"Bezeq" The Israel Telecommunication Corp. Limited

Annual Report for 2004*

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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. The values stated in respect of the report period are in reported amounts. All comparison numbers are adjusted to the index of December 2003.

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Chapter A – Description of Company Operations

1. Description of General Development of Group Operations

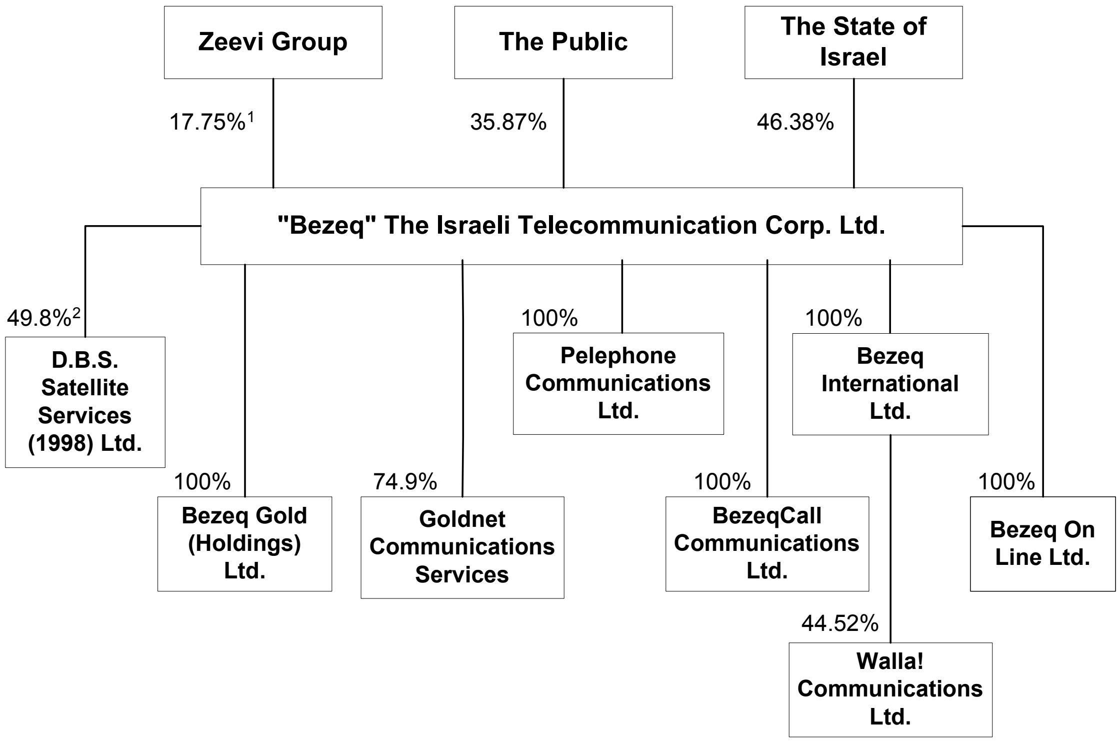
Bezeq The Israel Telecommunication Corp., Ltd. (hereinafter, "the Company" or "Bezeq") along with the subsidiaries (including partnerships) that it owns in whole or in part, whose financial statements are consolidated with the Company's, shall be jointly referred to in this periodic report as "the Group"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

1.1 Group Activity and Description of its Business Development

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

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

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



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

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

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

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

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

The Company is a publicly traded company.

1.1.5 <u>Mergers and Acquisitions</u>

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

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

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

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

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

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

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

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

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

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

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

1.2 Areas of Activity

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

1.2.1 Fixed-line domestic services

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

1.2.2 Cellular services

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

1.2.3 International communications and internet services

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

1.2.4 Multi-channel television

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

1.2.5 Miscellaneous

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

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

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

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

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

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

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

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

1.3 Investments in Equity and Stock Transactions

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

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

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

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

1.4 Distribution of Dividends

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

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

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

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

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

1.5 Financial Information on the Group's Areas of Activity

1.5.1 2004

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

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

1.5.2 2003

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

*Not consolidated in the financial statements.

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

(1) 2002

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

*Not consolidated in the financial statements.

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

1.6 General Environment and Effect of External Factors on Group Activity

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

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

2.1 General Information on Area of Activity

2.1.1 Area of activity and changes affecting it

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

2.1.2 Legislative and regulatory restrictions and special constraints

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

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

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

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

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

2.1.3 Changes in the volume and profitability of the activity

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

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

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

2.1.4 Developments in the market and in customer attributes

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

2.1.5 Technological changes that significantly impact on the area of activity

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

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

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

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

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

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

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

C. Technological and marketing innovation.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2.2 Products and Services

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

2.2.2 Telephony

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

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

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

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

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

2.2.3 Internet access services

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

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

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

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

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

2.2.4 Transmission and data communications services

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

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

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

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

2.2.5 Other services

A. Services to communications providers

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

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

B. Satellite services

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

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

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

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

C. Work as a contractor

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

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

D. Billing and collection services

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

2.3 Breakdown of Revenues and Profitability of Products and Services

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

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

2.4 Customers

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

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

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

2.5 Marketing, Distribution and Service

2.5.1 The Company has marketing, sales and service systems for the private and business sectors, which include customer managers for the business sector, joint sales and service centers (including the 199 center) located throughout the country, separate technical support centers for internet and IT services, support and repair centers for telephone services (166 center), as well as 24 points of sale and service (Bezeq Store) throughout the country.

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

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

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

2.6 Competition

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

2.6.1 <u>Telephony</u>

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

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

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

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

[3] Voice Over Broadband

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

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

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

2.6.2 Broadband internet access

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

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

2.6.3 Transmission and data communications

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

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

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

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

2.6.4 Competition from the cellular companies

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

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

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

2.6.5 Additional factors that may affect competition

A. Numbering and number portability

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

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

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

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

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

B. Additional potentially competing infrastructures

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

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

C. Advantages and technological developments

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

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

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

The rapid growth in the number of internet subscribers along with technological developments enabling the transfer of telephony services over the internet (VoIP) and over a data communications network negatively affect the number of calls passing through the Company's network and a decline in its revenues. VoIP technology is based on packet-switching and enables more efficient use of bandwidth and a reduction in call costs.

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

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

2.6.6 The Company's preparations for coping with increasing competition

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

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

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

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

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

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

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

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

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

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

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

Positive factors

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

B. Presence in most businesses and households.

C. Strong capital structure and positive cash flow.

D. Expansive service infrastructure and various customer interfaces.

E. Professional experienced and trained staff.

F. Brand with presence and power.

G. Some of the lowest tariffs in the world.

Negative factors

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

A. Duty of structural separation

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

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

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

C. Lack of flexibility in tariffs

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

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

D. Universal service obligation

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

E. Cross-subsidy

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

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

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

2.7 Fixed Assets and Facilities

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

2.7.2 Fixed-line domestic telecommunications infrastructure

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

A. Exchanges

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

B. Transmission network

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

C. Data communications networks

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

D. Access network

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

E. End-point equipment

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

2.7.3 Computing

The Company's IT system supports four main activities:

A. Marketing issues

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

B. Information systems for engineering infrastructures of the telecommunications networks

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

C. Information systems for management of Company resources

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

D. Cross-organization systems

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

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

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

2.7.4 Real estate

A. General

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

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

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

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

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

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

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

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

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

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

B. Registration

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

C. The Settlement regarding the land

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

Under the Settlement, 14 properties specified in the agreement will be returned to the State through the ILA on different dates (through 2010) and in accordance with the terms stipulated in the agreement (hereinafter, "Returned Assets"), out of the 31 assets in the asset transfer agreement which will be under renewable 2-year leases. Three additional properties in this category were returned to the ILA prior to the Settlement. Fourteen additional properties in this category which were specified in the agreement (hereinafter: the "Properties to be Retained"), are to remain in the Company's possession, under capital lease conditions as set forth below.

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

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

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

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

D. Properties with improvement potential

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

2.8 Intangible Assets

2.8.1 The Company's general license

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

2.8.2 Trademarks

The Company uses trademarks that reflect its products and services.

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

"Bezeq" – Company name.

"B BEZEQ" – Company logo.

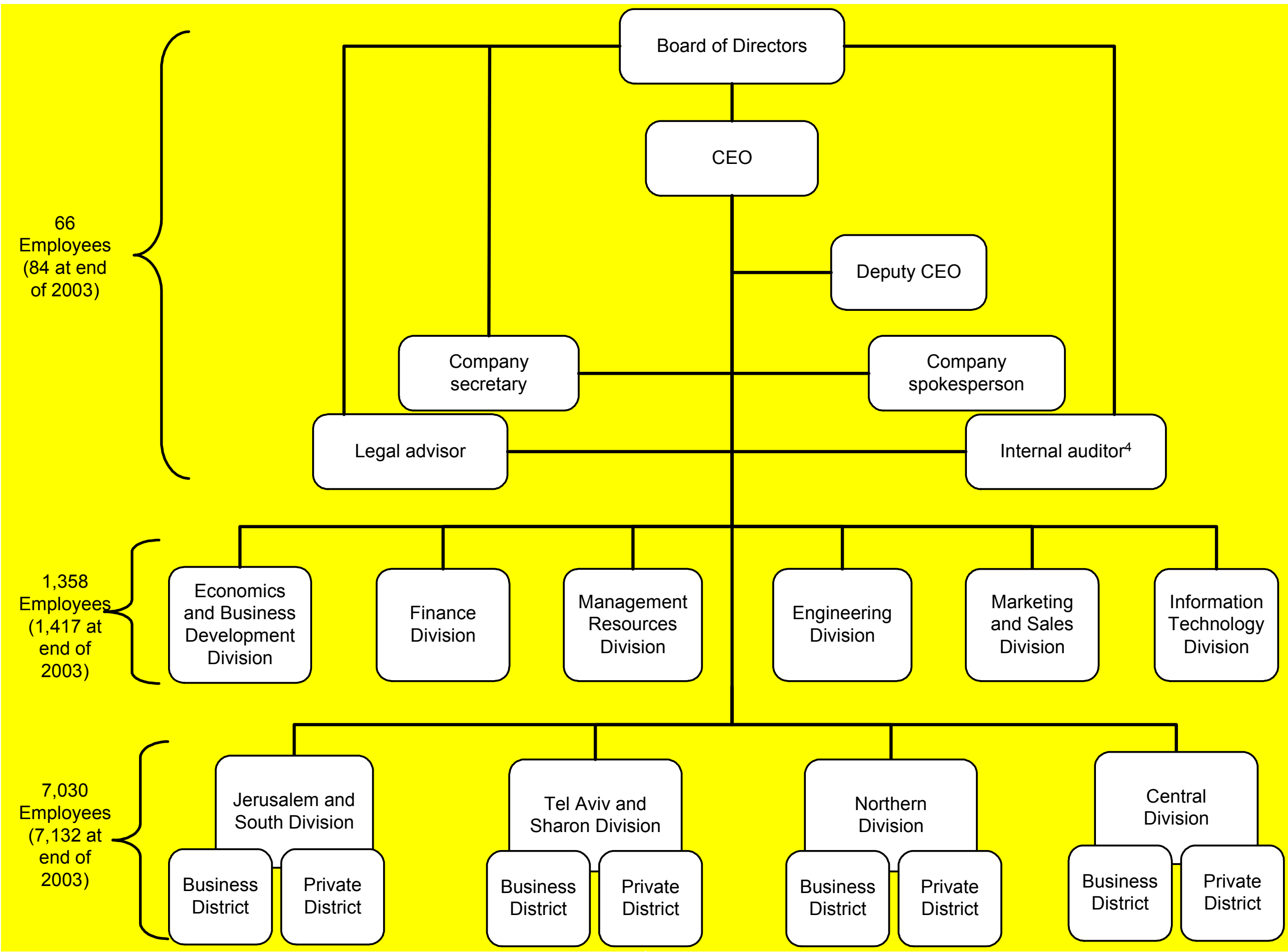
"WOW" – access to the Company's high speed internet services.

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

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

2.9 Human Resources

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



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

2.9.2 Personnel according to employment framework

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

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

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

2.9.4 Company investment in training

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

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

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

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

2.9.5 Nature of employment contracts and streamlining plans

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

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

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

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

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

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

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

2.9.6 Employee compensation plans

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

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

2.9.7 Company officers and senior executives

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

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

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

2.10 Raw Materials and Suppliers, Purchase of Equipment and Suppliers

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

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

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

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

2.11 Working Capital

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

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

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

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

2.12 Investments

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

2.13 Finance

2.13.1 Average interest rate on loans

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

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

2.13.2 Limitation in receipt of credit

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

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

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

2.13.3 Credit received during the reporting period

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

2.13.4 Credit received after December 31, 2004

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

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

2.13.5 Variable interest

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

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

Notes:

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

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

2.13.6 Credit rating

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

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

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

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

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

2.13.8 Liens and guarantees

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

2.14 Taxation

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

2.15 Environmental Protection

2.15.1 Regulations on facilities emitting electromagnetic radiation and proposed legislation

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

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

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

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

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

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

2.15.2 Private legislative initiatives for supervision of sources of electromagnetic radiation

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

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

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

2.16 Limitations and Regulation of Company Activity

2.16.1 <u>Regulation of Company tariffs</u>

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

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

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

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

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

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

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

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

2.16.2 <u>The Company's general license</u>

<u>The Minister's policy paper</u>

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

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

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

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

Highlights of amended license

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

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

B. Rules of structural separation

The Company must establish a structural separation between it and a "subsidiary", the definition of which, for this purpose, includes Pelephone, Bezeq International, BezeqCall Communications, DBS, Bezeq On-line, and Goldnet. (The Minister has the authority to expand the application of the rules of structural separation to an affiliated company[5], if it has been established that there is a real fear of injury to competition or to the public). Full separation between the respective managements of the companies, including all matters relating to the respective business, financial and marketing systems; full separation of the assets; and a prohibition against employing workers of the Company in the subsidiary and workers of the subsidiary in the Company; and also includes a prohibition on the transfer of commercial information to a subsidiary (where the definition of “commercial information” was expanded to include commercial information about the Company). No employee of the Company may be appointed a director of a subsidiary, if, within the scope of his duties in the Company, he has access to "commercial information" concerning a competitor, the use of which by the subsidiary could damage competition between it and the competitor. This limitation on appointment does not apply to the chairman of the board of directors of the Company).

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

C. Tariffs

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

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

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

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

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

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

D. Investments in other fields and restrictions on cooperation

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

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

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

E. Numbering and number portability

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

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

F. Operation of Company networks and service levels

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

G. Interconnectivity and use

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

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

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

H. Arrangements in the field of security

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

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

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

I. Liability and insurance

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

J. Control and reporting

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

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

K. Various matters

The general license includes "cross-ownership" restrictions.

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

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

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

Under the provisions of the Law, the Minister of Communications has the authority, at any time, to revoke, limit or suspend a license, if, for among other reasons, performance of telecommunications activity or provision of telecommunications services by a Licensee do not conform with the standard and at a proper level of similar activity or service, in accordance with the rules stipulated in the Law, or if the Licensee is in material breach of the terms of the license.

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

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

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

2.16.3 Royalties

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

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

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

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

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

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

2.16.4 Authority with respect to real estate

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

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

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

2.16.5 Immunities

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

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

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

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

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

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

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

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

2.16.6 Regulations and rules under the Telecommunications Law

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

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

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

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

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

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

2.16.7 Laws on anti-trust practices

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

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

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

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

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

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

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

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

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

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

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

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

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

2.16.8 The Wireless Telegraphy Ordinance

The Wireless Telegraphy Ordinance regulates the use of the electromagnetic spectrum, and applies, *inter alia*, to the Company’s use of radio frequencies, as part of its infrastructure. Set up and operation of a system that uses radio frequencies is subject, under the Telegraph Ordinance, to the grant of a license, and use of radio frequencies is subject to notice and allocation of an appropriate frequency. Under the Wireless Telegraph Ordinance, license fees and fees for notice and allocation of frequencies are imposed.

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

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

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

2.16.9 Proposed legislation regarding termination of contractual relations

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

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

2.16.10 Establishment of communications installations - National Outline Plan 36

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

B. NOP 36A

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

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

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

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

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

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

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

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

C. NOP 36B

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

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

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

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

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

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

2.17 Material Agreements

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

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

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

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

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

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

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

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

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

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

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

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

See Section 2.7.4C above.

2.17.6 Various agreements with DBS and its other shareholders

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

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

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

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

2.17.7 Labor agreements

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

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

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

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

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

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

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

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

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

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

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

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

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

2.17.9 Agreement between the Company and the Israel Postal Authority

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

2.18 Legal Proceedings

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

2.19 Objectives and Business Strategy

2.19.1 Forward-looking information

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

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

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

2.19.2 Summary of strategy and Company's future plans

Vision and objectives

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

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

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

B. Reducing the decline in revenues from core services;

C. Generating new sources of revenue;

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

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

Business customers

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

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

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

D. Offering a variety of value-added services.

Private customers

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

B. Providing differential pricing tracks;

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

Network

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

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

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

Changing organizational structure

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

2.19.3 Development trends in Company activities

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

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

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

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

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

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

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

2.19.4 Main projects being planned or currently being implemented

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

2.20 Events or Issues not within the Ordinary Course of Business

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

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

2.21 Risk Factors

A. Growing competition

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

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

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

B. Government regulation

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

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

The Company’s tariffs for services are subject to State regulation. These tariffs are stipulated in regulations, and regulations also stipulate a formula for linking them to the changes in the Consumer Price Index, less an amount for depreciation. The practical implication of this mechanism is erosion (in real terms) of the Company's tariffs. Some of the Company's tariffs are subject to the Control of Prices of Goods and Services Law, 5756-1996. Furthermore, the bureaucracy involved in setting "tariff baskets" for the sale of service packages by the Company delays the time to market of the tariff baskets, affecting the Company's ability to compete.

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

D. Difficulties in labor relations and human resources

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

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

E. Restrictions on providing new services and on partnerships

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

F. Ownership and control by the State

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

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

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

H. Legal proceedings

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

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

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

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

I. Exposure to exchange rates and inflation

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

J. Electromagnetic radiation and licensing of broadcast installations

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

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

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

Risk Factors Summary Table

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

3. <u>Mobile Radio Telephone – Pelephone Communications Ltd (“Pelephone”)</u>

3.1 General Information on Field of Activity

3.1.1 <u>Pelephone’s area of activity</u>

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

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

3.1.2 <u>Legislative and secondary legislation restrictions applicable to Pelephone</u>

3.1.2.1 General licence

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

3.1.2.2 <u>Tariff control</u>

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

3.1.2.3 <u>Royalties</u>

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

3.1.2.4 <u>Environment quality</u>

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

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

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

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

3.1.4 Market development in customer attributes

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

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

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

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

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

3.1.6 Critical success factors and the changes commencing therein

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

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

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

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

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

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

3.1.7 Principal entry and exit barriers

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

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

3.1.8 Substitutes for Pelephone products

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

3.1.9 Structure of competition in the field and changes occurring therein

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

3.2 Products and Services

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

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

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

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

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

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

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

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

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

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

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

3.3 Segmentation of Revenues and Profitability from Products and Services

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

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

3.4 New Products

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

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

3.5 Customers

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

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

3.6 Marketing, Distribution and Service

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

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

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

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

3.7 Competition

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

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

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

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

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

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

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

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

3.7.5 Positive and negative factors affecting Pelephone's competitive position

Positive factors

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

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

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

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

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

F. Strong capital structure and positive cash flow.

Negative factors

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

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

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

3.8 Seasonal Fluctuations

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

3.9 Fixed Assets and Facilities

Pelephone's fixed assets include infrastructure equipment in sites (some 85% of the investments in fixed assets as at December 31, 2004), electronic equipment, computers and software systems, motor vehicles, end-point equipment, office furniture and equipment and leasehold improvements.

3.9.1 Infrastructure

3.9.1.1 Pelephone's infrastructure investments

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

3.9.1.2 Pelephone operates two communications networks using three technologies

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

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

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

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

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

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

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

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

3.9.1.6 At the end of 2003, the Pelephone Board of Directors resolved to upgrade the CDMA 2000 1XRTT network to EVDO technology by means of the addition of a special–purpose carrier for data communications in the urban areas of Israel. This technology enables communication between the network and the end-point equipment at rates of up to 2,400 KSS and between the end-point equipment and the network at rate of up to 144 KSS. In the invitation to tender for the upgrade of the network, the winning bid was posted by Nortel. Total cost of the project is some $ 44 million. The spreading of the network included in the contract commenced in June 2004 and will be concluded by the end of 2005. In parallel with the set-up of the network, a portal was established for video services, which is the key service using EVDO technology.

3.10 Intangible Assets

3.10.1 MRT license

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

3.10.2 Frequency usage right

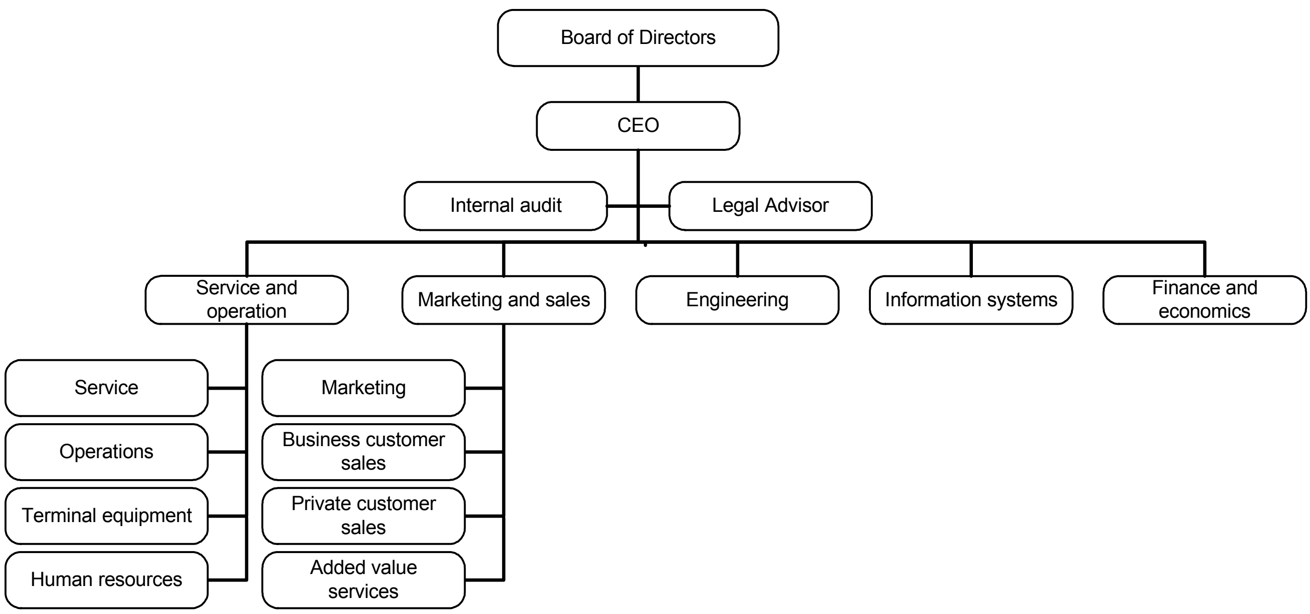
Pelephone uses frequencies in the 800 MHZ range, granted to it by virtue of its license. These frequencies serve the company with CDMA2000 1XRTT technology and EVDO technology. In addition, Pelephone was granted the right of future allocation and use of frequencies (in the 2000 MHZ ranges) using UMTS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

3.10.3 Trademarks

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

3.11 Human Resources

3.11.1 Organizational structure



3.11.2 Table of organization

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

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

3.11.3 Changes in the number of employees during 2004

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

3.11.4 Instruction and training

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

3.11.5 Employee reward plans

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

3.11.6 Employment contracts

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

3.12 Products and Suppliers

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

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

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

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

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

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

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

3.13 Working Capital

3.13.1 Policy governing inventory maintenance, return of merchandise and warranty

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

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

3.13.2 Policy governing credit to customers

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

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

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

3.13.3 Credit from suppliers

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

3.14 Investment in Investee Companies and in a Partnership

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

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

3.15 Finance

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

The average interest rate in 2004 for undesignated loans:

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

3.15.2 Restrictions

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

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

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

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

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

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

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

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

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

3.15.2.2 Pelephone gave a foreign bank an undertaking not to engage in a transaction or a series of transactions pursuant to which assets would be sold, mortgaged or otherwise transferred other than in the ordinary course of business, without obtaining the bank's consent, and not to perform any act of merger (except a merger with Bezeq) without obtaining the bank's consent. Likewise, certain instances were stipulated in which the bank may call for immediate repayment Pelephone's loans, the most significant being: (A) if Pelephone fails to pay to the lending bank any payment having fallen due; (B) if Pelephone shall be in breach of its undertakings to comply with the financial criteria aforesaid; (C) if Bezeq ceases to be a controlling shareholder in Pelephone and the lending bank will not be convinced that this change does not materially effect Pelephone; (D) if any material change takes place in Pelephone; (E) if Pelephone pursues any unlawful activity; (F) whenever any competent authority intervenes in the affairs of Pelephone; (G) if the management of Pelephone is ousted from office or if Pelephone's authority to manage its business is curtailed and such curtailment materially affects its business; (H) if Pelephone's license is revoked; (I) if any material change takes place (without the consent of the bank) in the nature of Pelephone's business or in case of nationalization or sale of all or most of Pelephone's assets by any Government or by virtue of any authority vesting in it; (J) if Pelephone fails to pay any one of the group of banks to which it has furnished an undertaking as regards financial criteria, any payment on due date thereof or if it is determined that its debt to any of the aforesaid group is due for payment or if any of the group of lenders shall have the right to call Pelephone's debts towards it for payment prior to the agreed due date thereof (provided that the amount to which all of the aforesaid applies shall be not less than 10 million dollars); (K) if Pelephone shall be insolvent or if it is found by a court to be insolvent; (L) if proceedings are taken against Pelephone such as receivership, liquidation, compromise or arrangement with creditors and also (M) if the monetary loan becomes unlawful as regards the lending bank. In addition, if an agreement with Pelephone contains a tax grossing up Clause whereby, if any tax or levy shall apply to the lender, it shall be borne by Pelephone. To date, Pelephone has not been required to gross up tax payments, other than the grossing up of a tax withholding on the interest payable to lenders. In respect of loans from local banks, no tax obligation exists, and in respect of the loans obtained from the aforementioned foreign banks, Pelephone is exempt from payment of tax out of the interest in accordance with an exemption approval confirmation provided by the Income Tax Commission.

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

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

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

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

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

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

Loans received subsequent to December 31, 2004

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

3.15.4 Credit limits

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

3.15.5 Guarantees and liens

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

3.15.6 Variable interest

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

3.15.7 Credit rating

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

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

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

3.16 Taxation

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

3.17 Environment

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

3.17.2 Anticipated costs and investments

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

3.18 Restrictions on and Control of Pelephone's actions

3.18.1 Legislative restrictions

3.18.1.1 Communications Law and licensing obligation in respect thereof

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

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

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

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

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

3.18.1.2 Wireless Telegraph Ordinance

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

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

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

3.18.1.3 Facilities emitting electromagnetic radiation

3.18.1.3.1 The existing regulations

The Pharmacists Regulations (Radioactive elements and the products thereof) 5740-1980, regulate, *inter alia*, relate to electromagnetic radiation in facilities emitting such radiation, and are applicable to some of Pelephone's facilities. The set-up of such a facility and such activity are subject, *inter alia*, to a permit from the Commissioner for Environmental Radiation at the Ministry of the Environment, and the Commissioner is entitled to render the issue of a permit contingent on certain conditions, both for the issue thereof and for the validation thereof post-issuance. The Commissioner is also entitled to issue directives as to the adoption of appropriate measures such as he may enumerate, if he is of the opinion that the facility is liable to jeopardize the health or wellbeing of an individual or the public or the environment. Non-fulfillment of the regulations or the terms of the permit or the Commissioner's directives is cause for revoking or suspending the permit.

3.18.1.3.2 Draft legislation

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

3.18.1.4 The numeration plan

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

3.18.2 Controlled tariffs

Payments for interconnect:

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

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

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

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

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

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

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

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

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

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

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

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

The following table itemizes tariff development:

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

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

3.18.3 License and site licensing

3.18.3.1 Pelephone license

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Royalties

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

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

3.18.3.2 Licensing of sites

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

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

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

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

C. Approval from the IDF.

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

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

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

In respect of a number of sites established several years ago, approvals from the Civil Aviation Administration and the IDF are still lacking, even though the applications for the approvals have long since been in the hands of those authorities. Similarly, administrative or other delays occur in some planning and building authorities in the issue of building permits for sites. Accordingly, Pelephone (and also its competitors) operate a number of broadcasting sites for which building permits have not been issued. Applications for the building permits have been filed by Pelephone with the planning and building authorities, and are at various stages of discussion and approval.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

All the aforementioned resolutions are subject to Government approval.

3.18.4 Standardization

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

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

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

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

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

3.19 Legal Proceedings

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

3.20 Goals and Business strategy

3.20.1 Pelephone's principal strategic goals are:

Increase market share;

Lead with third generation technology;

Improve profitability;

Streamline the company's distribution and sales system;

Improve the technological infrastructure and provide best-quality coverage;

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

3.20.2 Marketing strategy

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

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

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

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

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

3.21 Outlook for the Coming Year

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

3.21.1 Reduction of connectivity fees

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

3.21.2 Launch of 3rd generation services

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

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

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

3.21.4 Innovative added value services

In 2005, Pelephone is due to continue to launch a diverse range of advanced added value services that will help improve the perception of the brand and increase revenues from existing customers. Prime examples are the PTT (walkie-talkie) services that will enable new subscribers to be recruited in a market segment that was hitherto inaccessible to Pelephone (primarily MIRS subscribers) and AGPS (location based) services, which will secure Pelephone a competitive edge and will enable a diverse range of services to be launched for the private and business sector.

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

3.22 Risk Factors

A. Mounting competition

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

B. Investments in infrastructure and technological changes

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

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

C. Market risks

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

The following is a detailed description of the market risks:

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

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

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

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

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

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

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

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

The following are the guiding principles of exposure management:

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

D. Tariff control

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

E. Legal proceedings

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

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

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

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

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

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

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

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

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

G. Electromagnetic radiation

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

H. Licensing of sites

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

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

Risk Factors Summary Table

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

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

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

4.1 General

4.1.1 Structure and changes in area of operations

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

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

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

4.1.2 Legislative and statutory restrictions applicable to Bezeq International

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

4.1.2.1 General license

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

4.1.2.2 Royalties

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

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

4.1.3 The principal entry and exit barriers

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

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

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

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

4.1.4 Alternatives to Bezeq International products

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

4.1.5 Structure of competition in the sector and changes therein

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

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

4.2 Products and services

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

4.2.1 Voice Services

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

4.2.2 Internet Services

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

4.2.3 Data Services

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

4.3 Revenues

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

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

4.4 New Products

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

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

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

4.4.3 Online file backup service for private and business customers.

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

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

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

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

4.5 Marketing, Distribution and Service

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

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

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

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

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

4.5.6 B-one – joint venture with the Group companies Pelephone and BezeqCall aimed at increasing sales of the products and services of the parties to the venture since it is a principal point of interface with customers which use it to purchase products and services. The venture will make the agreement with customers and collect service usage fees, while each of the venture's companies will provide the services and maintain direct contact with customers for this purpose.

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

4.6 Competition

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

4.6.1 Voice Services

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

4.6.1.2 General characteristics of the competition in 2004:

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

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

4.6.1.2.3 The product is a commodity.

4.6.1.2.4 Price market (perception).

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

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

4.6.2 Internet services – Bezeq International@net

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

4.6.2.2 General characteristics of the competition in 2004:

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

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

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

4.6.2.3 Developments in 2004:

4.6.2.1.4 Continuing rapid growth of high-speed internet.

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

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

4.6.2.1.7 Entry of home networking.

4.6.2.1.8 Beginning of hotspot services.

4.6.3 Solutions for the business sector – Bezeq International business

4.6.3.1 Products and services for the business sector

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

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

4.6.3.2.1 Calls – approximately 35%.

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

4.6.3.3 Characteristics of the business arena in 2004

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

4.6.3.3.2 Aggressive battle for each customer and price erosion.

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

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

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

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

4.6.3.3.7 Large businesses – transition to IP solutions.

4.6.4 Coping with the competition

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

4.7 Seasonality

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

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

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

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

4.8 Fixed Assets and Installations

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

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

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

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

4.9 Intangible Assets

4.9.1 License for the provision of Bezeq International services

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

4.9.2 Infonet

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

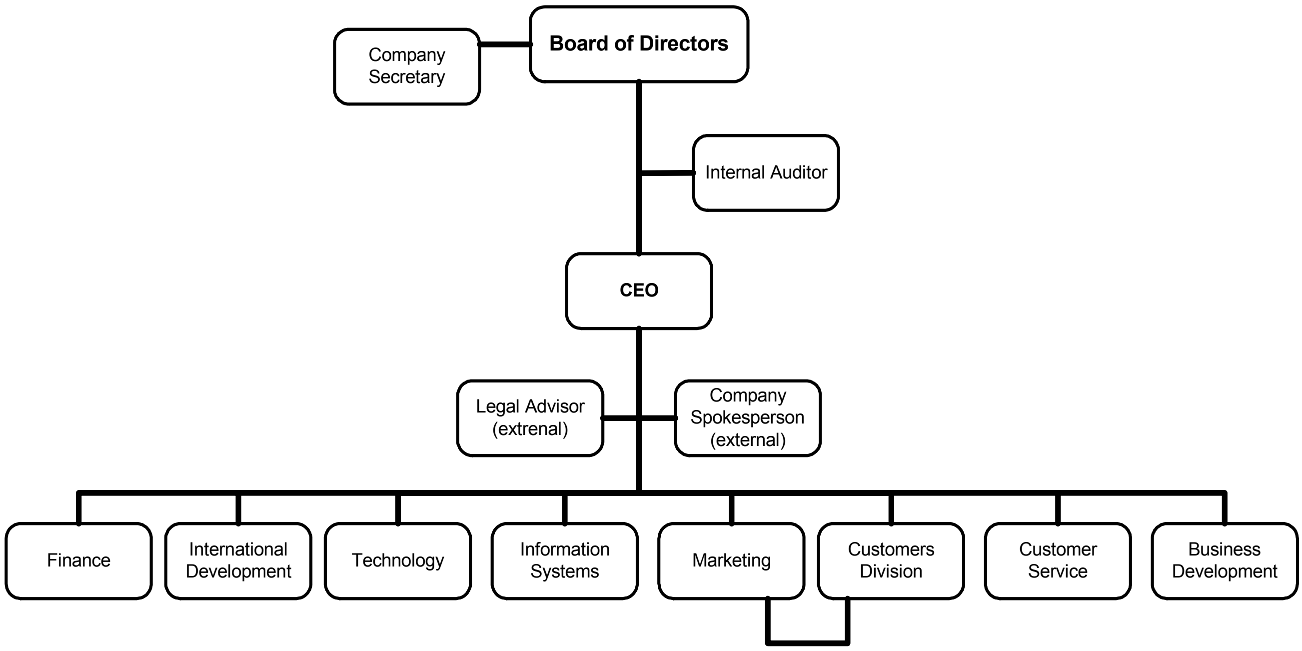
4.10 Human Resources

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

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

4.10.2 Organizational structure

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



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

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

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

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

4.11 Suppliers

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

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

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

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

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

4.12 Working Capital

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

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

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

4.13 Credit Policy

4.13.1 <u>Credit for customers</u>

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

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

4.13.2 <u>Credit from suppliers</u>

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

4.14 Investments

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

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

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

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

4.15 Finance

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

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

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

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

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

4.16 Taxation

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

4.17 Restrictions on and Supervision of Bezeq International's Operations

4.17.1 <u>Legislative restrictions</u>

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

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

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

A recently introduced amendment to the provisions of the Telecommunications Law permits the Minister of Communications to determine telecommunications services, the provision of which does not require a license. Pursuant to his declarations, the Ministry of Communications intends to exempt the provision of internet access services.

In view of said provisions of the Telecommunications Law, all Bezeq International's telecommunications services are provided by virtue of the provisions of the license granted to it and pursuant to its terms, as set forth in Section 4.1.2 above.

4.17.1.2 Interconnect payments

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

In September 2000 the Ministry of Communications enacted a regulation regarding the tariffs for calls to cellular telephones. Pursuant to the new regulation incoming call tariffs decreased gradually from October 2000 to January 2003.

With regard to payments to be made by Bezeq International, as an international licensee, for the completion of traffic on a cellular network, the present tariff of NIS 0.25 for completion of a call will be reduced from March 1, 2008 to a maximum tariff of NIS 0.22.

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

4.17.1.3 Royalties

For payment of royalties, see Section 4.1.2.2 above.

4.17.1.4 Standardization

Bezeq International is ISO 9001:2000 certified for quality management systems and ISO 7799 certified for information security management systems by the Israel Standards Institute.

4.18 Cooperation Agreements

4.18.1 In April 1997 Bezeq International signed an agreement with the communications corporation Concert for the sale of data transfer services via Concert. The corporation was set up by British Telecom (BT) and the American company AT&T and also provides uniform communications services to multinational companies. In 2002 the corporation split up and the network is presently managed by BT. Bezeq International has a BT service distribution agreement in Israel whereby Bezeq International provides network services managed by FR technology.

4.18.2 In June 2003 Bezeq International signed an agreement with Infonet Corporation (hereinafter: "Infonet") for the distribution of Infonet's data communications services. Infonet is a network connecting many sites worldwide and enables the efficient transfer of data between these sites. In December 2003 an agreement was signed by Bezeq International and Kardan Communications Ltd. for the acquisition of the operation of Infonet Israel Ltd., the Israeli representative of Infonet which provides international data communication and IP services on the Infonet network in Israel. The customer files were transferred to Bezeq International which received the equipment and rights to provide Infonet services in Israel, and it will provide technical support to all Infonet's global customers requiring services in Israel. This acquisition process enables Bezeq International to serve as a franchisee and strategic partner of Infonet in Israel and provide its customers with an expanded deployment of global communication networks and access to a wider range of advanced, high-quality communication services. On January 28, 2004, the Anti-Trust Commissioner gave his approval to the acquisition of the operation as a merger transaction. On March 24, 2004, an agreement was also signed with Infonet. The agreement from December 2003 was conditional upon the signature of this agreement. This agreement replaced the agreement with Infonet as of June 2003.

4.19 Legal Proceedings

4.19.1 On November 24, 1998, an equipment provider filed a claim in the Tel Aviv District Court against the Company and Bezeq International. The plaintiff argued that the Company and Bezeq International, jointly and severally, owe it some NIS 12 million owing to a violation of the agreement signed by the plaintiff and the Company in December 1995, the subject of which was the upgrading of an exchange.

Bezeq International, in its statement of defense, rejected the arguments of the plaintiff and even filed an application to dismiss the claim *in limine*. With consent from the parties the case was sent to a mediation proceeding. The mediation did not succeed and the hearing was returned to the District Court. A preliminary discovery of documents took place. The plaintiff filed its primary evidence affidavit on October 19, 2003, and Bezeq International's primary evidence affidavit was filed on March 30, 2004. On April 13, 2004 a reminder meeting was held regarding the case in which an evidentiary hearing was set for October 21, 2004. The evidentiary hearing was postponed until March 7, 2005 and was later cancelled and in its place a pretrial hearing was set for March 2, 2005.

The legal counsel of Bezeq International believe that in respect of some of the plaintiff's arguments Bezeq International has good counter-arguments, but they are unable to estimate, at this stage, the chances of the claim and Bezeq International has consequently decided not to include a provision for this claim in the financial statements.

4.19.2 On April 4, 2004 a competing international communications operator filed a claim in the Jerusalem District Court against the State of Israel in the amount of NIS 11.2 million, for damages allegedly caused to it by a violation by the State of Israel of an obligation to place at its disposal part of the total capacity of an underwater cable (which was granted as part of the tender which opened the international communications market to competition in 1995).

On September 22, 2004 the State of Israel filed a statement of defense and third-party notice against Bezeq International and the Company. In the third-party notice the State argues that if the claim is accepted, in whole or in part, Bezeq International and the Company will have to bear all the consequences of any relief handed down against the State in the claim. The State further argues that Bezeq International acted in bad faith as a licensee toward the regulator in that it used capacity which had been earmarked for the other licensees. The State also makes similar arguments to the Company and also argues that Bezeq International, as a subsidiary of the Company, bears full liability alongside the Company for the Company's operations.

On December 20, 2004 Bezeq International and the Company filed a statement of defense to the third-party notice filed by the State in which they argued that the third-party notice should be dismissed, *inter alia*, because the claim and the third-party notice exceeded the period of limitation, that Bezeq International and the Company had acted in good faith, pursuant to the provisions of the agreements, which did not cause a violation of the agreements by the State, that they had protested that they would be unable to comply with the obligations contained therein and that they had not violated the provisions of the license. On December 30, 2004 the State filed a statement of response to said statement of defense.

On January 27, 2005 the court handed down a mutual order for discovery of documents and the submission of questionnaires within 30 days, and also ordered the parties to file all their applications to be heard before the start of the evidentiary proceeding, up to 30 days before the pretrial date, which was set for April 10, 2005.

The legal counsel of Bezeq International believe that Bezeq International has good defense arguments against the claim and the third-party notice, among them arguments of exceeding the period of limitation and that there is a good chance that the third-party notice will be dismissed. However, especially in light of the preliminary stage which contains the third-party notice, the legal counsel of Bezeq International are unable to estimate, at this stage, the chances of the claim and Bezeq International has consequently decided not to include a provision for this claim in the Financial Statements.

4.19.3 On January 2, 2005 a claim was filed against Bezeq International, against two other international operators and against another company, in the amount of NIS 10 million, based on the argument that a patent for a prepaid telephone system had been infringed by persons alleging that they are the inventors and owners of said patent. According to the plaintiffs each of the defendants is infringing the patent which they own and unlawfully enriching themselves at their expense. In the statement of claim the plaintiffs demand that detailed reports of said revenues stemming from the infringement of the patent be submitted to them and that said full revenues, plus reasonable royalties and punitive compensation, be paid to them pursuant to the provisions of the Patents Law.

As at the date of preparation of this report, a statement of defense had not yet been filed on behalf of Bezeq International. The legal counsel of Bezeq International are unable to estimate, at this stage, the chances of the claim and no provision for this claim has been included in the Financial Statements.

4.19.4 For further claims, see Notes 19A(8), 19A(11), 19A(24) to 19A(26) and Note 19A(39) of the financial statements for the year ended December 31, 2004, included in this annual report.

4.20 Goals, Business Strategy and Expected Development

4.20.1 As part of the preparations for 2004, Bezeq International set itself a number of key goals outlining the nature of its operations and reflecting the strategy which it adopted during the year:

4.20.1.1 Increase of profitability compared with the previous year.

4.20.1.2 Transition to profitability and retention of leadership in high-speed internet market in general and ADSL in particular.

4.20.1.3 Readiness to expand international calls market for competition.

4.20.1.4 Addition of income sources.

4.20.1.5 Reduction of expenses for 2005 when competition will expand and have a greater effect.

4.20.1.6 Stabilization of organizational structure and improvement of work processes.

4.20.2 <u>Bezeq International's goals for 2005</u>

4.20.2.1 Improvement and streamlining of its customer service setup.

4.20.2.2 Retention of average fixed income per-customer.

4.20.2.3 Development of alternative income sources for voice, internet and data.

4.20.2.4 Adaptation of expense structure to the new income structure.

4.20.2.5 Steady streamlining, *inter alia*, by defining indices and compliance with goals.

4.20.2.6 Focus on and retention of customer base.

4.20.2.7 Retention of leadership status via market share or leading margin.

4.20.2.8 Achievement of profitability in data sector, thereby justifying volume of operations.

4.20.2.9 Focused and differentiated operations based on value-added services.

4.20.2.10 Assimilation of SoftSwitch and IN without harming service standards.

4.20.2.11 Utilization of benefits deriving from IT investments.

4.20.3 In 2004 Bezeq International positioned itself as Israel's leading service provider in its three core areas – Voice Services, internet access services in general, and high-speed internet in particular, including a range of value-added services as well as datacom operations for international customers.

4.20.4 An additional area is Voice over IP in accordance with the marketing trial license Bezeq International received in December 2004. The trial is expected to continue in 2005 and include some 8,500 private and business customers. As part of the marketing trial, Bezeq International will examine various scenarios for operation in the domestic calls arena. For the Company's position regarding this matter, see Section 2.6.1 above.

4.20.5 An additional operation is in the Application Service Provider (ASP) area, in which Bezeq International will examine various possibilities for providing private and business applications over the internet.

4.20.6 In 2004 Bezeq International retained its market position in all the areas of its operations. This year Bezeq International has expanded its data operations by acquiring the Infonet Israel operation (see Section 4.9.2), an acquisition which has turned Bezeq International into Israel's leading entity in this area.

4.20.7 In 2004 Bezeq International penetrated the hotspot field in which it succeeded in achieving market leadership in a number of sites (approximately 70) including strategic targets (leading café chains, gas stations, the Congress Center in Gan Oranim, etc.). In 2005 Bezeq International is planning to expand the deployment of its public infrastructures (WiFi hotspots) into additional sectors and offer value-added services on this infrastructure to end-customers.

4.20.8 In view of the intensifying market competition, observers believe that the market is likely to undergo consolidation processes, which will create merger and acquisition opportunities for the leading market players. Bezeq International will examine such opportunities as they are created based on their financial feasibility and on regulatory decisions, insofar as it will be permitted to do so.

4.20.9 In 2004 Bezeq International signed two strategic cooperation agreements with the global company iPass in order to increase its revenues from the surfing services created by incoming and outgoing business tourism, by providing surfing services to Bezeq International subscribers staying overseas as well as surfing services in Israel for overseas internet subscribers staying in Israel.

A public company traded on the Nasdaq, iPass is a remote access aggregator (with various access methods: analog, fixed and wireless broadband). iPass has more than 10,000 WiFi hotspots worldwide in more than 150 countries.

The first agreement (signed in the first quarter of 2004) was designed to provide Bezeq International subscribers traveling overseas with surfing services using all types of access (dial-up, broadband and WiFi). The second agreement (signed in the fourth quarter of 2004) was designed to allow iPass subscribers arriving in Israel to surf in all the public areas in which Bezeq International provides surfing services, particularly in the hotspots which Bezeq International has deployed throughout the country. In 2005 it will examine the possibility of signing agreements with other roaming services suppliers worldwide.

4.20.10 In 2005 Bezeq International is expected to replace its existing switches with the SoftSwitches manufactured by Veraz, and its current intelligent network system with a system manufactured by SigValue, as described in Section 4.11.1 above.

4.20.11 The above information looks to the future and as such is not certain and might not become reality, in whole or in part. The forward-looking information is based on information existing in Bezeq International as at the date of publication of this report, and contains estimates made by Bezeq International, its work assumptions or intentions, as at the date of publication of this report. The actual results are likely to be materially different from the results estimated or inferred from this information.

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

The above forecast might not become reality at all or might become reality in part only, owing to a downturn in the Israeli economy which will reduce purchasing power in Israel, owing to regulatory changes liable to harm the ability of Bezeq International to provide solutions to existing or changing market requirements, and owing to all the other risk factors listed below.

4.21 Risk factors

Changes in exchange rates, CPI and interest rates

A. Changes in exchange rates – the main currency used by Bezeq International is the shekel which is also its reporting currency. There is a special risk in the nature of Bezeq International's international transactions: most of its operations (sales) derive from Israeli customers. In addition, Bezeq International provides services to customers worldwide and collects the payments to which it is entitled in foreign currency, mainly in US dollars. In contrast, Bezeq International uses services from suppliers throughout the world and pays them for these services in foreign currency, mainly in US dollars. The changes in the exchange rates of the currencies in which Bezeq International operates against the shekel expose it to exchange rate differentials which are liable to harm its profitability by increasing finance expenses as well as its cash flow. To protect itself against currency exposure Bezeq International enters into hedging transactions and purchases other financial instruments. The Board of Directors of Bezeq International have nominated its internal financial committee to oversee its policy in respect of management of the market risks to which it is exposed. The internal financial committee of Bezeq International meets from time to time, at least once a quarter, in order to discuss market risks and ways of minimizing their effect on its financial position, its operating results and its cash flow. The finance committee reports to the Board of Directors every quarter and as necessary upon request.

   Changes in the CPI – Bezeq International is exposed to changes in the CPI, mainly in connection with CPI-linked loans it has received from the Company (see Section 4.15.4 above). In addition, the linkage of these loans to the CPI has no effect on the profitability of Bezeq International but on its shareholders' equity only, since the entire effect of the change is charged to a capital reserve account in accordance with accounting treatment of transactions between a corporation and a controlling party thereof in the financial statements.

   Changes in interest rates – Bezeq International has immaterial exposure to changes in interest rates in connection with disputes with the Ministry of Communications as stated in Section 4.1.2.2 above.

B. Competition – for the effect of the competition on the businesses of Bezeq International, see Section 4.6 above.

C. Investments in infrastructures, technological changes and dependence on suppliers – see Section 4.11 above.

D. Government oversight and regulation – for the application of the provisions of the Law and licensing policy and their effect on Bezeq International, see Sections 4.1.2 and 4.1.3.1 above.

E. Anchor countries

   Bezeq International has committed in an official price list, to the lowest prices for 4 countries (USA, Russia, France, Argentina) until the end of 2005. As a result, the revenues of Bezeq International will undergo an immediate negative effect if the price lists of its competitors are adjusted to below the existing price list of Bezeq International.

F. Verio

   On September 30, 2004, Bezeq International was notified by the American company Verio of termination of the agreement between the companies and a cessation in the supply of hosting server management services which it had provided, owing to the failure of Bezeq International to pay for the services and the consequent violation of their agreement. On October 7, 2004, Verio halted the service which it had supplied to Bezeq International and erased the content of the hosting servers which it had operated (belonging to Bezeq International and installed on its server farm).

   As a result of the above action taken by Verio, the site hosting service supplied by Bezeq International to its customers was halted. Bezeq International made immediate preparations to look after its customers and restore normal service.

   Bezeq International granted comprehensive compensation by giving three months' service free of charge to the site hosting service customers which had been subscribers to Verio services when the service was halted. The total extent of the compensation is not material.

To date, a few customers have requested additional compensation and two claims have been filed against Bezeq International. The cumulative rate of these demands is also not material.

At this stage it is not possible to estimate the extent of the additional exposure which Bezeq International might and will have in this regard.

G. Transition to SoftSwitch and upgrade of the IN system

In 2005 Bezeq International will replace the switch and upgrade its intelligent network system. Such an undertaking entails the risk of delaying timetables and faults which could harm service.

H. IN maintenance agreement

Failure to renew the IN system maintenance agreement with Alcatel from the conclusion of the previous agreement at the end of 2004 until the system replacement date, as set forth above in Section 4.21.1G, is liable to lead to a situation where a fault in the present system will not be repaired by Alcatel and Bezeq International will be required to present an alternative solution. Ongoing maintenance and backups are performed by Bezeq International employees so that the only risk is in the event of a system fault.

I. Legal proceedings

Bezeq International is a party to legal proceedings, among them class actions which are liable to cost material amounts and cannot at this stage be estimated, and for most of which no provision has been made in the financial statements of Bezeq International and the Company. For legal proceedings to which Bezeq International is a party, see Section 4.19 above.

Risk Factor Summary Table

	Extent of effect of risk factor on Bezeq International's operations		
	Large effect	**Medium effect**	**Small effect**
Macro risks			
Exposure to changes in exchange rates	X		
Exposure to changes in interest rates			X
Exposure to changes in inflation		X	
Sectoral risks			
Increasing competition	X		
Investments in infrastructures and technological changes	X		
Government oversight and regulation	X		
Special risks for Bezeq International			
Exposure to legal processes	X		
Anchor countries		X	
Verio			X
Transition to SoftSwitch switches and IN	X		
Failure to renew the IN maintenance agreement		X	
Dependence on suppliers	X		

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

5.1 General Information Regarding the Area of Operations

DBS, which trades under the name of "Yes", provides its subscribers with multi-channel satellite television services. Founded on December 2, 1998, DBS has been providing the service since July 2000.

This service allows for the provision of multi-channel encoded digital television broadcasts and value-added services to subscribers who receive the broadcast at home via small antenna dishes without the need for a ground communication infrastructure, except for the connection of the dish to a domestic decoder in the subscriber's home and connection of the decoder to the television.

Most of the revenues of DBS stem from subscriber fees and other subscriber payments. As at December 31, 2004 DBS had 470,494 subscribers.

DBS is the only company currently operating in the satellite multi-channel television broadcasting sector, even though neither the law nor the license awarded to it grant it exclusivity.

5.1.1 Structure and changes in area of operations

The multi-channel television broadcasting sector in Israel, consists of DBS and three principal cable television broadcasting corporations (hereinafter: the "Cable Companies"), is characterized by the broadcasts of Israeli and foreign television content to subscribers in the form of various broadcasting packages in return for subscriber fees and additional accompanying payments.

The field of multi-channel broadcasts is characterized by extensive competition between DBS and the Cable Companies. They operate by means of broadcasting licenses awarded to DBS and the Cable Companies by the Minister of Communications.

Since July 2002 the Cable Companies have been engaged in a process of merging into one company (which has not yet been concluded). In December 2003 the Cable Companies embarked on the launch of a joint brand ("HOT") and the change to a uniform screen appearance for marketing purposes allowed subscribers and potential subscribers to identify them. Furthermore, as far as DBS knows, content purchases, marketing and branding are implemented jointly by the Cable Companies.

5.1.2 Legislative restrictions and special constraints

The Telecommunications Law requires that a broadcasting license be obtained in order to transmit satellite television broadcasts to the public. In January 1999 DBS received the above-mentioned broadcasting license by virtue of the provisions of the law and pursuant to the Telecommunications Regulations (Processes and conditions for the granting of a satellite broadcasting license) 5758-1998 (hereinafter: the "Broadcasting License").

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

DBS' broadcasting operations are also overseen by the Cable and Satellite Broadcast Council (hereinafter: the "Council"). The Council sets policy and general standards in respect of broadcast content, duty to provide original broadcasts, division into genres, broadcasting ethics and other broadcasting policy topics, and also approves the channels which DBS wishes to broadcast or stop broadcasting.

The Council also has consumer protection powers, so that the determination and updating of price lists and customer promotions require its approval or advance notification. The Council does not interfere in DBS' tariffs but ensures that there is no bias or discrimination between subscribers or breach of the provisions of the law. Reductions, discounts, and promotions do not require Council approval, but a report should be submitted to the Council chairperson, who may intervene if it emerges that they deceive the public or discriminate between subscribers.

In addition, DBS is subject to oversight from the Ministry of Communications, in respect of the matters defined in its license (mainly technical and consumer matters). The provision of services and implementation of ancillary and supplementary broadcasting operations sometimes require licensing from the Ministry of Communications.

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

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

5.1.3.1 Differentiation, innovation and originality in its broadcasting content compared with the broadcasting content of its competitors, the Cable Companies. These factors are reflected in the purchase of content, which includes current movies, documentary programs and many series containing unique and innovative characteristics, as well as in the initiation, production and purchase of original Israeli programming. For this purpose, there is a need for continued investment in the purchase and renewal of the broadcasting content and value-added services (such as pay-per-view services and interactive services) provided to DBS customers.

5.1.3.2 Differentiation at the customer service level provided to DBS subscribers by the customer support and customer service setup, which constitutes a critical success factor in DBS' ability to retain customers in a competitive market.

5.1.4 The principal entry and exit barriers

5.1.4.1 The principal entry barrier derives from the burdensome regulation prevailing in the broadcasting sector, including the duty to operate in accordance with the relevant provisions of the law, pursuant to the provisions of the license and according to its conditions, as well as the ongoing oversight of the Council and of the Ministry of Communications.

5.1.4.2 An additional key entry barrier which derives in part from the above-mentioned barrier, is the enormous investment required from a competitor in the market in order to establish a public multi-channel broadcasting setup (including a broadcasting center and national infrastructure to receive satellite broadcasts and purchase satellite space segments or a nationally deployed cable infrastructure) and in order to broadcast and distribute content to the public in accordance with market requirements (see Section 5.1.3.1 above), and pursuant to regulatory requirements and restrictions.

5.1.4.3 The principal exit barriers from the sector derive from long-term agreements with satellite segment leasing companies (see Section 5.15.2 below), the large investments requiring long repayment periods and an obligation to repay the bank loans taken out by DBS (see Section 5.12.2 below). In addition, DBS is bound to provide service to its customers throughout the period of its agreement with them.

5.1.5 Alternatives to and changes in sectoral products

With regard to the broadcasting and service basket offered by DBS to its customers, the range of terrestrial channels and other channels broadcasted at no cost to the Israeli public can be categorized as alternative products. Among these channels are Channel 1 (belonging to the Israel Broadcasting Authority), Channel 2, the commercial Channel 3 ("Channel 10"), the Knesset channel, Channel 23 belonging to Educational Television, the Music Channel ("Channel 24"), the Russian-language channel ("Israel Plus"), and the Shopping Channel. In addition, video and DVD libraries constitute providers of alternative products to some of DBS's services.

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

The broadcasting sector is characterized by competition between the Cable Companies and DBS. The concentrated and complex ownership structure in the areas of content, communication and infrastructure in Israel is likely to lead to control by groups throughout the content production, packaging and supply chain. With their broad deployment of advanced infrastructures and being owned by other communication entity partners, the Cable Companies will soon offer a service basket containing line telephony, high-speed internet and multi-channel television, which constitutes a key component in creating differentiated offers to potential subscribers.

5.2 Products and Services

DBS provides its subscribers with a wide range of channels: approximately 100 different video channels, 17 radio channels, 30 music channels, and service and interactive game channels which can be ordered on a daily and monthly pay-per-view basis.

The broadcasts include a basic package which each subscriber is required to purchase as well as additional channels chosen by the subscriber, whether as a package or whether as a single channel, based on plans defined from time to time by DBS, with the approval of the Council and pursuant to the terms of the broadcasting license.

The main channel packages marketed by DBS in addition to the basic package are the movie package, the entertainment package, the children's package, the music package and the sport package. These channel packages appeal to different target populations depending on their viewing habits and preferences.

As part of its operations, DBS also allows its subscribers to purchase movies and programs on a pay-per-view basis, from a list of movies and programs which is updated from time to time.

DBS is endeavoring to increase the broadcasting frequency of its pay-per-view movies as well as demand for them. This is leading to a significant increase in revenues from this service.

5.3 Revenues and Profitability of Products and Services

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

	2004	2003	2002
Revenues	1,028	842	660
Gross profit	15	(170)	(409)

5.4 New Products

During January 2005 DBS began selling, through external resellers, a new decoder known as a Personal Video Recorder (PVR) under the brand name yesMax. This device, which offers enhanced audio and sound quality, replaces the ordinary decoder and adds advanced features while retaining simplicity of operation, among them the ability to record content selected by the subscriber, enable viewing of a program while at the same time recording another program, order recordings directly from the electronic broadcasting schedule, and pause a program during its broadcast and continue viewing from the point where it was paused.

Development updates of the software operating the device are expected from time to time, but material investments in development of the device are not expected in the near future.

5.5 Marketing and Distribution

DBS services are marketed by means of advertisements in various media outlets as well as by means of four principal distribution channels:

5.5.1 Sales people in the field working to recruit subscribers.

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

5.5.3 Sales stations in shopping malls and commercial centers throughout the country.

5.5.4 External resellers of the company's services working on the basis of agreements with the company.

The distribution channels, except for the external resellers, are operated by DBS employees.

5.6 Competition

5.6.1 Competitors in the broadcasting market

DBS's main direct competition comes, as stated above, from the three principal cable companies: Arutzei Zahav and Co., Matav Cable Communication Systems Ltd., and Tevel Israel International Communications Ltd.

DBS estimates its share of the multi-channel television market as at December 31, 2004, to the best of its knowledge, at around 33% of total subscribers.

5.6.2 Broadcasting characteristics of the competitors

The Cable Companies have been operating in the broadcasting market since the beginning of the 90's, formerly by virtue of regional franchises under the exclusivity conditions granted to them, which were replaced in 2002 by long-term broadcasting licenses. Currently, the cable companies are collaborating, as mentioned in section 5.1.1 above.

DBS transmits its broadcasts using only a digital method, by means of tiering at various price levels, while the Cable Companies transmit their broadcasts to most of their subscribers using a digital broadcasting method and the above-mentioned tiering, while for the remainder (who number around 35% of the Cable Companies' subscribers as at December 31, 2004) they use an analog broadcasting method, which does not allow for broadcasting packages but one identical channel package (for additional implications of this difference, see Section 5.6.4(B) below).

5.6.3 Characteristics of the current competition

In 2001 and 2002 the number of DBS's subscribers increased rapidly and within a relatively short space of time attained extremely high penetration rates compared with accepted global rates. The successful penetration derived from, *inter alia*, the temporary regulatory concessions granted to DBS at the time (and from which it no longer benefits) and from the technological preference for digital broadcasting which characterized DBS's broadcasting, as opposed to cable broadcasting which was analog only until the middle of 2001. In 2003 and the first half of 2004 there was a significant downturn in DBS's rate of acquiring new subscribers, but in the second half of 2004 this rate began a new upward path.

At present, the competition in the broadcasting sector is focused on content, on the channel packages offered by the broadcasting companies, on prices of channels, on packages and on service.

There is fierce competition between DBS and the Cable Companies in the content sector and each entity seeks to purchase content differentiating it from its rivals, which constitutes an incentive for subscribers to switch providers.

DBS invests efforts and resources both in marketing its services to the subscribers of its rivals as well as in purchasing special, quality content which it includes in its basket of services and broadcasts.

5.6.4 Positive and negative factors regarding the competition

DBS's management believes that DBS has a significant advantage thanks to the technical quality of the satellite broadcasts which also enable the reception of broadcasts in areas without a cable infrastructure. However, DBS' broadcasting infrastructure suffers from inferiority in a number of areas, the main ones being:

A. The fast satellite infrastructure is unidirectional (from broadcasting satellite to subscriber home), whereas the return direction (from subscriber home to broadcasting center) is based on the Company's telephone line and this makes it difficult for DBS to use its infrastructure to launch services such as internet services which require a high-speed bidirectional infrastructure. This is at a time when the Cable Companies together with an affiliated corporation are offering internet services alongside their broadcasts. Consequently, internet services are offered to DBS subscribers as a result of DBS' cooperation with internet access companies using the Company's infrastructure.

   DBS has recently received approval for an experimental transmission of movies and video content using the Company's ADSL infrastructure. However, DBS has not yet received approval to offer these services on a commercial basis owing to legal examinations of this issue being conducted by the Ministry of Communications and the Council with the aim of granting the approval and stipulating its conditions.

B. Some of the customers of the Cable Companies' are customers of the cable analog systems (see Section 5.6.2 above). Insofar as such customers wish to switch to the digital system, the Cable Companies have much greater access to them since the analog broadcasting system allows its subscribers to receive lower-cost broadcasts without using a digital decoder.

C. Since the Cable Companies were for a long time the first and only players in the market, a large number of homes of potential DBS subscribers have internal wiring installed by the Cable Companies which DBS usually has no alternative but to use. The directives issued by the administration of the Ministry of Communications require 36 hours' notice before disconnection of an existing subscriber of the Cable Companies (and vice versa in the case of disconnection of an existing DBS subscriber). The Cable Companies can exploit this time frame to make special offers to existing subscribers about to leave them for DBS, in order to retain their custom. In addition, where the internal wiring infrastructure is owned by the Cable Companies, the management directives stipulate that payment must be made thereof (and vice versa).

The Company's license imposes restrictions on the structural separation between the Company and its subsidiaries and certain affiliated companies, among them DBS. The longer these restrictions remain in force, and at the same time no similar restrictions are imposed on the Cable Companies (and telephony and internet corporations affiliated to them), the more they will harm the competitive ability of DBS (for further details regarding these restrictions, see Section 2.16.2B above).

5.7 Fixed Assets and Installations

DBS broadcasts to its subscribers via an engineering setup which contains a ground broadcasting center located in Kfar Saba broadcasting to the satellite the content received at the center via optical fibers, cassettes and direct reception from the satellites, a secondary broadcasting site situated close to the Re'em Junction, leased space segments on the Amos 1 and Amos 2 satellites and receiver dishes and decoders located in subscriber homes, enabling receipt of the satellite broadcasts and decoding in accordance with the broadcasting package purchased by the subscriber.

5.7.1 Rental of structures

The DBS management and its broadcasting center, including all the technical and technological equipment contained in the broadcasting center, are located in two structures in the eastern industrial area of Kfar Saba in a total area of some 6,800 sq. m., alongside which are parking spaces and ancillary installations which have been leased by DBS in accordance with a memorandum signed with Azorim Shoar Ltd. (hereinafter: "Azorim") in May 1999. DBS leases these structures (which are fully occupied) for a lease period which ends in 2009, and it has the option of extending the lease period for another 10 years under the same conditions. DBS has the right of first refusal to purchase the premises from Azorim whenever they are put on sale. In addition, DBS leases offices in various areas throughout the country, as follows:

Location of asset	Area in sq.m. (approximate)	Date of termination of lease
Haifa	1,288	05/2008
Beit Barkan	960	06/2006
Givat Savyon	1,350	01/2006
Kanot	1,100	08/2007

5.7.2 DBS also uses a third-party site at the Re'em Junction which provides it with services allowing for the operation of the secondary broadcasting site, in which DBS' broadcasting and backup equipment are located.

5.7.3 End-point equipment

DBS installs a receiver dish and other end-point equipment in subscriber homes, among them, decoders used as a receiving and decoding unit for the reception signals, which constitute an infrastructure to the subscriber's television screen as well as smart cards used to decode the encrypted broadcasts, which are transmitted via the encryption system of NDS company (see Section 5.15.3 below).

Some decoders are leased to subscribers in return for a fixed leasing fee paid during the broadcast reception period and some are lent to subscribers (some of these loans are made in return for a deposit which is reduced over the subscription period). A small number of the decoders are sold to subscribers and owned by them. The YesMax devices are currently being sold only by an external distributor.

5.8 Intangible Assets

5.8.1 Licenses

DBS owns the following licenses:

5.8.1.1 Broadcasting license valid until January 2014 - this license is material to DBS's operations and constitutes the regulatory permit for its broadcasting operations (for the conditions of this license, see Section 5.14 below).

5.8.1.2 License for satellite television broadcasts in the Judah and Samaria region valid until January 2009, and by virtue of this license whose provisions are similar to those of DBS's main broadcasting license, DBS broadcasts to the Judah and Samaria region.

5.8.1.3 License to perform uplink operations (transfer of broadcasts from DBS's broadcasting center to the broadcasting satellite and implementation of set and ancillary operation activities), which is valid until April 2006. This license is material to DBS's operations and constitutes the regulatory permit for the transmission of broadcasting messages from the broadcasting center to the broadcasting satellites and from them to subscriber homes.

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

5.8.1.5 License for the transmission of SMS messages between DBS subscribers and between them and subscribers of the cellular companies or email subscribers. This license is valid until April 2008. As at the date of publication of this report, DBS does not use this license.

5.8.2 Trademarks

DBS owns a range of trademarks designed to protect its various brands and services and also a number of trademarks which are in the process of being registered with the Trademark Registrar. The main trademarks relate to the protection of its trading name (Yes), its key content channel names, the channel packages it markets and its unique terminal equipment which it installs in subscriber homes.

5.8.3 Copyright

DBS owns the copyright to the various television content it produces as well as the copyright usage licenses owned by third parties for the purpose of broadcasting within the framework of its subscriber broadcasts. For these usage rights DBS pays the content copyright holders via the five official organizations in Israel, which collect the royalties owed to the owners of the intellectual rights pursuant to the general licenses granted to DBS. These payments are sometimes based on the number of subscribers viewing the content (or listening to recordings, as applicable), the rights to which have been purchased and sometimes on various pricing methods, including some which are not dependent on the above-mentioned number of subscribers.

In 2004 DBS paid said collection organizations some NIS 10 million.

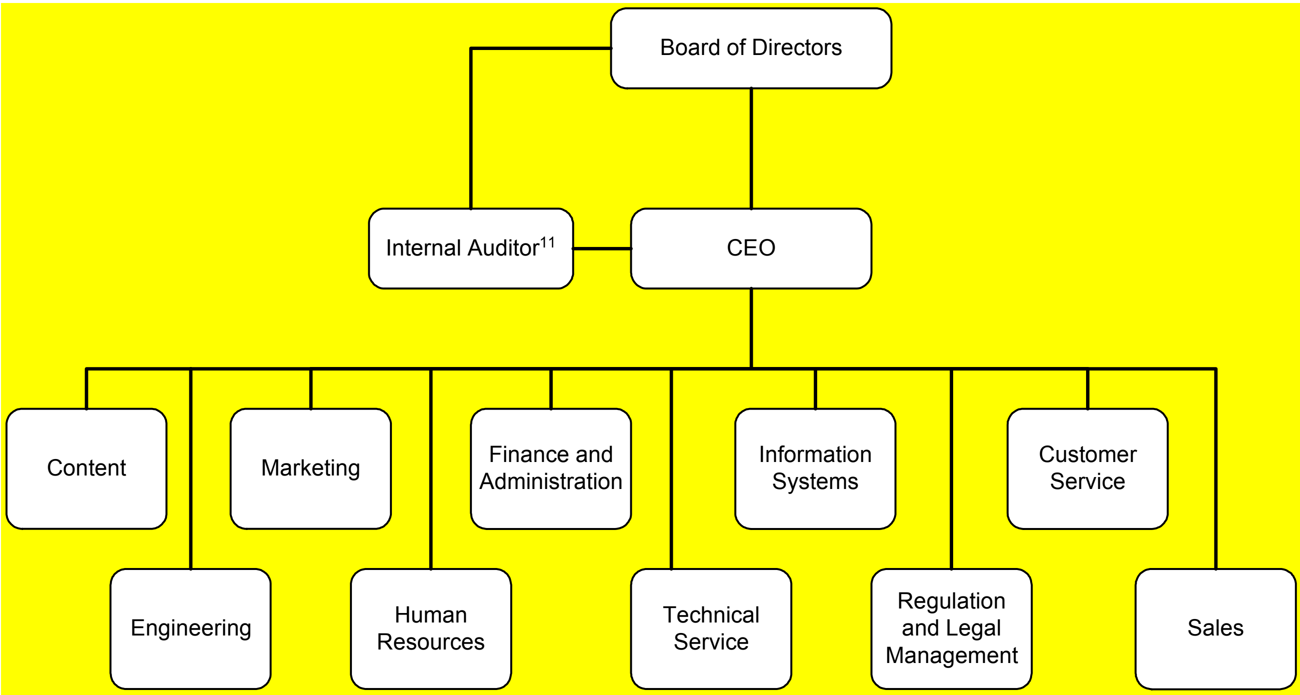
5.8.4 Investments in content

DBS purchased broadcasting rights for 2004 from various owners of copyrights to intellectual property for purchased content. DBS's usage rights to said content are very important to its operations since most of its broadcasts use third-party content and also combine purchased content with content used by DBS for the purpose of producing programs and trailers. DBS from time to time grants usage rights to television content it produces for franchisees from the Second Television and Radio Authority for re-broadcasting of said content. The total costs of the broadcasting rights to said content for 2004 amounted to some NIS 375 million.

5.9 Human Resources

5.9.1 Organizational structure

DBS consists of 10 divisions, each of which is headed by a vice president who serves as a member of DBS's management. The divisions include sales, customer service, technical service, content, marketing, engineering, finance and administration, human resources, regulation and legal management and information systems, as depicted in the following chart:



[11] External accountant

5.9.2 Headcount of DBS personnel by division

Division	Number of employees	
	As at December 31, 2003	As at December 31, 2004
Sales	266	388
Customer service	615	738[12]
Technical service	355	405
Content	39	38
Marketing	20	26
Engineering	61	63
Finance and Administration	88	91
Human Resources	7	10
Regulation and Legal Management	2	2
Information Systems	59	66[12]
Management	5	4
Total	1,517	1,771

5.9.3 Training and development of human capital

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

In 2004 DBS set up a training and instruction center consolidating the three main training tracks, which is used as a training center for all DBS managers and employees.

DBS trains some 1,000 employees every year.

5.9.4 Organizational change

DBS recently completed the transition from an operating setup based on geographic – district division, to a national operating setup covering all DBS' sales and service operations. As at the date of this report DBS has begun the process of consolidating customer service and technical service divisions into one division which will be called the Customer Division.

5.9.5 Employee compensation programs

In 2004 DBS integrated a target based compensation plan for its senior management.

5.10 Raw Materials and Suppliers

5.10.1 Main raw materials

The main raw materials used by DBS for its broadcasting operations are:

A. Television content

Television content, broadcasting and broadcasting channel rights purchased by DBS for its broadcasts. The broadcasting rights include movies, series and other original programs from local and foreign producers, mainly from the USA (see Sections 5.8.3 and 5.8.4 above).

In view of the proliferation of content providers from which DBS purchases broadcasting rights, DBS does not have a main provider and is not materially dependent on one single content provider. However, in the Israeli sport broadcasting sector there is dependence, as at the date of this report, on the purchase of broadcasting rights for the channels known as "Channel 5" and "Channel 5+" from the provider of these contents.

[12] In addition, DBS receives services in these divisions from third-party employees.

B. Space segments

DBS leases rights to satellite space segments via which DBS broadcasts from the satellites to the reception dishes installed in subscriber homes. The space segments are leased by means of long-term agreements with two owners of the rights to the space segments (see Section 5.15.2 below).

DBS is dependent on the continuing regular availability of the space segments (see Section 5.19(E) below).

C. Digital decoders

DBS purchases digital decoders in order to receive and decode encrypted broadcasts in the homes of its customers. DBS is dependent on the provider from which it purchases the decoders. Replacement of this provider with another provider does not entail material extra cost, but the replacement would require a significant preparation period to adapt the decoders of the replacement provider to DBS' broadcasting and encryption system. For a description of the agreement with this provider see Section 5.15.1 below.

D. Operating and encryption systems

DBS purchases from NDS services linked to the operating systems of its broadcasting setup and encryption means (see Section 5.15.3 below) as well as hardware for these services. DBS is dependent on the continuing supply of these services.

5.11 Working Capital

5.11.1 Content inventory

The broadcasting rights purchased by DBS are presented in DBS's books on the basis of their cost, where the broadcasting usage rights relating to the screening of movies and television programs includes payments made to rights providers pursuant to the agreements with them.

The broadcasting rights are amortized in accordance with their purchase agreements, on the basis of the actual content screening (where the part which is not amortized by the end of the agreement period is amortized in full on the basis of the agreement period) or in equal parts on the basis of the rights agreement period.

The costs of the independent productions of programs which DBS believes may be broadcasted a number of times or may be sold to a third party are considered part of the broadcasting rights inventory of DBS, and their cost is amortized over their estimated usage period.

5.11.2 Customers

DBS collects subscriber fees from its customers at the end of each calendar month for the previous completed calendar month. As at December 31, 2004, customer credit amounted to NIS 113,377 thousand.

5.11.3 Supplier credit

The average supplier credit period in 2004 was 204 days.

5.11.4 Deficit in working capital

As at December 31, 2004, DBS's deficit in working capital amounted to NIS 470,836 thousand. DBS intends to use appropriate cash flow sources, should there be any, to minimize its working capital deficit by means of reducing supplier credit.

5.12 Finance

5.12.1 Average interest rate for loans

5.12.1.1 Shareholders

The loans granted to DBS by its shareholders (among them the Company) are divided into three types:

5.12.1.1.1 CPI-linked non interest-bearing loans.

5.12.1.1.2 CPI-linked loans bearing annual interest of 5.5%.

5.12.1.1.3 CPI-linked loans bearing annual interest of 11%.

5.12.1.2 Banks

Short-term interest – the average interest rate for this credit as at December 31, 2004 is 7%.

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

A. Loans based on prime interest rates where the average interest rate as at December 31, 2004 is 6.5%.

B. CPI-linked loans where the average interest rate as at December 31, 2004 is 6.8%.

5.12.2 Credit restrictions applicable to corporations

Pursuant to the finance agreement of May 2001, as amended from time to time, between DBS and a bank consortium which arranged bank finance for DBS (hereinafter: the "Finance Agreement"), DBS must comply with all the following financial criteria:

A. Minimum overall income.

B. Minimum operating surplus.

C. Minimum operating surplus less DBS investment in decoders and modems.

D. Maximum supplier credit.

E. Minimum targets for coverage of the bank debt and debt balances.

F. Maximum overall finance requirements.

G. Maximum churn rate.

The values for compliance with the financial criteria change and are measured each quarter. Noncompliance grants the banks the right to demand early repayment of the loans and the right not to award DBS any further unused credit line. In addition to compliance with the financial criteria, the main condition for the bank credit not yet granted to DBS is the raising of shareholders' loans at rates determined in the Finance Agreement before the various types of bank credit were awarded. As at December 31, 2004 DBS is complying with all the financial conditions determined in the Finance Agreement.

In addition to the above-mentioned financial commitments, pursuant to the Finance Agreement additional restrictions anchored therein apply to DBS, the main ones being:

A. Restrictions on its compliance with its business plan and the update of this plan.

B. Restrictions on the assumption of third-party liabilities, including the receiving and granting of credit.

C. Restrictions on the distribution of profits and payment of management fees to the shareholders.

D. Restrictions on the creation of pledges and sale of certain assets without consent from the banks.

E. Restrictions on DBS's transactions with interested parties, changes of ownership in DBS, the purchase of securities in any corporation and the offering of its securities to the public (including the issue of debentures).

F. Restrictions on the shareholders' loans granted to DBS by the Company, among them their subordination in relation to the bank credit and restrictions on their repayment before repayment of the bank credit.

DBS encumbered its assets and goodwill with a floating lien in favor of the banks and placed fixed liens on its rights in accordance with material agreements to which it is a party.

DBS shareholders, with the exception of the Company, pledged the DBS securities in their possession in favor of the banks, to secure the amounts which the banks made available and will make available to DBS. Most of the shareholders also pledged their rights to repayment of the shareholders' loans granted to DBS in favor of the banks and confirmed to the banks that these loans would be subordinate to the bank credit. In view of the restrictions on the Company's ability to pledge its assets as a result of the negative pledge created by the Company in favor of its creditors (see Note 13D(1) to the financial statements for the year ended December 31, 2004, which are included in this Periodic Report), on November 23, 2000 the Company gave a guarantee of DBS's debts to the banks, provided that the amount which the banks receive in repayment by the Company of its guarantee does not exceed the value of its shares in DBS on the date on which the banks realize the shares which the other shareholders pledged in their favor. The Company also gave a commitment to sell its shares if the shares pledged by the banks are sold. Pursuant to a note of amendment to the guarantee of May 2, 2002, the Company consented that in the event of realization of the collateral given by the other shareholders the Company would waive repayment of the shareholders' loans it granted to DBS. The Company also consented that its guarantee would also apply, *mutatis mutandis*, to the options allotted to DBS and to the right to receive them.

The shareholders in DBS with the exception of Gilat DBS Ltd., gave an undertaking to the banks not to oppose the sale or other realization of their shares in DBS, which had been pledged or in respect of which a guarantee had been given (by the Company), so that the bank could make the sale without disturbance in the form of a friendly liquidation.

5.12.3 Credit amounts received in 2004

In 2004 DBS received shareholders' loans amounting to some NIS 326 million and the banks increased their credit framework by some NIS 58 million.

5.12.4 The Corporation's credit framework

DBS's credit framework is some NIS 1,360 million and it is used for the current operation and the granting of bank guarantees for DBS's operations. As at December 31, 2004 DBS had used NIS 1,352 million of this credit and there was no material change in the use of this framework.

5.12.5 Need for raising of additional sources of capital

DBS believes that for the purpose of the business plan, it will require additional credit from the banks (pursuant to the credit framework to which it is entitled in accordance with the Finance Agreement) as well as shareholders' loans from its shareholders (regarding this matter, see Section 5.19B below and Note 8E to the financial statements for the year ended December 31, 2004, which are included in this periodic report).

5.13 Taxation

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

5.14 Restrictions on and Supervision of the Corporation

5.14.1 Specific legal restrictions on operations

DBS's operations are regulated by and subject to a special extensive system of laws (from primary legislation to administrative directives and Council decisions). The abovementioned legislation, secondary legislation, Council decisions and administrative directives have a material effect on DBS and its operations. Legislation and secondary legislation also have a material effect on DBS in the communications arena in general.

Restrictions are applicable to DBS by virtue of the Telecommunications Law and the regulations promulgated pursuant thereto. The Telecommunications Regulations (Procedures and conditions for the granting of a satellite broadcasting license), 5758-1998 (hereinafter: the "License Regulations"), determine the processes and conditions for receipt of a broadcasting license, and also various restrictions applicable to a licensee in the license period. The License Regulations determine, *inter alia*, suitability conditions for a satellite broadcasting licensee, relating to the direct or indirect holdings of the broadcasting licensee and the interested parties therein, in cable broadcasting franchisees, in franchisees pursuant to the Second Authority for Television and Radio Law, 5750-1990, and in proprietors of daily newspapers.

The Telecommunications Regulations (Television Broadcasts through Satellite) (License Fees and Royalties), 5759-1999 determine the percentage of royalties and broadcasting license fees to be paid by the satellite broadcasting licensee to the state. Pursuant to these regulations, DBS is committed to pay royalties at 3.5% of its revenues from the provision of broadcasting services in 2004 and thereafter.

By virtue of Section 6(49) of the Telecommunications Law, maximum prices to be billed to the subscriber may be determined in the license.

In accordance with the requirements of the broadcasting license and regulations determined by the Council, in 2004 and 2005 DBS shall invest in local productions an amount which is not less than 8% of its revenues from subscriber fees.

In accordance with the requirements of the law and the license, DBS is obligated to allow independent channel producers pursuant to Section 6(55) of the Telecommunications Law to use its infrastructures in order to transmit broadcasts to its subscribers, in return for a payment which will be determined in the agreement, and in the absence of an agreement, in return for a payment which the Minister will determine after consultation with the Council.

5.14.2 Subordination of operations to the broadcasting license

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

The Minister of Communications, in consultation with the Council, and after granting the Broadcasting Licensee an opportunity to make its arguments and considering the harm to its rights, may change the terms of the broadcasting license, *inter alia*, for the purpose of the goals stipulated in the license.

5.14.3 Principal restrictions by virtue of the law and broadcasting license

The Telecommunications Law and Broadcasting Regulations stipulated the following principal general conditions: the broadcasting license may not be transferred or attached; encumbrance of the broadcasting license, insofar as it may be encumbered under the law, requires prior written approval from the Minister of Communications; transfer, encumbrance or attachment of any of the assets of the broadcasting license from August 2001 onwards, which were not granted advance permission in the license, require approval from the Minister of Communications, except for encumbrance of an asset in favor of a banking corporation; an encumbrance placed on any of the broadcasting license's assets shall not be realized unless as determined by the Minister of Communications; a change, directly or indirectly, in control or holding of the means of control in a percentage of 10% or more or in any percentage resulting in a person becoming an interested party or controlling party in the licensee requires approval from the Minister of Communications, after consultation with the Council (this provision does not apply to a change which does not exceed 15% of the holding of the means of control in a company whose shares are listed on the Stock Exchange, provided that it is not a change in the control thereof, all in relation to said shares listed on the Stock Exchange); reporting requirements were stipulated concerning holders of the means of control and restriction on encumbrance of the means of control; cross-ownership in the licensee is prohibited as set forth in the License Regulations; competition pertaining to the provision of broadcasts and services shall not be prejudiced, including terminal equipment or other telecommunications services, by any agreement, arrangement or understanding to which the broadcasting licensee, any body in which the broadcasting licensee, an officer of the broadcasting licensee, or any owner of a right in a company owning a broadcasting license (and also an officer of the owner of a right therein) are parties thereto, unless approved in advance and in writing by the Council; advertising broadcasts are prohibited (this prohibition also applies to the Cable Companies) except for the transmission of foreign channels containing advertisements which are not aimed primarily at Israel and except for sponsorships and service broadcasts.

The broadcasting license also contains terms governing the establishment and operation of a satellite broadcasting system; terms governing subscriber services, among them the duty of the Council and the Uniform Contracts Tribunal to approve subscriber agreements, the duty to connect applicants and ban on stipulating conditions, the duty to maintain the service throughout the year, prohibition on discrimination between subscribers, except for the offering of various tariffs to subscriber types which are reasonably differentiated, the establishment of a subscriber service center; establishment of an ongoing setup for the supply and maintenance of terminal equipment and protection of subscriber privacy; terms concerning the provision or disconnection of service and terms linked with the oversight of the operations of the broadcasting licensee and the duty to submit reports to the Ministry of Communications.

The broadcasting license stipulates provisions regarding the types of payments that the broadcasting licensee may collect from its subscribers. The broadcasting license also stipulates that the list of prices that the broadcasting licensee collects from its subscribers for broadcasts and services shall first be submitted to the Council for approval, and that each change therein shall first be submitted to the Council chair for approval, except for reductions, discounts and promotions (for a restricted period) which should be notified to the Council chair no later than the date of publication or commencement, the earlier of the two, and the chair may cancel them retroactively.

DBS also transmits to its subscribers the television and radio (FM) channels lawfully broadcast in Israel which can be received from the air, ground or satellite, the educational television channel and “must carry” broadcasts. By virtue of the provisions of the law, DBS currently transmits broadcasts of two ”must carry” channels, the music channel (“Channel 24”) and the Russian-language channel (“Israel Plus”), in return for a sum to be set by the Minister of Communications (as at the date of publication of this report a fixed payment had not yet been set for the transmission of the “must carry” channel), and also two independent licensees “Nature of Things Channel” and “Clicka” channel which collect subscriber fees directly from their customers.

5.15 Material agreements

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

5.15.1 Agreement for the purchases of decoders

In August 2000 DBS signed an agreement for the purchase of decoders with Advanced Digital Broadcast Ltd. (hereinafter: “ADB”) and Eurocom Marketing (1986) Ltd. (hereinafter: “Eurocom”), in which Eurocom Communications Ltd., an interested party in DBS, is also an interested party (hereinafter: the “ADB Agreement”). Pursuant to the ADB Agreement, DBS purchased from ADB a minimum number of decoders and is also entitled to purchase additional decoders from time to time in accordance with a purchase order which DBS will send to Eurocom. DBS is also responsible for the converters and support service thereof by means of Eurocom. Repair to the decoders is carried out in accordance with an agreement with it from April 2001, which is automatically renewed unless terminated by one of the parties thereto, and which determines conditions and dates for the provision of maintenance services (and replacement of the decoders, if necessary) by Eurocom.

5.15.2 Space segment lease agreements

First space agreement

In order to transmit the satellite broadcasts DBS signed an agreement in April 1999 with the HLL Satellite Communications Company (Spacecom) Ltd. (hereinafter: "HLL"), in which there is an interested party which is also an interested party in DBS, and with Israel Aircraft Industries for the leasing of space segments in the Amos 1 satellite as amended in May 2003 (hereinafter: the "First Space Agreement"). The lease period determined in the First Space Agreement will conclude on June 30, 2009 (in relation to the period from January 1, 2009 – subject to the purchase by DBS of insurance cover as defined in the agreement) or upon the end of the life of the Amos I satellite, the earlier of the two, and if DBS continues to use the space segments after the end of the lease period, it shall continue to pay the leasing fees. DBS undertook to lease at least 8 space segments on the Amos 1 satellite and it was granted an option to lease up to twelve additional space segments and the right of first refusal to lease any space segment on the satellite's Middle East beam, which will be offered for leasing by HLL or Israel Aircraft Industries. As at the date of publication of this Periodic Report, the company is leasing 8 space segments on the Amos 1 satellite.

The leasing fees set in the First Space Agreement consist of fixed monthly leasing fees and monthly leasing fees of varying amounts, in levels set in the agreement in accordance with the number of DBS subscribers, up to a ceiling fixed in the agreement.

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

Second Space Agreement

In May 2000 DBS signed another agreement with HLL to lease space segments on the Amos 2 satellite, as amended in May 2003 (hereinafter: the "Second Space Agreement"), whereby DBS leases from HLL no fewer than 12 space segments on the two satellites (of which 8 on Amos 1), and during 2005 DBS will start to lease two additional segments on the same polarity, so there will be no need to adjust DBS's receiver dishes. The Second Space Agreement stipulates that at the end of the First Space Agreement the leased capacity on Amos 1 will be transferred to Amos 2 or to another suitable subsequent satellite.

Pursuant to the Second Space Agreement, the lease period for the space segments on Amos 2 is for 12 years from the date on which the satellite is stationed in space (which took place during April 2004) or until the end of the satellite's life, the earlier of the two. The consideration for the lease determined in the Second Space Agreement consists of annual lease fees to be paid in monthly installments, the amount of which depends on the total number of segments leased on the Amos 2 satellite, DBS, its shareholders and lessors affiliated with it and/or with its shareholders, as defined in the Second Space Agreement. The Second Space Agreement brings together space segments which will be used as reserve capacity for the leased capacity on Amos 2, and alternative capacity if the leased capacity becomes unusable, and awards DBS the right of first refusal to lease other space segments on Amos 2 under the terms specified in the agreement.

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

As at the date of this report, DBS is leasing 4 space segments on Amos 2. In 2004 the lease fees for the First Space Agreement and the Second Space Agreement amounted to some NIS 96 million.

5.15.3 Information and encryption system development agreement

In October 2000, DBS signed an agreement with NDS Limited (hereinafter: "NDS") for the development, licensing, supply, training, assimilation and maintenance of software and equipment for encryption, broadcasting, compression operations and ancillary operations required for DBS's multi-channel, broadcasting system, including development of a smart card inserted into a special decoder drive, by means of which the subscriber's viewing options can be controlled. The smart card may be updated using a satellite broadcasting signal. NDS undertook to adapt its equipment and services to the decoders purchased by DBS in accordance with the provisions of the agreement. NDS also undertook to provide DBS with support services and provide a warranty for its products. Pursuant to the agreement DBS may order and pay for additional broadcasting equipment and software and also make modification to the existing ones under the conditions set forth in the agreement. DBS pays for NDS's services and products based in principle on the number of converters it uses and the number of its active subscribers. In March 2004, DBS signed an additional agreement with NDS whereby NDS provides DBS with services linked to the integration and assimilation of interactive applications into DBS subscriber services, the granting of usage licenses for these applications and the development of future interactive technological services.

5.15.4 Information systems outsourcing agreement

In March 2004 DBS signed an outsourcing agreement with Ness A. T. Ltd. (hereinafter: "Ness") whereby DBS transferred its information system management and project implementation services (hereinafter: the "Service") to Ness and Ness assumed overall responsibility for the supply to DBS of the Service in an outsourcing format. DBS also transferred to the ownership of Ness certain equipment for which the services are provided and which will be transferred to DBS upon expiry of the agreement. The agreement period (subject to early termination rights conditional upon payment) has been defined as eight years from April 1, 2004 (hereinafter: the "Original Agreement Period"), and at the end of the Original Agreement Period the agreement term will be extended automatically for an additional period of five years (hereinafter: the "Extension Period"), unless one party notifies the other party in writing, at least 12 months before the end of the Original Agreement Period of its desire not to extend the Original Agreement Period. In the Extension Period each party may notify the other party in writing, at least 12 months in advance, of its desire to terminate the agreement.

5.15.5 Finance agreement with the banks

For a summary of the main points of the agreement, see Section 5.12 above and also the description in Note 8E to the financial statements for the year ended December 31, 2004, which are included in this Periodic Report.

5.15.6 Agreements with DBS shareholders – see Section 2.17.6

5.16 Cooperation Agreements

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

The venture has been operating in the present format since the beginning of 2003 under the brand name "Yes-Wow" and the period of the venture has not been defined. As part of the joint venture, the parties operate customer service centers and they also implement marketing, sales, customer retention and joint operations.

The expenses common to the two parties, such as customer service center maintenance, are divided by the parties into two equal parts. In addition, each party bears its own individual expenses.

DBS collects the bill for the joint venture's services from the subscribers and transfers to Bezeq International Ltd. payment for its services.

5.17 Legal Proceedings

5.17.1 On January 30, 2003, a letter was received from the Ministry of Communications, stating that the arrangement whereby DBS takes from its subscribers a deposit lower than the purchase cost of the decoder lent by it, and deducts from it 10% of the value of the decoder every year is not legal and contravenes the provisions of the broadcasting license and subscriber agreement. In addition, DBS was required to stop implementation of said agreement and reimburse all its customers, from whose deposits money had been deducted in accordance with the arrangement. On June 16, 2003, the Telecommunications Regulations (Franchises), 5747-1987 were amended so that DBS could deduct up to 10% of the purchase cost of the equipment. From the date of said amendment of the regulations and until the date of this report DBS had not received any additional demand from the Ministry of Communications.

On April 14, 2004, DBS received a letter from the vice president of the Israeli Consumer Council (hereinafter: the "Consumer Council") in which the Consumer Council argued that the deductions made by DBS from the amounts of the deposit which had been reimbursed to subscribers (who had left) before the amendment of said regulations had been unlawfully implemented. The Consumer Council therefore demanded that DBS reimburse to said subscribers the deducted amounts which according to its argument had been deducted unlawfully and submit a detailed report regarding the matter to the Council

DBS rejected the arguments of the Consumer Council with the argument that it had acted in respect of said deduction pursuant to the license and the subscriber agreement. By the date of this report no further enquiry had been received from the Consumer Council. DBS's management believes that, based on the opinion of its legal counsel, it is impossible to estimate the possible exposure and consequently no provision has been included in the Financial Statements of DBS.

5.17.2 On September 27, 2004 two foreign companies filed a claim in the Tel Aviv District Court against DBS and Synergia Productions Ltd. (hereinafter: "Synergia"), arguing that the television program "Project Y" broadcast by DBS (in this section: the "Program") and produced by Synergia is a copy of a format which they had created. Consequently the amount of NIS 8.2 million (or alternatively, NIS 1.8 million without proof of damage) is being claimed from Synergia and DBS. On December 15, 2004, DBS submitted a statement of defense in which it argued that the format is not a creation protected by Israeli law and therefore the Program does not constitute a copy of said claimed format. A date for hearing of the claim has not yet been set. The legal counsel of DBS are unable to estimate the chances of the claim.

5.17.3 On February 23, 2005, DBS filed a claim in the Jerusalem District Court to obtain declaratory orders directing that a decision of the Minister of Communications from December 31, 2004, directed the Company in connection with the injection of the Company's funds to DBS and a decision of the Minister of Communications from February 14, 2005, mostly confirming the said decision, are null and void since they were made in an extremely unreasonable manner, disproportionately and breached DBS's right to a hearing (for details and the proceedings implemented by the Company in relation to the above ministerial decisions, see also Section 1.1.5B above and Note 8E to the financial statements of the Company for the year ended December 31, 2004, which are included in this Periodic Report). As at the date of publication of this Periodic Report no response had been received from the State to this claim and at this stage it is impossible for DBS to estimate its results.

5.17.4 On November 21, 2004, the Tel Aviv District Court approved an arbitration order granted on August 18, 2004, in a financial claim filed by Israel ICP Cable Programming Ltd. against DBS whereby DBS was ordered to pay NIS 9 million to the plaintiff.

5.17.5 For additional legal proceedings in which DBS is involved, see Sections 19A(35), 19A(36) and 19A(39) to the financial statements for the year ended December 31, 2004, which are included in this Annual Report.

5.18 Business Strategic Goals

DBS's goals for the coming year are to continue the trend of increased revenues by continuing the growth in the number of its subscribers and in average per-subscriber revenues.

In order to achieve said goals, DBS intends to invest significant efforts in marketing and sales and an appropriate marketing strategy adapted to continuing subscriber recruitment, by using its sales setup (see Section 5.5 above), and also continuing its effort to create differentiation and innovation in broadcasting content compared with the content of the Cable Companies (see Sections 5.1.3.1 – 5.4 above). In order to increase revenues from subscribers, the Company is also working to increase the volume of the content sold to subscribers and raise its prices (including reduction of discounts), and in this context on February 1, 2005 it raised its monthly price for the basic package by NIS 10.

DBS's goals relating to growth in the number of its subscribers and average per-subscriber revenues are based on forecasts of DBS's management, on the current trend in the broadcasting market and on DBS's assumptions regarding competition in the broadcasting arena and the present prevailing regulation. However, it is possible that the forecasts of DBS' management will not be fulfilled in view of changes in demand in the broadcasting market, the intensification of competition in this sector and the regulatory restrictions which have been imposed or will be imposed on DBS or on its cooperation with the Company (see Sections 5.1.6 and 5.17 above and Section 5.19 below).

5.19 Risk Factors

A. Licensing and regulation system

DBS's operations and broadcasts are subject to a licensing system, oversight and approvals from various regulatory bodies (see Section 5.14 above), and consequently DBS is likely to be influenced and restricted by considerations of the policy dictated by these entities and by changes in communications legislation; the content of DBS's broadcasts is subject to special legislative arrangements, to supervision by the Council and to the obtaining of approvals from the Council. Failure by the Company to comply with the provisions and rules of the regulatory bodies is liable to cause the imposition of financial sanctions and even termination of the licenses held by DBS.

B. Further injection of funds from shareholders and the banks in accordance with DBS's business plan

Continuation of the injections of funds from shareholders pursuant to DBS's business plans in the coming year is critical to DBS's capability to comply with its business plan and achieve a cash flow balance in accordance therewith (for the regulatory restriction on these cash flows, see Note 8E to the financial statements of the Company for the year ended December 31, 2004, which are included in this Periodic Report).

Non-implementation of all the cash flows from shareholders in accordance with the business plan also constitutes grounds for terminating the bank credit which DBS is authorized to receive in 2005 from the banks pursuant to the Finance Agreements, and is also liable to constitute grounds for making the bank credit payable immediately pursuant to and subject to the provisions and reservations of the Finance Agreement (see Section 5.12.2 above).

C. Ability to offer integrated services

The Cable Companies that compete with DBS are permitted to offer a basket of services including multi-channel television, internet connectivity and line telephony, while DBS is prevented, at this stage, from offering its subscribers a corresponding basket of services, in light of the restriction imposed on the Company (see Section 2.16.2 above).

D. Foreign currency risks

A material part of DBS's expenses and investments is linked to changes in the exchange rate of the US dollar. Consequently sharp changes in the exchange rate have a material effect on the Company's business results.

E. Broadcasting and satellite centers

DBS broadcasts from two broadcasting centers in Kfar Saba and at the Re'em Junction (see Section 5.7 above). Damage to the broadcasting center is liable to make it extremely difficult to continue broadcasting, however, the duplication of the broadcasting centers significantly reduces the risk entailed by damage to one of them and improves the survival ability of the broadcasts. As at the date of this report DBS broadcasts from the two broadcasting centers simultaneously. If one broadcasting center is damaged DBS will transfer most of its broadcasts through the other broadcasting center.

DBS broadcasts through space segments on the Amos 1 and Amos 2 satellites stationed in identical points in space (see Section 5.10.1 above). The duplication of the satellites by means of which broadcasts are transmitted to subscribers enables a significant reduction of the risk entailed by damage to one of them, and improves the survival ability of the broadcast. If there is a failure in one of the satellites, it will be possible to transfer most of the channels broadcast by DBS via the space segments on the second satellite and even possibly via additional segments which will become available.

F. Technical inferiority

DBS's infrastructure suffers from technical inferiority compared with the infrastructure of its competitors, as explained in Section 5.6.4 above.

Risk Factor Summary Table

	Extent of effect of risk factor on DBS operations		
	Large effect	**Medium effect**	**Small effect**
Licensing and Regulation regime		X	
Continued financial infusions	X		
Capability to offer combined services	X		
Exposure to changes in rates of exchange			X
Broadcast and satellites center			X
Technical inferiority compared with competition			X

Date

"Bezeq" The Israel Telecommunication Corp. Limited

Name and title of the signatories:
Adv. Miriam (Miki) Mazar, Chairperson of the Board
Amnon Dick, CEO