in this regard, see Note 1(c)(8) to the Company's Financial Statements for the period ending June 30, 2006.

To Section 2.9 – Human Resources

In the matter of Section 2.9.1 – the Company's Board of Directors approved the appointments to the following new positions: On May 10, 2006, appointment of a Vice President for Regulation, as of June 1, 2006, and on July 12, 2006, appointment of a Deputy CEO of Strategy and Business Development, as of October 1, 2006.

In the matter of Section 2.9.5 – negotiations between the Company's management and the employees' representatives regarding the change in the Company's organizational structure, retirement/dismissal of employees, and a new labor agreement, are at an advanced stage of drafting an agreement. The agreement requires the consent of the New General Trade Union and the board of directors of the Company. Regarding a collective labor dispute declared on April 27, 2006, see note 5 to the financial statements for the period ending June 30, 2006.

To Section 2.10 – Raw materials and suppliers, purchase of equipment and suppliers

For the purpose of fulfilling the duty to implementing number portability between communications licensees, the Company is in the process of contracting with various suppliers in order to purchase new systems and make adjustments to existing systems. These contracts include purchase of additional computing and switching systems to those currently in existence, and the effecting of changes, adjustments and upgrades to the existing systems used by the Company in order to provide services to its customers, and surrounding systems used by the Company to support those systems.

With respect to section 2.10.2 in the table in the Financial Statements for 2005, which contains details of the Company's purchases in 2005, the ratio of purchases out of total purchases in the field of operations as at June 30, 2006 changed with respect to Amdocs (billing) from approximately 5% to approximately 14%, and with respect to Supplier D (transmission equipment) from approximately 12% to approximately 2%.

To Section 2.13 - Financing

To Section 2.13.6 of the Periodic Report – Credit Rating

1. **Maalot rating** – on April 4, 2006 the Company's existing rating (AA) for the debentures in circulation (private, public and Eurobonds), which had been on the Watch List since May 10, 2005, was ratified and validated, after renewed examination of the business risk, the financial risk and the Company's strategy, and following the sale of the Company's controlling interest to Ap.Sb.Ar. Holdings Ltd. ("**Ap.Sb.Ar.**").
2. **Midroog rating** – on April 11, 2006 the Company's rating was removed from the Watch List and left as Aa1. However, Midroog decided to lower the Company's outlook from stable to negative in order to reflect the possibility that the change in the Company's ownership will affect the Company's future business and financial profile.

To Section 2.15 – Environmental Protection

In the matter of Section 2.15.2 - the Non-Ionizing Radiation Law, 5766-2006 – on March 26, 2006 the Radiation Supervisor notified the Company and the cellular operators that for the purpose of readiness for most of the provisions of the law coming into effect on January 1, 2007, and with the goal of tightening and improving supervision, he intends to exercise his authority under the Pharmacists Regulations. He further notified that therefore, as of June 1, 2006, those applying for operating permits would be required to comply with the conditions for issuing a permit, including the condition relating to submission of a permit under the Planning and Construction Law. The Company is examining its continued preparations for the new law, taking notice of the said notification, and *inter alia*, the Company is continuing to act to take out building permits for its broadcast installations. The Company is working with the Ministry of the Interior and the Ministry of the Environment regarding the coming into force of NOP 36B, which deals with building permits for large broadcast installations, and with the requirement under the Radiation Law regarding presentation of a permit under the Planning and Building Law. On July 19, 2006, the Company sent a letter to the Ministry of the Environment requesting

that the Law be amended so as to postpone application of the provisions of the Radiation Law regarding presentation of a permit under the Planning and Building Law for three years from the date of entry into force of NOP 36B.

See also update to section 3.18.1.3.2 below, and Note 6A(19) to the financial statements of the Company for the period ending June 30, 2006.

To Section 2.16 – Limitations and Regulation of Company Activity

To Section 2.16.2 of the Periodic Report – the Company's General License

On the subject of volume discounts – on May 24, 2006, the Ministries of Communications and Finance approved a basket of alternative payments (in force as of June 1, 2006) which allow the Company to provide volume discounts at a rate of up to 10%.

On the subject of measuring the Company's market share – on March 15, 2006 the Company submitted a detailed position document to the Ministry of Communications clarifying that the demand for the loss of "market share" – is vague and constitutes fertile ground for disputes, delays and legal charges; likewise, the Company's position is that the conditions are ripe for granting the Company the possibility of marketing joint packages with its subsidiaries. In any case, in the opinion of the Company, a date should be set for this matter – no later than the end of Q1 2007. The Company emphasized that the restrictions should be removed and the Company be permitted to market joint packages in areas in which the Company has lost 15% of market share. In the matter of the parameters for measuring market share (insofar as the demand is not rescinded), the Company believes that the appropriate test is the minutes test and not the revenue test, and that the loss of the Company's market share should be measured in relation to a relevant starting point (November 2004) and that proof that the loss was in favor of certain competitors should not be required. A letter from the VP of Economics at the Ministry of Communications, dated July 12, 2006, stated that the Ministry does not accept the claim that the minutes test is the correct test, and that the revenue test is the test prescribed, whilst the Ministry will determine the normative criteria the purpose of which is to reduce the influence of factors that might alter the revenue estimates. The letter also states that if subsidiaries of the Company are entitled to operate in the field of domestic communications, the Company's market share shall be calculated at the group level. The letter further clarified that the methodology upon which the normative determination of the market share is to be based will be published by the Ministry when the Company's market share reaches around 85%, and that the Ministry may amend such methodology from time to time, in accordance with changes in the market. The Company intends to reply to the Ministry in this regard, mainly due to the vagueness, lack of certainty and harm to the Company because of the Ministry's positions stated above.

To Section 2.16.3 of the Periodic Report – Royalties

In April 2006 the Company paid the sum that was requested by the Ministry in respect of the Company's revenues from interconnect fees on calls from cellular subscribers to Company subscribers (approximately NIS 17 million). It should be noted that the Company has reached agreements with the Ministry regarding various disputes related to royalties. In this regard, see also Note 6A(6) to the Company's Financial Statements for the period ending June 30, 2006.

In connection with the reduction in the rate of royalties from 3.5% to 3% beginning January 1, 2006 – on August 9, 2006, the Finance Committee of the Knesset approved regulations made by the Minister of Communications with the approval of the Minister of Finance regulating a reduction of the rate of royalties for all licensees required to pay royalties, as of January 1, 2006, in the rate of 0.5% per annum up to a rate of payment of royalties of 1% per annum, as of 2010. The Ministry further gave notice that it would act to amend the regulations so as to grant the Company a retroactive exemption, as of January 2004, from the requirement to pay royalties for revenue from services that have been opened to competition. In this regard see Note 1(c)(1) to the Company's Financial Statements for the period ending June 30, 2006.

To Section 2.16.7 of the Periodic Report – Antitrust Laws

To Subsection (C) on the subject of the Company's appeal against the failure to rescind the declaration of the Company as a monopoly in basic telephony – see update to Section 2.6.4 above.

In connection with the Antitrust Authority's application in the matter of claims by certain telecommunication operators, see note 1(c)(8) to the financial statements of the Company for the period ended June 30, 2006.

In connection with the search conducted at the Company's offices on May 23, 2006 and the interrogation of a number of Company employees regarding the alleged abuse of the status of the

monopoly and/or an unreasonable refusal to supply an asset or service under the monopoly, and for additional searches and the investigation of a number of other employees of the Company (including officers) which took place following this, see note 1(C)(9) to the Company's financial statements for the period ended June 30, 2006.

To Section 2.16.10 of the Periodic Report – Class Action Law

On March 12, 2006 a new class action law was published, whereby a class action can be filed on various grounds detailed in the addendum to the law and under an explicit provision of the law in the matter of class actions (individual provisions, *inter alia*, in the Antitrust Law, the Consumer Protection Law, and the Banking Law – have been cancelled). Under the law, its provisions will apply also to petitions and actions that were pending on the date of publication of the law. The law includes definitions and expansions of the parties who are permitted to file a motion for a suit to be recognized as a class action, and determines the terms for its filing. The law grants the court discretion in various matters such as compensation, relief, replacement of a plaintiff in a class action and a reservation regarding the approval of the action against a body that provides an essential service to the public. The law makes it very hard to abandon a claim or to reach a settlement, both of which, *inter alia*, require the court's approval. Under the law, a fund for financing class action suits is being established, whose function is to assist representative plaintiffs in financing petitions whose submission is of public and social importance.

To Section 2.16.12 of the Periodic Report – Bill to amend section 13 of the Communications Law

On July 24, 2006, a hearing took place in the Knesset Economics Committee on the amended wording of a bill, adding provisions regarding the hearing of licensees prior to the making of orders, granting of immunity, etc. The definition of "communications crisis" was also expanded, however, the making of orders regarding a communications crisis was limited. In this hearing, it was determined that within two weeks, the wording of a statutory provision would be proposed under the amendment, enabling the Minister to make orders to a licensee in the event of a fault on the network of another licensee, under certain circumstances.

To Section 2.17 – Substantial Agreements

Management Agreement

On March 23, 2006 the General Meeting of the Shareholders of the Company approved the Company's contractual arrangement under an agreement with a company that would be under the ownership and control of the shareholders of Ap.Sb.Ar., in the framework of which the Company would receive regular management and consulting services, including by means of directors who serve and who will serve from time to time at the Company and/or at its subsidiaries, all in consideration of \$1.2 million *per annum*. The term of the contractual arrangement is from October 11, 2005 (the date of closing the acquisition of 30% of the Company's shares by Ap.Sb.Ar.) to December 31, 2008, unless one party gives the other three months' notice of its wish to terminate the agreement. A full description of the terms of the contractual arrangement was provided in the Company's Immediate Report (Amendment) dated March 13, 2006, concerning a transaction between the Company and a controlling shareholder.

To Section 2.18 – Legal Proceedings

For updates on the subject of legal proceedings, see Note 6 to the financial statements of the Company for the period ended June 30, 2006.

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

To Section 3.7 - Competition

In the matter of Section 3.7.2 of the Periodic Report – during the first quarter of 2006, Pelephone obtained a license for a marketing trial using VoIP technology, in accordance with an application that it submitted. The license includes a condition which, in the main, stipulates that if, at the end of a hearing which is being held by the Ministry of Communications, the policy document of the Ministry of Communications is amended in a way which prevents Pelephone from providing VOB services, the license for the trial shall expire. The license for the trial allows Pelephone to provide domestic telephony services using VoIP technology in the scope of 8,500 extensions and lines.

On August 2006, Pelephone submitted an application for a special general license for the provision of fixed-line domestic telecommunications services.

To Section 3.18 – Restrictions and Supervision of Pelephone’s Activities

In the matter of Section 3.18.1.3.2 – during the first quarter of 2006, notification was received from the Radiation Supervisor ("the Supervisor") whereby the implementation of some of the requirements of the Non-Ionized Radiation Law, 5766-2006 (the "Radiation Law"), among them making the issue of authorizations contingent upon obtaining a building permit, will be brought forward to June 1, 2006. Pelephone informed the Supervisor of its opposition to the date being brought forward, and that the Supervisor should adhere to the effective date determined in the law, i.e. January 1, 2007. In discussions that took place with the Supervisor and the cellular companies, the Supervisor gave notice of his intention to restrict the term of the operations permits given under the Pharmacists Regulations to sites without building permits, up to January 1, 2007. Pelephone claims that this is exercise of power in contravention of the transitional provisions set out in the Radiation Law, to the effect that permits given to sites under the Pharmacists Regulations which were in force immediately prior to entry into force of the Radiation Law shall be deemed for the duration of their term, to be permits given in accordance with the Radiation Law. At the same time, Pelephone is acting to comply with the provisions of the Law as aforesaid. As at the date of this Report, the proportion of approved sites at which Pelephone operates is approximately 75%¹⁵ of the total number of sites. Pelephone is acting in order to obtain permits and substitute solutions for its other sites. In this regard, see also Note 6(A)(19) to the Company's Financial Statements for the period ending June 30, 2006.

In the matter of Section 3.18.2 (E) – in addition to changes in the Telecommunications Regulations (Interconnect fees), 5760-2000, from December 2004, whereby as of January 1, 2009 the payment for the call completion segment to another cellular network will be according to time units of one second (unlike the present billing method that permits billing according to segments of up to 12 seconds), Pelephone's license was amended in December 2004 so that as of January 1, 2009, the fee for the airtime segment will also be calculated (in addition to the call completion segment as aforesaid) according to time units of one second (rather than the present billing method, which is according to time units of 12 seconds).

In the matter of Section 3.18.2 (G) – a typographical error was made in the Periodic Report for the year 2005, and the following sentence should be deleted from the end of this section: "During the past few months, a hearing took place, both in writing and orally, in the matter of the interconnect fees for all the cellular operators and, as at the date of publication of these statements, Pelephone is awaiting the decision that shall be made by the Finance Ministry and the Ministry of Communications."

In the matter of Section 3.18.3.1:

- A. The Ministry of Communications recently amended the licenses of the cellular operators in the matter of limiting users' access to the internet in order to obtain services that include adult content. The amendment stipulates, *inter alia*, that access to erotic services included in a cellular portal or by means of an application such as a search engine which is included in a cellular portal and which enables access to sites on the internet, will be blocked for all subscribers by default, and only an adult aged 18 and above will be able to request the removal of the block from his cellular operator, in accordance with a reliable identification procedure. The amendment to the licenses entered into effect on March 30, 2006. At this stage Pelephone does not expect material damage to its revenues as a result of the amendment. Partner and Cellcom have petitioned the High Court of Justice against this amendment.
- B. The Ministry of Communications is holding a hearing with regard to its intention to require a subscriber whose call is routed to a voicemail box be given the option of disconnecting the call with no charge, by means of a preliminary voice message notifying the subscriber that his call is being transferred to a voicemail box, and that he will be charged only from that time. In response to a hearing in writing, Pelephone expressed its objection to this process. If the Ministry of Communications puts its intention into full effect, this is expected to harm Pelephone's revenues.

This section 3.18.3.1 includes forward-looking information. Forward-looking information is uncertain information about the future, which is based on information that Pelephone has as at the date of the update, and includes Pelephone's assessments of its intentions as at the date of the update. The circumstances that might cause the forecast described above not to happen include the extent to which the Ministry of Communications implements its intentions, the conduct of the market and the acts of competitors.

¹⁵ This number includes approximately 6% of sites defined as access installations. These installations are exempt from building permits although there are local councils which claim that such a permit is required.

With respect to section 3.18.3.3, as at the date of this update, Pelephone has deposited 20 deeds of indemnity with various local councils.

To Section 3.19 – Legal Proceedings

For updates on the subject of legal proceedings, see Note 6 to the financial statements of the Company for the period that ended on June 30, 2006.

4. International Communication and Internet Services – Bezeq International Ltd. ("Bezeq International")

To Section 4.1 – General

In the matter of Section 4.1.2 – Legislative and Regulatory Restrictions Applicable to Bezeq International – on May 16, 2006 Bezeq International submitted an application for a special general license for the provision of fixed-line domestic communications services to the Ministry of Communications. The issuing of a license, as stated, by virtue of which domestic VOB services will be provided (constituting an essential part of the product mix of internet service providers), will enable Bezeq International to continue to provide its customers with comprehensive communications solutions (of the types that its competitors will offer, some of which have already received similar licenses) and to expand as an equal among equals. Since the Ministry of Communications has not yet replied to Bezeq International's application to receive a general license, on July 25, 2006, Bezeq International submitted an application to extend the term of the trial license to market VoIP services for payment given to it up to August 31, 2006, up to the date of the decision by the Ministry of Communications regarding grant of the general license.

To Section 4.6.1.1 – Competition in the field of voice

To the best of the Company's knowledge, "Netvision" and "Barak" are negotiating to examine a merger between them. Likewise, according to publications, Internet Zahav has purchased 60% of the shares of Golden Lines, and the companies intend, in the future, to merge. For these matters, see also the update to section 2.6 above.

If and when the aforesaid mergers come into effect, four competitors will remain in the market: Bezeq International, the Barak-Netvision Group, the Internet Zahav-Golden Lines Group, and Exphone Corp.

To Section 4.6.2.1 – Competition in the field of internet

Upon execution of the mergers set out in section 4.6.1.1 above, there will be 3 main competitors in the market: Bezeq International, the Barak-Netvision Group and the Internet Zahav-Golden Lines Group.

To Section 4.9 – Intangible Assets

On April 30, 2006 Bezeq International signed an agreement with Malam Systems Ltd. ("Malam") and the Company, for the acquisition of all the operations of the Goldnet Communication Services ("Goldnet"), a registered partnership owned by Malam (25%) and the Company (75%), which provides solutions for the dissemination and transfer of information via secured electronic means between organizations, in consideration of the sum of NIS 6.8 million, which would be paid to Goldnet. In the framework of this acquisition all the agreements between Goldnet and its customers and its suppliers, and the franchise agreements and business cooperation agreements that it has entered into will be endorsed to Bezeq International and all the intellectual property rights, inventory and/or fixed assets of Goldnet will be transferred to the ownership of Bezeq International.

Upon fulfillment of all the suspending conditions stipulated in the acquisition agreement and the payment of the consideration, Goldnet, which conducted its business under the trade name of "Bezeq Gold", shall cease to provide services. Likewise, for a period of 12 months from the date of completion of the acquisition deal, Goldnet will continue with its contractual arrangements with customers by the power of agreements that it will not be possible to assign to Bezeq International and shall transfer all the receipts in respect thereof to Bezeq International. On June 30, 2006, Goldnet fired most of its employees and paid them the full sums to which they were entitled on account of termination of their employment. A large portion were accepted into various functions at Bezeq International, in accordance with the provisions of the agreement.

After signing of the Agreement, a supplier of services of Goldnet exercised his right to refuse assignment of the contract between him and Goldnet to a contract with Bezeq International. Bezeq International reached an agreement with the supplier under which Bezeq International sold the supplier the right to continue contracting with Goldnet's existing customers with respect to the services that he

supplied, subject to payment of consideration by the supplier, which did not harm the viability of the deal.

For evaluation of the possible merger of operations of Bezeq International and BezeqCall Communications Ltd. (a wholly owned subsidiary of Bezeq dealing in the field of NEP), see update to section 1.1.5 above.

To Section 4.10 – Human Resources

In the matter of Section 4.10.3 - Organizational Structure - on May 15, 2006, Bezeq International consolidated the Technologies Division and the Information Systems Division into a new division to be called Information Technologies, which shall be headed by, as Vice President, the individual who served as director of the Technologies Division up to that time. The reason for the change is the need to adapt the organizational structure to Bezeq International's changing needs and technologies, which stems from the customers' needs.

On July 24, 2006, Bezeq International consolidated its business sales department with its integration and new business department, into a new department called "business solutions", at the head of which will be the person who, up until now, acted as Deputy CEO of Integration and New Businesses. The reason for this change is the need to adjust the organizational structure to the needs of the developing communications market, and provide a total communications solution to business customers.

Likewise, on July 24, 2006, Bezeq International resolved to consolidated the finance, economics and regulation department and the management resources department into a single department to be called "finance and human resources", to be headed by the person who had been Deputy CEO of Finance, Economy and Regulation at the company prior to that.

To Section 4.14 – Investments

During the report period, Bezeq International and others exercised option warrants of Walla (Series 3). In total, Bezeq International exercised 2,564,764 option warrants (Series 3) during Q1 2006, in consideration of a sum total of NIS 4,617 thousand, which was offset from the owners loan balance that Bezeq International extended to Walla. Following the exercise of the option warrants as stated, Bezeq International's holding in Walla grew from 42.85% on December 31, 2005 to 44.56% as at the date of the interim financial statements (fully diluted, as at June 30, 2006 – 33.66%). Following the exercise of the option warrants, goodwill in the sum of NIS 2,313 thousand was generated for the Company.

To Section 4.15 – Financing

With respect to the Company's loan to Bezeq International, described in section 4.15.3 of the Periodic Report for 2005, on February 14, 2006, Bezeq International repaid the entire sum of the loans to the Company, linked to the index as at the date of repayment, in the sum of approximately NIS 173 million.

To Section 4.19 – Legal proceedings

1. In connection with the intention of the Ministry of Communications to impose a financial sanction on Bezeq International in respect of a breach of the terms of its license, due to the provision of access by telephone to erotic services, described in Section 4.19.4 of the Periodic Report, the Director General of the Ministry of Communications informed the Company, on March 29, 2006, of his decision to impose a financial sanction on the Company in the sum of approximately NIS 1,064 thousand; this is in respect of a single breach of provisions of Bezeq International's license and due to an ongoing breach of 115 days. After Bezeq International's request from the Ministry of Communications to delay the payment until the appeal that it intends to file has been clarified was rejected, the said sum was paid in April 2006 and was fully credited to the Statement of Operations.

On May 9, 2006, Bezeq International filed an appeal to the Tel Aviv Magistrates Court against the said ruling of the Director General of the Ministry of Communications, on the basis of the opinion of Bezeq International's legal advisors whereby there is a good chance that the sum of the sanction will be either cancelled or reduced.

On July 6, 2006, a preliminary hearing was held in which it was held that the State must submit its response to the appeal by July 27, 2006. Appeal proceedings have not yet been set down. In the estimate of Bezeq International, in reliance, *inter alia*, upon its legal counsel, the chances are good that the sum of the sanction will be cancelled or that the amount of the sanction will be reduced.

2. With respect to the claim by a competing international communications operator against the State of Israel for the sum of NIS 11.2 million dated April 4, 2004, under which the State of Israel filed a third party notice against the Company and Bezeq International, set out in section 4.19.2 of the Periodic Report for 2005, on December 5, 2005, the plaintiff submitted affidavits of evidence on its

behalf. On April 9, 2006, the State submitted an expert opinion. On May 9, 2006, the Court ruled that given the lack of a factual version at this stage by the State, the Company's and Bezeq International's evidence regarding damage should be adduced on time, however, their evidence regarding liability should only be filed after hearing evidence from the State. On June 13, 2006, a preliminary hearing was held under which the Company and Bezeq International gave notice that they would not be filing an opinion as to damage. The plaintiff and the State also agreed in the hearing that the statement of claim, which another international carrier had filed against the State, the Company, and Bezeq International at the time, would be filed as evidence under agreement. The State also agreed to admit the fact that under the claim by the other international communications carrier, the parties applied to mediation, which ended in an agreement, together with payment by the defendant to the plaintiff.

3. With respect to the claim submitted against Bezeq International and two other international operators claiming breach of patent for a prepaid telephone system in the sum of NIS 10 million by persons claiming to be the inventors and owners of the aforesaid patent, described in section 4.19.3 of the Periodic Report for 2005, on June 25, 2006, the plaintiffs submitted a response by them. In their response, the plaintiffs claim, *inter alia*, that their claim had not expired and was not tainted by laches, estoppel or injunction, that the patent was valid and belonged to them (and not to the State of Israel – Ministry of Communications), and they repeat their claims regarding breach of the patent by the defendants, and their demand to rule the relief sought under the statement of claim. On the same date, the plaintiffs also submitted an application to expunge claims from the statement of defense, regarding the claim that the plaintiff has no right of standing in this matter, and the claim that the general idea of the patent was conceived within the Ministry of Communications, during the period in which the plaintiff acted as Chief Scientist of the Ministry, and that therefore the plaintiffs are not the real owners of the patent. A date for submission of the Company's reply to the application has not yet been set down.
4. For additional updates regarding legal proceedings, see Note 6 to the Company's Financial Statements for the period ended June 30, 2006.

5. Multi-channel Television – D.B.S. Satellite Services (1998) Ltd. ("D.B.S.")

To Section 5.1 – General Information on Area of Activity

As at June 30, 2006, the number of DBS subscribers amounted to 534,629 subscribers.

To Section 5.1.3 – Developments in Markets in the Field of Operations

With regard to the government's decision on the free dissemination of certain channels by means of a land-based system of transmitters based on digital technology, supported by a digital satellite system: DBS is conducting negotiations with representatives of the Treasury with regard to the implementation of the said government decision and was told that the Finance Ministry intends to publish a public hearing on the matter.

With regard to the government decision on the subject of obligating the multi-channel television companies to sell the public reduced channel packages, DBS is conducting negotiations with representatives of the Finance Ministry. Legislative amendments regarding implementation of the Government's decision were not included in the Budget Law for 2006, and in discussions in the Knesset Committees, it was decided to separate treatment of them from the enactment of the budget.

To Section 5.6 - Competition

To Section 5.6.5 – Principal Methods for Coping with Competition

In July 2006, the director general of the Ministry of Communications wrote to DBS asking to terminate DBS's campaign offer to its subscribers which, so it was alleged, contained an offer of a "basket of services" which included, *inter alia*, the installation of a Bezeq telephone line at a lower price than that set out in the Communications Regulations (Telecommunications and Broadcasts) (Payments for Telecommunications Services), 5766-2006, such as to give rise to a suspicion of breach of DBS's license which allegedly states that DBS is prohibited from dealing in matters regarding telephony. In DBS's response to the letter, DBS dismissed the allegations of the Ministry of Communications, noting that it had performed activities to market the installation of Bezeq telephone lines, which activities do not require any license, just as such activities are marketed by many other resellers. DBS further noted that the marketing of installation of telephone lines was not part of a total basket of services as alleged, the service itself not being provided by it, but rather by Bezeq, and therefore, its activities do not constitute a breach of the provisions of the law or of DBS's license. Without derogating from its claims, DBS has, at

this stage, stopped the campaign offer to its customers. As at the date of this report, the Ministry of Communications reply has yet to be received.

In the matter of VOD – DBS was recently informed by representatives of the Ministry of Communications that it will receive a license for conducting the technological trial within a short period, but as at the date of this report the license for the trial has not yet been received.

To Section 5.10 – Raw Materials and Suppliers

To Section 5.10.1 – Main Raw Materials

In the matter of Sub-Section B – space segments – as at the date of this report, DBS is paying the regular leasehold fees in respect of space segments in the Amos 1 satellite, and remits partial payment on account of the leasehold fee debt in respect of the previous period whose date of payment to Israel Aircraft Industries has passed (in view of the endorsement of the right to receive the leasehold fees from HLL to Israel Aircraft Industries). In view of DBS's delay in payments that were stipulated in the said agreement, Israel Aircraft Industries contacted DBS in March 2006 demanding that the entire debt be settled, and the parties are conducting negotiations on the matter. In addition, there is a dispute between DBS and HLL in the matter of the annual leasehold fees that HLL is entitled to receive in respect of the leasing of space segments in the Amos 2 satellite, which has not yet been arranged, with DBS paying only those sums that are not in dispute.

To Section 5.11 – Working Capital

In Q2 2006 an increase occurred in the working capital deficit of DBS, which totaled approximately NIS 546 million as at June 30, 2006.

To Section 5.12 - Financing

To Section 5.12.2 – Restrictions of the Corporation for the Receipt of Credit

As at March 31, 2006 DBS met the financial criteria, as per the financing agreement (after the banks agreed to amend the targets of these criteria with regard to Q2 2006). In the estimation of the management of DBS, in view of its forecasts with regard to its business results for the years ahead, it is also necessary to adjust the criteria with regard to the period up to the end of the repayment of the bank credit. In consequence, in July 2006 DBS contacted the banks requesting, *inter alia*, an amendment of the relevant provisions of the financing agreement relating to targets for financial criteria. As at the date of this report, the banks' response has not yet been received.

As at the date of this report, DBS has not fully met its undertakings under the financing agreement to take out insurance in connection with its activities and its assets in general, including with regard to its obligation to take out satellite failure insurance with regard to the satellites leased by DBS from the space segments for the purpose of its broadcasts. DBS is conducting negotiations with the banks to obtain concessions with regard to its insurance undertakings, which will enable it to meet these undertakings.

In addition, the delay in DBS's payments to Israel Aircraft Industries (as stated in the update to Section 5.10.1 above) constitutes a *prima facie* breach of the financing agreement; however, the banks have confirmed to DBS that they will not deem the demand by Israel Aircraft Industries for the repayment of the debt to be a breach of the financing agreement on the part of DBS, provided that by December 31, 2006, the parties arrive at a written settlement with Israel Aircraft Industries with regard to the repayment of the said debt and that during the period up to December 31, 2006, Israel Aircraft Industries does not employ any means whatsoever to collect the said debt.

As at the date of approval of the financial statements, DBS is acting in order to obtain additional sources of funding in order to enable it to realize its targets for the coming year. In the event that such sources are not obtained, the Company shall act in accordance with an alternate business plan that does not require additional sources beyond those already in existence.

To Section 5.14 – Restrictions and Supervision of the Corporation

To Section 5.14.1 – Operations being subject to specific laws

On the subject of original (local) productions - DBS has met its obligation for the year 2004 (including the relative share of completing past obligations), apart from immaterial deviations in the subdivision into the various genres, which the Council ordered DBS to amend during 2005. DBS notified the Council that it has met its original productions obligation for the year 2005 (including the relative share of completing past obligations), and the issue is under examination by the Council as at this date.

To the best of DBS's knowledge, as at the date of this report an amendment to secondary legislation has been approved, whereby the rate of royalties applicable to DBS beginning in the year 2006 and thereafter will be gradually reduced to a fixed percentage of 1% as of 2010.

To Section 5.14.3 – The Principal Limitations by virtue of the Law and Broadcasting License

As at the date of this report, the Council has issued an additional broadcasting license to a designated "Israeli Heritage" channel, which is also expected to be aired via DBS's broadcasts. At present, no broadcasts of independent license holders are aired in the framework of DBS's broadcasts.

The Council decision with regard to the restrictions that apply to DBS as to the percentage of local channels under its ownership which aired in the framework of its broadcasts, was approved by the Council as part of the rules and entered into effect in March 2006.

With respect to administrative guidelines regarding tiering in the subscriber's home: at the beginning of March 2006, the cable companies gave notice to the Director General of the Ministry of Communications to the effect that in light of DBS's breaches of the administrative instructions, they were ceasing to accept disconnection notices sent to them by DBS. And indeed, the cable companies stopped accepting any notices under the administrative guidelines, including connection plans and notices of termination. DBS dismissed the claims of the cable companies and argued that their refusal to accept notices from DBS not only amounted to breach by the cable companies of the administrative guidelines, but also of the provisions of their licenses and of the agreements by which they contracted with their own customers, since they were continuing to charge subscribers subscription fees even though they knew that those customers had disconnected from their broadcasts. DBS also requested the Ministry of Communications to instruct the cable companies to cease charging subscribers immediately upon receipt of notice of disconnection. Following these letters, further correspondence was exchanged between the cable companies and DBS, in which each party repeated its claims. As at this date, no response has been received from the Ministry of Communications on this issue, and the cable companies continue not to accept notices from DBS.

In the estimation of DBS's management, should the Administration's provisions be cancelled, without the existence of a suitable alternative arrangement that will enable one supplier to make use of another supplier's infrastructures at the subscribers' homes, this will constitute a material barrier to the transition of subscribers between the various providers.

To Section 5.17 – Legal Proceedings

In the matter of Section 5.17.1 – application for approval of class action in the matter of telephone communications – after DBS submitted an application to strike out the application *in limine* on March 8, 2006, on April 11, 2006 the applicant's response was submitted, in which it requested that DBS's application be dismissed. No ruling on the application has yet been handed down.

In the matter of Section 5.17.3 – with regard to the arbitration proceedings between DBS and Play TV Ltd., producer of the Playboy and Adult channels ("Play TV"), in connection with the arbiter's ruling and the request for clarification thereof, the parties have arrived at a settlement agreement whereby all the proceedings that were conducted between them that are the object of the arbiter's ruling, have ended. According to the settlement agreement DBS is entitled to receive a certain sum from Play TV. Commercial agreements were also reached between the parties on other matters that were anchored within the bounds of the settlement agreement.

In the matter of Section 5.17.4 – in the matter of the Endemol lawsuit: the parties have arrived at an agreement in principle with regard to the termination of the dispute with a settlement, but this has not yet been formulated into a binding agreement whereby the lawsuit will be annulled, and DBS will pay Endemol approximately \$180,000 (including in respect of the purchase of certain content from Endemol).

In addition:

1. On March 15, 2006 a verdict was handed down against DBS and Mr. Shlomo Liran, its former CEO, following DBS's conviction at the Tel Aviv District Labor Court of the offense of disturbing a work supervisor on behalf of the Ministry of Labor and Social Welfare – an offense under Section 26(2) of the Hours of Work and Rest Law, 5711 – 1951 and Sections 36(A)(1) and 36(C) of the Organization of Supervision of Labor Law, 5714 – 1954, and with regard to Mr. Liran, also under Section 27(A) of the Hours of Work and Rest Law, 5711 – 1951 and Section 36(E) of the Organization of Supervision of Labor Law, 5714 – 1954. DBS's conviction was based on the failure to submit documents to a work supervisor, on demand, in contravention of the obligations stipulated by law. The District Court imposed an administrative fine in the sum of NIS 25,800 on DBS and an administrative fine in the sum of NIS 38,700 on Mr. Liran. In May 2006, DBS and Mr. Shlomo Liran appealed to the National Labor Court against their conviction. The appeal was set down for hearing before a panel on December 4, 2006.

2. On July 6, 2005, DBS filed a statement of claim in the District Court at Tel Aviv against Pace Micro Technology Plc., under which DBS requested that the Court charge the defendant with paying the direct expenses borne by DBS in order to repair faulty converters of a particular model, compiled and/or manufactured by the defendant, and supplied to DBS between 2000 and 2001. Under the statement of claim, this model of converter suffered from three serial hardware faults which were under the liability of the defendant and which caused DBS serious damage, mainly due to the need to repair them and to bear the costs involved in such. The claim is for the sum of approximately NIS 31.4 million, and is based on various grounds, including breach of the framework agreement by the defendant and negligence towards DBS, and breach of provisions of the law, DBS reserving its right to sue for additional damages. Contemporaneous with its filing of the claim, DBS also filed an application to the Court for a permit to serve the process in this file outside of the jurisdiction. On July 17, 2006, the District Court upheld DBS's application for the permit of service as aforesaid, and held that process be translated into English and served upon the defendant personally. Likewise, the Court held that the statement of defense be submitted by the Defendant within 60 days. Service of process was effected at the end of July 2006. A statement of defense has not yet been filed in this matter.

For additional updates regarding legal proceedings, see Note 6 to the Company's financial statements for the period ending June 30, 2006.

August 14, 2006

Date

Bezeq, The Israel Telecommunication Corp. Ltd.

Names and titles of signatories:

Dov Weissglas, Chairman

Yacov Gelbard, President & CEO